American Benefits Council

CIEBA
The Committee on Investment of Employee Benefit Assets

TESTIMONY OF

BELLA SANEVICH

ON BEHALF OF THE

AMERICAN BENEFITS COUNCIL

AND THE

COMMITTEE ON INVESTMENT OF EMPLOYEE BENEFIT ASSETS

BEFORE THE

COMMITTEE ON AGRICULTURE

OF THE

U.S. HOUSE OF REPRESENTATIVES

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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 $75 billion under management for over 130 clients, including private and public retirement plans. I am testifying today on behalf of the American Benefits Council (the "Council"), with respect to which NISA is a member, and the Committee on Investment of Employee Benefit Assets ("CIEBA").

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 the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") for private retirement plans governed by the Employee Retirement Income Security Act of 1974 ("ERISA")[1]. And we applaud the Committee 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, the Securities and Exchange Commission ("SEC"), and the prudential regulators—have been working extremely hard to provide needed guidance. Also, the agencies have been very open to input on the swap issues from the ERISA plan community. We very much appreciate the open and frank dialogue we have had with the agencies to date.

However, certain proposed regulations affecting ERISA plans could have very adverse effects on plans, none of which were intended by Congress. Accordingly, for reasons discussed in more detail below, we testify today in support of:

- This hearing's legislative discussion draft that would address critical issues arising under the proposed business conduct standards;

- Needed legislation that would modify the anomalous treatment of ERISA plans under proposed regulations addressing margin requirements; and

[1] For convenience of presentation, the references in this testimony to swaps, swap dealers, and major swap participants include security-based swaps, security-based swap dealers, and major security-based swap participants, respectively.

- H.R. 1840, which would set forth specific factors that must be considered by the CFTC in connection with a cost/benefit analysis of any regulation or proposed regulation.

IMPORTANCE OF SWAPS TO ERISA PLANS

At the outset, it is important to discuss why the use of swaps is so important to ERISA pension plans and why any material disruption of that use could have significant adverse effects on plans, the companies sponsoring plans, and the participants whose retirement security depends in large part on plans.

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. The risk being managed is largely interest rate risk. If swaps were to become materially less available or become significantly more costly to pension plans, funding volatility and cost could increase substantially. This would put Americans' retirement assets at greater risk and force 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, the present value of liabilities can grow, 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 using bonds in lieu of interest rate swaps 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, the U.S. markets, and the economy in general.

SUMMARY OF KEY CONCERNS

We have four main concerns to discuss today. Those concerns are summarized below.

- ***Business conduct standards.*** The Dodd-Frank Act directed the SEC and the CFTC to impose business conduct standards on swap dealers and major swap participants ("MSPs"), with heightened standards applicable when dealers and MSPs enter into swaps with a "Special Entity" (which includes ERISA plans). These rules were intended to protect ERISA plans that enter into swaps. As proposed by the CFTC and, to a lesser extent, the SEC, these standards would have very harmful effects on ERISA plans and could operate to eliminate their ability to use swaps. The legislative discussion draft raised for discussion in connection with this hearing would address this issue very effectively.

- ***Margin requirements.*** The CFTC and the prudential regulators have proposed margin requirements that would treat ERISA plans as high-risk financial end-users (i.e., treating ERISA plans as entities that pose a systemic risk to the financial system). Accordingly, the proposed rules would impose very costly margin requirements on ERISA plans that enter into swaps. These requirements will create more risk for ERISA plans, and will divert plan assets away from more productive uses that could benefit participants. In some cases, the requirements could even discourage plans from entering into swaps due to the significant increase in opportunity cost as well as actual cost. These results are clearly unjustified, since ERISA plans are among the safest counterparties, for reasons discussed below. Legislation may well be needed to solve this problem.

- ***Cost/benefit analysis.*** We believe that an appropriately thorough cost/benefit analysis would clearly reveal that the treatment of ERISA plans in the proposed business conduct standards and the margin requirements would have significant costs and no real benefit. We are concerned that the unique nature of ERISA plans has not been taken into account in the regulatory process, and a more detailed cost/benefit analysis is needed to avoid serious unintended consequences. H.R. 1840, as introduced by Representatives Conaway, Quigley, McHenry, Boswell, and Neugebauer, would be very helpful in addressing this issue.

- ***Effective date.*** The retirement plan community will need substantial time to prepare to comply with an entirely new system. Near-term effective dates can only bring substantial harm by triggering confusion and misunderstandings that undermine our country's retirement security. In this regard, it is essential that the rules have sufficiently long implementation dates so that plans and their advisors can plan for an orderly transition to the new system without unnecessary, harmful, and costly disruptions. Moreover, plans and their advisors will need to establish additional operational and compliance systems, and the rules should be sequenced in a manner so that new systems do not have to be modified to take into account rules issued subsequently. Of course, it is also critical that no rules apply to swaps entered into before the regulatory effective date.

Discussion

Business Conduct Standards.

Under the proposed business conduct rules, a swap dealer or MSP entering into a swap with an ERISA 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. 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 surely have no interest in counsel from their counterparty. So at best, the rules have no effect. Unfortunately, the rules as proposed by the CFTC and, to a lesser extent, the SEC would actually have very serious adverse effects. Here are just three 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 rules proposed by the CFTC would make the swap dealer a plan fiduciary under ERISA; the SEC's rules may have the same effect. This is the case because the proposed rules would require the swap dealers and MSPs to review the qualifications of the plan's advisor. Such a review would make the swap dealer or MSP a fiduciary under ERISA. (Under the proposed regulations issued by the Department of Labor ("DOL") regarding the definition of a "fiduciary," other actions required by the proposed business conduct standards would also convert a swap dealer or MSP into a fiduciary. The announcement that the DOL will re-propose the fiduciary regulations provides some help on these issues, but does not address the present-law problem.)

  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 or MSP is a plan fiduciary, then any swap entered into with an ERISA plan is an illegal prohibited transaction under the DOL rules applicable to plans. Thus, the business conduct rules would require a swap dealer or MSP to perform an illegal action or refrain from entering into a swap with a plan. Generally, the only way to avoid violating the law would be for swaps with plans to cease, with the adverse results described above.

  Congress clearly never intended to indirectly prohibit plans from utilizing swaps. The CFTC, SEC, and DOL should jointly announce that no action required by the business conduct rules will cause a swap dealer or MSP to be treated as fiduciary. This would simply be a clarification that there is not an irreconcilable conflict between two sets of regulations. If the agencies do not do this, Congress needs to step in and enact the legislative discussion draft which does exactly this.

- ***Acting as an advisor.*** Under the Dodd-Frank Act, if a swap dealer acts as an advisor to a Special Entity, such as an ERISA plan, the swap dealer must act in the best interests of the Special Entity. Unfortunately, the CFTC's proposed business conduct standards interpret "acting as an advisor" so broadly that all swap dealers would be treated as advisors, *e.g.*, by reason of providing information on the risks of the swap. Even if that were not the case, the CFTC's proposed business conduct standards do not distinguish between selling (e.g., a dealer pitching a swap might describe a swap as meeting the objectives of a plan) and advising (where a relationship of reliance exists based on shared objectives).

  If a dealer is treated as an advisor and thus must act in the best interests of its counterparty, this is an unworkable conflict of interest that in virtually every circumstance would render swaps unavailable to plans. It is not clear to us how a swap dealer that owes a fiduciary duty to its shareholders to obtain the best possible deal with the plan can simultaneously act in the best interests of the plan, which is the dealer's counterparty. Absent clarification of this issue, if the proposed business conduct standards are finalized as proposed, we are concerned that virtually all swaps with ERISA plans would likely have to stop, due to this conflict.

  The core point is that it would be a violation of ERISA for an ERISA plan to rely on its counterparty for advice. Based on that point and business common sense, our members do not rely on their counterparty for advice. A dealer makes its pitch to an ERISA plan. The plan representatives then take the dealer's pitch and fully analyze it with their own advisors. That is how the ERISA plan world works. ERISA plans may not, and do not, rely on their counterparties. The CFTC needs to revise its regulations to reflect this.

  We believe that the business conduct standards should state that a dealer is not an "advisor" if (1) the dealer represents in writing that it is functioning as a counterparty and not as an advisor, and (2) the Special Entity represents in writing that it has its own internal or external advisor. In general, this is the structure adopted by the SEC in its proposed business conduct standards and by the legislative discussion draft. We believe this provides a very workable framework on this issue.

- ***Dealers' right to veto plan advisors.*** Under the proposed CFTC and SEC rules, swap dealers and MSPs are required to carefully review the qualifications of a plan's advisor; as noted above, this could effectively preclude swaps with plans by making the swap dealer or MSP a fiduciary. In addition, this requirement would give swap dealers and MSPs the ability to veto any advisor advising a plan with respect to a swap. We are not suggesting that a dealer or MSP would use this power, but the fear of that result could have a significant effect on advisors' willingness to zealously represent plans' interests against a dealer or MSP. In addition, a dealer or MSP could use this requirement to demand information regarding the plan or the advisor, potentially giving the dealer or MSP an unfair informational advantage in the swap transaction.

Also, the specter of liability for not vetoing an advisor that subsequently makes an error may have an adverse impact on the dealers' or MSPs' willingness to enter into swaps with plans; this may result in the dealers and MSPs demanding additional concessions from the plans or their advisors, or may cause the dealers and MSPs to cease entering into swaps with plans. In all of the above cases, the effect on plans' negotiations with dealers and MSPs would be extremely adverse. This, too, was never intended by Congress.

Congress' intent in the business conduct standards was to ensure that Special Entities are being advised by a qualified advisor. Congress' objective is by law met in the case of an ERISA plan, so there is no need for swap dealers or MSPs to be given a counterproductive veto power. By law, ERISA fiduciaries must have expertise in the area in which they are advising and must use their expertise prudently. Consistent with the statute, a dealer or MSP should be deemed to meet the business conduct standards relating to dealers or MSPs acting as counterparties if a plan represents that it is being advised by an ERISA fiduciary. The legislative discussion draft would do exactly this with respect to ERISA plans.

Margin Requirements.

The CFTC and the "prudential regulators" (i.e., banking regulators such as the Board of the Federal Reserve System and the FDIC) have proposed very burdensome margin requirements on uncleared swaps entered into by ERISA plans. The CFTC and prudential regulators would treat ERISA plans as "high-risk financial end users" and impose the same margin requirements on ERISA plans as are imposed on, for example, hedge funds. As explained below, this treatment is inappropriate and inconsistent with Congressional intent because ERISA plans are highly regulated, and subject to mandatory funding requirements, and cannot file for bankruptcy; thus, they are actually the lowest risk end-users. Treating ERISA plans as high-risk financial end-users will actually create risk, rather than reduce it, thereby adversely affecting plan participants. We strongly believe that, as one of the safest counterparties, no mandated margin requirements should apply to the uncleared swaps entered into by ERISA plans.

Background. The Dodd-Frank Act directed the CFTC, the SEC, and the prudential regulators to adopt rules for swap dealers and MSPs that impose margin requirements on uncleared swaps. The Dodd-Frank Act directed the agencies to use this authority to protect the financial integrity of the markets by ensuring that the margin requirements are appropriate in light of the risk associated with an uncleared swap.

The precise nature of the statutory direction to the agencies is not clear. But, as described below, the agencies have used this statutory provision to impose margin requirements on ***all*** end-users, which is hardly consistent with the statute.

Proposed regulations. The CFTC and the prudential regulators have issued proposed regulations under the Dodd-Frank provisions described above. The proposed regulations establish three levels of risk, and place all end-users in one of the following categories:

- High-risk financial end-users (the riskiest),
- Low-risk financial end-users, and
- Non-financial end-users (the lowest risk).

The "high-risk financial end-users" include, for example, hedge funds and ERISA plans. End-users in the "high-risk" category are subject to the most onerous margin requirements. The "low-risk financial end-users" are financial entities that are subject to regulatory capital requirements, like insurance companies and banks. End-users in the "low-risk" category are subject to somewhat less onerous margin requirements. Non-financial end-users are considered the lowest risk group under the rules and are subject to the least onerous requirements.

Our view. The treatment of ERISA plans as high-risk financial end-users does not make sense; ERISA plans are at the least some of the lowest risk end-users:

- Unlike almost any other counterparty, ERISA plans cannot avoid their obligations to their counterparties by filing for bankruptcy. If an ERISA plan's sponsor files for bankruptcy and the plan has outstanding liabilities, the PBGC assumes those liabilities. We are not aware of any instance where the PBGC has avoided, or could have avoided, any assumed swap liabilities.
- ERISA plans are subject to stringent funding requirements. In addition to ERISA plans having their own assets, plan sponsors are obligated to make contributions to satisfy plan liabilities. Virtually no other counterparty has that type of "credit enhancement".
- ERISA plans are not operating entities with the corresponding business risks.
- ERISA plans are tightly regulated by, for example, prudent diversification rules and strict fiduciary rules.
- ERISA plan assets must be held in a trust that is not subject to the creditors of the plan sponsor.
- Informal surveys indicate that no ERISA plan has ever failed to pay off its swap liabilities.

In this context, onerous margin requirements for ERISA plans do not make sense. The margin requirements would result in a significant increase in both opportunity cost as well as the actual cost of swaps. The proposed margin requirements are so onerous that some plans will find it prohibitively expensive to enter into the swaps necessary to hedge their risks. This would undermine the retirement security of millions of Americans, and leave plans and plan sponsors exposed to very significant market and interest rate risk. To the extent some plans continue to use some swaps, the increased costs will result in more potential risk (due to a reduction of a risk mitigating strategy, such as interest rate swaps), benefit reductions, and freezes, thus hurting the plan participants we are all trying to protect. In light of the absence of risk posed by ERISA plans, we believe that ERISA plans should not be subject to any mandated margin requirements.

Cost/Benefit Analysis.

ERISA plans are subject to a regulatory regime under ERISA which makes them unlike any other counterparty. We are not suggesting that ERISA plans deserve better treatment, but they do deserve the right treatment taking into account their unique circumstances. As demonstrated above, the agencies have not recognized these unique aspects in their rulemaking. We believe that a requirement that, prior to issuing any proposed or final regulation, the agencies must engage in an appropriately thorough cost/benefit analysis might well address this shortcoming. If ERISA plans are already required by law to have expert advisors, there is no benefit and there is substantial cost to giving dealers and MSPs veto power over plan advisors. Similarly, if it is illegal for an ERISA plan to rely on a dealer to act as its advisor, and there is no evidence that this has ever happened, there is no benefit attributable to a rule that treats dealers as advisors based on normal selling activities. In contrast, the cost of effectively precluding ERISA plans from using swaps is enormous.

The agencies need a more effective and more specific means of assessing the costs and benefits of their regulations. H.R. 1840 would be a major step forward in that regard.

Effective date.

A $600 trillion market cannot be restructured overnight without devastating consequences. As discussed above, the use of swaps is critical to the ability of plans to manage very significant risks. If a regulatory structure is imposed in haste, the possibilities for damage to the retirement system and the retirement security of millions of Americans are very high. In that context, three principles should be followed.

Time to comply. Plans and their advisors will need substantial time to comply with complex and significant new rules. A sufficiently long implementation time is essential so that plans and their advisors can plan for an orderly transition to the new system without unnecessary, harmful, and costly disruptions. If there is not sufficient time to design compliance systems, plans may be unable to enter into needed swaps. In other cases, confusion and misunderstandings will lead to unnecessary disputes, which will in turn create costs and disruption.

Ordering guidance. When an entire market is being restructured, there are substantial interrelationships between the different parts of the restructuring. If one set of rules has an earlier effective date, systems will have to be built to accommodate those rules. In building those systems, ERISA plans and others will need to make judgments about how to comply with other parts of the Dodd-Frank Act for which there is no guidance. When subsequent rules are issued, and those rules inevitably vary in some respect from the systems built by market participants, the compliance systems will need to be rebuilt, requiring a whole new transition period. This is very costly and disruptive. To avoid this, it is essential that the agencies coordinate the timing of guidance on related issues, including providing guidance first on definitional issues.

Prospective effect. It almost goes without saying that no new rules should apply directly or indirectly to swaps entered into prior to the effective date of such rules. The dollars involved in swap transactions can be enormous, and accordingly, the transactions are very carefully negotiated. In that context, it would be fundamentally unfair to impose new rules on prior transactions that were negotiated by the parties in good faith based on the law in effect at the time. Moreover, the effect of disrupting the financial arrangement of the parties could be extremely adverse for one or both of the parties.

CONCLUSION

We thank the Committee for holding this hearing and for the opportunity to testify. Swaps are very important instruments for ERISA plans, giving plans a means to manage risks that are potentially very disruptive. We applaud the agencies for their hard work and openness to input. However, we remain very concerned that certain proposed rules have been issued that are inconsistent with the structure of ERISA plans and could cause very significant disruption for ERISA pension plans and the participants who rely on those plans for retirement security. We would like to continue to work with this Committee, the other Committees of jurisdiction, and the agencies to address these concerns so that we have a system that provides the important protections intended by the Dodd-Frank Act without unintended adverse consequences.

I would be happy to answer any questions.