2012 fi360 Conference

Moving Beyond 401(k): Developing A Defined Benefit Advisory Practice

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A Professional Corporation

1. Defined Benefit (DB) Plans Today
2. Legal and Fiduciary Issues
3. How Advisors Can Add Value

DB Plans Today: Basics

- DB plan provides stated pension benefit beginning at retirement.
  - Normally stated in form of life annuity.
  - Employer contributions are determined actuarially.
- Types of DB plans
  - <u>Fixed Benefit Plan</u>: fixed $ amount payable annually.
  - <u>Flat Benefit Plan</u>: % of pay payable annually.
  - <u>Unit Benefit Plan</u>: benefit formula is based on years of service (*e.g.*, 1% of pay for each year).
  - <u>Cash Balance Plan</u>: benefit stated in the form of a hypothetical account.

DB Plans Today: Basics *(cont'd)*

- Methods for calculating pay
  - Final Average Pay – pension is based on average compensation during defined period.
  - Career Average Pay – pension is based on pay earned during employee's entire service period.
- IRS limits on pay
  - Plan may not consider more than $245,000 (2010) of pay per year.
- Integration with Social Security
  - Plan can be designed to provide pension reduced for portion of participant's Social Security benefits.

DB Plan's Today: Characteristics

- Employer considerations
  - Commitment to contribute to plan.
  - Fully financed by employer.
  - Investment risk is borne by employer.

- Benefit considerations
  - DB plan can recognize past service.
  - Easier to provide cost of living adjustments (COLA).
  - May pay disability and death benefits.
  - Generally may <u>not</u> pay layoff or medical benefits.
  - No in-service distributions generally.
  - PBGC guarantee financed by employer premiums.

1. DB Plans Today
2. Legal and Fiduciary Issues
   - Prudence Standard
   - Liability Driven Investments
   - Financial Derivatives
   - Swaps
   - Hedge Funds
   - Securities Lending
3. How Advisors Can Add Value

Prudence Standard

- Theory for ***Prudent Man*** Standard of Care
  - What does it mean to make a prudent decision?
  - ERISA 404 requires fiduciary to act with care of a "prudent man" familiar with investment matters.
- Bringing Theory to Practice
  - Fiduciary must have required knowledge and skill.
  - Consult experts, as necessary.
  - Follow a deliberate information-gathering process.
  - Give ***appropriate consideration*** to relevant data.
  - Arrive at ***reasoned*** decision.
  - Document plan's decision, rationale and process.

LDI Background: Accounting Standards

- Original Rules under FAS 87
  - Issued in 1985
  - De-linked cash contributions and pension expense.
  - Introduces expense volatility to *Income Statement*.
  - Footnote disclosures only for plan's funded status.

- Revisions Under FAS 158
  - Rule changes issued in 2006.
  - Plan's funded status moved from footnote into *Balance Sheet*.
  - Introduces funding-based volatility to *Balance Sheet.*

LDI (Liability Driven Investments)

- Introduction
  - LDI strategy designed to reduce expense and liability volatility.
  - Matches asset allocations with benefit liabilities.
- Immunization Using Plan’s Bond Portfolio
  - Bond portfolio constructed to match plan’s future stream of benefit payments.
  - Benefit liabilities may be segmented by duration.
  - For example, portfolio may immunize short- and intermediate-term liabilities only.

LDI Hedging and Rate of Return

- Hedging Interest Rates
  - Non-immunized benefit liabilities increase if rates fall.
  - May hedge through interest rate derivatives.
- Reduction in Plan's Expected Rate of Return
  - Shifting allocations from equity to bonds will lower plan's expected return.
  - Lower expected return may increase pension expense and cash contributions.
  - One-time cash contribution may be required to avoid such increases.

LDI: Fiduciary Implications

- Duty of Loyalty
  - Fiduciaries must act for exclusive purposes of providing benefits and defraying reasonable costs.
  - But is LDI strategy for employer or plan participants?
- Conflict-of-Interest Rules
  - ERISA prohibits fiduciary self-dealing.
- Duty of Prudence
  - Traditional strategies emphasize maximizing return for given level of risk.
  - LDI strategies emphasize minimizing volatility.

DOL Guidance on LDI Strategies

- Advisory Opinion 2006-08A
  - Investment manager requests DOL's opinion on whether LDI strategy violates ERISA.
  - Argues that lower volatility also reduces underfunding risks.
  - Notes ***incidental benefit*** to employer for financial reporting purposes.

Advisory Opinion 2006-08A *(cont'd)*

- Favorable opinion issued to investment manager.
  - Plan fiduciaries have broad discretion.
  - No restrictions against fiduciary's consideration of liabilities.
- Adv. Opinion does not address issues under Duty of Loyalty and Conflict-of-Interest Rules.
  - But courts have ruled that ***incidental benefit*** for employer is ok.
  - DOL made similar ruling in Adv. Opinion 2001-01A.

LDI-Related Best Practices

- Emphasize benefit to plan participants.
  - Meeting minutes should highlight benefits from plan's perspective.
  - Employer's benefits from LDI strategy should be ***incidental*** only.
- Financial officers should recuse themselves from any fiduciary vote on LDI strategy.
  - Perception issue, especially if LDI proposal significantly reduces plan's expected return.
  - Financial officer may approve LDI proposal on behalf of ***employer*** (and not on behalf of ***plan***).

LDI-Related Best Practices *(cont'd)*

- Hire outside experts.
  - Engage an independent ***co-fiduciary*** when implementing and monitoring LDI strategy.
- Revise investment policy statement (IPS).
  - Plan fiduciaries are subject to guidelines in IPS.
  - Must revise to avoid violations of IPS.
- Update plan and trust documents.
  - Amend to reflect any additional named fiduciaries, and to accommodate use of financial derivatives.

Financial Derivatives

- DOL Info. Letter to OCC (Ludwig) in 1996
  - ERISA permits investments in “derivatives” (which include structured products, such as CMOs).
  - Same investment procedures apply, but ***higher degree of sophistication*** required of plan fiduciaries.
  - Must obtain enough info to understand investment.
  - Must perform ***independent*** analysis of credit risk and market risk (*e.g.*, stress simulation model).
- Thus, fiduciaries must conduct separate risk analysis, and cannot rely on dealer’s analysis.

DOL's Ludwig Letter *(cont'd)*

- Ongoing duty to evaluate derivatives.
  - Evaluate risks and exposure with proper frequency.
- Duty to investigate pooled vehicles.
  - Understand pooled vehicle's derivatives strategy.
- Duty to investigate outside managers.
  - Ensure manager has personnel with proper expertise on using derivatives.
- Duty to evaluate legal risk.
  - Ensure legal documentation (*e.g.*, ISDA) is proper.

Illustration – Application of Ludwig Letter

- In 2005, consultant hired to create new IPS.
  - New IPS allows investments in asset-backed securities.
  - Also requires compliance with Ludwig Letter rules.
- Consultant also engaged to advise on plan's investments in accordance with new IPS.
  - Plan invests in bank's *Short-Term Bond Fund*.
  - Fund benchmark is *1-3 Year Government Bond Index.*
  - Disclosures merely state that Fund ***may*** invest in asset-backed securities from time to time.

Illustration *(cont'd)*

- Plan's investment suffers in 3Q '07.
  - *Short-Term Bond Fund* incurs heavy subprime losses.
  - Consultant blames misleading disclosures of *Short-Term Bond Fund*.
- Plan sponsor blames consultant.
  - Relying solely on a fund's disclosures is inconsistent with plan's new IPS and Ludwig Letter rules.
  - Consultant should have advised plan to act in 1Q '07.
- Who is at fault?
  - Both parties could have mitigated the plan's losses by following risk evaluation rules in Ludwig Letter.

Swaps

- Dodd-Frank Act enacted on July 21, 2010.
  - Restructures marketplace for swaps.
  - Expansive definition of a “swap.”
  - Imposes new requirements on swaps and swap counterparties.
- Implications for Plan Investors
  - Swap instruments used by pension plans (*e.g.*, swaps used for LDI strategy).
  - Stable value contracts.

Swap Definition and Stable Value Contracts

- Stable value contracts viewed as "swaps."
  - Dodd-Frank Act directs SEC and CFTC to study whether 401(k) stable value contracts are swaps.
  - Unclear if DB plans' stable value contracts are automatically deemed to be swaps.
- Pending study and rules may impose new requirements on entire industry and plans.

Swaps and Plan Investors

- Trade associations petitioning CFTC and SEC to accommodate plan investors in swap regulations.
  - Proposed CFTC rules would require swap dealer to provide assistance to plan investors.
  - They would also require swap dealer to have veto power over plan's advisor.
- However, assistance and veto power could make swap dealer a "functional" fiduciary of the plan.
  - Engaging in swap transaction with a fiduciary (dealer) would trigger PT violation under ERISA.

Hedge Funds

- Working Group on Financial Markets
  - Twin committees for hedge fund ***managers*** and ***investors*** issue separate reports in 2009.
    - *Principles and Best Practices for Hedge Fund Investors* (Investors Report)
    - *Best Practices for the Hedge Fund Industry* (Managers Report)
- Investors Report highlights hedge fund traits.
  - Restrictions on redemption rights.
  - Frequently leveraged.
  - Regular use of derivatives.
  - Managers receive performance-based pay, in addition to asset-based fee.

Fiduciary Due Diligence for Hedge Funds

- Fundamental Questions *(Investors Report)*
  - Can plan tolerate uncertainties of investment?
  - Do plan terms permit investment?
  - Resources to evaluate and monitor hedge fund?
  - Can plan's liquidity needs be met?
  - Are fees reasonable?
- Operational Steps
  - Define role of hedge fund in overall portfolio.
  - Modify IPS and plan documents.
  - Identify responsible parties and define roles.

Best Practices for Hedge Fund Investments

- Selection of Hedge Fund *(Managers Report)*
  - Use Managers Report as checklist to see if prospective fund manager follows best practices.
- Monitoring Investment in Hedge Funds
  - Construct due diligence questionnaire to facilitate monitoring.
  - Questionnaire should be tailored to specific investor and funds.

Securities Lending

- Traditional Perspective
  - "Safe" way to enhance investment return.
- Operational Overview
  - Plan engages lending agent to lend plan's securities to a borrower (*e.g.*, broker-dealer).
  - Borrower posts cash collateral, which is invested with collateral pool manager.
  - *Gross Spread* is excess of collateral pool's return, over pool manager's fee and borrower's interest.
  - Any profit is split between plan and lending agent, but any loss is incurred by plan only.

Recent Developments for Sec. Lending

- Subprime Mortgage Aftermath
  - Plans suffer losses due to collateral pool managers' investing in assets backed by subprime mortgages.
  - Triggers lawsuits and Senate hearing (March 2011).
- GAO Reports Issued in March 2011
  - *Certain Inv. Options and Practices That May Restrict Withdrawals Not Widely Understood* (GAO-11-291)
  - *Issues Involving Securities Lending in Plan Investment* (GAO-11-359T)

GAO Reports and Sec. Lending *(cont'd)*

- Findings from GAO Reports
  - Risky assets in cash collateral pools caused both realized and unrealized losses for plan investors.
  - Plan sponsors were frequently unaware of risks.
- GAO Recommendations
  - DOL should provide guidance on lending agent's fees for securities lending with cash collateral.
  - PTE 2006-16 does not require lending agent to share in plan's gains ***and losses***.
- Best Practices
  - Fiduciaries should formally evaluate risk of securities lending as well as lending agent's compensation.

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MOVING BEYOND 401(K):
DEVELOPING A DEFINED BENEFIT ADVISORY PRACTICE

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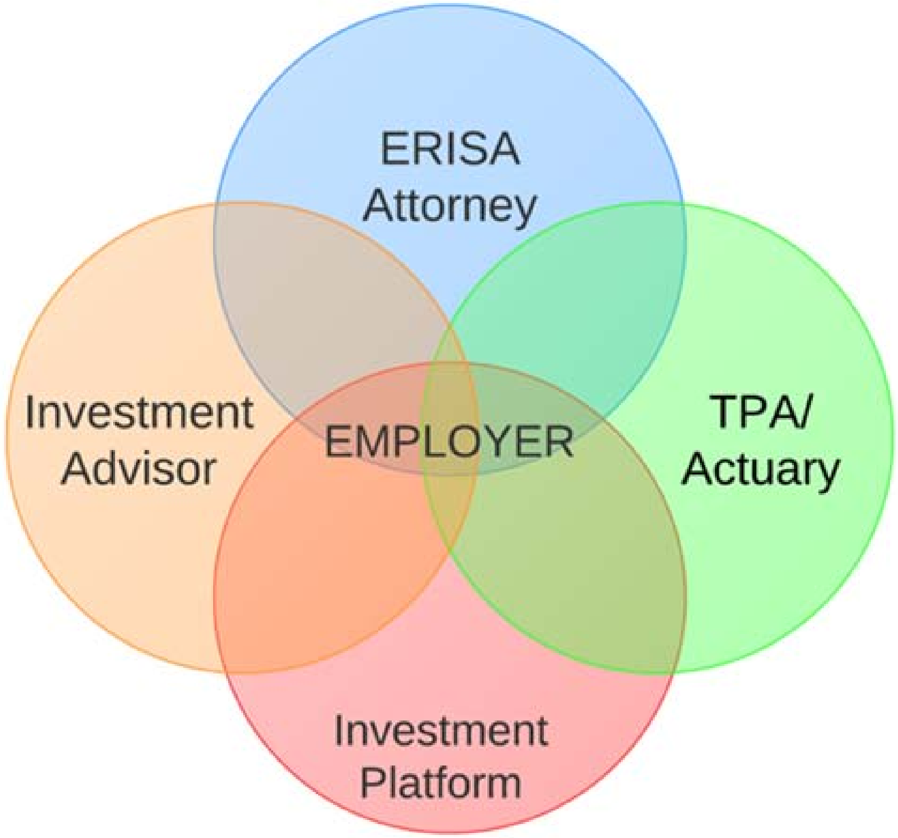
Overview

1. DB Plans Today
2. Legal and Fiduciary Issues
3. How Advisors Can Add Value

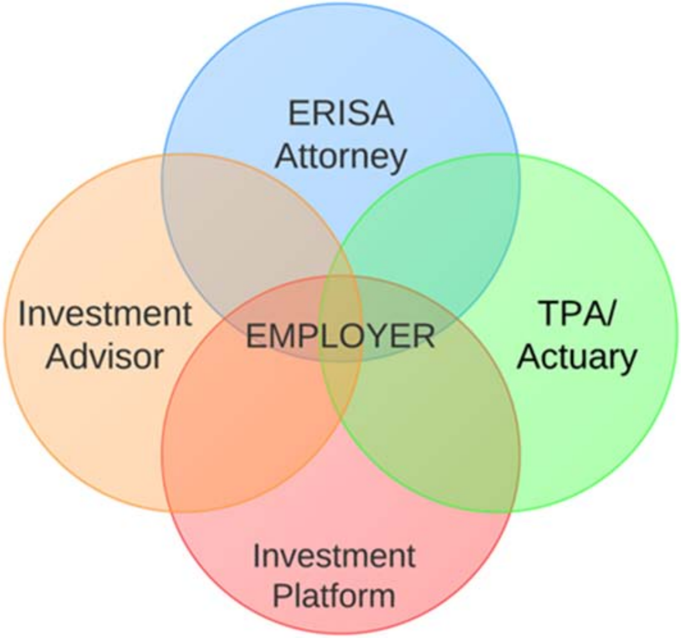
How Advisors Can Add Value

1. The Role of the Advisor
2. Helping Employers Develop a Strategic Approach to Meeting Plan Liabilities
3. Finding the Opportunities

The Role of the Advisor



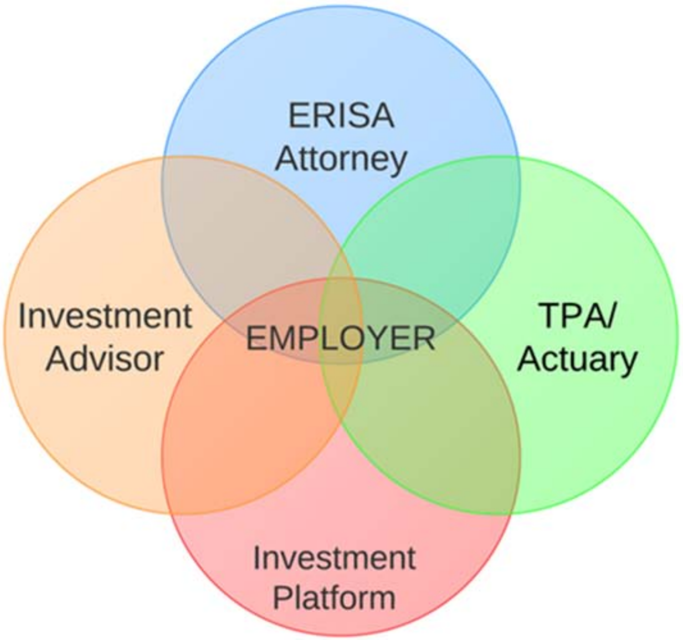
The Role of the Advisor



- Why target the DB market?
- What do clients need from their advisory team?

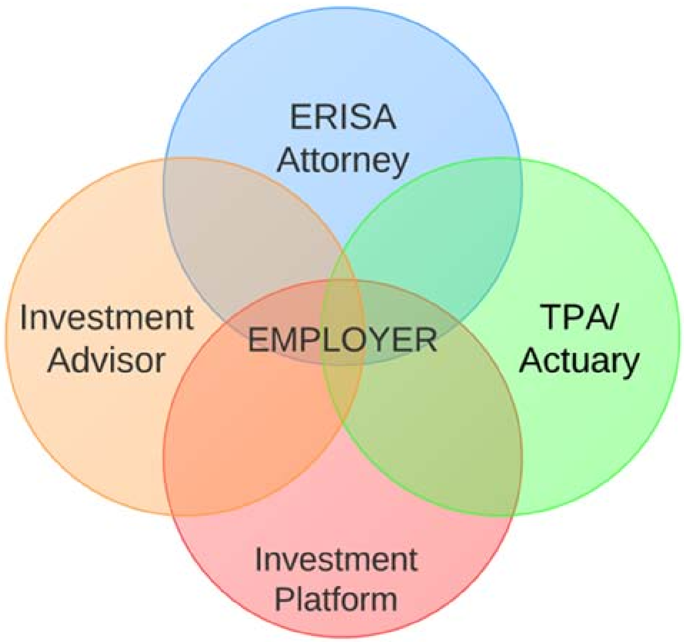
Why Target the DB Market?

- Obtain increased revenue in the new fee environment
- Increase client retention when manage both DC and DB plans
- Obtain ancillary business



What Do Clients Need From Their Advisory Team?

- Limiting exposure to plan "risk"
- Implementing and maintaining a governance process
- Planning prior to year end
- Developing an exit strategy for frozen plans



Helping Employers Develop a Strategic Approach to Meeting Plan Liabilities

Helping Employers Develop a Strategic Approach to Meeting Plan Liabilities

- ERISA funding requirements
- Pension Protection Act of 2006
- Quarterly contributions
- PBGC variable premiums
- Pension accounting rules
- Lump sum distributions to HCES
- Plan termination

ERISA Funding Requirements

- Requires employer to meet “Minimum Funding Requirement”

Impacts cash flow and tax deductions

Pension Protection Act of 2006

- Requires plan to meet "AFTAP" (Adjusted Funding Target Attainment Percentage"

May trigger benefit restrictions and notices to employees

Quarterly Contributions

- Applies if not fully funded in prior year
- Interest charged on amounts not timely contributed
- Notice to employees
- Notice to PBGC

Impacts cash flow and employee morale

PBGC Variable Premiums

- Basic premium of $35/employee plus
- Additional premium of $9 for every $1,000 of underfunding

Impacts cash flow

Pension Accounting Rules

- Discloses pension cost and liabilities on employer's financial statements

Impacts financial statements (and those who rely upon them)

Lump Sum Distributions to HCEs

- Applies to top-25 highest paid "Highly Compensated Employees"
- General rule: Lump sum cannot be paid unless assets are 110% of current liabilities *after* distribution is made

Exceptions to rule

Plan Termination

- How liabilities are valued and when

Impacts cash flow, tax deductions, and employee morale

Finding the Opportunities

Finding the Opportunities

- Where are the new plans?
- Developing an exit strategy for frozen plans

Where Are the New Plans?

- Owners needing to catch up on retirement contributions
- Owners able to make contributions in excess of IRS limits on DC plans ($50,000 plus $5,500 catch-up)
- Companies with predictable cash flow
- Cash balance plans for professional firms

Developing an Exit Strategy for Frozen Plans

- Impact on defined contribution plans
- Impact on non-qualified deferred compensation plans
- PBGC termination process as “Standard Termination”
- IRS submission for favorable termination letter
- Lump sums vs. annuities

Timing is everything

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