529 Plans: Ripe Market for Stable Value

By Randy Myers

They have different funding goals, of course, but in many other respects 529 college savings plans are a lot like 401(k) retirement savings plans—with at least one notable difference. While stable value funds can be found in a high percentage of 401(k) plans, they are only in four of the nation's 51 state-sponsored 529 plans. And that, a panel of industry insiders explained at the 2013 SVIA Spring Seminar, is a growth opportunity that stable value providers should be keen to embrace.

Steve LeLaurin, senior client portfolio manager at Invesco Advisors, conceded that there are challenges to breaking into the 529 market. As a group, stable value wrap providers are just now emerging from a period in which wrap capacity was constrained, and they have not spent much time looking at the market. Also, because 529 plans are not qualified plans under the Employee Retirement Income Security Act, they cannot participate in bank collective trust funds, which means they cannot use standard pooled stable value funds. Finally, there's just not as much awareness of 529 plans, as they have only been available since 1996, as there is of 401(k) plans. In fact, although they've been around since 1996, 529 plans did not really begin to gain traction until qualified withdrawals were temporarily exempted from federal income taxes beginning in 2001. That exemption was not made permanent until 2006.

Still, 529 plans are a big and growing market, with $190.7 billion in assets at the end of 2012[1]. And their similarities with 401(k) plans make them attractive to stable value providers who have already broken into the market. To illustrate the point, LeLaurin showed a graph of crediting rates over the past 10 years for two 529-plan stable value funds under his firm's management, and compared them to crediting rates for a 401(k) plan stable value fund the firm runs. The general trends and absolute numbers were highly correlated.

The one area where the performance of the 529 funds did diverge from that of the 401(k) fund was in their monthly cash flow histories. Unlike 401(k) plans, 529 plans experience withdrawal patterns that tend to be seasonal, with the heaviest outflows coinciding with the beginning of the spring and fall college semesters, when tuition, room and board payments are due. Still, LeLaurin noted, those withdrawal patterns are highly predictable, and ultimately tend to be less volatile than those for 401(k) plans.

The Invesco stable value fund in the 401(k) plan example, LeLaurin noted, was completely and successfully underwritten for the last 10 years, and considered by wrap providers to be a good risk. Yet in terms of cash flow volatility, he said, the funds in the 529 plan look to be an even better risk.

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[1]Source: March 2013 College Savings Plans Network

Regulators Continue to Study Dodd-Frank's Applicability to Stable Value Contracts

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contracts qualify as swaps but are exempt from Dodd-Frank regulation, assuming regulators conclude that such an exemption would be "appropriate" and in the public's best interest.

The Commissions' heightened interest in the study does not guarantee that anything is imminent in terms of the study being completed, Steve Kolocotronis, vice president and general counsel for Fidelity Investments and chair of the SVIA Government Relations Committee, said at the 2013 SVIA Spring Seminar. The request for stable value contracts does indicate, however, that the CFTC and SEC are paying attention to the issue. "I don't know that we have a timeframe as to when we think we will get the study," he said.

Based on discussions with regulators, Kolocotronis said it appeared that the CFTC has "some nervousness" about declaring that stable value contracts are not swaps, as it might encourage other financial services firms to argue that they have developed similar products that should be exempt. "It seems from their perspective that the safer thing is to say that a stable value contract is a swap, but exempt," he said. "That way, they maintain some control over other products that come along down the line."

By contrast, Kolocotronis said, the SEC seemed more comfortable with the idea of declaring that stable value contracts are not swaps.

The SVIA position, which it has conveyed to regulators, has consistently been that stable value contracts are not swaps. The association has noted that stable value products do not present a systemic risk to the financial system, and did not cause any problems during the 2008 financial crisis, nor did stable value contribute to the financial crisis. The SVIA has also stressed that stable value products are already heavily regulated. They have a 39-year history of operating under the Employee Retirement Income Security Act through a diverse range of financial stresses and cycles and have continued to perform well despite these market challenges. All this, SVIA President Gina Mitchell said at the Spring Seminar, suggests that "the potential for this product to have a bad outcome for plan participants is pretty remote."

One good bit of news for the stable value industry as it pertains to the study's delayed completion, Mitchell noted, is that delays do no harm. Until regulators make a decision as to how stable value contracts are to be treated, stable value contracts do not count as swaps, and any stable value contracts issued prior to the study's conclusion will be grandfathered as such.

Kolocotronis reaffirmed that the SVIA position has been and remains that stable value contracts are not swaps. He also said the SVIA has suggested to regulators that Dodd-Frank may offer some clues to Congress' intent on this matter. "If you look at Dodd-Frank, although they (regulators) are required to do the study, there seems to be an indication of what Congress thought here," he said. "If Congress is willing to grandfather this entire set of contracts—basically every contract that exists today gets grandfathered—that seems to be an indication of some intent that should push them (regulators) in the direction of this not being a swap."

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Gary Ometer, chief financial officer for the Virginia College Savings Plan, noted that there have been no large, net, cash outflows from stable value investments in that $2.2 billion plan, where about 21 percent of the total assets are allocated to stable value investments. Most of that stable value money is in age-based target-date funds that progressively shift more of their money into stable value funds as the target date approaches, eventually reaching a 100 percent allocation. A contributing factor to the cash-flow stability in the fund, he said, is that the Internal Revenue Code allows investors in 529 plans to make only one change in investment direction per year.

Ometer noted that the Virginia College Savings Plan weathered the 2008-2009 market downturn well, continuing to post positive cash flows throughout. "These are definitely sticky deposits," he said. "People don't change investments often."

In addition to a 529 college savings plan, Virginia also operates a so-called "prepaid" 529 plan in which investors buy tuition credits rather than simply amass savings. Ometer said the cash flow and investment patterns of stable value investors in that fund have been similar to those of stable value investors in Virginia's 529 savings plan.

The Virginia plans eliminated money market funds from their roster of investment options in 2012, Ometer noted, in a bid to attract additional wrap capacity for their stable value funds.

In neighboring West Virginia, Hartford Life Insurance Co. administers the West Virginia Direct 529 plan. It also administers the Hartford SMART529 in that state and the SMART529 Select plan in Connecticut, both of which are sold nationally by registered investment advisors. Stable value funds are offered in the West Virginia plans. Jeff Coghan, assistant vice president with Hartford, said his company would like to offer stable value in the Connecticut fund, too, "if there was availability out there." Combined, he said, the three programs have about $1.8 billion in assets, including about $271 million in stable value funds.

Coghan said his company participates in the 529 market in part because the assets are so sticky. "Participants don't chase from fund to fund like they do in the more traditional mutual fund business," he said. "Inter-plan transfer activity is basically non-existent. It's that stability and predictability, that ability to serve as anchor to our fund business, which caused us to enter the business, and it's why we continue to be excited about it. We see a tremendous opportunity, not only in the growth of the market but in the stability of the assets. We need some more wrap providers, and I think those that get into the business will have a lot of opportunity to find their way into target-date portfolios and other structures that would be very appealing."

Two wrap providers already active in the business are ING Life Insurance and Annuity Co. and Aviva Investors.

Eric Hasenauer, managing director at Aviva Investors, said his firm decided to enter the 529 market as a wrap issuer about a year and a half ago. While acknowledging the similarities between 529 and 401(k) plans, he noted that some of the differences may actually be beneficial to stable value providers. In addition to limitations on changes in investment allocations, for example, 529 plans offer greater participant diversity, with individual plans often having tens of thousands of participants with relatively low account balances (about $17,000, on average, at the end of 2012, according to The College Savings Plans Network). There also are no corporate events to worry about and no pooled-fund considerations.

Among the potential risks of participating in 529 plans, Hasenauer said, are the potential for headline risk should a plan's operator run into hot water, the potential for a state to run into solvency issues, the ability of account owners to transfer funds to other qualified tuition plans, and the potential for new tax legislation that could establish a more popular college savings vehicle in the future. "Ultimately, he said, "we thought these were risks we could overcome."

ING Life and Annuity provides wrap contracts for four 529-plan stable value funds in Virginia, West Virginia, Rhode Island and Illinois, covering about $1 billion in assets. In addition, its sister company, ING Investment Management, serves as program director for the 529 plans in Wisconsin, Ohio and Iowa.

Tony Camp, vice president, ING Stable Value Products, explained how his firm created its 529-plan wrap contracts. It started with the base contract it uses for a synthetic GIC funding agreement in the defined contribution retirement-plan market, then eliminated provisions specific to that market and added in others specific to 529 plans. The vast majority of the contract's original provisions, however, remained intact. Areas that required customization pertained primarily to IRC code references and annuity provisions, benefit withdrawals, participant-directed transfers and contract termination. "It wasn't that big of a job," he said. "In fact, it was fairly straightforward"

For wrap providers considering entering the business, Camp advised paying attention to the quality and popularity of the 529 plan under consideration. He also suggested looking closely at states where the conservative investment option today is a money market fund. In his own informal survey of the marketplace, he said, he counted 27 states where the 529 plan was using money market funds. Those funds are currently yielding near zero percent, while the average stable value fund is offering a crediting rate of about two percent. After accounting for inflation, Camp said, investors are losing money in money market funds. That should make stable value funds attractive to 529 plans currently offering money market funds as their conservative investment option.