



TESTIMONY OF
BELLA SANEVICH
ON BEHALF OF THE
AMERICAN BENEFITS COUNCIL
AND THE
COMMITTEE ON INVESTMENT OF EMPLOYEE BENEFIT ASSETS
BEFORE THE
SUBCOMMITTEE ON GENERAL FARM COMMODITIES AND RISK
MANAGEMENT
OF THE
COMMITTEE ON AGRICULTURE
OF THE
U.S. HOUSE OF REPRESENTATIVES

FEBRUARY 15, 2011

My name is Bella Sanevich and I am the General Counsel of NISA Investment Advisors, L.L.C. NISA is an investment advisor with over \$60 billion under management for over 100 clients, including private and public retirement plans. I am testifying today on behalf of the American Benefits Council, with respect to which NISA is a member, and the Committee on Investment of Employee Benefit Assets.

The Council is a public policy organization representing principally Fortune 500 companies and other organizations that assist employers of all sizes in providing benefits to employees. Collectively, the Council's members either sponsor directly or provide services to retirement and health plans that cover more than 100 million Americans.

CIEBA represents more than 100 of the country's largest corporate sponsored pension funds. Its members manage more than \$1 trillion of defined benefit and defined contribution plan assets, on behalf of 15 million plan participants and beneficiaries. CIEBA members are the senior corporate financial officers who individually manage and administer ERISA-governed corporate retirement plan assets.

We very much appreciate the opportunity to address the swap-related issues raised by Dodd-Frank for private retirement plans governed by the Employee Retirement Income Security Act of 1974 ("ERISA"). And we applaud the subcommittee for holding a hearing on this critical set of issues.

We believe that the agencies—the Commodity Futures Trading Commission ("CFTC"), which has jurisdiction over the types of swaps most important to plans, and the Securities and Exchange Commission ("SEC")—have been working extremely hard to provide needed guidance. Also, both agencies have been very open to input on the swap issues from the plan community. We very much appreciate the open and frank dialogue we have had with the agencies to date.

TIMING.

Implementing Dodd-Frank is an enormous undertaking. With respect to the derivatives title of Dodd-Frank, there is one issue, however, that is dwarfing all others: timing. The agencies are attempting to perform a complete restructuring of a nearly \$600 trillion market with rules developed over a few months. It simply is not possible to do that in a way that takes into account all relevant factors. It is inevitable that the rules will have unintended and unforeseen consequences that could adversely impact the retirement security of millions of Americans, and cost our country billions of dollars and countless jobs.

In the pension area alone, almost no one can keep up with the breathtaking speed at which regulations are being proposed and will soon be finalized. The pension community barely digests one significant proposed regulation when another significant proposed regulation is issued. More importantly, subsequent proposed regulations can affect the application of prior proposed regulations, making the comment process very challenging at best and ineffective at worst. Also, the pension community finds itself having to comment on everything, even

regulations that it hopes will not apply to ERISA plans, because of the uncertainty regarding whether the regulations may apply.

As noted, the regulators are rushing to meet statutory deadlines. Those statutory deadlines were aggressive at the time they were adopted. In retrospect, given the enormity of the market, such deadlines now appear dangerous for pension plans because, in an attempt to meet those deadlines, regulators have proposed regulations which could ultimately threaten pension plan participants' retirement security.

As noted the CFTC and the SEC have opened their doors to ERISA pension plans and we have seen our comments very helpfully taken into account by these agencies in a number of proposed rules. But these agencies are under extreme time constraints. And pension trade groups are very concerned that such time constraints could result in regulations being adopted that inadvertently harm pension plans.

Effects of staying on the current course. To stay on the current course is to invite, if not ensure, a train wreck. In the pension area, inadvertent adverse developments with respect to the use of swaps would have devastating effects.

ERISA pension plans use swaps to manage the risk resulting from the volatility inherent in determining the present value of a pension plan's liability, as well as to manage plan funding obligations imposed on companies maintaining defined benefit plans. If swaps were to become materially less available or become significantly more costly to pension plans, funding volatility and cost could increase substantially, putting Americans' retirement assets at greater risk and forcing companies in the aggregate to reserve billions of additional dollars to satisfy possible funding obligations, most of which may never need to be contributed to the plan because the risks being reserved against may not materialize. Those greater reserves would have an enormous effect on the working capital that would be available to companies to create new jobs and for other business activities that promote economic growth. The greater funding volatility could also undermine the security of participants' benefits.

Let me explain this volatility issue further. In a defined benefit pension plan, a retiree is promised payments in the future. The obligations of a pension plan include a wide range of payments, from payments occurring presently to payments to be made more than 50 years from now. The present value of those payments varies considerably with interest rates. If interest rates fall, the present value of liabilities grows. So if interest rates drop quickly, the present value of liabilities can grow quickly, creating additional risk for participants and huge economic burdens for the company sponsoring the plan. Swaps are used to address this risk, as illustrated in a very simplified example below.

Assume that a plan has \$15 billion of assets and \$15 billion of liabilities so that the plan is 100% funded and there is thus no shortfall to fund. Assume that interest rates fall by 1 percentage point. That alone would increase liabilities substantially. Based on a real-life example of a plan whose interest rate sensitivity is somewhat higher than average, we assume a 13% increase in plan liabilities to \$16.95 billion. Based on a realistic example, we assume that assets increase to \$15.49 billion. Thus, the decline in interest rates has created a \$1.46 billion shortfall. Under the general pension funding rules, shortfalls must be amortized over seven years, so that

the plan sponsor in this example would suddenly owe annual contributions to the plan of approximately \$248 million, starting with the current year. A sudden annual increase in cash outlays of \$248 million can obviously present enormous business challenges as well as increased risks for participants.

Swaps are a very important hedging tool for plan sponsors. Hedging interest rate risk with swaps effectively would avoid this result by creating an asset -- the swap -- that would rise in value by the same \$1.46 billion if interest rates fall by 1 percentage point. Thus, by using swaps, plan sponsors are able to avoid the risk of sudden increases in cash obligations of hundreds of millions of dollars. If, on the other hand, plans' ability to hedge effectively with swaps is curtailed by the new rules, funding obligations will become more volatile, as illustrated above. This will, in turn, increase risk for participants and force many employers to reserve large amounts of cash to cover possible funding obligations, thus diverting cash from critical job retention, business growth projects, and future pension benefits.

Without swaps, some companies would attempt to manage pension plan risk in other ways, such as through the increased use of bonds with related decreases in returns. One company recently estimated that its expected decrease in return that would result from the increased use of bonds would be approximately \$100 million. And this pain will be felt acutely by individuals. Companies that lose \$100 million per year may well need to cut jobs and certainly will have to think about reducing pension benefits.

We also note that the bond market is far too small to replace swaps entirely as a means for plans to hedge their risks. There are not nearly enough bonds available, especially in the long durations that plans need. Furthermore, a flood of demand for bonds would drive yields down, increasing the present value of plan liabilities dramatically. In short, a shift from swaps to bonds would be costly, insufficient, and potentially harmful for plans.

What is needed. We believe:

- The agencies need more time to develop proposed rules. They also need to sequence the rule proposals in a logical progression.
- The retirement plan community needs more time to review those proposed rules and to provide comments to the agencies. Given the volume of rules being proposed in such a compressed time period, we propose that the Commission give much more than 60 days to comment.
- The agencies need more time to consider the comments and provide final rules.
- The retirement plan community needs more time to prepare to comply with an entirely new system.

Accordingly, we strongly urge you to adopt legislation that would provide that each provision of Title VII shall become effective as of the later of (a) January 1, 2013 or (b) 12 months after the publication of final regulations implementing such provision.

ISSUES.

It is important for two reasons to share with you some specific issues arising under Title VII for plans. First, those issues will strikingly illustrate the need for more time and the potential adverse consequences of forcing the process to move too quickly. Second, if additional time is not provided or if the agencies do not modify their rules, it may be important for Congress to step in to prevent potentially devastating results.

Business conduct standards. Under the business conduct rules, a swap dealer entering into a swap with a plan is required to provide counsel and assistance to the plan. The underlying rationale of these rules was that swap dealers are more knowledgeable than plans and are likely to take advantage of plans unless compelled to help them. By definition, this rationale has no application to ERISA plans. By law, ERISA plans are prohibited from entering into swaps unless they have an advisor with an expertise in swaps. Accordingly, ERISA plans do not have any need for any assistance or counsel from dealers. And ERISA plans have no interest in counsel from their opposing party. So at best, the rules have no effect. Unfortunately, the rules as proposed by the CFTC would actually have devastating effects. Here are just two examples, although there are other issues with respect to these proposed rules.

- **Requiring actions that would make swaps impossible.** The counsel that a swap dealer is required to provide to a plan under the CFTC's proposed rules would make the swap dealer a plan fiduciary under regulations recently proposed by the Department of Labor (the "DOL"). Pursuant to the DOL's prohibited transaction rules, a fiduciary to a plan cannot enter into a transaction with the plan. So, if the swap dealer is a plan fiduciary, then either no swap transaction can be entered into or the swap is an illegal prohibited transaction under the rules applicable to plans. Thus, the business conduct rules would require a swap dealer to perform an illegal action or refrain from entering into a swap with a plan. The only way to avoid violating the law is for all swaps with plans to cease, with the adverse results described above.

The above characterization is not just our view. To our knowledge, it is the universal business community perspective, and informal conversations with agencies indicate that they also recognize this problem.

Congress clearly never intended to indirectly prohibit plans from utilizing swaps. The CFTC must not propose conduct standards that require a swap dealer to do the impossible – act in the best interests of both itself and its counterparty. Even more importantly, the CFTC and the DOL must jointly announce that the business conduct rules will not be interpreted in a manner that will require the swap dealer to perform an illegal act under ERISA when trading with an ERISA plan in order to comply with a CFTC rule under the Commodity Exchange Act. If the agencies do not do this—and because of the time constraints and the difficulties of inter-agency coordination it is very possible that they will not—Congress needs to step in.

- **Dealers’ right to veto plan advisors.** Under the proposed CFTC rules, swap dealers are required to carefully review the qualifications of a plan's advisor and would have the ability to veto any advisor advising a plan with respect to a swap. We are not suggesting that a dealer would use this power, but the fear of that result would have an enormous effect on advisors’ willingness to zealously represent plans’ interests against a dealer. Moreover, the specter of liability for not vetoing an advisor that subsequently makes an error may have an adverse impact on the dealers' willingness to enter into swaps with plans; this may result in the dealers demanding additional concessions from the plans or their advisors, or may cause the dealers to cease entering into swaps with plans. In all of the above cases, the effect on plans’ negotiations with dealers would be extremely adverse. This, too, was never intended by Congress.

As stated above, placing the responsibility on the dealers to veto advisors is not a service that would benefit plans. ERISA has a long history of requiring plan fiduciaries to be held to the highest fiduciary standard - that of a prudent expert. Therefore, not only are investment advisors held to this standard, but the plan sponsors choosing the advisors are held to the same strict standard. It is hard to see how a counterparty whose interests are adverse to a plan's interests can do a better job of choosing advisors. Consistent with the statute, a dealer should be deemed to meet the business conduct standards relating to dealers acting as counterparties if a plan represents that it is being advised by an ERISA fiduciary.

Required clearing. Business end-users, such as operating companies, have the right to decide whether to clear a swap (i.e., the "end-user exemption"). Oddly, the plans sponsored by such companies do not have that right. Although plans have an “end-user exemption” with respect to major swap participant status, they are not eligible for the end-user exemption from the clearing requirement. To our knowledge, there is no substantive reason for this distinction; in fact, like operating companies, plans have an inherent risk to hedge - interest rate risk. Moreover, plans are required by law to be diversified, prudent, and focused exclusively on participants’ interests. Fiduciaries, acting pursuant to the highest standard of conduct under the law, should have the right to decide whether to clear a swap. In this regard, here are two examples of very troubling aspects of applying the clearing requirement to plans:

- **Anti-avoidance and potential loss of customized terms.** Each plan has different risks, based on the unique demographics of its plan participants and its unique investment strategy. Accordingly, plans have a great need to customize the terms of their swaps to seek to most effectively hedge their unique risks; because of the customized terms, plans' swaps may not be generally clearable. An issue arises because Dodd-Frank contains a section directing the CFTC to prescribe rules precluding evasion of the clearing requirement. The problem is that there is no clarity as to how this requirement will be interpreted and applied, and this may cause plans and their advisors to forego customized swaps that they think are in the best interests of the plan and its participants, in order to avoid inadvertently violating Dodd-Frank. It is critical that plans not be forced to give up those customized terms. Plans should be free to retain their customized terms and to use the over-the-counter market if the customized terms render a swap unclearable, without fear of violating the law.

- **Fellow customer risk.** Unless the CFTC allows segregation of collateral, the collateral posted by a pension plan would be aggregated with the collateral posted by other users of the clearing platform and thus could be subject to risks posed by other far less secure swap market participants. For example, in a clearing context, collateral posted by a plan could be used to address defaults by a very risky hedge fund that uses the same clearing platform. Prior to Dodd-Frank, plans were not exposed to the risk of other far riskier entities. It would be strange and ironic if Dodd-Frank were to force plans to assume far greater risk.

We ask Congress to step in and extend the end-user exemption from clearing to plans.

Real-time reporting. The CFTC has issued rules regarding the real-time public reporting of swaps. The purpose of such reporting is to enhance price transparency, with the ultimate goal of reducing prices. But the CFTC issued rules that we believe would likely have exactly the opposite effect. In fact, we believe that if the CFTC rules were finalized in their current form, swap transaction costs would increase dramatically, perhaps by as much as 100% in some cases.

The problem is that if the terms of a swap are immediately known to the market, the dealer assuming the risk with respect to the swap will have far more difficulty in offsetting that risk in a subsequent transaction. Knowing that the dealer has to offset a specific risk, the rest of the market has a large negotiating and informational advantage over the dealer and can charge the dealer much more to offset its risk. The dealer thus has to charge much more for the original swap.

This is a problem that can be easily solved with data regarding how much time dealers need to offset risk with respect to different types of swaps. Any effort to act before sufficient data are collected and analyzed is likely to result in exactly the wrong result—cost increases.

Plan swap terms should not be altered without plan consent. It is essential that the CFTC and SEC adopt clear rules under which no party involved in the reporting or clearing process has the power to modify the terms of any swap. For example, today, it is not uncommon for a swap data repository or an electronic confirmation service provider to require, as a condition of using their service, the unilateral right to modify swap terms by “deeming” a user to have agreed to such terms if they use the system after notice. Today, plans can simply elect not to use those services. But after Dodd-Frank becomes effective, plans will be required by law to report swaps. If the swap data repository receiving such reports or an entity providing services with respect to such repository has the right to modify plan terms, the repository or entity would effectively have government-type power to control swap terms. This would be shocking and certainly not what Congress had intended.

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In conclusion, the CFTC, the SEC, and the swaps community have an enormous challenge in working together to implement a complete restructuring of a nearly \$600 trillion market. This cannot, and should not, be done in a few months. If we are forced to do this too quickly, it is inevitable that there will be negative unintended consequences, costing billions of dollars in the aggregate. With respect to the plan area alone, retirement benefits would be subject to greater risk and huge numbers of jobs and billions of dollars of participants' benefits could be adversely affected. We urge Congress to (1) modify the effective date of Dodd-Frank to let the process proceed in an orderly and careful manner, (2) extend the end-user exemption from clearing to plans, and (3) address any problems under the regulations, such as the fact that the proposed business conduct rules would effectively ban all swaps with plans.

Thank you for the opportunity to present our views. I would be happy to take any questions that you may have.