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

By Randy Myers

When Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, it tasked the Securities & Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC) with conducting a study of stable value contracts. The goal was to determine whether stable value contracts should be treated as over-the-counter derivatives contracts—what Dodd-Frank calls swaps—under the legislation, making them subject to additional regulation and oversight. At the time of the law's passage, there was concern that the statute's definition of a swap was so broad that it might encompass products, most prominently stable value contracts, that many policymakers felt were never intended to be subject to the law.

Of the two regulatory bodies, the CFTC has been taking the lead in the study, while the SEC has been addressing more pressing imperatives imposed by Dodd-Frank. Recently, the SEC asked some wrap issuers to provide examples of their contracts for the study, suggesting that the Commissions may be devoting more time to the stable value study in the months ahead.

Regulators have three options for how to handle stable value contracts. They can rule that the contracts do qualify as swaps and are subject to Dodd-Frank regulation. They can rule that they do not qualify, and are not subject to regulation. Or they can determine that stable value

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Washington has also been the source of some good news lately, Davidson noted, even if it has gone little noticed. The federal deficit, for example, has been shrinking at a rapid pace relative to the size of the economy. It stood at about 10 percent of GDP in 2009, but should be only about 3 percent of GDP by 2015, Davidson said. Congress and the White House showed some surprising harmony in getting things done in the first quarter, raising the federal debt limit and making sure that the federal government did not shut down.

Goldman Sachs Asset Management is projecting that the economy will grow approximately 2.3 percent this year, Davidson said, although potential pitfalls abound. Key risks include the possibility that the federal government will tighten fiscal and/or monetary policy prematurely or excessively, and that Europe's sovereign debt woes might flare anew. The Euro zone economies are already weak, Davidson said, and GDP there could fall by around 3 percent this year.

Looking to Asia, China is a concern as well. Its economy grew approximately 10 percent annually for the past decade, but the consensus is that it will grow only around 7 percent a year for the next decade, Davidson said. Even that is dependent in part on the country being able to drive consumer spending without excessive reliance on credit.

Closer to home, the U.S. economy faces headwinds, Davidson conceded, including the sequestration spending cuts that began to take effect earlier this year. They will be negative for the economy, she said, but also temporary and manageable, as will recent income tax increases. Meanwhile, she said, improved corporate profit margins should help to offset those negatives. She noted that rising profit margins preceded investment growth during the last two business cycles.

Davidson said interest rates are likely to remain low over the next 12 months, with the yield on the 10-year Treasury bond possibly climbing to 2.5 percent, up from about 1.7 percent in mid-April. Guidance from the Federal Reserve, which has vowed to keep interest rates low until unemployment falls to 6.5 percent, suggests that interest rates may not start to rise in earnest until the 2015-2016 time frame. Inflation, Davidson added, is likely to remain below 2.0 percent through 2015, although the risk that it might unexpectedly accelerate has picked up. Here again, the concern is that the Fed might misread signs of falling unemployment and tighten monetary policy too soon. Alternatively, some geopolitical event could cause commodity prices to spike, which typically spurs inflation.

In light of her firm's economic outlook, Davidson said Goldman Sachs Asset Management in mid-April considered equity valuations "still somewhat attractive," even if they were less attractive in both the U.S. and Europe, due to recent rallies, than they had been several months earlier. "We expect equity markets to be quite strong," she said. Davidson added that her firm was recommending an overweighting in Japanese equities in the wake of the Bank of Japan's recently announced plan to double the country's monetary base.

In the credit markets, Davidson said, strong corporate balance sheets suggest that defaults should remain low. In mid-April, her firm considered high-yield bonds more attractive than either investment-grade corporate debt or emerging markets debt. The firm also saw less risk in shorter-duration assets than in longer-duration assets. "Relative to other asset classes," she said, "muted returns can be expected from emerging markets debt, corporate credit, and government bonds, given their current low yields and potential for rising rates."

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well as a weakened European economy. All this suggests, he said, that we can expect the recovery from the 2008 crisis to continue to proceed at a slow pace, keeping downward pressure on interest rates and inflation for the next few years. While real GDP growth should be 2.4 percent, he said, it is more likely to be in the 1.5 percent to 2 percent range.

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

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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." SVIA