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Liability Driven Investments:
A Global Legal Perspective

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- **Moderators:** Kees-Pieter Dekker & David W. Powell

Introduction

- What is LDI?
- Why has interest been developing?
  - risk management after the 2008 market break
  - accounting developments, need to reduce funding/balance sheet volatility
- An evolving area
- Experiences in countries with different regulatory and legal regimes

1. The legal framework – comparison of US, NL and CA

2. Specific application to annuity purchases and other alternatives

LDI – The US legal perspective

- David W. Powell, Groom Law Group, Washington DC, US

US LDI background

- FAS 87 has long required sponsors to recognize a balance sheet liability for unfunded pension benefits and disclose their obligation for pension benefits based on expected future compensation levels

- For private sector, most DB plans had been
  - Converted to cash balance to mitigate volatility, or
  - Frozen (no further accruals or no further entrants)

- Exceptions: Collectively bargained, multiemployer, public employer plans

Motivations for increasing US interest in LDI

- Over 30+ years of ERISA, there developed a fairly entrenched view of fiduciary duties based on modern portfolio theory (emphasizing diversification as a means of reducing risk)

- Then in 2006, the Pension Protection Act:
  - Increased the funding target (so much so it had to be mitigated by amending the law to change the interest rate in 2012 (MAP-21))
  - Resulted in faster recognition of market affects, i.e. more volatility
  - Imposed more restrictions on underfunded plans

- Followed by the market break in 2008 and lower interest rates from quantitative easing, growing underfunding

DOL opines on fiduciary duty and LDI

In 2006, Department of Labor was asked to opine on LDI under ERISA:

Proposal was "to 'risk manage' the assets of defined benefit plans by better matching the risks of a plan's investment portfolio assets with the risks associated with its benefit liabilities,

[T]hese liabilities most closely correlate with fixed-income assets, so that one approach for risk managing assets would be to invest directly in a portfolio of fixed-income securities with a duration of the plan's benefit obligations.

However, you note that there may be aspects of a plan's obligations that correlate more closely with other types of investments, and it may not be possible to match liabilities precisely with fixed-income securities due to limitations in the fixed-income market.

As a result, you indicate that a variety of approaches may be used in practice, depending on the facts and circumstances of the particular plan."

What the DOL said

"a fiduciary would not, in the view of the Department, violate their duties ... solely because the fiduciary implements an investment strategy for a plan that takes into account the liability obligations of the plan and the risks associated with such liabilities and results in reduced volatility in the plan's funding requirements.“

But they also said:

"Whether any particular investment strategy is prudent with respect to a particular plan will depend on all the facts and circumstances involved."

In the US, LDI

- May involve purchasing significant amounts of fixed-income securities, or may mix equities, alternatives and fixed-income securities with
  - Interest rate swaps
  - Equity hedging strategies
  - Synthetic equity and credit

- Dynamic investment style and accelerating frequency of portfolio analysis goes against traditional investment committee structure under ERISA
  - Fiduciary committees don't have months to react
  - Increased outsourcing of investment discretion

- Is generating interest in what the liability discount rate should be and will be, including effect of QE on rates
  - Corporate and multiemployer plans subject to fluctuating corporate bond rates post-PPA '06 for funding purposes
  - Public plans not subject to those rates; most have fixed rates around 7% to 8%

- Is also generating concern over longevity risk

US experience with LDI to date

- Significant study of Asset Liability Management (ALM) and LDI by economists
- Recent SEI study: 66% of US plans polled were implementing some form of LDI (up from 17% in 2007) (www.seic.com)
- Increasing involvement by lawyers in the US in advising fiduciaries on their duties with respect to implementing LDI
- Defeasement other than by annuity purchase currently not accepted by US regulators (despite intensive lobbying)
- Expense of laying off risk through purchase of annuities has significantly discouraged doing so in the US - until a few recent instances

LDI – the Dutch legal perspective

- Kees-Pieter Dekker, Van Benthem & Keulen, Utrecht, the Netherlands

Features of Dutch pension system

- Predominant focus on defined benefit schemes
  - Conditional adjustment for increase in cost of living expenses
- Pension providers
  - Pension funds
  - Pension insurers
  - Premium pension institutions (pension provider for DC schemes)
- Regulatory solvency framework
  - Providing nominal guarantee on benefits
  - Conditional adjustment
- General risks
  - Interest rate
  - Longevity
  - Investment

Regulatory framework

- Prudent person rule
  - Investment of assets such that safety, quality, liquidity and yield of entire investment portfolio is safeguarded
  - Assets for the coverage of the technical provisions are investment in a way that is in line with the nature and duration of the pension benefits
  - Investments in derivatives are allowed for enhanced portfolio management or reduction of risk profile
  - Proper diversification of the investment portfolio

- Position Dutch Central Bank
  - Pension fund decides on investments
  - Pension fund needs to be aware of: risks related to investment, product details, market, valuation

Alternative investments

- Legal framework allows for alternative investments
- Dutch Central Bank principles for the assessment of the risk management of alternative investments:
  - Characteristics of alternative investments
  - Portfolio policy
  - Due diligence
  - Contract conditions and monitoring
  - Communication

LDI – the Canadian legal perspective

- Randy Bauslaugh, McCarthy Tétrault LLP, Toronto, Canada

LDI defined

- Risk management ; not necessarily risk minimization.
- Use of a range of assets – equities, bonds, hedging structures, and annuities to construct an investment portfolio that closely matches the behaviour of pension liabilities. Not just bonds.
- Primary purpose seems to be to help plans remain fully funded throughout market cycles vs. maximizing asset growth for a given level of investment risk.
- Primary goals seem to be to achieve more stability in: funded status, required contributions and balance sheet impact.

LDI – general legal issues

Compliance with objective legislative criteria, including

- Must have “Statement of Investment Policies and Procedures”
  - This is required in all Canadian jurisdictions. (Legal risk under a prudent person test can be attenuated by defining risk and return objectives in a manner that makes LDI appropriate, e.g., “the long-term objective is to generate sufficient cash flow to pay benefits and the short-term objective is to improve funded status without risk of loss”. Asset allocation is then matched to objectives.)
- Must comply with quantitative diversification and concentration limits
- Must avoid defined related party transactions

Compliance with statutory and common-law fiduciary standards

- “prudent person” investment rule
  - Reasonable return without undue risk of loss ?
  - Understanding of complex investments (get expert advice)
  - Documentation (negotiation of investment contracts, including service provider and consulting contracts)
  - Monitoring
  - Avoid conflicts of interest
    - » Not likely to preclude consideration of employer’s interest , such as accounting volatility or funding volatility

Purchase of annuities

A three country comparison

LDI assets-insured annuities (CA)

Annuity purchase usually considered a <u>discharge</u> of liabilities for

- Actuarial valuations
- Accounting purposes

Does annuity purchase legally discharge employer's pension promise?

- Pension promise is part of contract of employment
- Can't assign employment contract, unless
  - Employee expressly consents in writing
  - Contract expressly provides for discharge by purchase of an insured annuity (gray area)

Purchase is also subject to fiduciary duties:

- Selection of insurer
- Communication to plan members
- Structure of annuity purchase
  - Assuris Protection (Canadian insurance industry protection for monthly income polices up to $2,000/month, death benefits up to $200,000 …)
  - Laddering of coverage from different insurers can "guarantee" full Assuris protection (i.e, pension will not be paid, only if the whole insurance industry in Canada fails)

Annuities – the Dutch perspective

- Dutch focus on defined benefit:
  - Design of financial basis pension scheme
  - Aimed at coverage of defined benefits
  - Risk-based approach

- In defined contribution plans
  - Market approach: purchase of annuities on pension date
  - Immediate annuitization possible
    - adjustment to more recent longevity data

Annuities – the Dutch perspective

- Lump sum payments:
  - Only allowed in pre determined situations
  - Violation of provisions leads to tax penalties

Defeasement through annuity purchase, lump sums (US)

- General Motors – USD 29B
  - For retirees, offered lump sum election
  - Purchase of separate account Pru annuity required overfunding annuitized liabilities by 11.5%
  - Assumed a 3% annual long-term ROA
- Similar at Verizon (USD 7.5B)
- Ford offered 90,000 retirees lump sums
- More likely to come
- Some lingering concern at the PBGC?

ERISA considerations (US)

- Selection of annuity provider subject to fiduciary duties - DOL has provided guidance
- Annuities are no longer “plan assets”:
  - not subject to ERISA
  - not insured by the PBGC, but backed by state guarantee funds
  - no more PBGC premiums
- Plan must be 80% funded to offer lump sums

Other types of LDI

A three country comparison

Alternative investments (NL)

- Duties of board pension fund
  - Understand nature and characteristics of alternative investments
  - Risk assessment and risk management
    - Risks related to the product
    - Counterparty's bankruptcy
  - Valuation of alternative investments
    - Dutch law: mark to market valuation

- Derivatives
  - Interest rate swap
  - Longevity swap: unknown
    - Risk: is it an insurance or a banking product
    - Unauthorized offerings of longevity swaps
  - Swaptions to reduce risk of under-funding

Alternative investments (NL)

- Interest rate swaps
  - Counterparty risk
  - Official point of view: Dutch pension funds cannot go bankrupt
    - Benefits can be reduced if pension fund is under funded
    - Right perspective?

New Dutch pension system

- National de-risking operation?
- Longevity becomes part of pension benefits
  - Increase in longevity - > adjustment of pension benefits
- Adjustment of benefits for increased cost of living expenses:
  - Part of the pension benefits
  - Payment depending on financial position pension fund
- Adjustment of pension benefits to developments in financial markets
  - Decrease of increases cost of living expenses
  - Decrease nominal annuity
  - Decrease may be spread over 10 year period (maximum)

LDI – interest rate swap legal issues (CA)

1. Fiduciary
   - Integration with portfolio (integration with bond portion)
   - Duty to understand investments

2. Legal authority
   - SIP&P contemplates
   - Plan documents do not prohibit
   - Plan sponsor not prohibited

3. Source of payment/security
   - Master trust /pension trust

LDI – interest rate swap legal issues (CA)

4. Credit risk
   - Performance in the event of counter-party insolvency
   - Transfer/assignment to another counter-party
   - Contract enforcement
   - Collateral requirements
   - Termination rights

5. Taxation

6. Documentation
   - ISDA Agreement
     - Documentation forms oriented to provider
       - Important to evaluate/identify particulars and overall substance of the transaction (debt/equity/insurance….)
     - Transaction Confirmation/Schedule – specific terms for particular transaction, including pension law terms
     - Credit Support Annex – collateral provision

LDI - interest rate swap legal issues (CA)

7. Negotiation
   - Methodology for determining settlement calculations and timing
   - Termination provisions
     - Downgrade termination
     - One-way, two-way and cross-default termination
   - Collateral (permitted by pension standards?)
   - Dispute resolution provisions
     - Choice of governing law
   - Set-Off provisions
   - Swap insurance
   - Assignment rights

8. Monitoring
   - Performance in accordance with contract terms
   - Effectiveness

LDI – longevity risk solutions legal issues (CA)

Buy-outs

- Annuity under which insurer pays pensioner

Buy-ins

- Annuity under which insurer pays to plan
- Redemptions (in the event of full or partial plan wind up, change of administrator … etc.)

Longevity Swaps

- Insured or non-insured
  - If non-insured, is it insurance/gambling?
  - Recharacterization issues (insurance / other)
- Privacy Issues
  - Based on identifiable reference group or index?
  - If identifiable group, privacy issues relating to verification of data by provider, audit by provider, reinsurance by provider, cross-border transmission of private information

Some US legal considerations

- Fiduciaries have a duty under ERISA to understand complex investments and seek appropriate advice if necessary
- How well do the fiduciaries understand
  - what its investment managers and advisors are telling it?
  - how alternative investments, hedges, swaps, etc. will work?
  - all the risks?
- How to measure the performance of LDI advisors
- How well do the documents reflect best practices?
- Negotiation of schedules, credit support annex, confirmation for derivatives under the ISDA Master Agreement

More US legal considerations

- Is it prudent under the ERISA standard? Does it meet the ERISA diversification requirement?

- Is it for the exclusive benefit of participants and beneficiaries or for the benefit to the employer?

- Annuity purchases and lump sums:
  - Selection of provider
  - Possible regulatory changes, possible employee litigation

Some questions in the US

- Does LDI add value or reduce risk?
- Are other risks (e.g. counterparty risk, interest rate risk, duration risk, credit risk) being created?
- Is there regulatory/event risk that some hedging instruments, e.g., swaps, may be restricted, affected by credit downgrades or other developments?
- Too early to tell?
- Lump sum options controversial