Matters of Interest

Executive and Director Benefits and COLI

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Featured Articles

Rating Agencies' View of U.S. Life Insurance Industry

Due to concerns about the COVID-19 pandemic, increased market volatility, and the general economic slowdown, three of four major ratings agencies changed their outlook for the U.S. life insurance industry from stable to negative during March and April of this year, while one agency maintained its stable outlook, citing the industry's widely acknowledged strength of capital and liquidity. While there are uncertainties to be worked through, there is at present no reason to doubt the ability of the industry to weather these stressful social and economic times.

In an April Economic Update—The Status of the Life Insurance Industry, we discussed the U.S. life insurance industry in light of the COVID-19 epidemic. In the Economic Update, we noted the strength of the life insurance industry during previous events such as the Spanish flu pandemic of 1918, the Great Depression, World War II, 9/11 and the Great Recession of 2008. The strength of the life industry during economic and socially stressful times is due to several factors, including its highly regulated nature, its conservative approach to asset management, and its continual and public scrutiny by rating agencies.

In this newsletter, we take a closer look at what four major agencies have to say about the current and near-term state of the industry.

A.M. Best, Fitch, and Moody's have changed their outlooks for the industry to negative following the onset of the COVID-19 pandemic. The fourth major agency, S&P Global Ratings, elected to maintain their stable sector outlook for North American life insurers, though it noted that the pandemic could negatively affect a few outliers that are more exposed to asset risk, equity market volatility, near-zero interest

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rates, and heightened mortality risk or that were already facing ratings pressure prior to the coronavirus.

Latest Ratings Agency Reports on Life Insurance Industry

S&P Global Ratings. In a comment issued March 26, 2020, "Assessing the Top Risks COVID-19 Poses to North American Life Insurers," S&P Global Ratings announced that it is maintaining its stable outlook for the U.S. life insurance industry. It stated: "The COVID-19 pandemic has escalated risks for North American life insurers—namely asset risk, equity market volatility, near-zero interest rates, and heightened mortality risk. Nevertheless, our outlook for the sector remains stable. We believe that the majority of North American life insurers are well-positioned to handle the immediate impact of COVID-19—particularly from the increase in corporate bond downgrades and moderate pandemic risk—given their buildup of solid capital buffers and liquidity."

S&P also noted that they had recently conducted a hypothetical mortality stress test to estimate the potential impact of a pandemic on the U.S. life insurance sector. "In a moderate pandemic," S&P stated, "we anticipate current capital buffers will generally absorb additional excess net mortality claims."

Fitch Ratings. In March, Fitch Ratings revised its rating outlook for the U.S. life insurance industry to negative from stable. The revision was due to increased concerns over the pandemic and related impacts on the credit quality of life insurers.

The rating outlook revision reflected significantly increased uncertainties facing life insurers associated with the material disruption in the financial markets, which may last for an extended period of time. Fitch was also concerned that the industry is exposed to a spike in mortality risk, the severity of which is highly uncertain.

Keith Buckley, managing director and global head of insurance ratings at Fitch Ratings, has also noted that the speed at which events are unfolding and changing are creating what he described as "tremendous uncertainty," making forward-looking analysis an immense challenge.

AM Best. On March 16, AM Best revised its outlook to negative for the U.S. life/annuity segment of the insurance industry, finding the COVID-19 virus adds significant volatility and uncertainty to the financial markets. In AM Best's view, the life/annuity industry maintains strong capital and liquidity resources. However, the following key factors led to the change in outlook:

- A material acceleration in a global economic slowdown, increasing the expectation of dampened earnings throughout 2020 for both spread and fee-driven businesses.
- A rapid further deterioration in the U.S. economy, paired with its direct impact on equities and interest rates, with a greater expectation of a longer path to sufficient improvements from record low levels for the 10-year Treasury yield, as well as a flattened yield curve.

Factors moderating these negatives include:

- Strong capitalization and improved liquidity.
- Stress testing has better prepared the industry for downturns from economic and pandemic-type events.
- Credit spread widening to offset some of the interest rate decline.

Moody's. On April 1, Moody's announced its outlook for the U.S. life insurance sector changed to negative from stable, owing to the unprecedented economic turmoil from the coronavirus pandemic amid the

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decline in U.S. Treasury rates and a higher likelihood of a prolonged low rate environment.

U.S. life insurers have been significantly challenged by lower-for-longer interest rates, particularly at the long end of the curve. "Over time, we expect much of the impact of low rates will affect insurers' earnings and reduce interest-sensitive product earnings because of spread compression, which is prevalent in the already sizable blocks of the industry's liabilities at minimum guaranteed rates," Moody's Vice President Manoj Jethani said.

Although capital is strong, Moody's finds that severe economic shock across sectors, regions and markets could result in an uptick in rating downgrades and corporate bond defaults, which could weaken capital adequacy in 2020.

Summary

Although three of the four agencies have changed their outlooks for the industry from stable to negative, the agencies generally see robust capital and liquidity helping the industry to absorb elevated credit risk from corporate sectors, particularly from those most vulnerable to social distancing measures and the energy sector. Stress testing has also better prepared the industry for downturns from economic events. There is too much uncertainty in forecasting future events from today's volatile state of the world to say anything definitive, but the U.S. life insurance industry is starting from a position of strength and, at present, there is no reason to doubt that the industry will weather this storm as it has the last century of storms. ■

COVID-19: Employee Withdrawals from Qualified and Nonqualified Plans

> The CARES Act eased requirements for withdrawals and loans from qualified plans to allow participants to access their accounts for reasons related to the coronavirus epidemic. No easing of distribution rules was provided to nonqualified plans.

In this time of economic distress and significant job loss, some employees may find it necessary to withdraw money from an employer-sponsored retirement savings plan. The Coronavirus Aid, Relief, and Economic Security Act (CARES Act), signed into law by President Trump on March 27, addressed the financial needs of those affected directly or indirectly by the coronavirus with the introduction of a separate distribution category that relaxes requirements for early distributions and loans from qualified plans. It does not, however, change the hardship distribution rules under nonqualified plans.

Coronavirus-Related Withdrawals from Qualified Plans. Under the CARES Act, early withdrawals from qualified plans are permitted penalty-free in amounts up to $100,000 to provide tax-advantaged financial assistance to those suffering from a coronavirus-related hardship. Such withdrawals will not incur the 10 percent early distribution penalty that would normally apply to payments made prior to age 59½. In addition, any such withdrawal will be taxed over a three-year period, with the option to repay the amount into the qualified plan within the three-year period.

Distributions will be considered coronavirus-related if made between January 1, 2020, and December 31, 2020, to a qualified individual:

- Who is diagnosed with the virus SARS-CoV-2 or with coronavirus disease 2019 (COVID 19) by a test approved by the Centers for Disease Control and Prevention; or
- Whose spouse or dependent is diagnosed with the virus or disease; or
- Who experiences adverse financial consequences as a result of quarantine, furlough, layoff, reduced work hours, or being unable to work due to lack of child care due to the virus or disease, or other factors as determined by the Secretary of the Treasury.

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An employee may certify to a plan administrator that a coronavirus-related condition was satisfied.

Loans under Qualified Plans during a 180-day Period. The CARES Act doubles the limit on loans made to qualified individuals during the 180-day period following the date of enactment of the Act, from $50,000 to $100,000 and up to 100 percent (instead of 50 percent) of the employee's vested account balance.

In addition, due dates for outstanding loan repayments from the CARES Act's enactment through December 31, 2020, are delayed for one year for qualified individuals. Per the CARES Act, any subsequent repayments will be adjusted to reflect the delay and interest accrued during the delay.

The extension of repayment loan dates appears to be mandatory. Consultation with qualified plan counsel on these issues is recommended.

Plans would need to be amended to reflect these rules under the CARES Act by the last day of the plan year that begins on or after January 1, 2022 (for calendar year plan years, by December 31, 2022).

Hardship withdrawals under nonqualified plans. The CARES Act does not modify the hardship distribution provisions under Internal Revenue Code § 409A applicable to nonqualified plans. These rules provide that a hardship withdrawal request may be granted by a plan should a participant show severe financial hardship resulting from an illness or accident of the participant, the participant's spouse, or a dependent of the participant, loss of the participant's property due to casualty, or other similar extraordinary and unforeseeable circumstance arising as a result of events beyond the control of the participant.

Presumably, the coronavirus pandemic would be considered an extraordinary or unforeseeable circumstance, but the participant will still need to demonstrate significant hardship before being eligible for a distribution.

If granted, the distribution will be fully taxable to the individual in 2020. And although the money cannot be paid back directly into the plan, the participant can increase future deferrals as a way to help offset the withdrawal.

Comparison of Qualified Plan and Nonqualified Plan Withdrawal Opportunities

Distribution Options	401(k) or Other Qualified Plan	Nonqualified Plan
Withdrawal		
Need to show hardship?	▪ No, but need to certify that withdrawal is coronavirus-related ▪ In addition, if a hardship provision is available in the plan, normal hardship distribution rules would apply	Yes, need to show severe financial hardship
Distribution limitations	$100,000	Limited by the amount of demonstrated need
Penalty	No	No
Income taxation	Spread ratably over three years	Taxed in year of distribution
Can repay withdrawal back into the plan?	Yes, within three-year time period, and repaid amounts are not subject to tax	No, but participant can increase later deferrals to make up for earlier withdrawal
Loan		
Available?	Yes, relaxed limits available to qualified individuals	No
Limitation on amount	$100,000	N/A
Limitation on % of vested account balance	100%	N/A

Summary

Assuming an employer makes the provisions of the CARES Act available under its 401(k) or other qualified plans, employees will generally find it more advantageous to withdraw or borrow money from their qualified plan than to seek a hardship withdrawal from their nonqualified plan. If an employee has a severe financial hardship with a demonstrated need greater than $100,000, that individual is not limited in the amount of additional funds that can be drawn from their nonqualified plan account. ■

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Setting Every Community Up for Retirement Enhancement Act of 2019 (SECURE Act)

Lifetime Income Disclosure (Section 203)

The SECURE Act requires that defined contribution plans, such as 401(k) plans, will have to include information on equivalent lifetime income streams derived from plan account balances in benefit statements annually once the DOL issues guidance on the parameters of such disclosure.

The SECURE Act was signed into law on December 20, 2019. The new law contains many significant changes that may impact employer-sponsored qualified benefit plans. Much has been written on the SECURE Act, but here we focus on one provision that will apply to qualified plans, and which may also in time come to be used to provide enhanced disclosure in nonqualified plans.

Section 203 of the SECURE Act provides that defined contribution plans, such as 401(k) plans, must include information on equivalent lifetime income streams derived from plan account balances in benefit statements annually.

Lifetime Income Stream Equivalent. The lifetime income stream equivalent to the account balance is the stream of monthly payments the participant would receive if the total account balance were used to provide lifetime income streams, based on assumptions that will be specified in guidance by the Department of Labor (DOL). The required lifetime income streams are: (1) a qualified joint and survivor annuity for the participant and the participant's surviving spouse, based on assumptions specified in DOL guidance, including the assumption that the participant has a spouse of equal age, and (2) a single life annuity.

Model Disclosure. The DOL is to provide, not later than December 20, 2020, a model lifetime income disclosure, written in a manner to be understood by the average plan participant. The model disclosure must include provisions to: (1) explain that the lifetime income stream equivalent is only provided as an illustration, (2) explain that the actual payments under the lifetime income stream that may be purchased with the account balance will depend on numerous factors and may vary substantially from the lifetime income stream equivalent in the disclosure, (3) explain the assumptions on which the lifetime income stream equivalent is determined, and (4) make other explanations as the DOL considers appropriate.

Assumptions. In addition, not later than December 20, 2020, the DOL is to (1) prescribe assumptions that plan administrators may use in converting account balances into lifetime income stream equivalents, and (2) issue interim final rules under the provision.

Effective Date. The requirement to provide a lifetime income disclosure applies with respect to benefit statements provided more than 12 months after the latest of the issuance by the DOL of: (1) interim final rules, (2) the model disclosure, or (3) prescribed assumptions.

Application to Nonqualified Plans This requirement is added in a provision of the Employee Retirement Income Security Act (ERISA) that is not applicable to top-hat plans. Nonqualified deferred compensation plans, therefore, will not be subject to the new disclosure requirements. However, once employees begin receiving these disclosures for the qualified plan account balances, it will be natural for them to ask for a similar disclosure for their non-qualified deferred compensation plan balances. M Benefit Solutions will keep abreast of developments from the DOL in this area in anticipation of requests from our clients to implement such disclosures for their nonqualified plans. ■

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SSAE18 Audit Report

In light of the increased financial controls being placed on corporations, M Benefit Solutions made a corporate commitment in 2003 to begin providing a SAS 70 for our clients. Beginning in 2011, we obtained a SSAE 16, and beginning in 2017, a SSAE 18, the successors to the SAS 70.

The SSAE 18 report represents that a service organization has been through an in-depth audit of their control activities which generally include controls over information technology and processes which relate to the data belonging to their clients.

In 2019, M Benefit Solutions received a clean opinion without exception on our SSAE 18 SOC I Type II report, an indication of our ongoing success in assessing and improving our internal control activities for the benefit of our clients.

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