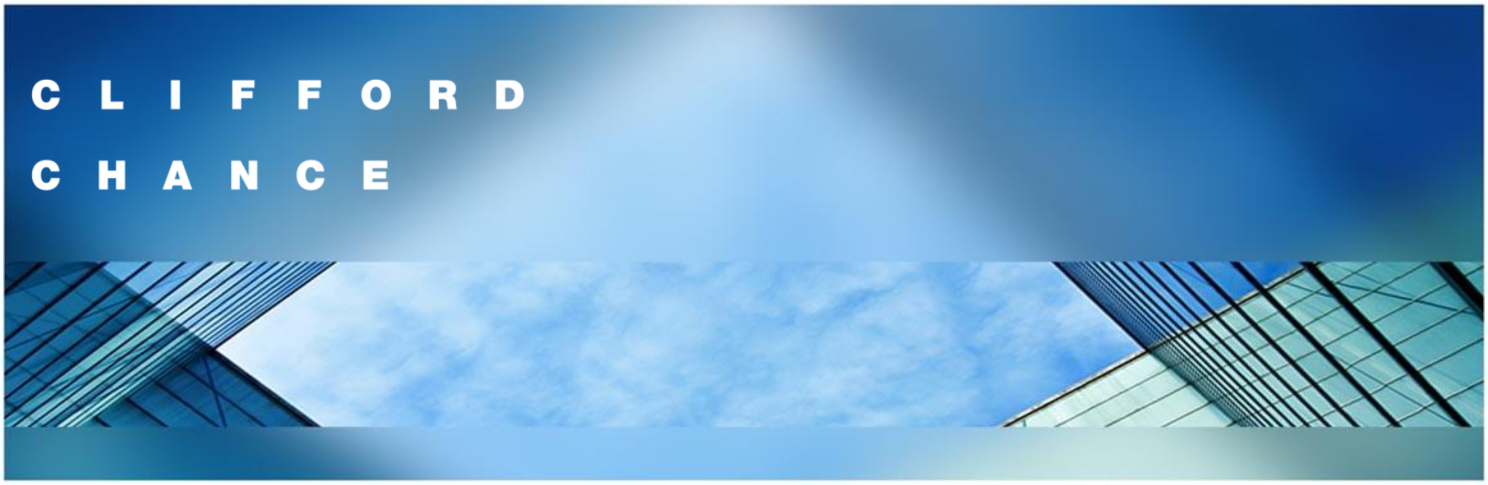

PENSION RISK TRANSFER MARKET - DEPARTMENT OF LABOR RELEASES REPORT TO CONGRESS ON INTERPRETATIVE BULLETIN 95-1

EXECUTIVE SUMMARY

After a thorough review of the pension risk transfer ("**PRT**") market and the function that the Department of Labor's ("**DOL**") Interpretative Bulletin 95-1 ("**DOL 95-1**") has had in that market, the DOL released a report to Congress (the "**DOL Report**") in which it did not recommend any changes to DOL 95-1. The DOL Report examined various perspectives of insurance industry stakeholders on a substantial number of key areas.

The DOL Report was inconclusive on whether private equity ownership of insurers is inherently riskier than ownership by other types of owners based solely on the types of investments held by private equity backed insurers. Further, while the DOL Report examined the ways in which investments and liabilities held by insurers have generally become riskier, there is no clear evidence that the increase in risk will lead to an increasing number of distressed insurers, especially in light of the regulatory regimes that govern insurance activities. Finally, although the DOL Report acknowledged that the use of affiliate and offshore reinsurers may subject an insurer to more risk due to different regulatory requirements, it noted that such reinsurance strategies can offer efficiencies and risk management tools that could improve an insurer's overall financial strength and performance.

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DISCUSSION

The Securing a Strong Retirement Act of 2022 directed the DOL to undertake a review of DOL 95-1 and report to Congress whether any amendments are warranted. The DOL Report was issued on June 24, 2024, and summarizes the broad review of DOL 95-1 undertaken by the Employee Benefits Security Administration ("**EBSA**"). While the DOL Report offers insight into various positions held by industry participants[1] and reflects information received during consultations with the U.S. Department of the Treasury and the Pension Benefit Guaranty Corporation, it does not propose any changes to DOL 95-1 and concludes that "Interpretative Bulletin 95-1 continues to identify broad factors that are relevant to a fiduciary's prudent and loyal evaluation of an annuity provider's claims-paying ability and creditworthiness."

Although the DOL Report did not recommend any changes to DOL 95-1, EBSA noted that it had not concluded that "changes to [DOL 95-1] are unwarranted," but rather that "further exploration into developments in both the life insurance industry and in pension risk transfer practices is necessary to determine whether some of [DOL 95-1]'s factors need revision or supplementation." In the following paragraphs we will summarize some of the discussion in the DOL Report that EBSA considered.

The DOL Report discussed a variety of topics[2], but this alert focuses on some of the key areas discussed in the DOL Report: 1) the ownership structures of life insurers; 2) insurers' exposure to risky assets and non-traditional liabilities; and 3) the use of affiliated and offshore reinsurance.

Ownership Structures

The DOL Report explored multiple perspectives on the question of whether private equity ownership of insurance companies necessarily implies that such insurance company is riskier than insurance companies with more traditional ownership structures. Some of the stakeholders raised questions about whether the potential for conflicts between the interests of policyholders and the interests of investors in stock insurance companies would be exacerbated in the case of private equity-owned insurers because the typical private equity model is to make relatively short term investments to achieve the highest returns possible for investors. These stakeholders suggested that due to private equity's history and structure, private equity owners of insurance companies may be incentivized to direct the insurance companies to invest in risky assets and fail to match assets with liabilities, all in an effort to maximize returns for its investors.

Stakeholders also suggested that EBSA consider making changes to DOL 95-1 to require that an insurer's entire holding company system be reviewed when choosing an insurer for a PRT transaction. One perspective was that DOL 95-1 should consider the capital of the entire holding company system to evaluate

[1] The DOL Report states that during over 40 stakeholder meetings, EBSA received feedback from organized labor, employer groups, consumer groups, insurance companies, insurance trade associations, other regulators, consultants, academia, and other interested parties.

[2] Some of the items discussed in the DOL Report that are beyond the scope of this alert include: certain key individual protections for spouses of annuitants, disclosures to annuitants in partial buy-outs, adequacy of state guaranty funds and the PBGC payment protections, the effects of partial buy-outs on the assets of the remaining pension plan and minimum administrative capability requirements.

whether additional capital may be available to the insurer in case of distress. Others, however, posited that only the capital and surplus of the particular insurer should be evaluated, since state insurance regulators generally require an insurer to support its liabilities from its own resources. In addition, stakeholders suggested that DOL 95-1 should consider affiliate transactions that are expected to occur in conjunction with a proposed PRT transaction, as some affiliate transactions might require the insurer to pay higher fees for services than the market would otherwise accept, or otherwise not be at arms' length.

Risky Investments and Non-Traditional Liabilities

EBSA also considered the kinds of investments that insurers hold and the types of liabilities that they are willing to assume. Some stakeholders focused on private equity-owned insurers' tendency to hold "riskier" investments compared to insurers with more traditional ownership structures, while others noted that holding riskier investments has been a recent trend across the entire the insurance industry as insurers searched for higher yields during a period of near-zero interest rates. The concern examined was that "assets, such as asset-backed securities, subordinated debt and stock of affiliated companies, could overexpose insurers to investment and liquidity risk that could lead to solvency issues." On the other hand, stakeholders pointed out that insurance companies are heavily regulated entities, and the NAIC and state regulators continue to assess trends in the insurance industry and have implemented standards to prevent insurance companies from becoming too risky.

Another concern raised by certain stakeholders is that insurers have increased the percentage of liabilities they hold that may come due at unexpected times, thereby creating an asset-liability mismatch that may lead to a "run" on the insurer. Such stakeholders noted that if a "run" were to occur, the insurer's ability to pay former pension plan participants (who have become annuitants) may be diminished. Therefore, those stakeholders suggested that fiduciaries should understand how the nature and timing of an insurer's liabilities may affect its capital and claims-paying ability. Other stakeholders countered by noting that DOL 95-1 already requires fiduciaries to consider the insurer's exposure to liability and that stress testing and risk management measures by insurers could prevent overexposure to these liabilities.

Although noted in a separate section, EBSA also considered feedback regarding the use of separate accounts. Specifically, the DOL Report noted that some stakeholders expressed concern that poor investment of the assets in a separate account could make it risky, while others highlighted the fact that a separate account insulated from the liabilities of the general account can provide significant benefits.

Reinsurance

Finally, EBSA noted some of the positions provided by stakeholders regarding the use of affiliated and offshore reinsurance for PRT transactions. Stakeholders expressed concerns that affiliated reinsurers, in particular, U.S. captive reinsurers could pose risks because there are differences in the regulatory requirements for affiliated and unaffiliated transactions.

In addition, some stakeholders noted that a significant amount of reinsurance involves offshore reinsurers that are in jurisdictions that may have less stringent regulatory regimes (e.g., less stringent reserving requirements and accounting arbitrage) than the U.S. In fact, the DOL Report noted that the Treasury Department, in a letter to Senator Sherrod Brown, noted that the speed and scale of the growth of offshore and affiliated reinsurance "suggests the need for regulators and policymakers to better understand the role of offshore reinsurers and whether regulatory capital arbitrage opportunities, tax advantages, and other potential gaps that are not under the oversight of U.S. regulators are obscuring (or even amplifying) the level of risk stemming from these activities." However, other stakeholders pointed out that reinsurance is an essential tool for insurance companies to manage risks and the amount of capital required for reserves.

Despite many differences of opinion, most stakeholders agreed that a fiduciary's analysis should consider an insurer's use of reinsurance, as well as the reinsurer's jurisdictional, financial and ownership characteristics, when selecting an insurer for a PRT transaction.

CONCLUSION

After a thorough analysis of the PRT market (including the key areas highlighted in this alert and 10 other more granular issues) and the use of DOL 95-1 by fiduciaries, EBSA did not recommend any changes to DOL 95-1. In fact, the DOL Report states clearly that the broad factors in DOL 95-1 continue to be relevant to a fiduciary's prudent and loyal evaluation of an annuity provider's claims-paying ability and creditworthiness. Although no changes have been proposed in the DOL Report, EBSA has not precluded changes in the future. We will continue to monitor pronouncements.

If you have any questions with respect to the issues raised in the DOL Report or the PRT market generally, please contact Dennis Manfredi or a member of the Clifford Chance team for further information.

CLIFFORD CHANCE

CONTACTS

Dennis Manfredi
Partner

T +1 212 878 3226
E dennis.manfredi@cliffordchance.com

Eugene Benger
Counsel

T +1 212 878 8033
E eugene.benger@cliffordchance.com

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www.cliffordchance.com

Clifford Chance, Two Manhattan West, 375 9th Avenue, New York, NY 10001, USA

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