

MEMORANDUM

November 30, 2015

TO: Connecticut Retirement Security Board

FROM: Michael Kreps Ernie Lorimer
David Levine Jose Singer-Freeman

RE: Lifetime Benefits – “Non-profit” and Insurance Company Annuities

We understand that, subsequent to the November 4 meeting, members of the Connecticut Retirement Security Board have raised questions regarding the structure, availability and pricing of different retirement annuity options. Annuitized retirement benefits historically have been provided in one of two ways in the public sector – by paying benefits from a traditional defined benefit pension plan (*e.g.*, the Connecticut Teachers’ Retirement System) or by purchasing annuities from an insurance company.

Below, we provide a short summary of the differences between the two types of retirement benefits.

	State/Local Pension Plan	Insurance Company Annuity
Benefit Promise	Periodic installment for life or specified term (and possibly life of spouse)	Periodic installment for life or specified term (and possibly life of spouse)
Guaranteed By	Employer – <i>e.g.</i> , state or local government	Insurer
Paid From	Pension plan trust	Insurance company general account
Funding Source	Periodic contributions set by statute or other governing documents, generally based on long-run asset return assumptions, with the state, locality, and/or active employees responsible to make up underfunding	Assets paid to insurer at time of annuity purchase
Capital Requirements	None	Insurer must maintain capital reserves appropriate to support its overall business operations in consideration of its size and risk

Often, the estimated cost of an “annuity” benefit paid by a state pension plan is lower than the cost of an annuity purchased from an insurance company. This lower cost is largely due to the fact that the pension benefit is paid out of state pension plan assets without the purchase of an actual annuity contract from an insurer. State pension plans use this approach because the benefits are usually guaranteed by the state or locality sponsoring the pension plan. Thus state pension plans are assured of the future cash flow necessary to cover the “annuity” benefit because the governmental guarantor can make up underfunding through other sources (*e.g.*, taxes). That allows pension plans to assume more investment risk.

For insurance company annuities, the insurers themselves are the guarantor of last resort, and the annuities are not backed by state or local governments. State regulations usually impose stringent investment, funding, and capital requirements on insurers to prevent insolvency and protect consumers. Because of these requirements, insurance companies are not able to assume the same types of investment risks as pension plans, and consequently, they are not able to achieve the same returns. Therefore, insurers must price their annuities at a cost higher than the “costs” assessed for lifetime payment streams under state pension plans.

Based on discussions with an official from the Connecticut Department of Insurance, we understand it may be possible to annuitize payments through a captive insurance company established by the state rather than purchasing an annuity from the private sector. That approach could potentially achieve cost savings by eliminating profit, commissions, and marketing expenses. Of course, the captive insurer would need to charge fees to cover the costs of reserves and capital requirements mandated by insurance laws, and it may also be necessary to amend the existing statutory annuity regulations to accommodate the new program. Captive insurance companies are generally not guaranteed by the state, so there is a risk that a captive insurance company could become unable to pay all promised benefits. There are also likely to be significant, but not necessarily insurmountable, barriers in federal law. For example, it may be necessary to seek exemptive relief from the U.S. Department of Labor for potential violations of the prohibited transaction rules under the Internal Revenue Code.

We note that there may be opposition to the captive insurance approach from those concerned about an implicit state guarantee or insurers who may view the captive as competition in the annuity space. Nevertheless, this is a potential avenue for the implementing board to explore.

We hope you find this broad overview helpful. We are happy to discuss specifics in more detail.