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STABLE VALUE: IS THERE REALLY A PROBLEM?

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Stable value has been in the news far more than the facts warrant, and not for the reason that deserves highlighting: stable value continues to deliver returns far superior to other options that qualify as a defined contribution plan's "safe option."² The long-time motto of the Society of Actuaries, "The work of science is to substitute facts for appearances and demonstrations for impressions," is more than ever worth recalling, when self-interested spin has become so sophisticated, and so often aims at obscuring the facts rather than at bringing them to light. This article will set out the facts about stable value returns versus those of other options that can qualify as a plan's "safe option": a money market fund, some version of an FDIC insured account, and a short bond fund. It will then discuss various issues raised to cast doubt on the continued value offered by stable value options: alleged restrictions on participant rights and the lack of availability of stable value investment contracts. It will conclude that stable value remains as outstanding a value for participants seeking safety as it has ever been, and that the doubts raised about it are generated by self-interested parties whose revenues have been threatened by the risk revaluation that followed the 2008 financial crisis.

WHAT IS STABLE VALUE?

The defining feature of stable value is principal preservation: in normal circumstances, participants are able to exercise all rights available under the plan to transfer among options to make withdrawals at values that never decrease. Like money market, stable value is able to maintain non-decreasing values because, in what is an increasingly rare exception, participant-directed defined contribution plans are able to account for "fully benefit responsive investment contracts" at contract value, which is equal to the purchase price of the investment contract plus contributions less withdrawals plus credited interest.

The accounting guidance that confers this right is FASB's Staff Position AAG INV-1/SOP 94-4-1, which was posted on Dec. 29, 2005, and effective for accounting periods

ending on or after Dec. 15, 2006. I am including the conditions for an investment contract to qualify as fully-benefit responsive in the footnote to this paragraph. However, the most important point is that they have not changed since promulgated before the financial crisis.³

It is critically important in evaluating significant recent developments, to recall what stable value was designed to be and what it was not designed to be: stable value was designed to provide contract value for participant-directed transactions. **It was not designed to provide contract value for plan-directed transactions.** To quote AAG INV-1, "Contract value is considered the relevant measurement attribute because that is the amount **participants** in the fund would receive if they were to initiate permitted transactions (for example, withdrawals) under the terms of the underlying defined-contribution plan." [emphasis added.]

As we shall discuss further below, in the case of individually-managed stable value options, the plan has never had a right to contract value. Some collective investment funds, but not all, have given plans the right to a contract value exit.

STABLE VALUE WAS DESIGNED TO BE A DEFINED CONTRIBUTION PLAN SAFE OPTION⁴

Stable value is a triumph of financial engineering, designed to offer DC plan participants the greatest yield consistent with protection of principal in the benefit plan environment. A DC pension plan's provisions will itself restrict a participant's access to funds, and withdrawals from the plan incurs tax liabilities and sometimes tax penalties. These features mean that a stable value manager can safely invest at longer durations than money market. The fully-benefit responsive contracts⁵ required for contract value accounting assure that any required liquidity will be available. These features mean that stable value returns will normally exceed those for options that might also qualify as "income-producing, low-risk, liquid."

RETURN AND ACCUMULATION COMPARISONS

Average Returns⁶

	5 Yr Ave %	Std. Dev.	10 Yr Ave.	Std. Dev.	15 Yr Ave.	Std. Dev.
Stable Value	3.03	0.83	3.65	0.88	4.39	1.28
Money Market⁷	0.73	1.07	1.70	1.65	2.59	1.97
FDIC⁸ Model	1.48	1.07	2.45	1.65	3.34	1.97
Short⁹ Bond	3.20	2.31	2.94	2.10	4.07	2.53

Accumulations and Payouts

	15 year accumulation of \$1000 per year	Years to Depletion at \$2000 payout per year
Stable Value	\$20,516.11	14
Money Market	\$17,455.31	10
FDIC Model	\$18,590.37	11
Short Bond	\$19,841.87	13

CONTINUED ON **PAGE 10**

The tables demonstrate the clear superiority of stable value not only to its traditional competitor, money market funds, but also to potential new competitors. Stable value has higher returns with less volatility than its current and potential competitors for the low risk DC option. Only the return for a short bond fund, an option longer than any unwrapped fund of which I am aware, comes close to that of stable value, with much higher volatility.

Let's turn to the arguments that some use to attempt to undercut what the return analysis shows.

THE AVAILABILITY OF STABLE VALUE INVESTMENT CONTRACTS

A fair evaluation of the availability of stable value investment contracts requires that one look back further into the history of stable value contracts than simply to the period immediately predating the financial crisis. It is worth remembering that a little more than 20 years ago the most prevalent form of stable value contract was an insurance company general account Guaranteed Interest Contract. A stable value option's portfolio would consist of a ladder of GICs from different issuers. The insurance company offered a rate out of its black box, and the plan sponsor, or, ever increasingly, a stable value manager on behalf of the plan, took it or went elsewhere.¹⁰ There was no transparency about the charge for the wrap, for the management of assets supporting the GIC, for insurance company expenses and risk charges, or for profit.

The insolvencies of Confederated Life and Mutual Benefit Life sharply reduced the appeal of GICs, and insurance company separate account backed contracts, and contracts that provided the required AAG INV-1 guarantees disaggregated from the underlying assets (synthetic GICs), which could then remain in the plan trust, came to dominate the stable value field.

When these contracts first emerged in the early '90s, wrap charges of 27 basis points and above were common. In the long period of relative economic tranquility that marked the

late '90s and early 2000s, and with the complete dominance of wrap contracts which transferred the risk of participant withdrawals to other participants rather than to issuers,¹¹ wrap issuers did begin to compete entirely on price, and major stable value managers were able to purchase wrap contracts for fees in the single digits.

Further, competition among stable value managers increased as well, and some managers began to compete on yield, rather than on the soundness of their overall stable value management philosophy. Some stable value managers kept their eye on the principal protection ball, but suffered losses in market share as a result of the focus on yield.

THE ECONOMIC CRISIS OF 2008

I have discussed previously in *Risks and Rewards* how well stable value weathered the crisis overall.¹² However, a period when the market value of the underlying assets was in some cases more than 10 percent below the contract value, and in many cases 7 percent to 10 percent below, led to a re-evaluation of the stable value risk. In the case of some of the large banks that had become major writers of synthetic GICs, those contracts were written on derivatives desks that had fallen overall in disfavor. Some of those banks sought to withdraw from the wrap market, and it is certainly true that capacity for "blank check" synthetic GICs declined.

However, other forms of stable value contracts remained available. Many insurance companies of varying sizes continue to offer traditional GICs. MetLife, for example, which had withdrawn from the synthetic GIC market because it judged the fees inadequate, continued to sell its separate account product, as well as traditional GICs. Several companies expanded their presence in the market or re-entered the market, although often with offerings limited in various ways. For example, some major insurers will only sell wrap contracts when the assets are managed by affiliated asset managers. Further, many issuers of synthetic or separate account contracts did restrict guidelines in various ways so as to reduce the volatility that led to deep declines in portfolio market values in the crisis, and to take account of

the prolonged and to some extent artificial low interest rate environment.

In short, stable value investment contracts remain plentiful, but choice with respect to the manager of the underlying assets is meaningfully reduced. In order to obtain wrap coverage, a manager might be forced to buy an insurance company GIC where the manager would choose a comparably rated bond where wrap coverage for the bond was available. A stable value manager might need to incur the additional due diligence expense of an insurer-affiliated manager, and perhaps adjust more than the stable value manager would like to that manager's style in order to obtain wrap coverage. A stable value manager might be forced to choose passive management when it would overall prefer active management.

STABLE VALUE MANAGEMENT FEE STRUCTURES

Some stable value managers assess a fee on all the assets in the separate account or pool the manager manages. If such a manager manages some portion of the assets directly, and retains sub-advisors to manage other portions, the manager's fee does not fall as a result of retaining sub-advisers, since the sub-advisers' fees are paid from the sub-advised portfolios, which remain part of the stable value manager's fee asset base. Such a manager actually has a cost incentive to place as high a percentage of assets with sub-advisors as possible, although, of course, that incentive could easily be outweighed by many other factors: desire to build a track record for various mandates, desire to grow assets under direct management, desire to sell stable value management based on performance managing underlying assets, etc.

Other managers might charge separate fees for their management of underlying assets and their management of the stable value option as a whole. While ERISA would prohibit their use of discretion to double fee, if the plan sponsor exercised the discretion to direct a certain portion

of the assets to that manager, the manager could collect a higher fee than would generally be available to stable value managers.

Such a manager could face a loss of revenues if the manager could not obtain stable value contracts and also retain management of the underlying assets.

"HYBRID" STABLE VALUE FUNDS

A manager as described above, would certainly have an economic incentive to attempt to persuade a plan sponsor to move to a structure that would allow the manager to retain management of all the underlying assets. Plan sponsors would do well to look at the economic motivations of the manager should their manager be touting the advantages of a partially unwrapped fund, a so-called "hybrid." We have set out above the return characteristics of stable value and the alternatives to it. Based on this analysis, it is difficult to see what case a fiduciary could build for choosing a hybrid fund.¹³ Such a fund, if meeting the criteria for an income-producing, low-risk, liquid option would likely have lower expected yield and higher volatility than stable value, since any combination of the options listed above with stable value would have that effect.

THE STABLE VALUE SURPLUS

It may be somewhat more complicated to assess the "stable value surplus" compared to when the safe options of all plans were stable value or money market or both. For the purpose of this discussion, I define "stable value surplus" to be the excess return of stable value over the next best stable net asset product. Using the information from the return comparisons above, that option would be some form of FDIC-insured account.

A reassessment of risk and changes in the stable value investment contract marketplace may both have reduced somewhat the overall stable value surplus and changed

CONTINUED ON **PAGE 12**

somewhat the allocation of the surplus. What is not in doubt is that participants remain the overwhelming beneficiaries of the stable value surplus after the financial crisis, as before.

STABLE VALUE POOLED FUNDS

As far as I know, no issuers of stable value investment contracts lost money on a single contract as a result of the financial crisis of 2008. However, that is not the case for sponsors of stable value pooled funds.

Some stable value pooled funds offer plans a “put” right to investing plans. That right gives participating plans an option to exit at contract value after some stated period of time, most commonly 12 months. If a plan’s fiduciary knows that the market value of the pooled fund is less than the contract value, and is not likely to rise to contract value by the end of the put period, one could argue, assuming a reasonable subsequent placement is available, that the fiduciary has a duty to put the plan’s position to the pooled fund.

In the modern world where essentially all stable value investment contracts other than GICs mean that continuing participants absorb any losses on withdrawals where market value is less than contract value,¹⁴ the ability of prudent plan fiduciaries to exercise an economic put against the pooled fund could lead to a death spiral for the fund.

The prospect of such a spiral presents the pooled fund sponsor with an array of unpalatable choices. The sponsor can do nothing, paying out exiting plans an ever greater premium over market value while the crediting rate for continuing plans falls, eventually to zero. At the point where the last plan exits, the wrap providers will be paying on the wrap contract. However, it is likely that following this course will expose the pooled fund sponsor to a claim of breach of its ERISA fiduciary duty. The plans that receive a zero rate will point out that the plan sponsor should have terminated the pooled fund when the threat began to materialize, so that all participants would have been treated equally. I judge

this a very powerful argument. In particular, if anything in the death spiral allows wrap providers to escape, the pooled fund sponsor could face very substantial financial liabilities.

Certainly if any provision of a wrap contract for the pooled fund would permit wrap coverage for one or more contracts to lapse during the death spiral, the dilemma faced by the pooled fund sponsor would intensify. However, to the extent that the sponsor of a pooled fund with a put feature used non-participating contracts, the danger of a death spiral would be reduced.

FIXED RATE PRODUCTS NON-PARTICIPATING WITH RESPECT TO WITHDRAWAL EXPERIENCE: A GOOD ANSWER TO MANY CURRENT STABLE VALUE PROBLEMS

The potential problems for sponsors of pooled funds with put provisions discussed above do not exist to the extent that such funds are invested in non-participating with respect to withdrawal experience (NPWE¹⁴) contracts. For a fund invested entirely in NPWEs, a stampede out the door would have no effect at all on rates continuing participants would receive. A fund with a substantial volume of NPWEs and participating contracts that took projected cash flows into account in setting crediting rates would substantially mitigate the death spiral risk.

However, the value of NPWEs is not restricted to pooled funds with puts. The stability of the crediting rate of any stable value fund or option would be substantially enhanced when there was a substantial allocation to NPWEs. In particular, plans that offer a competing money market option might be able to purchase NPWEs when traditional PWEs would not be available.

POOLED FUNDS WITH PUT FEATURES DISADVANTAGE PARTICIPANTS

From an issuer perspective, the liability duration of a pooled


fund with a put feature is much shorter than that of a pooled fund where the exit is at the lower of contract value or market value, one common alternative to the predominant pattern.

For that reason, an issuer of a participating product cannot prudently agree to an underlying asset duration in a product with a put feature as long as the issuer could permit it in a fund without a put provision. Given the normal yield curve, this means expected lower returns. It is difficult to see how a plan sponsor could prudently choose this option in the context of a retirement income program.

From the perspective of expected long-term returns to participants with no sacrifice of participant principal pro-

tection, funds without a plan put feature, other things equal, are clearly superior to those with a put feature.

CONCLUSION

Stable value continues to provide outstanding value to defined contribution plan participants, markedly greater than current or potential competitors for a DC plan safe option. The managers of stable value pooled funds and plan options may be forced to move outside their current comfort zones to deliver the full potential of stable value to the participants whose money they are managing, but the need of stable value managers to adjust to new market realities should not be confused with any fundamental problems with one of the true triumphs of financial engineering, stable value. 

END NOTES

- ¹ The author is a member of the Investment Section Council and works in the law department of MetLife supporting stable value and other retirement income products. He previously worked at INVESCO, a leading stable value manager, and has written extensively about stable value.
- ² See PAUL J. DONAHUE, *Plan Sponsor Fiduciary Duty for the Selection of Options in Participant-Directed Defined Contribution Plans and the Choice Between Stable Value and Money Market*, 39 AKRON L. REV. 9 (2006), at 18-19, which describes the requirement for an "income-producing, low-risk, liquid fund." My view that a short duration bond fund could meet this requirement is not universally shared, but I will illustrate returns for such a fund in my return comparisons.
 - a. The investment contract is effected directly between the fund and the issuer and prohibits the fund from assigning or selling the contract or its proceeds to another party without the consent of the issuer.
 - b. Either (1) the repayment of principal and interest credited to participants in the fund is a financial obligation of the issuer of the investment contract, or (2) prospective interest crediting rate adjustments are provided to participants in the fund on a designated pool of investments held by the fund or the contract issuer whereby a financially responsible third party, through a contract generally referred to as a wrapper, must provide assurance that the adjustments to the interest crediting rate will not result in a future interest crediting rate that is less than zero. If an event has occurred such that realization of full contract value for a particular investment contract is no longer probable (for example, a significant decline in creditworthiness of the contract issuer or wrapper provider), the investment contract shall no longer be considered fully benefit-responsive.³
 - c. The terms of the investment contract require all permitted participant-initiated transactions with the fund to occur at contract value with no conditions, limits, or restrictions. Permitted participant-initiated transactions are those transactions allowed by the underlying defined-contribution plan, such as withdrawals for benefits, loans, or transfers to other funds within the plan.⁴
 - d. An event that limits the ability of the fund to transact at contract value with the issuer (for example, premature termination of the contracts by the fund, plant closings, layoffs, plan termination, bankruptcy, mergers, and early retirement incentives) and that also limits the ability of the fund to transact at contract value with the participants in the fund must be probable of not occurring.
- ³ The term probable is used in this FSP consistent with its use in FASB Statement No. 5, Accounting for Contingencies.

CONTINUED ON PAGE 14

⁴ An investment company registered under the Investment Company Act of 1940 (the Act) would not meet this requirement because Rule 22c-1 under the Act requires transactions between the investment company and its shareholders to be executed at current net asset value. Under Rule 2a-4 of the Act, current net asset value is computed using the fair value of the investment company's portfolio securities.

e. The fund itself must allow participants reasonable access to their funds.⁵

⁵ Paragraph 11 of SOP 94-4 provides guidance for determining whether certain restrictions violate the provision that participants in the investment company have reasonable access to their funds. Restrictions that do not violate this provision shall also not be considered to violate the provisions in paragraph 7(c)

⁴ This paragraph summarizes my treatment of the same topic in my article *Stable Value Re-examined*, 54 *RISKS AND REWARDS* 26 (Investment Section of the Society of Actuaries, August, 2009), pp. 26-27.

⁵ I will refer to these contracts in what follows as "stable value investment contracts."

⁶ Data through June, 2012. I am grateful to Besim Demiri of MetLife's Corporate Benefit Funding Division, for his assistance with the numerical analysis that underlies the tables below.

⁷ I have used three-month Treasury bill yields to approximate money market returns. These returns are generally slightly higher, with slightly lower standard deviations, than the corresponding IBC taxable money fund statistics, but I chose to use them, assuming for the sake of conservatism in the comparison to stable value that plan money funds returns would be somewhat better than the taxable average. Other choices might have shown slightly higher results for money market funds, but not sufficient to affect materially the analysis and the conclusions.

⁸ I have chosen a simple approximation to an FDIC product based on the expected return described for one such product of money market plus 75 bps.

⁹ I have used the Barclay's U.S. Government 1-3 Index returns less 20 bps to approximate the return of such a fund. It is worth noting that some ERISA counsel have suggested that a return as volatile as that of this return would arguably not qualify for the income producing, low risk, liquid option. I have nowhere seen any suggestion that any longer fund could possibly qualify.

¹⁰ I describe the origins of stable value in greater detail in my article "What AICPA SOP 94-4 Hath Wrought: The Demand Characteristics, Accounting Foundation and Management of Stable Value Funds," 16:1 *BENEFITS QUARTERLY* 44 (First Quarter, 2000), pp. 55 ff.

¹¹ See my article, "The Stable Value Wrap: Insurance Contract or Derivative? Experience Rated or Not?" 37 *RISKS AND REWARDS* 18 (Investment Section of the Society of Actuaries, July, 2001).

¹² See footnote 4 above.

¹³ Indeed, I generalize from the position I took in *Plan Sponsor Fiduciary Duty*, see above footnote 2, to state that it is difficult to see how a plan sponsor can choose any option other than stable value for the income-producing, low-risk, liquid option and discharge the sponsor's fiduciary duty.

¹⁴ I am going to refer to stable value contracts where participant withdrawal activity affects the contract's crediting rate as Participating with respect to Withdrawal Experience or PWE. Contracts where the crediting rate does not affect the contract's crediting rate I will refer to as NPWE contracts or simply NPWEs.



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