AUGUST 2021

PBGC REQUEST FOR COMMENT

PENSION BENEFIT GUARANTY CORPORATION, SPECIAL FINANCIAL ASSISTANCE BY PBGC, RIN 1212-AB53

ON JULY 9, 2021, THE PENSION BENEFIT GUARANTY CORPORATION (PBGC) ANNOUNCED ITS INTERIM FINAL RULING ON THE BUTCH LEWIS ACT. IT INCLUDED REQUESTS FOR COMMENT ON CERTAIN ASPECTS. THIS DOCUMENT PROVIDES INSIGHT INVESTMENT'S FEEDBACK.

INSIGHT INVESTMENT'S COMMENTS ON ELIGIBLE ASSETS FOR THE SPECIAL FINANCIAL ASSISTANCE (SFA)

Extract from interim final ruling

"PBGC is interested in understanding the potential benefits and risks of investing SFA assets in other vehicles that are or have the nature of fixed income. These might include synthetic replications of fixed income securities, insurance contracts, hybrid securities, preferred stock or other vehicles. In this regard, the following questions are of interest:

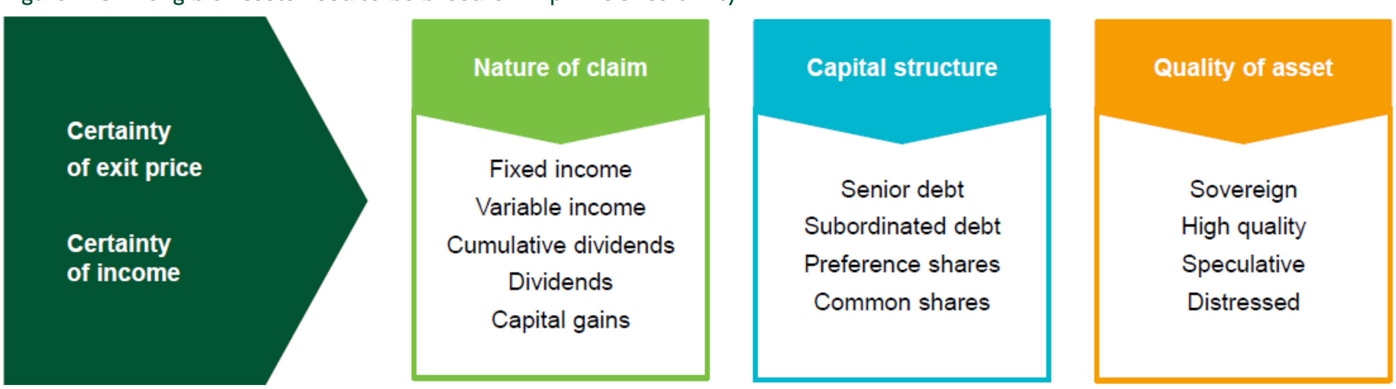
- What are the advantages of investing in such vehicles, relative to a portfolio of investment grade fixed income, in terms of expected returns, reduced risk or other improved outcomes?
- What are the disadvantages of investing in such vehicles relative to a portfolio of investment grade fixed income, including lower returns, higher risk, inequitable outcomes amongst participants or other issues?
- What are the implementation and management costs of investing in such vehicles?
- Which organizations are qualified to manage and advise on these vehicles?
- Can the vehicles, as they might be used in multiemployer plan portfolios or in the pool of SFA assets, be clearly defined and easily used?"

Upholding the spirt of the Butch Lewis Act

Our interpretation of the spirit of the Butch Lewis Act is to ensure that struggling multi-employer plans are protected against immediate plan insolvency, deliver near-term promised benefits with the highest level of certainty and avoid an intergenerational transfer of risk to younger plan participants.

We believe that assets deemed appropriate for SFA allocations need to rank highly on what we call the 'pillars of certainty' (Figure 1).

Figure 1: SFA-eligible assets need to be based on a 'pillars of certainty'[1]



In our view, there are three pillars to consider. Asset returns that are contractual in nature rather than based on undefined future capital gains (i.e., 'fixed income-like' rather than 'equity-like') offer greater certainty. Certainty can be improved further by credit quality and the strength of the legal claim (e.g., seniority in the capital structure and/ or security against underlying collateral).

[1] For illustrative purposes only

We believe that the goal for SFA allocations should be to encourage plans to invest in higher-certainty assets while maximizing returns and generating adequate diversification. In Figure 2 we evaluate several potential asset classes for SFA suitability.

Figure 2: Advantages and disadvantages of asset classes for SFA allocations[2]

	Advantages	Disadvantages	Comment
Publicly traded investment grade bonds	Relatively high-certainty liquid and transparent instruments	Low yields, particularly relative to discount rate used to determine SFA assistance	We believe it is correct that publicly traded investment grade bonds form the backbone of SFA allocations
Insurance contracts	High certainty	Expensive	We believe investment grade structured credit investments are a more efficient solution to yield enhancement
Synthetic replications of fixed income assets	Can improve returns if employed to generate capital efficient exposures	Incompatible with SFA rules forbidding leverage	We believe synthetic instruments and leverage should be allowed for risk management purposes
Non-publicly traded investment grade bonds	Potential to capture 'illiquidity premium'	Lower liquidity can impair 'mark-to-market' returns during periods of market stress	Suggest removing the limit that bonds be 'publicly traded' to provide greater possibility for plans to target illiquidity premia
High yield bonds	Wider spreads, relatively large 'fallen angels' universe offers exposure to large household names with investment grade-style capital structures and potential upside of return to investment grade	Additional credit risk means lower certainty.	We believe high yield bonds should be allowed but constrained to a small allocation (such as 10-20%), subject to quality allocation restrictions
Non-US bonds and emerging market debt	May offer tactical or strategic relative value vs US bonds	Additional country and currency risk	We suggest allowing plans to hold non-US dollar denominated bonds provided they appropriately hedge interest rate and currency risks back to US dollars
Hybrid securities / preferred stock	Potential for yield enhancement, contractual returns	Lower certainty given low capital structure rank and potential to convert to equity at benefit of the issuer.	If allowed, we suggest allocations to hybrid securities should be constrained (e.g., 5%).
Structured credit	Additional premium reflecting complexity and illiquidity, rather than credit risk	Requires specialist investment capability	We suggest investment grade structured credit is appropriate as SFA assets given

[2] For illustrative purposes only

			potential benefits for cashflow matching and yield enhancement
Private debt	Potential for higher returns than public structured credit and corporate bonds, more carefully structured security and collateral packages	Higher risk and cost, fiduciaries may need education to be fully comfortable with allocations	We suggest that investment grade private debt should be eligible within restrictions given potential for yield enhancement. We believe that sub-investment grade private credit should not be allowed given typically high leverage and material default risks.
Alternatives	Potential for diversification and higher returns	Higher cost, lower certainty higher volatility of returns	We suggest that alternatives are generally **unsuitable** for SFA allocations and more appropriate for non-SFA assets
Equities	Potential for higher returns	Low certainty of returns, higher volatility, bottom of the capital structure in the event of distress	We believe equities are generally **unsuitable** for SFA allocations and more appropriate for non-SFA assets. However, if implemented, we believe they should be paired with 'downside protection' strategies (e.g. long equity + put options or zero-coupon bond + call options)

INSIGHT INVESTMENT'S COMMENTS ON NON-FIXED INCOME ASSETS

Extract from interim final ruling

"Should permissible investments of SFA assets be limited to fixed income securities? For instance, should the rule permit investment of a percentage of SFA assets in certain stock ETFs or mutual funds that have investment profiles that are not materially riskier than fixed income-based investment grade securities?"

We believe that non-fixed income securities, such as equities, are generally inappropriate for investment within SFA portfolios. This is in line with our view that SFA allocations need to rank high across the 'pillars of certainty' (Figure 1), to ensure the spirit and intent of the Butch Lewis Act is preserved.

In the case that equities or other 'equity-like' risk assets are granted eligibility within SFA portfolios, we believe that plans should be required to implement downside equity protection strategies to reclaim a measure of certainty. This will, however, require the eligibility of derivatives for risk management without the current restrictions around leverage.

We do see the appeal of adding equities and do believe that they have a role in a plan's overall asset allocation. Historical negative correlations between fixed income and 'growth' assets indicate that a portfolio allocated 100% to fixed income will be less efficient than a portfolio with even a small amount of growth assets. As such, 'growth' assets would be appropriate for non-SFA allocations.

However, for plans with little-to-no non-SFA assets, it may therefore be appropriate to allow the plan a tightly constrained allocation to such 'growth' assets. In such an instance, it would be particularly important for plans to apply 'downside protection' strategies against the plan's equity exposure and additional securities to require some level of risk management.

If the PBGC permits 'growth' assets in order to generate higher required returns, we believe that periodic tests relating to liquidity and other metrics tests may be advisable. It is crucial that plans are rigorous in risk management, particularly liquidity risks to ensure the integrity of the SFA consistent with the long-term funding objective.

Extract from interim final ruling

"What is the appropriate amount of SFA assets that may be permitted to be invested in non-investment grade securities?"

We suggest allowing for 10-20% of fixed income to be held in non-investment grade securities. This would help to balance the need to generate incremental returns with excessive credit risk.

This would also allow for investors to mitigate some of the credit migration risk that is unavoidable when investing in quality-based benchmarks. Historically, being a forced seller of fallen angels has led to a negative performance impact and allowing plans to hold on to some amount of fallen angels may be prudent.

Further, asset classes such as high yield and structured credit are generally shorter duration risk than investment grade credit, particularly following the start of the pandemic as many investment grade corporates extended their debt maturity profiles. This would allow for additional ability to mitigate long duration risks and would be consistent with the underlying fixed income mix for a cashflow-aware investment solution.

We also suggest constraints around the quality of non-investment grade bonds permitted, for example (i) requiring an average credit quality for below-investment grade assets of BB or (ii) placing a limit on Single B or C-rated bonds.

Extract from interim final ruling

"What is the proper relationship to restrictions on SFA asset investments to other plan asset allocations?"

Given the high discount rates that most plans will be using relative to market yields, many plans will likely re-risk their non-SFA assets.

Therefore, we do not believe that there should be cumbersome restrictions placed on non-SFA assets, and plan fiduciaries should consider both SFA and non-SFA assets to develop a prudent and well-diversified investment strategy.

Most likely, plans in "critical or declining status" that qualify for SFA grants are 'poorly funded'. Thus, SFA assets will potentially comprise the majority of the plans' assets. The PBGC should be careful to avoid placing restrictions on existing investments that trigger 'forced selling' (e.g., having to sell investments to raise cash to pay benefits, which is exacerbated during periods of 'market stress' (e.g., Global Financial Crisis, Covid-19 pandemic outbreak) and potentially crystallizing losses unnecessarily. As SFA assets are depleted we believe non-SFA assets should be allocated to address benefits payments with explicit allocation to high certainty, cash-flow matched, income-generating assets.

INSIGHT INVESTMENT'S COMMENTS ON REQUIREMENT FOR PLANS TO RETAIN A YEAR OF LIQUIDITY IN INVESTMENT GRADE FIXED INCOME ASSETS

Extract from interim final ruling

"PBGC encourages interested parties to respond, and provide supporting data, to the following questions:

- Will the requirement to maintain 1 year (or until the date the plan is projected to become insolvent, if earlier) of benefit payments and administrative expenses in investment grade fixed income assets result in an allocation that is significantly different from the allocation that the plan's investment policy (after receiving SFA) would otherwise attain?"

We do not believe the requirement to hold one year of benefit payments and expenses in investment grade fixed income assets will result in a significant difference in the overall investment allocation.

In our view, however, the rule is not prudent enough. We believe plan sponsors need to consider securing more years of cash outflows (between 1 to 5 years for example) in order to protect benefits for current participants. Market downturns can persist for multiple years, requiring more years of cashflow matching to prevent inopportune 'forced selling' of investments to raise liquidity to meet obligations.

Extract from interim final ruling

- "What are the advantages and disadvantages of PBGC not imposing any conditions under section 4262(m) of ERISA on asset allocation compared to the proposed condition requiring 1 year (or until the date the plan is projected to become insolvent, if earlier) of benefit payments and administrative expenses in investment grade fixed income?"

In our view, advantages of imposing no conditions include preserving the freedom of plans to set risk and reward targets based on the combined non-SFA and SFA assets available. This may result in plans seeking higher returns through larger growth allocations (e.g., equities). The disadvantage of course is that this could result in plans assuming higher risks, increasing the possibility of the SFA assets not meeting the intended objective for the plans and resulting in a larger probability of plans falling into insolvency and therefore requiring some additional form of SFA in the future.

Extract for interim final ruling

- "Could an alternative condition, or modification of the condition under § 4262.16(c), better achieve the objective of preventing excessive risk-taking by plans while allowing plans to meet their investment objectives?"

We believe that excessive risk-taking may be better prevented by requiring that the plan pass some liquidity tests (e.g., between 1 to 5 years in high certainty cashflow matched, income-generating assets) and/or comply with maximum risk thresholds for the overall trust. Requiring more than one year of cash flow matched assets may also prevent 'runs on the assets' and ensure that benefits are being paid consistently with the objective of the SFA assets.

THREE ADDITIONAL REQUESTS FOR PBGC CLARIFICATION

Incorporating derivatives for risk management

Extract from interim final ruling

"…the regulation permits investment in vehicles allowing for [derivatives] so long as any derivative or leveraging strategy does not increase the interest rate risk or credit risk of the investments beyond the risk in a similar portfolio of physical securities (i.e., non-derivative securities) with the same market value."

Given the confirmed SFA-eligible assets (subject to further comment and PBGC update) offer relatively low returns relative to the discount rate, we believe the rules around synthetic instruments are overly restrictive.

We understand the PBGC's concerns around risk-taking. We believe that derivatives should be allowed with greater scope for plans to manage risks such as interest rate, yield curve, credit, equity and currency risks even if it leads to leverage from an asset-only perspective. Additionally, many of the structured credit and esoteric fixed income markets that offer higher return potential typically pay floating rate coupons. Derivative overlays allow investors to convert these floating rate bonds to the desired duration profile. We believe derivatives should not be allowed for leveraged speculation purposes.

Clarification on benefits of liability and cashflow-aware investing

Extract from interim final ruling

[Under benchmark assumption that: "All plans that receive SFA utilize an LDI strategy to match assets to benefit payments"] "Plans required to invest all available plan assets in high quality fixed income securities are expected to attain lower investment returns, which accelerates plan insolvencies."

We propose that the PBGC clarifies that liability-driven and cashflow-driven investing, while not feasible for an entire SFA portfolio, can potentially offer benefits within an SFA allocation. We believe the approaches are consistent with the objective of the SFA and can help deliver greater certainty for multi-employer plans that require assistance.

Clarification on harvesting 'illiquidity premia'

Extract from interim final ruling

"The interim final rule provides plans that receive SFA with the opportunity to invest in a portfolio that can benefit from risk and illiquidity premiums over the long-term investment horizon. This flexibility to invest in other assets is likely to extend the solvency of these plans, and the limit on that flexibility will only constrain plans that would otherwise accept an inappropriate level of risk after receiving taxpayer assistance."

We strongly agree that certain assets that offer an 'illiquidity premium' can help improve returns in SFA portfolios, particularly for cashflow-aware investors. However, the current eligible assets are limited to publicly traded investment grade corporate bonds and other assets. These are assets that tend to offer little 'illiquidity premia'.

We suggest removing the requirement for bonds to be publicly traded and that the PBGC considers allowing private debt assets (particularly high-quality private structured credit assets) which can potentially offer compelling premia for lower liquidity.

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