Regulatory ‘Collateral Damage’ Threatens Stable Value Funds

By Editor Test *Wed, Jun 9, 2010*

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Providers of stable value funds for employer-sponsored retirement plans are concerned that some of the tougher restrictions on derivatives trading in the Democrats’ proposed financial regulations could disrupt their business and hurt the plan participants who hold about $650 billion in the funds.

The campaign to protect stable value funds from collateral damage under the new proposals (S. 3217 and H.R. 4173) is being led by the Defined Contribution Institutional Investors Association (DCIIA), a recently formed trade group of plan providers. According to a recent release from the DCIIA, “Financial Regulation and Consequences on America’s Retirement Savings”:

We believe that the definition of a “swap” contained in the bills could have the unintended consequence of materially and adversely impacting stable value funds.

Existing language in the bill could be interpreted to define “swaps” to include synthetic guaranteed investment contracts, sometimes referred to as “synthetic GICs,” and other types of stable value investment contracts.

DCIIA believes the impact of including stable value investment contracts in the provisions of the bill regulating ‘swaps’ may reduce millions of 401(k) plan participants’ access to or, at minimum increase the cost of, stable value funds.

We also believe it is possible that this legislation may lead to the complete elimination of stable value funds in DC plans, impacting the millions of Americans at or near retirement who rely the return and stability of stable value.”

The conflict apparently stems from the fact that stable value funds have, since the early 1990s, used swaps in the wrap contracts that keep their values stable. According to the Pension Investment Handbook (1998):

“A synthetic GIC is an investment for tax-qualified, defined contribution pension plans consisting of two parts: an asset owned directly by the plan trust and a wrap contract providing book value protection for participant withdrawals prior to maturity.

“The synthetic is an alternative to a traditional GIC in a stable value fund that unbundles the GIC’s investment and insurance components. The plan investing in a traditional GIC owns a group annuity contract, and the insurance company owns and retains custody of the assets backing the contract. With a synthetic, the plan has custody of the asset and negotiates for the wrap contract providing the book value insurance protection separately.

“Synthetic GICs were first introduced in the late 1980s by banks and investment managers anxious to capture a share of the rapidly growing stable value market. By replicating the traditional GIC’s book value payment feature for participants, synthetic GICs were granted similar book value accounting treatment by many accounting firms.

“Synthetics offered the investor the opportunity to diversify away from what had become a very large single-industry concentration in their GIC funds. This need for diversification became a driving force in the stable value market following the financial difficulties of Executive Life and Mutual Benefit in 1991 and 1992 respectively. From a very low volume of sales in 1990, synthetic GICs rose to 35% of stable value sales in 1996.”

Other language in the proposed legislation would cause the swap dealers who are parties to stable value fund management to become fiduciaries and would redefine 401(k) plans as “major swap participants,” thus subjecting them to a host of new regulations and requirements.

In its release, DCIIA recommends that S. 3217 and H.R. 4173 “be reconciled to preserve the benefits of the current system for stable value funds.” It calls for:

- An exemption for stable value investment contracts issued by bank and other regulated financial institutions, to all or part of the swaps requirements of the bills.
- A provision that swaps dealers not be considered fiduciaries to those plans, when the swaps dealers don’t provide advice and when the plan is represented by an established fiduciary that is not related to the swaps dealer.
- An exemption of defined contribution plans that use swaps primarily to reduce portfolio risk from the definition of “major swap participant.”