

CIEBA

The Committee on Investment
of Employee Benefit Assets



AMERICAN BENEFITS
COUNCIL

**Developing Standardization, Clearing
and Anti-Evasion Models for ERISA
Pension Plans to Protect Custom
Portfolio and Risk Management Swap
Terms**

Main Objectives

- ▶ **CFTC/SEC rules should be:**
 - Specific and provide guidance as to when a given swap “is required to be cleared;”and
 - Not be so narrow that plans regulated by the Employee Retirement Income Security Act of 1974 (“ERISA”) lose the ability to use customized swaps without the fear of potential (and in many cases unintended) repercussions.

ERISA Plans – Unique Issues

- ▶ Plans regulated by ERISA are unique users of OTC derivatives because:
 - ERISA plans' many fiduciaries utilize *customized swaps* solely for the benefit of the participants.
 - ERISA plans and their fiduciaries *are already subject to the oversight* of multiple regulators, including the Department of Labor and the Internal Revenue Service.
 - Each ERISA fiduciary is required to *act solely in the best interests* of plan participants.
 - Each transaction executed by an ERISA fiduciary with a dealer is required to be done *at "arms length."*
 - Each ERISA fiduciary is subject to the *highest fiduciary standard* under any US regulatory scheme – that of a prudent expert.
 - Clear rules need to be established in order for plans to be able to continue utilizing customized swaps without fear of potential (and in many cases unintended) repercussions.

Benefits of Clearing

- ▶ **The benefits of clearing include:**
 - Matching the “buy” and “sell” sides of the transaction prior to accepting the trade for clearing;
 - Collecting margin, including daily mark-to-market posting; and
 - Guaranteeing trades by substituting the credit and risk of the clearinghouse for the credit and risk exposure of each party.

Current Market Practices with ERISA Pension Plans

▶ Valuation

- ERISA plans generally have processes in place to price their uncleared swap positions independently of the dealer. Although ERISA plans may receive daily values for swap positions from dealers in their role as calculation agents, typically ERISA plans will have a plan fiduciary or a service provider conduct an independent valuation of their swaps.

▶ Collateralization

- ERISA fiduciaries have in many cases negotiated ISDA terms that include zero, or close to zero, collateral thresholds for their uncleared swaps. Zero collateral thresholds mean that the mark-to-market exposure of a counterparty is required to be collateralized, subject typically to *de minimis* amounts.

▶ Retaining ERISA Plan Protections

- Accordingly, many ERISA plans already have many of the benefits of clearing built into their OTC documents and processes for their uncleared swaps, without sacrificing the customization that ERISA plans' need to protect the best interests of their participants.

Concerns of ERISA–Regulated Pension Plans

▶ Loss of Custom Terms

- ▶ An expansive view of “Standardization” combined with vague or overbroad “anti–evasion regulation” could result in ERISA pension plans losing, as a result of clearing of swaps deemed “Standardized”, important “custom” terms which provide portfolio and risk management protections and benefits to pension plans and their beneficiaries.
- ▶ *See Annex A for an example of what the loss of custom terms could mean for a plan.*

Why Do ERISA Plans Use Custom Terms?

- ▶ ERISA plans use customized swaps predominantly for hedging purposes
- ▶ For example, an ERISA-regulated plan may use:
 - Interest rate swaps to hedge the interest rate risk associated with benefit obligations owed to participants in the future and use specifically tailored terms in order to more precisely hedge the ERISA plan's interest rate exposure than is provided through a "cleared" swap.
 - In other words, customized swap terms allow an ERISA pension plan to line up its payments with the obligations owed to beneficiaries.
 - Equity or commodity swaps to hedge the risk of adverse price changes in assets held by the ERISA plan, and may seek to use swaps with specifically tailored terms in order to more precisely hedge the plan's risks.
- ▶ *See Annex B for a comparison of select terms of potential standardized, clearable interest rate, equity and commodity swaps and customized interest rate, equity and commodity swaps*

Standardization and Clearing

▶ Proposition

- *Whether an ERISA pension plan loses or keeps important custom terms will depend on (i) the model that the CFTC/SEC utilizes to determine when a swap is “standardized” and required to be cleared, and (ii) the breadth of any CFTC/SEC anti-evasion regulation.*
- ▶ The relevance of the standardization model is illustrated in the following example:
 - (1) ERISA Pension Plan A enters into a swap which contains Terms X, Y, Z. Term Z is an important custom term in the view of the pension plan fiduciary.
 - (2) A Clearing Organization is willing to clear swaps with Terms X and Y.

Standardization and Clearing

(continued)

- ▶ Depending on the standardization model chosen, results will be different:
 - Standardization Model 1:
 - All Swaps with only Terms X and Y.
 - Result: Trade is not cleared
 - Standardization Model 2:
 - All Swaps which have X and Y as terms and, once cleared, all other swap terms are deemed cancelled
 - Result: Trade is cleared and ERISA Pension Plan A loses important portfolio and/or risk management term protections and benefits
- ▶ We would advocate that the CFTC/SEC adopt Standardization Model 1, otherwise pension plans and their beneficiaries stand to lose important portfolio and risk management terms and benefits as a result of mandatory clearing.

Anti-Evasion

▶ Proposition

- *Even if the CFTC/SEC adopts Standardization Model 1, a regulation prohibiting the “evasion” of clearing could still inadvertently cause ERISA pension plans to lose important portfolio and risk management terms*
- ▶ For example, an anti-evasion CFTC/SEC regulation which is vaguely written and/or overbroad could result in:
 - (1) ERISA pension plan fiduciaries not insisting on legitimate “custom” terms “in the best interests” of participants to avoid being deemed in violation of the “anti-evasion” regulation; and
 - 2) Dealers refusing to accommodate ERISA pension plans’ “custom” terms for fear of being deemed to have violated or have enabled the violation of the “anti-evasion” regulation

Anti-Evasion (continued)

▶ Unintended Results

- The end result is that the implementation of Dodd-Frank Act (DFA) which was intended to reduce systemic risk could result in pension plans and their beneficiaries being exposed to more risk.

▶ Right-Sizing Anti-Evasion Rules

- We recognize the challenge that the CFTC/SEC has in formulating an “anti-evasion” regulation which does not encourage the avoidance of clearing but which also does not limit swap terms for portfolio management, risk management or other legitimate purposes.

Legislative Focus – Margin

- ▶ We suggest that the principal reason why a party would seek to evade clearing under the DFA, other than specific contract terms, is MARGIN.
- ▶ We would advocate that anti-avoidance should be viewed in terms of AVOIDING POSTING MARGIN, as compared to focusing on particular trade terms.
- ▶ MARGIN is the equivalent to POSTED COLLATERAL for UNCLEARED SWAPS. The posting of MARGIN is one of the key reasons why clearing platforms can reduce systemic risk.

Proposal for Regulation

- ▶ **A PARTY SHOULD NOT BE DEEMED TO BE “EVADING” THE CLEARING REQUIREMENT FOR A PARTICULAR SWAP IF:**
 - (i) The swap’s terms are not identical to a “swap that is required to be cleared” or the swap is not “clearable”;
 - (ii) The swap is for the benefit of a plan that is subject to ERISA regulation;
 - (iii) The swap is essentially fully collateralized (taking into account minimum transfer amounts, rounding, timing differences between collateral notification and delivery and other de minimis amounts contained in a plan’s swap documentation negotiated with the dealer); and
 - (iv) the transaction is reported to the CFTC/SEC and/or a swap data repository.

Annex A

Example of the potential value of customized swaps for ERISA pension plans

To provide some context of the importance of this issue, CIEBA members manage \$867 billion in defined benefit pension plan assets on behalf of 11.6 million participants. This represents 40% of all *private sector* defined benefit plan assets according to data from the Federal Reserve.

The below example is just one of many countless potential ways that custom swaps can uniquely protect the benefits promised to retirees.

Background

In a defined benefit pension plan, a retiree is promised payments in the future. The payment obligations of a pension plan span payments occurring presently to payments promised more than 50 years from now. The present value of payments to be made in the future varies considerably with interest rates. As such, plans often use interest rate derivatives to hedge their risk of interest rate fluctuations (i.e., to align asset fluctuations more closely with the fluctuations in the economic value of the promised payments). Interest rates for calculating funding levels are set by law.

Illustrative Interest Rate Example

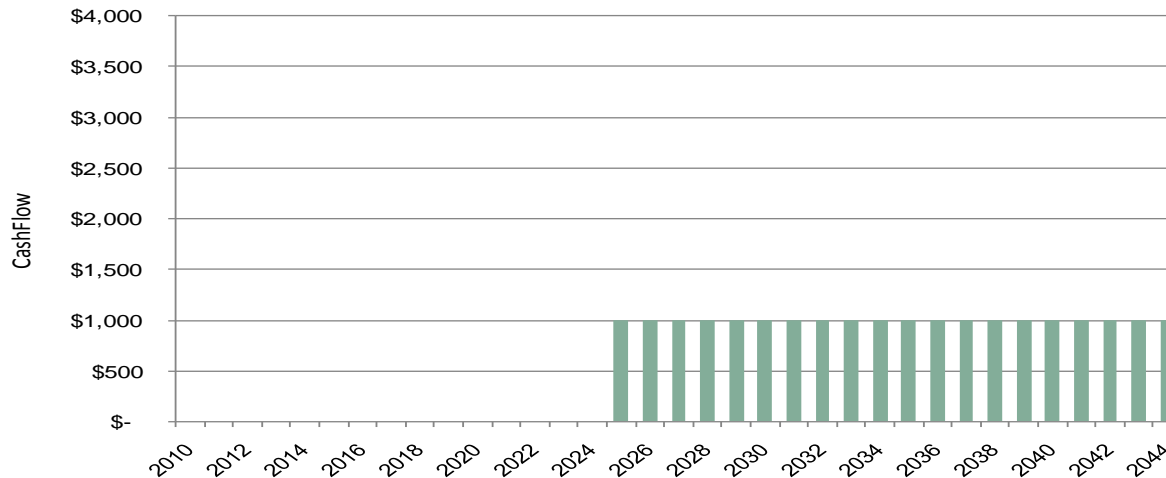
A simplified example will illustrate plans' critical need to manage interest rate risk effectively. Assume that a plan has \$15 billion of assets and \$15 billion of liabilities so that the plan is 100% funded and there is thus no shortfall to fund. Assume that interest rates fall by 100 basis points. That alone would increase liabilities substantially; based on a real-life example, we assume a 13% increase in plan liabilities to \$16.95 billion solely by reason of the interest rate decline. We assume a plan portfolio invested 25% in bonds, which increases in value to \$15.49 billion. Thus, the decline in interest rates has created a \$1.46 billion shortfall. Under the current pension funding rules, shortfalls must be amortized over seven years, so that the plan sponsor in this example would owe annual contributions to the plan of approximately \$248 million, starting with the current year, solely attributable to the interest rate decline.

Hedging interest rate risk effectively could avoid this result by creating an asset that would cause the value of the plan assets to rise to the same \$16.95 billion if interest rates fall by 100 basis points. Thus, plan sponsors are able to avoid the spectre of sudden increases in cash obligations of hundreds of millions of dollars. If, on the other hand, plans' ability to hedge effectively is curtailed by the clearing rules, funding obligations will become very volatile, as illustrated above. This will, in turn, force employers to reserve large amounts of cash to cover possible funding obligations; this will divert cash from critical job retention and business growth projects.

An example explaining interest rate hedging is set forth below.

Interest Rate Hedging

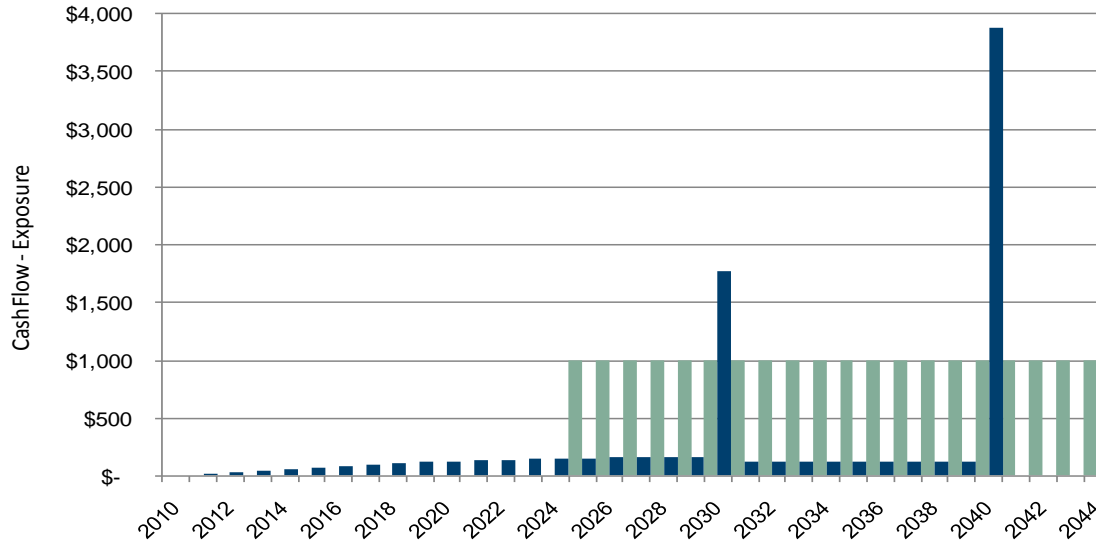
Below is as a simplified promised benefit to an employee who will retire in 15 years, and receive \$1,000 per year over the term of the following 20 years. This is the cashflow profile of the liability.



Company needs to reserve \$8,915 today in order to pay the benefit described above. If interest rates fall 1%, the Company will need to reserve approximately \$1,960 (or 22%) more in order to pay the same benefit. If assets of the pension plan do not increase commensurately, the solvency of the plan is at risk to the Company's ability to contribute the additional assets. In the event the Company is unable to do so by reason of bankruptcy, the burden would be placed on the Pension Benefit Guaranty Corporation (PBGC) – a federal corporation – to provide the additional assets and/or benefits would be reduced as part of the PBGC settlement of the liabilities.

The Company can mitigate this risk by hedging against interest rate fluctuations using interest rate swaps.

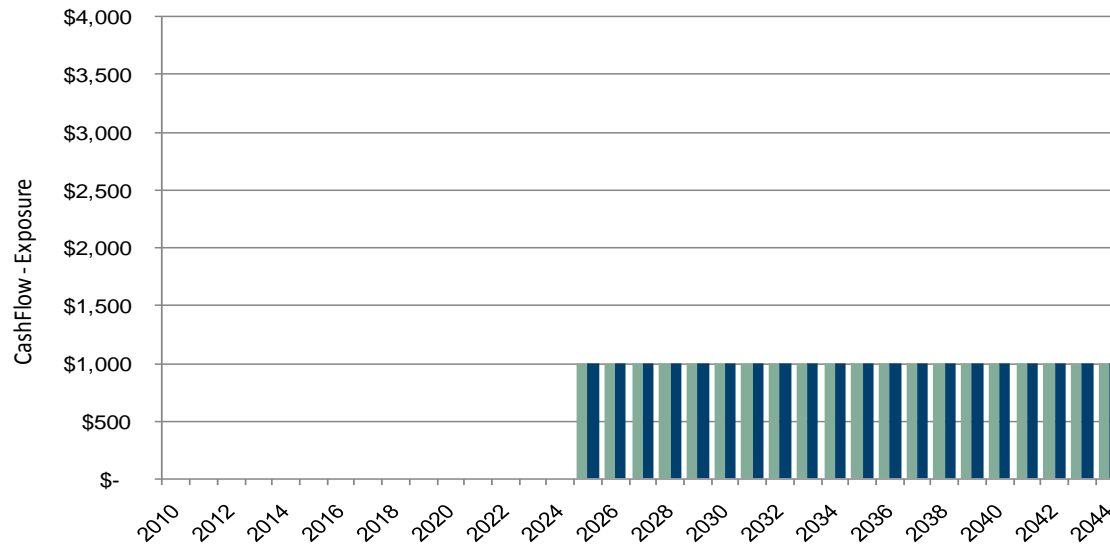
Assume that the Company can only use 10, 20 and 30 year interest rates swaps (whether due to clearing requirements or other regulatory action). The following portfolio could be designed in an effort to match the effective cashflow profile of the liability (the "standardized swap portfolio").



In the above example, cashflows do not precisely match the expected benefit payments. Therefore, the Company is still exposed to interest rate fluctuations (although to a smaller extent than if it was not hedged at all). As a recent example, if interest rates moved in a manner similar to that experienced between April and September 2010, the standardized swap portfolio would have a mismatch of 3% vs. the customized swap portfolio (illustrated below). Thus, the Company would still need to reserve an additional \$267—3% of the full \$8,915—in order to pay the retirement benefit.

If this need to reserve an additional 3% arises in, for example, a \$15 billion plan, as discussed above, the extra reserve would total \$450 million, a very material amount for any company.

If, however, the Company is not limited as to which swaps it may use (in other words, customized, zero coupon swaps are available and permitted), the Company can design a portfolio with the following cashflow portfolio – ostensibly an identical profile to that of the liability.



The above example is over-simplified for expository ease and “standardized”/“clearable” positions may be available to more completely mitigate the specific risk than described above.

While it is impossible to say at this time what instruments will be “clearable,” and this particular example may not be applicable, regulators need to be cognizant of the critical importance of customization to pension plan fiduciaries seeking to protect the retirement benefits of their participants.

Annex B

- ▶ Comparison of select terms of potential standardized, clearable interest rate, equity and commodity swaps and customized interest rate, equity and commodity swaps:

Interest Rate Swaps

Provision	Standardized Term	Customized Term
Float-side Index	3 month LIBOR	1 month LIBOR or another Index (e.g., Fed Funds)
Coupon Rates	Par rate (on market)	Step-up or Step-down coupon rates or zero coupon swaps
Starting Date	Spot starting date	Forward starting date
Coupon Payment Dates	Semi-annual based on maturity date of spot starting swap	Custom payment dates (longer or shorter than standard intervals)
Notional Value	Remains Constant	Notional amount adjusts on an amortization schedule or based on inflation

Equity Swaps

Provision	Standardized Term	Customized Term
Equity Reference Index	Well known Indices and widely traded names	Customized basket of issuers tailored to Plan Portfolio and specific market segments
Reset/Payment Dates	Quarterly reset and payment dates	Monthly reset and payment dates or annual reset and payment dates
Rights of Counterparty (e.g. voting, disclosure, hedging rights)	No voting No disclosure No restrictions on hedging	Voting rights Disclosure requirements (13D, 13G filings) Limitations on hedging
Adjustments to Notional Amounts or Reference Shares	No Adjustments to Notional Amounts or Reference Shares	Adjustments to Notional Amounts or Reference Shares to Rebalance Portfolio

Commodity Swaps

Provision	Standardized Term	Customized Term
Exposure Adjustment	No ability to unwind or add exposure prior to expiration	Only the Plan has the right to unilaterally terminate a transaction at no cost or can negotiate increase features
Reset/Payment Dates	Quarterly reset and payment dates	Monthly reset and payment dates or annual reset and payment dates
Maturity	Quarterly	Any negotiated date
Commodity Reference Index	Well known Indices	Customized basket of commodities

ABOUT CIEBA



The Committee on the Investment of Employee Benefit Assets, better known as CIEBA, is the voice of the Association for Financial Professionals (AFP) on employee benefit plan asset management and investment issues. CIEBA represents more than 100 of the country's largest private sector retirement funds. Its members manage \$1.4 trillion of defined benefit and defined contribution plan assets, on behalf of 17 million plan participants and beneficiaries.

CIEBA was formed in 1985 to provide a nationally recognized forum and voice in Washington for ERISA-governed corporate pension plan sponsors on fiduciary and investment issues. Members are the senior corporate financial officers who individually manage and administer ERISA-governed corporate pension plan assets.

CIEBA's mission is to improve retirement security and increase investment management effectiveness by:

- ▶ Informing pension plan sponsors of legislative, regulatory and investment issues affecting defined benefit and defined contribution plans
- ▶ Providing a forum for discussion of these issues and development of effective solutions
- ▶ Helping its members address these issues and effectively discharge their fiduciary responsibilities
- ▶ Serving as an information resource for legislative and regulatory bodies
- ▶ Supporting constructive policy and legislative initiatives
- ▶ Building understanding and support for the private sector pension system

CIEBA is committed to strengthening the private sector pension system so that it continues as a major source of retirement income for millions of Americans. Its members also recognize that the private pension system's assets provide a significant source of long-term capital essential for growth.

Robert Hunkeler, Vice President of Investments at International Paper, is the current chairman of CIEBA.

About the American Benefits Council

- ▶ The American Benefits Council (the Council) is a public policy organization principally representing 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.
- ▶ We are professionals in the benefits field with expertise in investments, retirement, health insurance, accounting, actuarial science, banking, law, and benefits consulting who provide service and support to corporate benefit plan sponsors.
- ▶ We serve as a technical resource on benefits issues for lawmakers, the media and other industry trade associations. We also lead other public policy organizations in developing and communicating a collective business community position and forge alliances on benefits issues.
- ▶ Our mission is to be the most effective advocate for voluntary private employee benefits.



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