Insurance Company Products Offered to Employee Benefit Plans

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The AICPA Employee Benefit Plan Audit Quality Center has developed this primer to provide Center members with a general understanding of products offered by insurance companies as funding options for employee benefit plans. It provides a general overview and includes discussions of unique characteristics of various types of products offered by insurance companies, including general and separate account products and trust-account based products; trusteeship and custodianship; identifying the various products; the differences between allocated and unallocated contracts; reporting; and references to the relevant accounting and auditing professional literature related to products offered by insurance companies.

Introduction

Insurance companies offer a number of different products that provide funding, insurance, and services to employee benefit plans. This primer will discuss some of the more common products issued for the benefit of ERISA covered plans.

Plan funding products issued by an insurance company are typically established pursuant to a contract. The insurance industry refers to all contracts issued to employee benefit plans by an insurance company as insurance contracts. For accounting purposes, these contracts may be classified either as "insurance contracts" or "investment contracts," depending on the contract terms. An insurance contract subjects the insurer to significant insurance risks including, but not limited to, mortality or morbidity of plan participants. Many of these contracts also contain an additional element of interest rate guarantees and/or investment performance risk. Contracts that do not have substantial mortality or morbidity (or similar) risks are referred to as investment contracts. Many of these types of contracts have features that are similar to financial or investment products offered by other types of financial institutions. The contract and supporting documentation provide information for determining the appropriate accounting classifications and financial reporting of the contract.

The same insurance company may offer a wide variety of product options to plans. In addition, contracts that appear to be similar can have very different terms, including different restrictions on the transfer of the funds among various parts of the contract or the ability to terminate or renew the contract. For example, certain guaranteed annuity contracts include restrictions that can delay the participant or the plan from withdrawing or transferring all or part of the contract value immediately, or may impose a withdrawal charge, or may have some other similar provision. These types of contract provisions are designed to mitigate certain risks such as large-scale withdrawal risks that could be detrimental to the insurance company and remaining contract-holders.

The assets that support the insurance company's contractual liabilities can be held in the insurance company's general account or in a separate account of the insurance company.

General Overview

Most contracts issued by insurance companies to plans are either funding agreements or annuity contracts.

Funding Agreements

Funding agreements are contracts that provide guaranteed principal repayment and interest payments for a predetermined period of time. They provide a certain return (which may be guaranteed or variable) as

described in the funding agreement, but they offer no ability for an insurer to guarantee the payment of income based on the life of a participant – there is no annuity purchase option (see a discussion of annuities below).

Annuities

There are many different types of annuity contracts, but all of them allow plans or participants to purchase guaranteed income to be paid over the life of a participant or for a fixed period of time, or some combination thereof. A plan may purchase guaranteed income from an insurance company for an individual participant or a group of participants.

With the exception of many 403(b) plans, most plans that invest in annuities are funded using group annuity contracts (the plan sponsor or trustee owns one contract on behalf of the plan and all plan participants are covered under the group contract) rather than individual annuity contracts. Whether the contract is a group contract or an individual contract, the rights given to the individual participant can vary.

Contracts may be Single Premium contracts whereby the contract-holder makes one large payment, or the contract-holder may make multiple or open-ended payments. Examples of Single Premium contracts are certain large GICs (see the *General Account Products* section below for information about GICs) and annuities used to transfer to the insurance company the liability to pay benefits.

The type of annuity contract most commonly used by plans provides for a flexible premium and the option to purchase income for the life of the participant, usually at retirement. Such contracts generally allow for multiple payments to the insurance company over time and include both an “accumulation” phase and a mandatory or optional “annuitization” phase. During the accumulation phase, the amounts paid to the insurance company by the plan are credited to the benefit of the plan as a whole. If an annuity is purchased for a participant, during the annuitization phase (the period when the participant receives payments from the annuity), the participant is guaranteed the payment of benefits either for life or for a set period of time in return for the consideration previously paid to the insurance company to guarantee the annuity payments.

Payout annuities are most commonly purchased by defined benefit plans. Many defined contribution plans do not purchase annuities unless a participant specifically requests that a purchase be made.

Contracts Purchased by Defined Contribution Plans

Insurance products are purchased by defined contribution plans, including 401(k) and other profit sharing plans, 403(b) plans, and money purchase pension plans. Most of these contracts are group annuity contracts. Group annuity contracts include annuity income options that may be used by plans that provide for distributions in the form of an annuity. These contracts almost all have a guaranteed and a variable component and allow either the plan, or the plan and the plan participant, to select among different investment options.

Contracts Purchased by Defined Benefit Plans

Certain types of annuity contracts are issued almost exclusively to fund defined benefit pension plans. The vast majority of these contracts are group annuity contracts. Many types of contracts such as Income Endowment Contracts, Single Premium Group Annuity Contracts, and certain Deposit Administration (DA) and Immediate Participation Guarantee Contracts (IPG) were issued prior to the passage of ERISA or shortly thereafter, and are not common today. This document does not address those contracts. See the *General Account Products* section below for information about DA and IPG contracts that are used currently. Newer generation IPG or “Hybrid DB” contracts allow a plan to obtain guaranteed annuity

income payments for specific retirees, and commit a portion of plan assets to those guarantees, but also allow the plan to receive direct investment gains and losses, direct mortality gains and losses, and determine the timing for the purchase of the annuity.

General Account Products

Some products are supported by the general account of the insurance company.

The obligation to meet the guarantees provided for under general account-supported contracts are backed by the full faith and credit of the contract issuer. The insurance company owns all securities and other investments held by its general account. The plan's asset is the contract, not the underlying assets in the general account of the insurer. The ability to satisfy the contractual guarantees made in the contract is dependent upon the issuer's claims-paying ability. In the event that an insurer was unable to satisfy the guarantees provided for in its general account-supported contracts, contract-holders would line up in a legally pre-determined priority as set forth under State law to seek fulfillment of any outstanding guarantees and/or return of premiums, if applicable. It is for this reason that an insurer's claims-paying rating (also known as the financial strength rating) plays an important role in a plan sponsor's decision to offer a general account-based contract as a funding option in an employer-sponsored plan.

Guaranteed Interest Contract (GIC) with Defined Maturity Date

Many plans hold guaranteed interest contracts (GICs) as funding options for their plans. A Defined Maturity Date GIC is a contract between an insurance company and a plan that provides for a guaranteed return on principal invested and matures at a defined date(s). In the simplest form of this type of GIC, often referred to as a "bullet GIC", the insurance company guarantees a rate on a single deposit for a specified period of time. The rate is set at the start of the contract and is fixed until the GIC matures on some future agreed upon date. Upon the maturity date, the original principal deposited plus interest at the specified rate (less benefit payments, if allowed) may be paid to the plan.

Variations on these GICs include those in which the plan is permitted to make additional deposits or withdrawals during certain windows during the contract life, contracts with multiple maturities, and contracts with rates that may be periodically re-determined prior to maturity in accordance with the contract. Contracts can allow money to be moved with a surrender charge or market value adjustment, or be completely locked up until the guarantee period matures.

Evergreen Guaranteed Interest Contract (GIC)

"Evergreen" contracts may be issued as individual or group contracts. They often allow the plan participant to reallocate amounts under the contract, but impose limitations on the plan's ability to remove amounts from the guaranteed part of the contract. These limitations may include a market value adjustment or other charge or adjustment, or an advance notice provision. This type of contract offers a guaranteed rate for a set period (such as 6 months or one year) and when that period is over a new interest rate is set. Unlike Defined Maturity Date GICs, Evergreen GICs do not have a specified maturity date (thus it is evergreen), only the interest crediting rate reset dates are specified. The contracts continue in-force until they are terminated by either the contract-holder or the insurance company.

An Evergreen GIC generally has the following characteristics:

- The promise to credit interest at crediting rates that are declared in advance and reset from time to time as specified in the contract. In some cases, interest may be credited above the contractually guaranteed minimum crediting rate, which generally is determined at the sole discretion of the insurance company and announced in advance.

- The guarantee that such crediting rates will not be less than the contractually guaranteed minimum crediting rate (floor rate)
  - The guaranteed minimum crediting rate can differ by contract but in no event will a contract have a minimum crediting rate that is less than 0.00%.
  - The minimum crediting rate may be set at contract inception and remain static for the life of the contract or may be reset from time to time as specified in the contract. Frequently, the amount and resetting of the minimum crediting rate is determined by or by reference to state law.
- A means for the contract-holder to initiate a discontinuation of the contract. The methodology for determining the amounts payable by the insurance company upon a contractual discontinuance is detailed (and guaranteed) in the contract. In some cases, discontinuance of an individual contract may not be permitted; however, the contract will often contain a provision allowing for contract surrender in exchange for immediate or installment payments with or without an adjustment to contract value.
- A specified set of rules governing the participant's ability to withdraw amounts from the contract.

Deposit Administration Contract (DA)

The term *deposit administration* is applied to a type of contract that is most commonly used to fund defined benefit plans. The newer versions of these contracts (which often go by other names as they differ from the original DA contracts in a number of ways), allow for the purchase of guaranteed income benefits on behalf of active and retired participants and have the capacity to accumulate funds on behalf of the plan that are not used to guarantee income. The payments to the insurance company that are not immediately intended to provide guaranteed annuity income for a specific individual are credited to an account under the contract. Many DAs have a choice of accounts that are credited based on the general account of the insurance company or a return based on a separate account of the insurance company. The account is credited with interest at the rate specified in the contract. The contract value is reduced by the purchase price of guaranteed income benefits when such benefits are purchased on the life of an individual participant. The contract value is also reduced by any distributions made to participants and any incidental benefits (death, disability, and withdrawal) disbursed directly from the account. As with all general account products, although the DA contract will guarantee a minimum rate of interest on funds in the accumulation phase and a rate at which guaranteed income can be purchased, it does not guarantee that sufficient funds will be available to meet the cost of guaranteed income benefits ultimately owed to plan participants.

Many DA contracts may offer experience-rated interest credits on funds based on the performance of a segment of the insurer's general account compared to the contract rate guarantee. Performance above a stated minimum is not guaranteed. The calculation of these credits is based on internal records kept by the insurance company for each contract and are determined by the actual investment experience of the insurance company. These interest credits may be paid out, added to the balance of funds in the undivided account, or considered in an overall dividend calculation that also takes into account mortality, other actuarial experience, and reserves required by the insurance company. Under DA contracts, amounts of dividend or rate credits are generally determined solely at the discretion of the insurance company, which has no contractual obligation to pay a dividend.

Immediate Participation Contract (IPG)

The IPG contract is the next evolutionary step of the DA contract. Used to fund defined benefit plans, it allows amounts to be deposited into the contract on a regular basis to pay for the ongoing funding needs of the plan. The terms of these contracts may vary. For newer versions, the contract-holder usually can choose between allocating amounts under the contract to the general account-supported contract option or to insurance company separate accounts. Originally, all IPG contracts had a general account investment whose return was dependent on a series of “cells” which were based on the investment return of a segment of the general account, generally by investment year (e.g., securities in the segment bought in 1997, 1998, and 1999 would make up three cells). The cells would be treated like a coupon bond bearing a rate that reflected the aggregate performance of the assets in the cell and would determine the rate paid under the contract. For contracts issued after 1998 the general account option more closely resembles a GIC, although they are still referred to as IPG contracts.

The insurer may guarantee a retiree’s benefit payment amount upon retirement by “purchasing” a portion of the contract. The contract is charged the full cost of the guarantee, and the insurance company becomes responsible for the payments of the income and bears all investment and mortality risk. Many IPG contracts also provide the option to purchase guaranteed income by using the “floor” method, in which the insurance company calculates the amount needed to guarantee the income payments to retirees. The rate is set at the time of retirement and does not change. This “floored” amount is held separately in the general account of the insurance company. Payments are made from this account to the retirees. The insurance company retains the amount necessary to pay the future benefits to retirees and returns any excess to the accumulation portion of the contract as a dividend or credit based on the investment and mortality experience of the company. However, the balance of the floor must be maintained according to a premium schedule in the contract to provide for the remaining pension benefits for all current retirees. That portion of the account is referred to as the *retired life fund*. Thus, if necessary, the account could be used to buy all annuities in force.

Newer Generation IPG or “Hybrid DB” Contracts

Several variants on the IPG contract have emerged that give the contract-holder more control--and therefore more potential risk and benefit--over how assets supporting the income guarantees will be invested. In one variation, the insurer makes an irrevocable guarantee of payment to the retiree, but the premium amount of the annuities is “escrowed” in the accumulation portion of the contract, often in variable separate accounts available under the contract (see a discussion of separate accounts below). Payments to the retirees are made from the escrowed funds. The contract-holder also has the choice to make benefit payments from un-escrowed funds, or to have all or a portion of the escrowed funds moved to finalize the purchase of the annuity, thereby locking in a purchase rate and cutting off any mortality risk or investment gains and losses. The contract prohibits the contract-holder from transferring amounts held in escrow from the contract accounts (although the contract-holder can allocate amounts among the separate accounts) and requires that the accumulation portion be maintained above a contractually stated amount or that the necessary amount to guarantee the income payments will be transferred out of the accumulation portion of the contract to lock down the rate and move the mortality and investment risks to the insurance carrier.

Under another structure the contract provides for an accumulation phase with annuity purchases in “slices” of a certain period, such as 12 months at a time only, with no guarantee beyond the 12 months unless a new guaranty was purchased.

Separate Account Products

What is a separate account?

A separate account is not a distinct legal entity, but rather an accounting entity created by and under the control of an insurance company. The insurance company owns all of the assets held in the separate account. Insulated separate account arrangements legally protect the assets backing the contracts from the claims of general account contract-holders or general creditors of the insurance company should the insurance company become insolvent. Most insulated separate account contracts will state that they are designed to be insulated. Insurance companies can also offer separate accounts that are not insulated from the claims of the insurance company's other contract holders or creditors.

Separate account products may:

- be pooled (sold to plans of more than one employer), also known as a pooled separate account (PSA),
- be individual (the plans of one employer only), also known as a separate separate account
- provide for fixed or variable returns
- provide guarantees, such as a guaranteed rate of return or guaranteed life income.

Separate accounts are not publicly traded funds. However, participants can receive prospectuses for registered funds (under the Investment Company Act of 1940) and other disclosure documents that describe the separate account if they are not registered funds.

Variable Separate Accounts

Variable separate accounts are pools of assets, which may consist of stocks, bonds, real estate, collective investment funds, and shares in a mutual fund. Separate accounts may even invest in units of other separate accounts. The contract-holder generally assumes the investment risk, and the insurance company receives a fee for investment management, certain administrative expenses and, in some instances, mortality and expense risks assumed.

While the insurance company cannot make investment allocation decisions for the plan, the insurance company does hold title to the investments in the separate account and generally has certain rights associated with those investments, such as the ability to vote proxies on behalf of the plan. Separate accounts operate similarly to a mutual fund at the investment level and are invested in assets that match the investment objective of the separate account, which is reflected in the contracts that provide plans access to the separate accounts.

A retirement plan's interest in a variable separate account is evidenced by "units". Units of a separate account function and perform in the same way as shares in a mutual fund in that the unit value of a separate account fluctuates (up or down) in accordance with the fluctuation in the value of the underlying investments; cash-flow into or from the separate account increases or decreases the number of units, but not their value. A unit value is assigned to a separate account when it is established. The unit value is calculated by dividing the total value of the assets of the separate account by the number of units in the separate account. In addition to the unit value fluctuating due to changes in the value of the separate account's underlying investments, it may also (1) be affected by dividends and capital gain distributions from the separate account's underlying investments, or their impairment, and (2) reflect other charges (such as expenses related to the administration and investment management of the separate account), as set forth in the relevant annuity contract or other governing documents.

Fixed Return Separate Accounts

Fixed return separate accounts operate similarly to general account-backed fixed rate contracts previously described. Some of these separate account-based fixed rate annuity contracts provide for the insulation previously described, however, separate account assets that exceed liabilities are technically owned by the general account. Other of these arrangements are not insulated, such as a “synthetic” GIC type arrangement where a specific interest rate is guaranteed to a participant for a specific time period, but is not guaranteed to the plan as a whole. The plan may lose or gain more on the underlying investments than the rate credited to the plan participants, and will need to lower or raise crediting rates to the participants based on the return of the underlying assets.

Guaranteed Separate Accounts

Some insurers offer a guaranteed annuity product, sometimes referred to as a Guaranteed Separate Account, where the assets that support the guarantees made under the contract are held in a separate account. Contract-holders do not own units of the separate account as they would with a typical variable separate account. Rather, they own an insurance company guaranty of payment similar to that described under the GICs or Evergreen GICs sections above. The guaranty may have a secondary support from the insurer’s general account in the event that separate account assets are not sufficient, or may be limited to the assets of the separate account with no ability to call on the general account. Under many guaranteed contracts supported by separate accounts, deposits from participants in multiple plans may be commingled in the separate account.

Separate Account GICs

Separate Account GICs are contracts that provide plans guarantees supported by insurance company separate accounts; however, the insurance company owns the underlying assets within the separate accounts. The contract generally provides for guaranteed crediting rates announced in advance and generally guarantees a minimum floor crediting rate of 0.00%. These contracts typically are “fully fee-based,” meaning the gross crediting rate is determined in accordance with a contractual formula and deductions for investment management expenses, administration/plan servicing, product costs, risk charges and/or certain other expenses associated with operating the separate account are made to arrive at the net crediting rate that participants will receive. The gross crediting rate may vary by contract and can be based on an outside index; the yield to maturity of the underlying assets in the separate account portfolio, plus or minus an adjustment; or forward looking investment expectations.

The contract value (also referred to as book value) is the sum of deposits to the contract, less withdrawals, plus interest at the net crediting rates in effect over time. As such, Separate Account GIC crediting rates are influenced by the actual performance of the assets in the separate account as well as actual plan and participant cash flow experience.

In the event that the separate account’s assets are insufficient to meet benefit payment obligations the insurer’s general account may, depending on the product, be required to fund the amount of the deficit. So while this structure greatly reduces general account credit risk it does not entirely eliminate it. Some forms of separate account-based guaranteed annuity arrangements specifically do not provide for insulation of the assets within the separate account.

Trust-Account Based Products (Synthetic GIC/Wrap Contracts

With these products the plan owns the underlying assets.

A Synthetic GIC is similar to a Separate Account GIC described above; however, the underlying assets supporting the contract are held in a trust (owned by the plan) rather than an insurance company's separate account. These contracts, also known as "wrap" contracts, are issued by insurance companies and some banks or other financial institutions to provide guarantees of book value liquidity. Unlike a Separate Account GIC which is the only source for payment of amounts to plans and participants, a Synthetic GIC often is not the primary source of payment. Generally, the payments are made from the assets of the underlying fund; the contract is not required to pay until the fund it wraps runs out of assets or liquidity. If the assets in the trust account are insufficient to meet benefit payment obligations, then the general account of the insurance company is generally required to fund the deficit. Since the assets are held in a trust and are owned by the plan (or group of participating plans), they cannot be accessed to satisfy general account contract-holder claims or general creditors of the insurance company.

A Synthetic GIC may be for a single client or for a commingled pool. Crediting rates are determined via a formula included in the contract that is dependent on the values of the "wrapped" assets and guaranteed minimum crediting rates are generally 0.00%. Fees are typically deducted from the gross crediting rate to arrive at the net crediting rate. Synthetic GICs can be "bundled" or "unbundled". In a bundled arrangement, an affiliate of the contract issuer manages the assets in the trust account. Under an unbundled Synthetic GIC (also referred to as a "third-party wrap"), the assets are managed by an investment manager that does not have any direct affiliation with the contract issuer.

Trusteeship and Custodianship

Insurance companies are not trustees or custodians.

Regardless of the type of contract, amounts remitted to an insurance company become assets of the company, in return for which it assumes an obligation to fulfill the contract terms. Depending on the contract's terms, the assets will be included in the insurance company's general account, segregated in separate accounts, or a combination of these two options. In some cases, an affiliated or unaffiliated bank or trust company may be contracted to serve as trustee or custodian for some of the plan's assets, such as when a plan offers both insurance company contracts and mutual fund investment options; the plan administrator will receive a certification from both the insurance company and the bank or trust company, or the bank or trust company has authorized the insurance company to certify on its behalf.

In a trust or custodial arrangement, the bank or trust company acts as trustee or custodian for the plan's assets which are held in a separate trust or custodial agreement. An insurance company does not have trust powers and under state law is not a trustee or custodian for the employee benefit plan.

Identifying the Various Products

Identifying the various products can be a challenge.

Identifying the nature of arrangements with insurance entities can often times be challenging. Reading the contracts is critical to gaining an understanding. Depending on the timing of the Form 5500 preparation, reviewing the Form 5500 schedules may provide valuable information as these investments should be identified by applicable line item or applicable schedule.

Some separate accounts may be identified by the name of a mutual fund. However, in instances where the unit value does not equal the published net asset value of the mutual fund, this may be an indication that the plan's investment is in a separate account which primarily consists of an investment in the named mutual fund.

Allocated vs. Unallocated Contracts

The portion of a group annuity contract that is unallocated is considered plan assets; the portion of a group annuity contract that is allocated is not.

Only contracts that are considered *unallocated* are plan assets for financial reporting purposes. However, generally accepted accounting principles define an *allocated* contract differently than the DOL defines it in the instructions to the Form 5500. Both of these definitions may differ from that utilized by the insurance industry.

Determining whether a particular contract meets the GAAP and 5500 definitions of an allocated contract requires a careful review of the contract's terms. To the extent that a contract is considered allocated it is not recognized as a plan asset, because the obligation to pay has generally been passed to another entity, and is therefore removed from the plan's financial statements. Conversely, the portion of the unallocated contract, where the plan generally retains the legal obligation to pay the benefits, are recognized as plan assets and the related benefit obligation is presented in the plan's financial statements.

DOL Advisory Opinion 2010-01A provides an example of factors the DOL considered in determining whether one specific contract is considered allocated for annual reporting purposes on the Form 5500. While this advisory opinion is specific to the facts and circumstances of a particular defined contribution contract, readers may find it helpful in understanding the information the DOL considered in making its determination.

Reporting

GAAP and Form 5500 reporting requirements may be different.

Reporting requirements for insurance and investment contracts may be different for GAAP purposes than for Form 5500 purposes. GAAP reporting requirements are specified in the Financial Accounting Standards Board (FASB) Accounting Standards Codification™ (ASC). The Form 5500 reporting requirements are detailed in the instructions to the Form 5500. The values and classifications of insurance products as reported by the insurance company may not be in accordance with GAAP. Careful review of the contracts and inquiries of the insurance company may be helpful in determining the correct financial reporting of specific products for GAAP.

If a pooled separate account meets certain requirements then the insurance company can file a Form 5500 covering it as Direct Filing Entity or DFE.

References to Auditing and Accounting Professional Literature

FASB ASC 820, Fair Value Measurements and Disclosures, provides a framework for measuring fair value, and requires expanded disclosures about fair value measurements.

AICPA Audit and Accounting Guide, ***Employee Benefit Plans***, gives guidance on auditing plan investments.

AICPA's ***Alternative Investments – Audit Considerations, A Practice Aid for Auditors*** is a resource useful to plan auditors relating to the audit testing of these investments. This Practice Aid includes an example confirmation for alternative investments, illustrative examples of due diligence, ongoing monitoring, and financial reporting controls as well as practical advice in auditing these investments.

PCAOB Staff Audit Practice Alert No. 2, ***Matters Related to Auditing Fair Value Measurements of Financial Instruments and the Use of Specialists***, issued December 10, 2007, highlights certain requirements in the auditing standards related to fair value measurements and disclosures in the financial statements and certain aspects of GAAP that are particularly relevant to the current economic environment.

EBPAQC's ***Plan Advisory: Valuing and Reporting Plan Investments***, is a guide to assist plan sponsors in understanding their responsibilities for valuing and reporting their plan investments. It is a comprehensive document that contains information about their responsibility for reporting plan investments, how plan investments are reported, investment valuation and related disclosures, their responsibility for valuing investments and establishing internal controls, special considerations for alternative investments, investment information they should request from the plan trustee or custodian, how their independent auditor can assist them, and where to obtain additional information.

EBPAQC's ***Investment Resource Center***, gives general information about investments, and links to authoritative literature, primers and past center calls related to those investments.

Annual AICPA Audit Risk Alert, ***Employee Benefit Plans Industry Developments***, highlights the hot topics in the employee benefit plans industry, including current issues with alternative investments.

AICPA Audit and Accounting Guide, ***Life and Health Insurance Entities***, provides additional information about insurance company products.

AICPA Audit and Accounting Guide, ***Investment Companies***, provides additional information about how certain investments are valued.

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