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THE DISTINCTION BETWEEN "SPREAD" AND "FEES" IN STABLE VALUE INSURANCE CONTRACTS

By Paul Donahue

One of the most important—and most widely misunderstood—concepts in the stable value arena is the distinction between fees and spreads, and which applies to each type of contract. The heightened prominence fees receive as a result of participant and contract owner disclosures required by regulations under ERISA sections 408(b)(2) and 404(a)(5) makes it important to distinguish clearly between fees and spread.

SPREAD

The difference between what the issuer of a debt instrument earns on the funds it has borrowed and the yield the buyer of the debt instruments receives is "spread." The buyer of a bond or insurance company guaranteed interest contract has no reason to be concerned about spread. What concerns the buyer is the risk / return characteristics of the yield the debt issuer is offering.

FEES AND REQUIRED DISCLOSURES

"Fees" are deducted from the investment earnings of a designated portfolio and reduce the portion of the investment earnings that are credited to the plan and its participants. ERISA 408(b)(2) requires the disclosure of fees assessed against the investment earnings of plan assets to the plan. There are two reasons for this disclosure: (1) to enable the investor to reduce the yield it can anticipate from market returns by the fees charged; and (2) to enable the sponsor to determine if the fees assessed for the investment management style are reasonable. ERISA 404(a)(5) requires disclosure of fees to participants.

NO REQUIREMENT TO DISCLOSE ANTICIPATED SPREAD

There is no comparable requirement for the disclosure of spread for a contract offering a fixed return, because the assets supporting the debt instrument are not plan assets, and the investment performance of the supporting assets does not affect the yield the issuer has guaranteed to the purchaser. Moreover, the yield is known at the point of the investment or allocation decision, and can be easily compared by the sponsor to other similar arrangements in determining which is best for its plan.

Spread is in any case an estimate. The issuer of a debt instrument has no doubt priced for some anticipated spread, but whether or not that spread will be achieved is dependent on the performance of the investment in which the issuer has invested the debt proceeds.

404(A)(5) EXAMPLE

For stable value investments, plans must report to participants: (1) the amount and a description of each fee charged directly against a participant's investment; and (2) the total annual operating expenses of the investment expressed as a percentage, among other things not figuring in our example (29 CFR 2550.404a-5(d)(iv)(A)&(B)).

Let's see how this works out for the following two stable value investment portfolios of the same size and with approximately equal yields. This example assumes direct management by the plan without sponsor asset-based charges. If there was a stable value manager with an asset-based charge, and/or plan sponsor charges assessed against participant account balances, the total fees illustrated would rise by the same amount for both portfolios.

THERE IS NO COMPARABLE REQUIREMENT FOR THE DISCLOSURE OF SPREAD FOR A CONTRACT OFFERING FIXED RETURN.

	SV Portfolio A	SV Portfolio B
Bonds Yielding 3.5%	$100,000,000	$80,000,000
Investment Management Fee at 25 Basis Points	$250,000	$200,000
Wrap Fee at 23 Basis Points	$230,000	$184,000
Custody Fee at 2 Basis Points	$20,000	$16,000
Book Value SA Contracts Yielding 3.1[1]	$0	$20,000,000
Average Net Yield	3.00%	3.02%
Total Fees	$500,000	$400,000
Fee Percentage	50 basis points	40 basis points

For the bonds, the investment management fee, the wrap fee and the custody fee are charged against the value of the assets, which must all be disclosed. The insurance company has no doubt made provision for its expenses in determining the guaranteed rate it would offer on its book value separate account stable value contract, but, depending on the performance of the assets in which the company invested the funds it received from the plan, the company may or may not actually recover its expenses. Further, under the definition of plan assets, assets supporting guaranteed benefit contracts are not plan assets—another good reason why the costs of managing the assets do not concern the plan sponsor or participants. The result is that a reallocation of a part of a managed stable value bond portfolio to insurance company fixed return stable value contracts will certainly reduce the option's expense ratio and would likely modestly increase rates credited to participants as well.

Paul Donahue, FSA, CFA, is a member of the New York bar. He works in the law department of MetLife, suporting Stable Value and other funding products. He can be reached at pdonahue@metlife.com.

ENDNOTES

[1] Believers in active management demand a premium to invest in an instrument that cannot be traded.