# 2022 NCCMP Annual Conference

9/19/2022

# Strategies for Investment of SFA Assets under PBGC's Final Rule

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# 2022 NCCMP Annual Conference

## Strategies for Investment of SFA Assets under PBGC's Final Rule:

## *Summary of Changes in the Final Rule*

**September 19, 2022**

**David Pazamickas, ASA, EA**

# Overview

## American Rescue Plan Act of 2021 (“ARPA”)

- Enacted on March 11, 2021
- Created Special Financial Assistance (“SFA”) Program

## Pension Benefit Guaranty Corporation (“PBGC”) SFA Regulations

- ***Interim Final Rule (“IFR”)***
  - Published on July 9, 2021 and effective on July 12, 2021
- ***Final Rule***
  - Published on July 8, 2022 and effective on August 8, 2022

### Disclaimer

*This presentation includes a summary of the presenter’s understanding of significant changes from the interim final rule to the final rule and does not represent a complete summary of the final rule.*

*In addition, this presentation is provided for informational purposes only does not represent legal, tax, or other professional advice.*

*Further, the opinions expressed in this presentation are those of the presenter and do not necessarily reflect the views or positions of Horizon Actuarial Services, LLC.*

# Changes from IFR to Final Rule

## Disconnect between Interest Rate and Investment Return Expectations

| | IFR | Final Rule |
|---|---|---|
| **Interest Rate Assumption[1]** | Lesser of interest rate used in a plan's 2020 zone status certification[2] and the 3rd segment rate[3] plus 200 basis points (currently near 5.5%) | Lesser of interest rate used in a plan's 2020 zone status certification[2] and:<br>• Non-SFA Interest Rate: the 3rd segment rate[3] plus 200 basis points (currently near 5.5%)<br>• SFA Interest Rate: *average of the 1st, 2nd, and 3rd segment rates[3] plus 67 basis points (currently near 3.3%)* |
| **SFA Permissible Investments** | 100% of SFA assets must be invested in U.S. investment grade bonds | *At least 67% of* SFA assets must be invested in U.S. investment grade bonds<br><br>*Up to 33% of SFA assets may be invested in return seeking assets (e.g., U.S. equities)* |

1. For purposes of determining the amount of SFA
2. Plan's latest zone certification filed prior to January 1, 2021
3. Segment rates are the 24-month average of high-quality corporate bond rates for bonds with a maturity of less than 5 years (1st segment rate), at least 5 years and less than 20 years (2nd segment rate), and 20 years or more (3rd segment rate). Based on the segment rates as of the month of the plan's initial application date, if published by such date, or the prior three months.

# Changes from IFR to Final Rule

## MPRA Plans[1]

| | IFR | Final Rule |
|---|---|---|
| **Methodology for Determining Amount of SFA for MPRA Plans** | **Basic Method:** SFA calculated the same way as a non-MPRA plan[2] | **Basic Method:** SFA calculated the same way as a non-MPRA plan[2]<br><br>**Increasing Assets Method:** Minimum amount of SFA needed to project rising plan assets starting in 2051<br><br>**Present Value Method:** Present value of retroactive and prospective reinstated benefits payable through 2051 using the SFA interest rate |

1. Plans that received approval for a suspension of benefits under the Multiemployer Pension Reform Act of 2014 as of March 11, 2021
2. Reflects reinstatement of retroactive and prospective benefit suspensions

# Changes from IFR to Final Rule

## Withdrawal Liability

| | IFR | Final Rule |
|---|---|---|
| **Interest Rate** | • Plans must use interest rates required for mass withdrawal liability[1] (currently 2.75% to 3.00%) when determining unfunded vested benefits ("UVBs")<br>• Required for 10 years following receipt of SFA or, if later, when the plan exhausts its SFA assets | • Plans must use interest rates required for mass withdrawal liability[1] (currently 2.75% to 3.00%) when determining UVBs<br>• Required for 10 years following receipt of SFA or, if later, when the plan *is initially projected*[2] *to* exhaust its SFA assets |
| **Assets** | • SFA is included in assets when determining UVBs for measurement dates following the plan's receipt of SFA<br>• SFA is recognized fully and immediately | • SFA is included in assets when determining UVBs for measurement dates following the plan's receipt of SFA<br>• *SFA is phased in over the period that the plan is initially projected to maintain SFA assets*[2,3] |

1. Interest rates used to value benefits in Appendix B to 29 CFR Part 4044
2. Assuming SFA assets are used to pay benefits and expenses before non-SFA assets
3. PBGC requested comments on this provision by August 8, 2022

# Supplemented Application

***Application Filing Date***

| *Application filed under IFR* | *before* **August 8, 2022** *on or after* | *Application filed under Final Rule* |
|---|---|---|

## Supplemented Application

Plans that received approval for SFA based on an application filed under the IFR must file a Supplemented Application to reflect certain changes under the Final Rule:

- Updated calculation of SFA
- Additional permissible investments (effective upon filing)
- SFA phase in for withdrawal liability purposes (effective upon filing)

# Lock-in Application

## Lock-in Application *(new under the Final Rule)*

- ***Treated as a plan's initial SFA application, which "locks-in" a plan's:***
  - SFA measurement date,
  - Interest rate assumptions, and
  - Census data
- ***Filing prior to March 11, 2023***
  - Limited to eligible plans in priority group 5, priority group 6, or other priority groups PBGC may designate in the future
  - May only be filed during periods when PBGC has temporarily closed the filing portal
- ***Filing on or after March 11, 2023 and prior to December 31, 2025***
  - May be filed by any eligible plan
  - Not limited to periods when PBGC has temporarily closed the filing portal

# Changes from IFR to Final Rule

## Other Notable Changes

| Other Notable Changes |
|---|

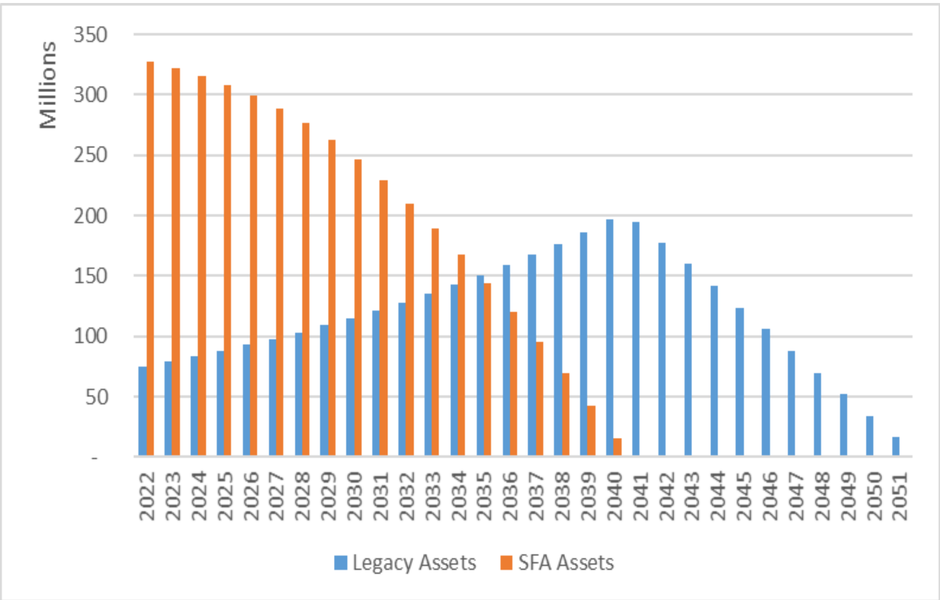
- ***Projected Contributions***
  - Exclude contribution rate increases agreed to on or after July 9, 2021
- ***Benefit Improvements***
  - New exception for limitation on retroactive and prospective benefit improvements
  - Must demonstrate to PBGC that the plan will remain solvent following improvement
  - May apply for exception as early as 10 plan years following receipt of SFA
- ***Plan Mergers***
  - Plans that receive SFA must request PBGC approval before engaging in a merger
  - Some, but not all, SFA conditions and restrictions apply to merged plan
  - PBGC clarifications show willingness to remove unnecessary impediments to plan mergers that would be beneficial to plans and plan participants

# PBGC Final Rule: Investments

- Special Financial Assistance (SFA) assets must be held separately from existing Plan assets.
- Up to 33% of SFA assets may be invested in return seeking assets. Generally, must be invested in publicly traded assets on liquid markets.
- Remaining 67% of SFA assets must be invested in investment grade fixed income.
- Plan is required to submit annual statement of compliance at purchase and at least once in every rolling period of 12 consecutive months, AND
- Permissible investments, whether through fund vehicles or directly through a portfolio of individual securities, may not be supplemented by derivatives, or leveraged in a way that could increase the interest rate risk or credit risk in the fund vehicle or portfolio beyond the risk in a portfolio of physical securities. Any notional derivative exposure, other than exposure gained through a permissible fund vehicle, must be supported by liquid assets that are cash or cash equivalents denominated in U.S. dollars.
- During the SFA coverage period, Plan Assets, including special financial assistance, must be invested in cash or short-term investments sufficient to pay for at least one year (or until the date the Plan is projected to become insolvent, if earlier) of projected benefit payments and administrative expenses.
- Use of two separate interest rates for SFA and non-SFA assets.

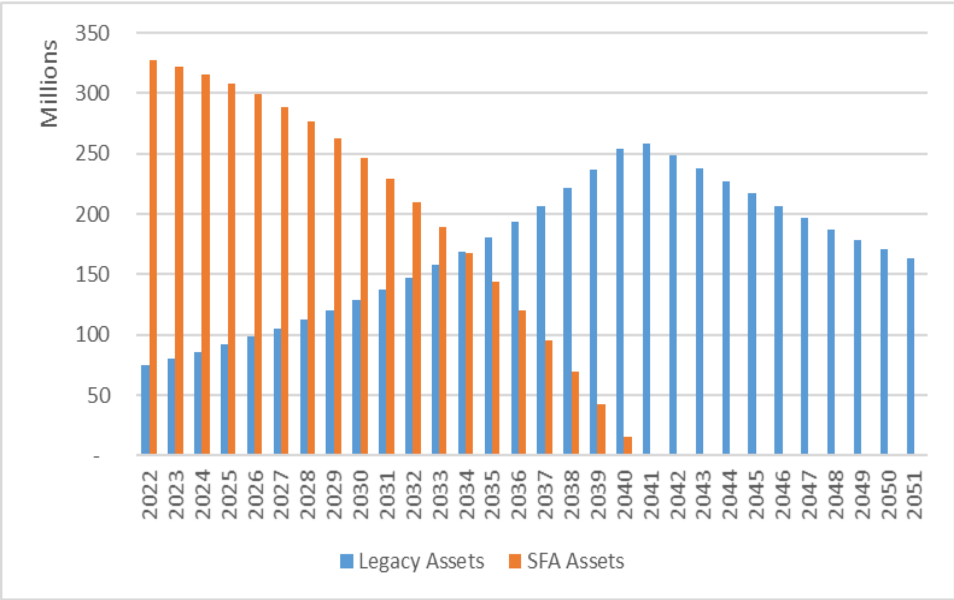
# Final Rule Improves Success of SFA Plan and Potentially Legacy Plan

- The SFA Amount is now calculated at $327m, using a *separate interest assumption for Legacy assets and SFA assets*




- The SFA amount of $327m SFA amount would see the plan run out of money right after making the 2051 benefit payment -- assuming the Legacy Assets earn 5.5% annually and the SFA assets earn 3.0% annually

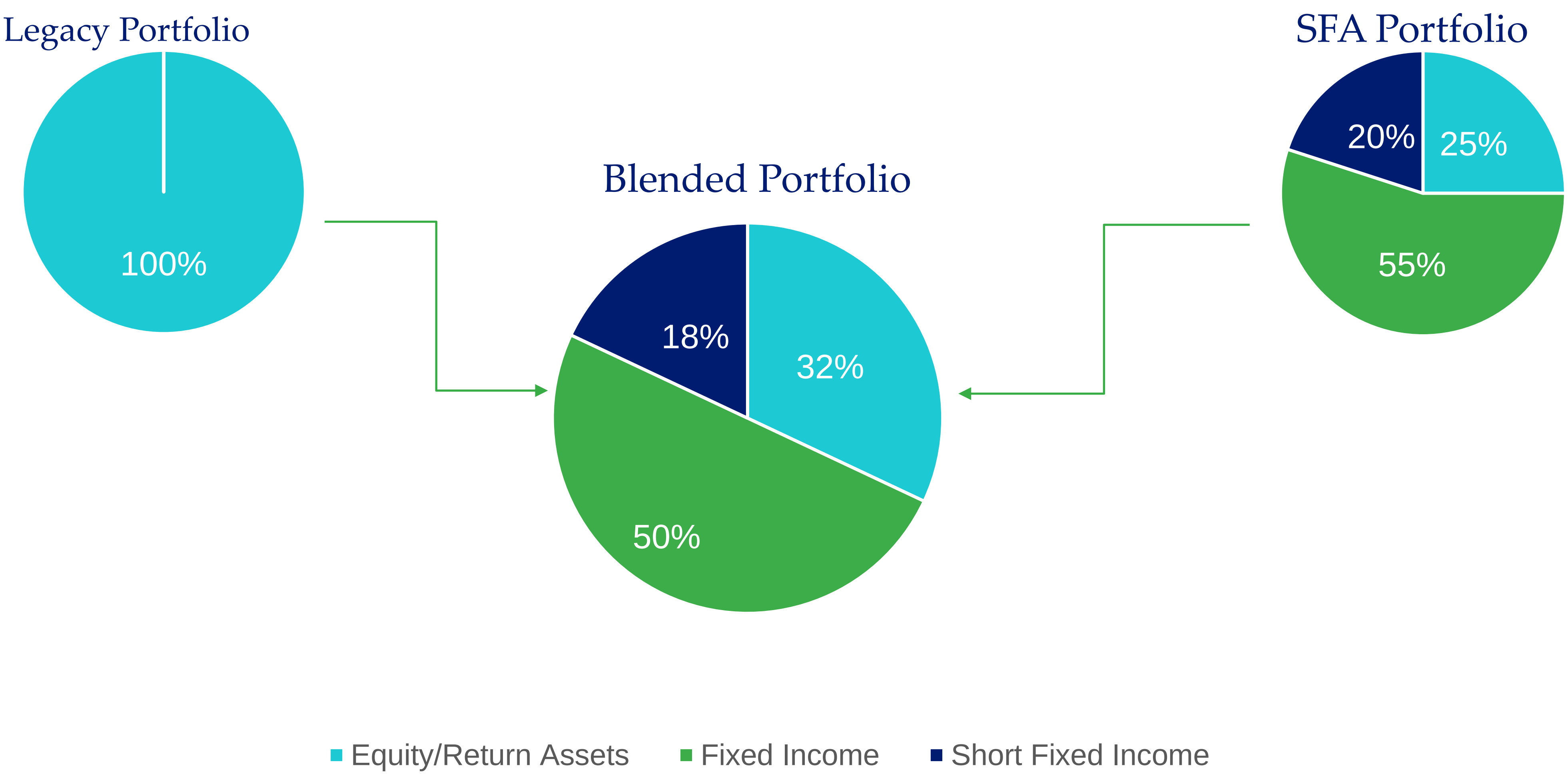
- If the Legacy Assets are expected to earn 7.0% annually, the plan would be expected to remain solvent well past 2051




- SFA assets are still assumed to earn 3.0% annually because they are invested exclusively in bonds (note: the final rule does permit SFA investments other than bonds, this chart assumes they are invested exclusively in bonds)

# Holistic and Customized Approach to Both Parts of the Plan

- Interaction of the asset allocation/cash flows of each piece of the Plan is critical to success



# Trustee Considerations

- Sizing of the SFA assets versus the Non-SFA assets
- Risk tolerance: maximization of both the SFA and the Legacy assets to provide benefits to 2051 and beyond
- Asset Allocation considerations for SFA and Non-SFA portfolios
  - Cash needs/liquidity management
  - Risk tolerance for both plans
  - Surplus management and/or glide path
- Separate account versus commingled funds
- Active management versus passive management
- Investment Policy Statements: SFA, return seeking assets, fixed income assets AND Legacy Assets updated
- Compliance with yearly and/or purchase considerations

# Investment Strategy: Components for Success

### Ongoing Monitoring

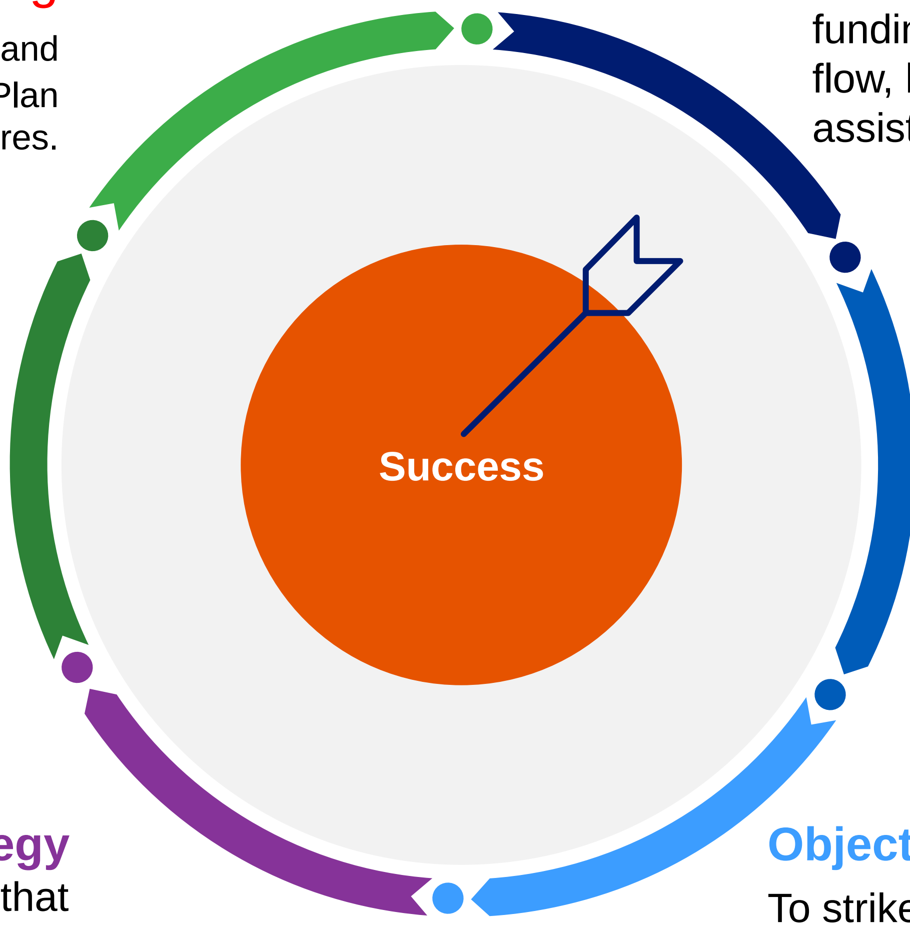
planning, and reporting is key to long term success, including ongoing monitoring implementation and exploration of a glide path as the Plan matures.

### Philosophy

Each multiemployer pension plan has its own characteristics – funding level, demographics, cash flow, liquidity, size of financial assistance, etc.

### Asset Allocation and Implementation

To manage the overall portfolio (combined SFA and Legacy), the Fund's risk and liquidity profile and determine the role of existing and/or new managers and cost.




### Approach

Need to develop an investment solution that is customized, given current limitations on permissible assets for SFA, and holistic in its attention to assets and liabilities

### Strategy

To structure a SFA portfolio that is focused on benefit driven investing and a Legacy portfolio that invests in return generating assets.

### Objectives

To strike the proper balance between meeting the needs to pay benefit obligations and building long-term financial security.

**Martin Jaugietis**
Managing Director, Multi Asset Strategies and Solutions

September 19, 2022

BlackRock®

# Will your total SAA make sense at all times?

## Implementation issues created by the need to keep non-SFA vs SFA assets separate

# The need to keep non-SFA vs SFA assets separate

- **The PBGC Final Rule, as described in § 4262.14(a), dictates that SFA assets and earnings on those assets must be held separately from other plan assets**
- **SFA assets may be used before other plan assets are used to make benefit payments and pay administrative expenses**
- **Within SFA assets, the PBGC is allowing up to 33% of SFA assets to be invested in return-seeking assets (RSA), but from an implementation perspective it acknowledges:**
  - Does not mean RSA are no greater than 33% on each and every day;
  - Portfolio allocations naturally get out of balance due to cash flow and as prices of investments fluctuate over time, so the percentage of SFA funds in RSA could at times be greater than 33 percent;
  - The 33% limit need only be met at time of purchase and at least one day during any rolling 12-month period.

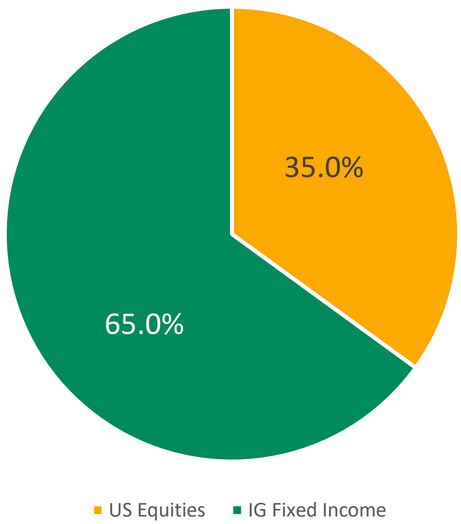
**Does the need to keep non-SFA vs SFA assets separate create problems in keeping the total Strategic Asset Allocation (SAA) on target?**

# Sample portfolio with the same SAA, but two different non-SFA vs SFA set-ups

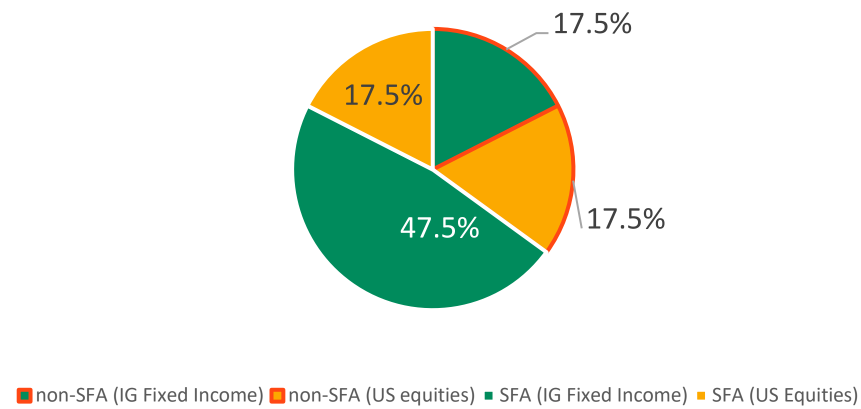
## Sample Portfolio Parameters on Day 1

- Assets = $1bn
- Non-SFA = 35%
- SFA = 65%
- Monthly benefit payments = $4.17m
- Rebalancing frequency = monthly

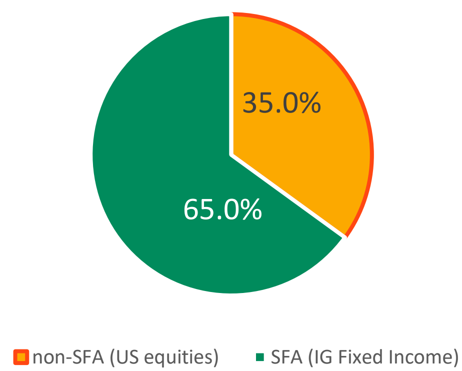
## Total SAA by Asset Class




## Day 1 Total SAA – common holdings between non-SFA vs SFA



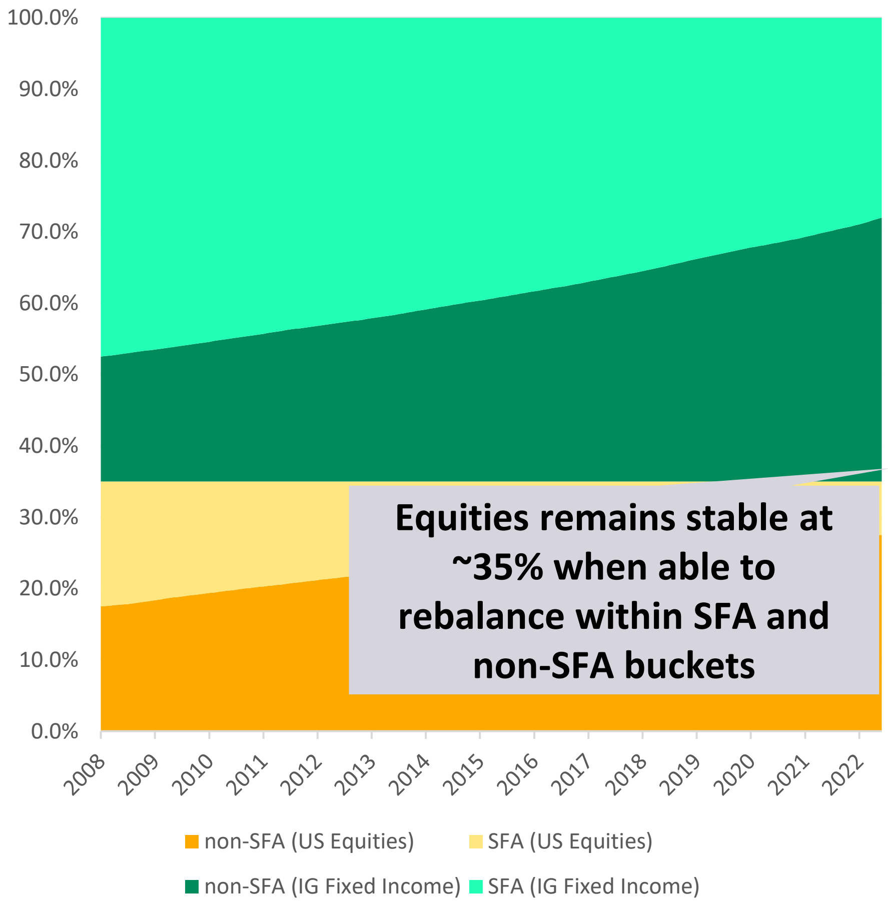

## Day 1 Total SAA – distinct holdings between non-SFA vs SFA



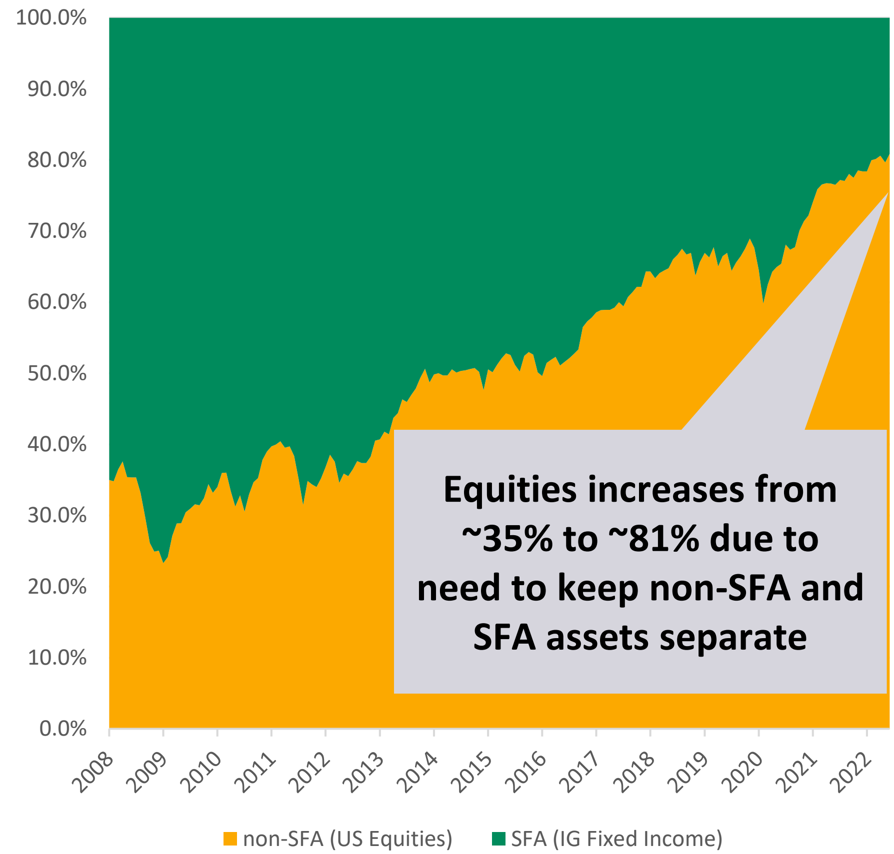

Source: BlackRock, for illustrative purposes only. US equities is assumed to be returns on the Russell 3000 Index, IG Fixed Income is assumed to be returns on the Bloomberg Barclays Long Government Index. Past performance is no guarantee of future results.

# Evolution of SAA if assuming common vs distinct holdings between non-SFA and SFA assets

## Evolution of Total SAA – <u>common holdings</u> between non-SFA vs SFA




## Evolution of Total SAA – <u>distinct holdings</u> between non-SFA vs SFA




Source: BlackRock for illustrative purposes only. The 'Evolution of Total SAA – <u>common</u> holdings between non-SFA and SFA' is a historical analysis of asset allocation weights using the sample portfolio shown on page 3 using historical monthly returns from 2/29/08 to 8/31/22 assuming rebalancing to total SAA policy targets at each month end using both SFA and non-SFA assets to achieve those targets, and benefit payments are paid from SFA assets only. The 'Evolution of Total SAA – <u>distinct</u> holdings between non-SFA and SFA' is a historical analysis of the same sample portfolio shown on page 3 using historical monthly returns from 2/29/08 to 8/31/22, but assumes the plan is unable to rebalance between equities and IG fixed income because both are held in non-SFA and SFA buckets respectively so cannot be commingled, benefit payments are paid from SFA assets only. Past performance is no guarantee of future results.

# Steps to ensure your total SAA makes sense at all times

Total SAA is the primary determinant of Solvency Ratio outcomes

Annual review of SAA, including common holdings between non-SFA and SFA, is warranted

Establish protocols to monitor and adjust for both 33% limit on RSA assets in SFA, and total SAA vs policy

Subject to change

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# Invesco Investment Solutions

## Strategies for Investment of SFA Assets

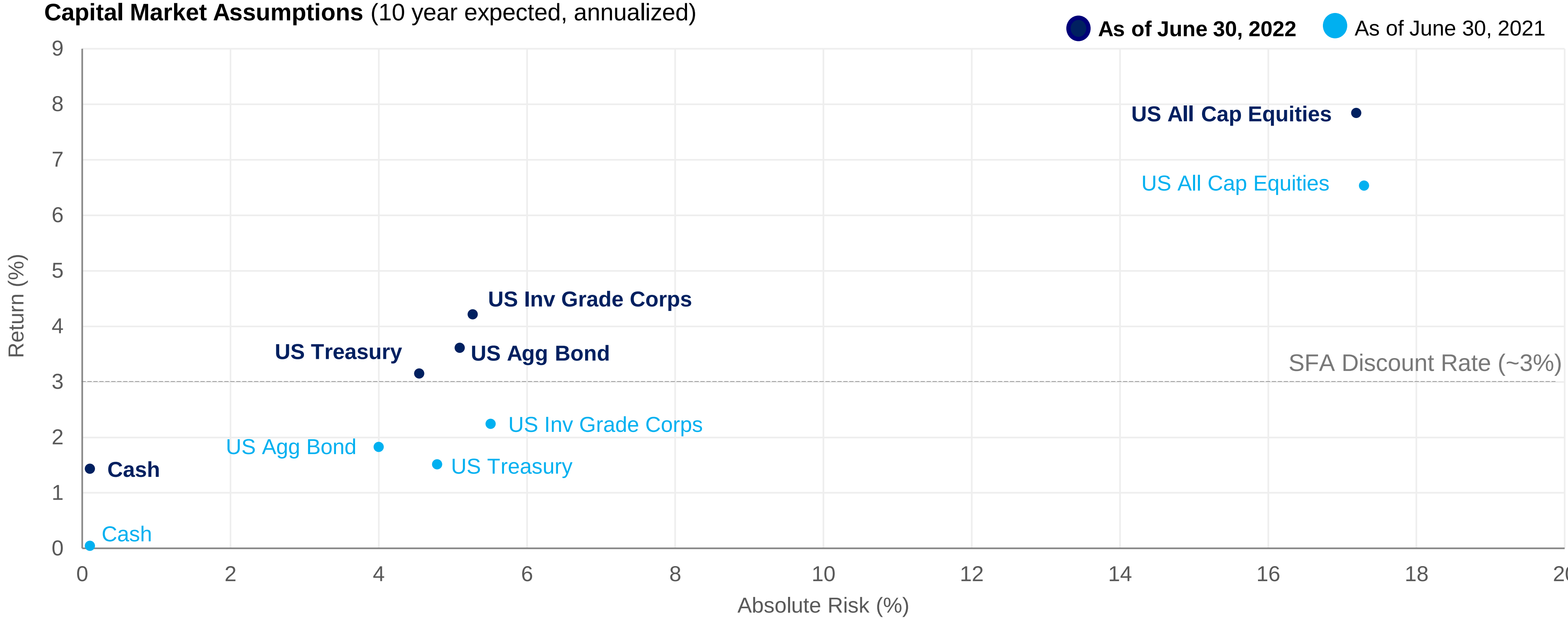
September 19, 2022

# Today's return landscape can potentially alleviate pressure on SFA allocations

## Capital market assumptions indicate assets may not need to reach as far for return

**Expected returns for SFA permissible investments**
Yields have nearly doubled as monetary policy tightens and inflation runs hot

**Capital Market Assumptions** (10 year expected, annualized)




Source: Invesco Investment Solutions. Capital Market Assumption estimated return and risk information is forward looking. These are not guarantees and involve risks, uncertainties and assumptions. These CMAs provide broad guidelines for asset allocation and are not used to predict market performance. Capital market assumptions reflect the current yield for fixed income/cash and total return (price + income) for equity. SFA discount rate is based on the lowest average of the last four months' first, second and third segment rates + 67bps, per the IRS website and SFA Final rule. See disclosures section for additional information.

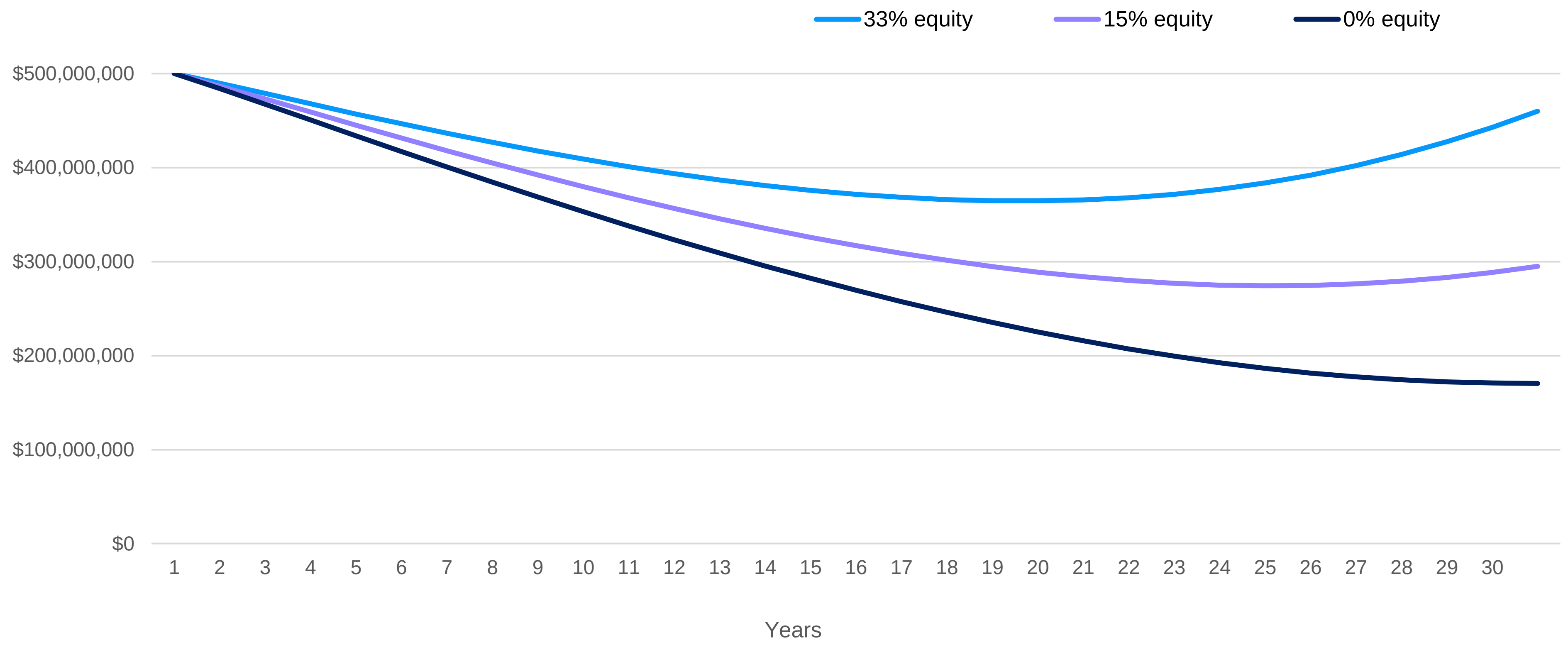
# Considering allocations based on plan objectives

## Analyzing potential outcomes for different asset allocations

**Outlining various approaches to SFA allocations**

Adding equities to a portfolio may benefit portfolio solvency to year 2051 and beyond

**SFA portfolio return hypothetical scenarios**




For illustrative purposes only. Source: Invesco Investment Solutions. Hypothetical asset projections account for rolling 3Y cash flows, administration expenses and contributions. The 33%, 15% and 0% equity portfolios are 33%, 15% and 0% Russell 3000 Index, 47%, 65% and 80% ICE Bofa US Corporate Index and 20% Bloomberg 1-3 Year Government/Credit Index (“3Y Cash Match portfolio”) in year 1. Median performance is calibrated to Invesco’s 10 year capital market assumptions. The ratio of equity to US IG Credit is maintained throughout while the cash match portfolio declines to zero at year 30 as the projected cash flows are disbursed. See disclosures section for additional information. For illustration only - no investment decisions should be taken on the basis of these charts

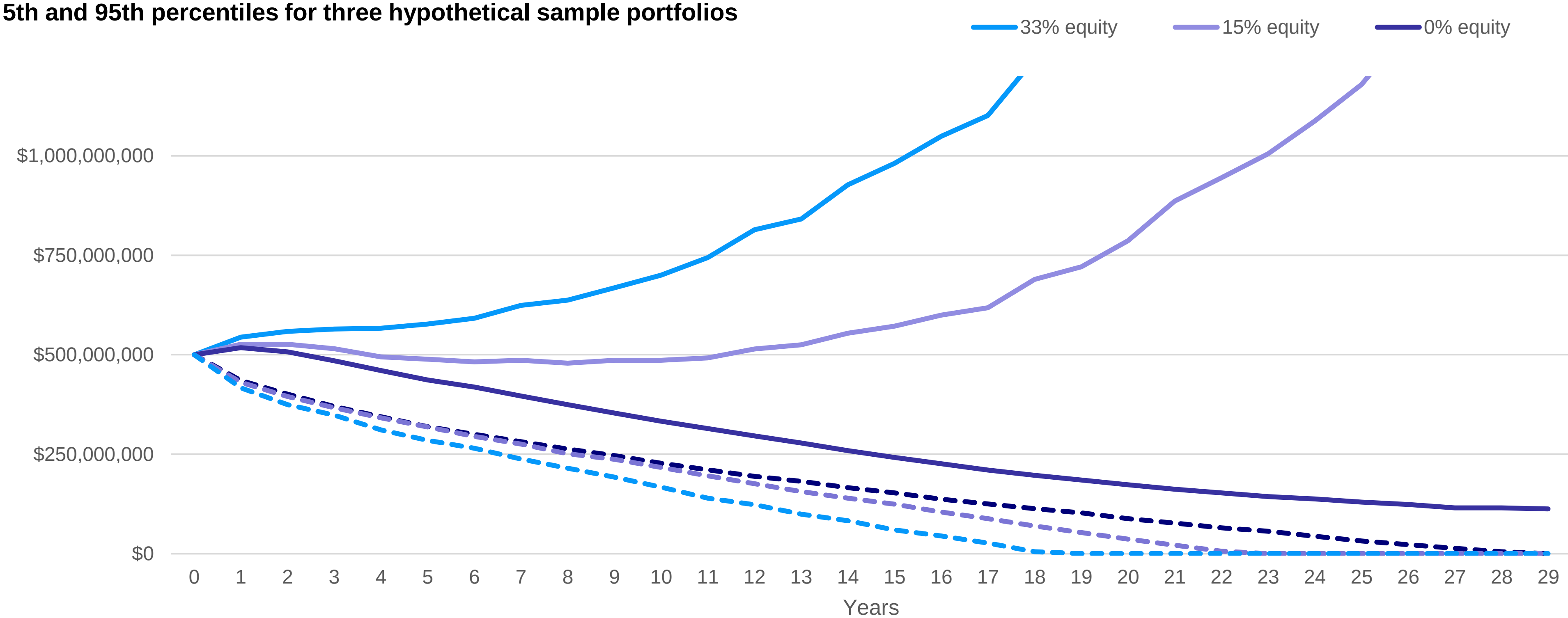
# Considering surplus and shortfall risk

## Analyzing potential outcomes for different asset allocations

**Outlining various approaches to SFA allocations**

Real world outcomes depend on the path markets take, so portfolio allocations should be aligned with plan objectives

**5th and 95th percentiles for three hypothetical sample portfolios**

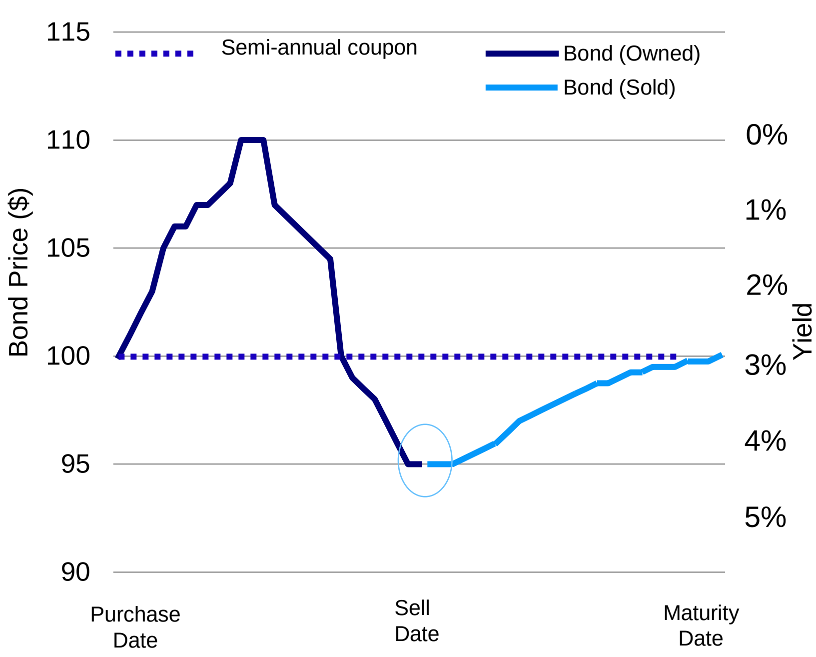



For illustrative purposes only. Source: Invesco Investment Solutions. Hypothetical asset projections account for rolling 3Y cash flows, administration expenses and contributions. The 33%, 15% and 0% equity portfolios are 33%, 15% and 0% Russell 3000 Index, 47%, 65% and 80% ICE Bofa US Corporate Index and 20% Bloomberg 1-3 Year Government/Credit Index (“3Y Cash Match portfolio”) in year 1. Median performance is calibrated to Invesco’s 10 year capital market assumptions, with risk (annual volatility) calculated using the BARRA risk model. The ratio of equity to US IG Credit is maintained throughout while the cash match portfolio declines to zero at year 30 as the projected cash flows are disbursed. Modeling ranges are calculated using Moody’s economic scenario generator which accounts for annual path dependency of the volatility of returns. 5th percentile (dotted lines) indicates that there are only 5% of outcomes that are less than the projection; 95th percentile (solid lines) indicates that there are only 5% of outcomes that are greater than the projection. See disclosures section for additional information. For illustration only - no investment decisions should be taken on the basis of these charts

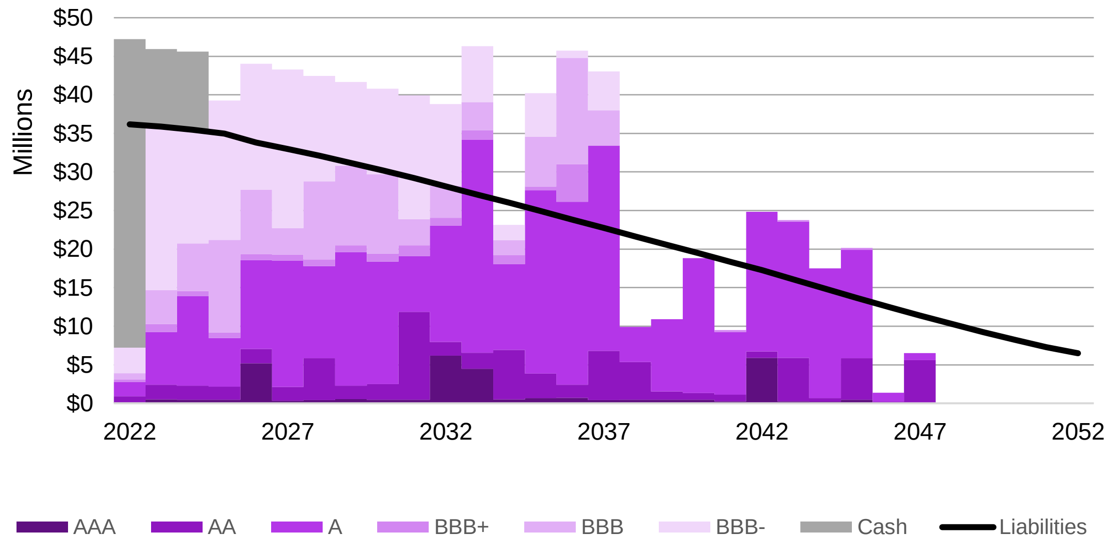
# Taking advantage of fixed income
## Incorporating elements of a "buy and hold" strategy can increase certainty

**Reducing market risk through reliance on structured cash flows**

**Market volatility can impact the success of replenishing a cash match portfolio**




**Cash flows by credit rating of a hypothetical buy and hold portfolio**




| Summary | Avg Credit Rating | # Issuers | # Securities | YTW (%) | OAD (Yrs) |
|---|---|---|---|---|---|
| Optimized | A- | 104 | 111 | 6.13 | 8.3 |
| Screened | A- | 580 | 4,615 | 4.75 | 5.6 |
| Universe | A- | 1,323 | 9,660 | 4.97 | 7.1 |

For illustrative purposes only. No investment decisions should be taken on the basis of these charts.
Source: Invesco Investment Solutions. Buy and hold cash flow structured portfolio using yield and return assumptions as of September 8th, 2022. See disclosures section for additional information.

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# Capital market assumptions (CMAs)

Invesco Investment Solutions develops CMAs that provide long-term estimates for the behavior of major asset classes globally. The team is dedicated to designing outcome-oriented, multi-asset portfolios that meet the specific goals of investors. The assumptions, which are based on a 10-year or 5-year investment time horizon, are intended to guide these strategic asset class allocations. For each selected asset class, we develop assumptions for estimated return, estimated standard deviation of return (volatility), and estimated correlation with other asset classes. For additional details regarding the methodology used to develop these estimates, please see our white paper Capital Market Assumptions: Methodology update.

This information is not intended as a recommendation to invest in a specific asset class or strategy, or as a promise of future performance. These asset class assumptions are passive, and do not consider the impact of active management. Given the complex risk-reward trade-offs involved, we encourage you to consider your judgment and quantitative approaches in setting strategic allocations to asset classes and strategies. This material is not intended to provide, and should not be relied on, for tax advice.

References to future returns are not promises or estimates of actual returns a client portfolio may achieve. Assumptions and estimates are provided for illustrative purposes only. They should not be relied upon as recommendations to buy or sell securities. Forecasts of financial market trends that are based on current market conditions constitute our judgment and are subject to change without notice. Estimated returns can be conditional on economic scenarios. In the event a particular scenario comes to pass, actual returns could be significantly higher or lower than these estimates.

Indexes are unmanaged and used for illustrative purposes only. They are not intended to be indicative of the performance of any strategy. It is not possible to invest directly in an index.

# Assumptions

### Moody's Economic Scenario Generator

- All analysis as of June 30, 2022, unless otherwise stated
- Returns based on Invesco's 10-year Capital Market Assumptions
- Scenario modelling based on 1,000 simulations using economic scenario paths provided by Moody's, adjusted for June 30, 2022 market conditions
- Projections allow for plan expenses and future contributions and assume annual rebalancing to a constant asset allocation

**10 Year Capital Market Assumptions for Asset Proxies as of June 30, 2022**

| Asset class | Index | Mean return | Volatility |
|---|---|---|---|
| US All Cap Equity | Russell 3000 | 7.8% | 17.2% |
| US IG Corp | Bloomberg US Corporate Investment Grade | 4.2% | 5.3% |
| US Agg Bond | Bloomberg US Aggregate Bond | 3.6% | 5.1% |
| US Treasury | Bloomberg US Treasury Bond | 3.2% | 4.6% |
| Cash/equivalents | Bloomberg US Gov/Credit 1-3y | 3.2% | 4.6% |

### Buy and Hold Portfolio

- All analysis as of Sept 8, 2022, unless otherwise stated
- For illustrative purposes only. In practice these figures, and decision-making, will be contingent on experience over the period.
- Starting Universe is ICE BofA ML US Corp Master Index
- Screens include:
  - Minimum credit quality BBB
  - Max 20% exposure to emerging market bonds
  - No companies with Invesco ESG score below D-stable and companies failing our ESG screen criteria (business involvement, unconventional fossil fuel extraction, tobacco)
  - Exclude companies with the highest carbon emissions
- Optimization considerations:
  - Hold lower rated bonds within the overall mix at shorter maturities
  - Diversify across sectors (e.g. max 20% to Bloomberg Barclays class 3 sectors), issuers (e.g. max 1% to each issuer)
  - Deliver at least sufficient cash from bond coupons and maturity proceeds to pay benefits in full for the first 10 years, and be mindful of benefit levels thereafter; surplus cash accruing over the period will be invested to cover any shortfall in years beyond that.

Source: Invesco as of June 30, 2022

# Thank you

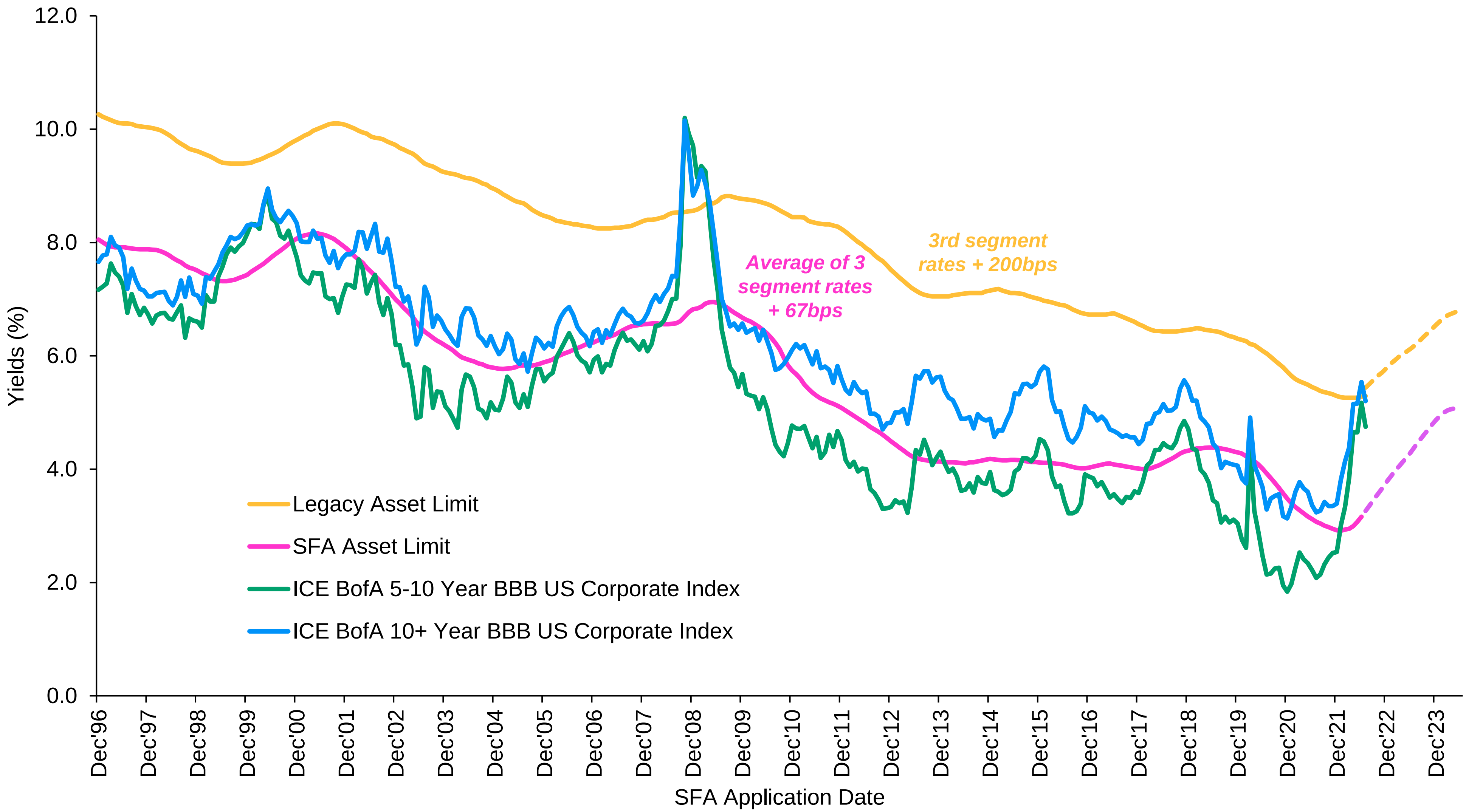
Invesco

# Thoughts on Final Ruling

- The final ruling has made the SFA investment problem significantly more manageable by loosening the investment constraints and increasing the size of the SFA assets (in most cases)
- Rather than seek to maximize legacy asset returns and SFA portfolio yields, many plans should have enough flexibility to build a balanced portfolio that seeks long-term solvency with a prudent level of risk
- If the goal is only to reach 2051, an SFA risk-seeking budget of 33% may be excessive for some plans
- With more investment levers available, final ruling solutions should be more flexible and less “scientific” over time. Cross-asset strategy becomes more valuable

# Discount Rates Are Currently In Line With Investable Yields

### SFA Rate Limit & Legacy Asset Limit vs. BBB Investment Yields (%)




Source: J.P. Morgan Asset Management, BAML ICE, IRS, Data as of July 31st, 2022

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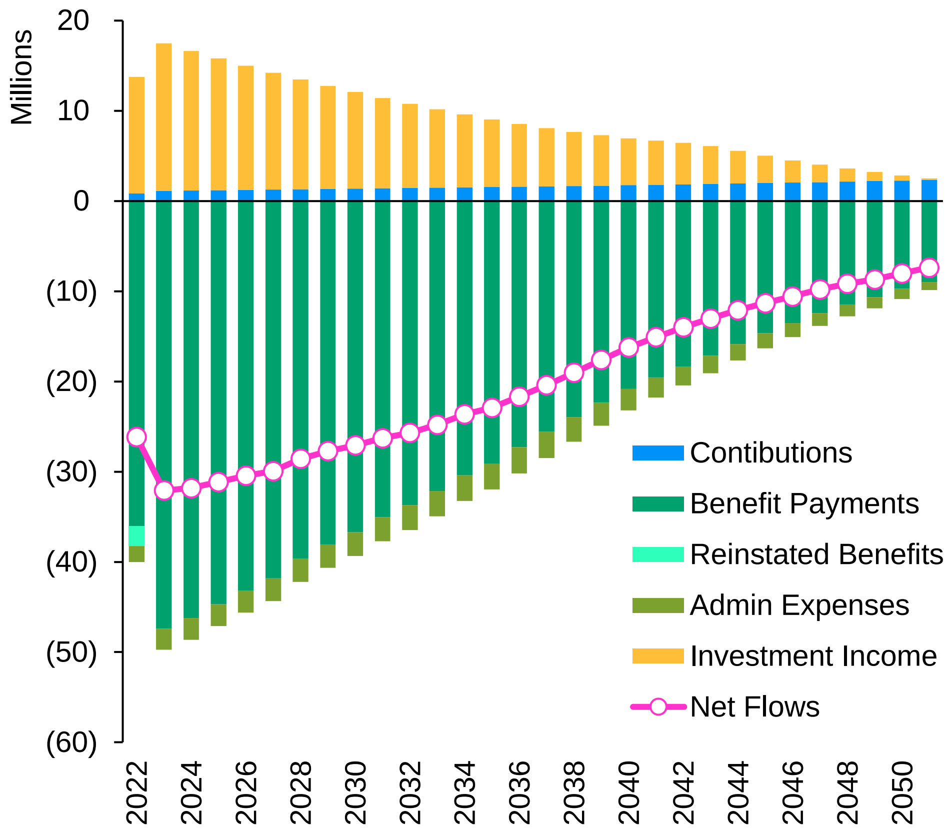
# Plan XYZ: Application Cashflows and Depletion Analysis

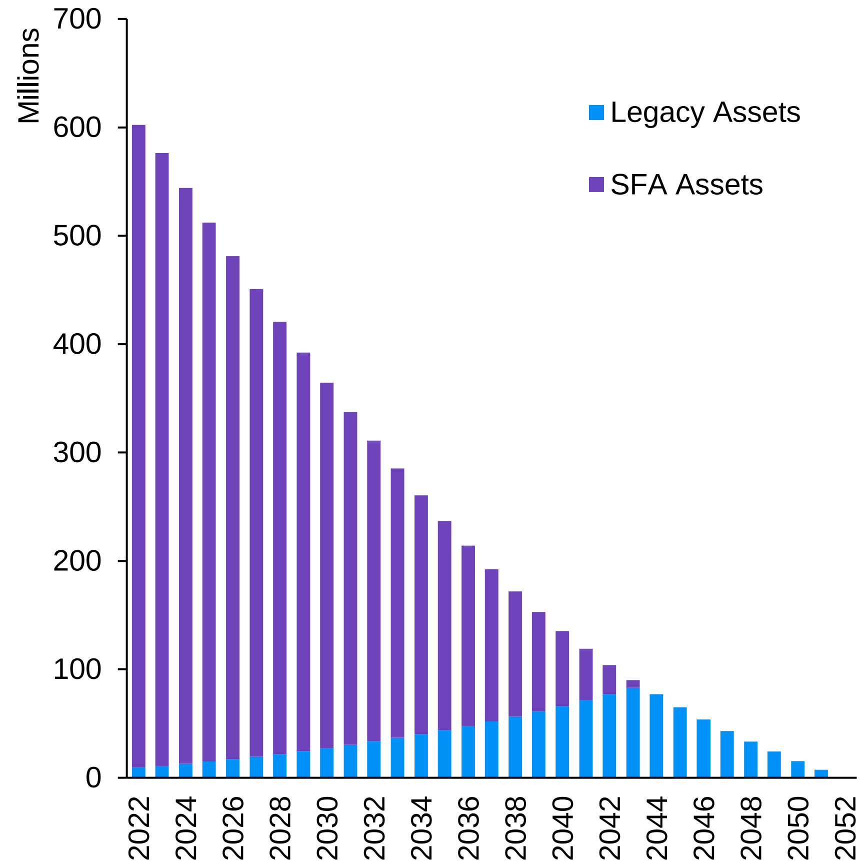
## Plan is Cashflow Negative Every Year

Total Plan Cashflows: 5.36% Legacy Discount Rate / 3.00% SFA Discount Rate




## SFA Expected to Deplete in 2043

Asset Pool Depletion: 5.36% Legacy Discount Rate / 3.00% SFA Discount Rate





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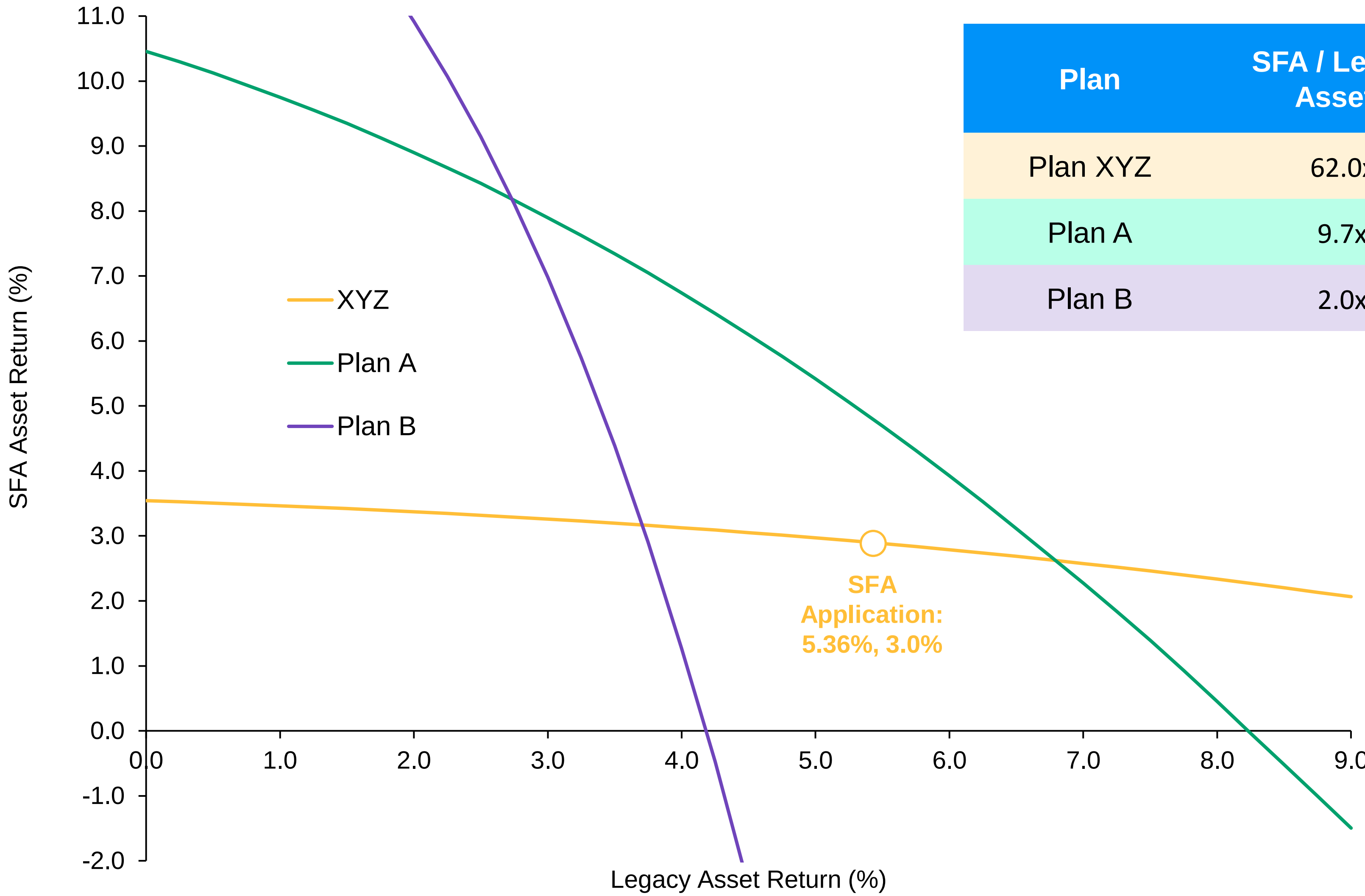
# Higher Shares of SFA Assets Reduce Sensitivity to Legacy Asset Return

## SFA & Legacy Asset Return Needed to Reach Year 30 – Illustrative Comparisons




| Plan | SFA / Legacy Assets |
|---|---|
| Plan XYZ | 62.0x |
| Plan A | 9.7x |
| Plan B | 2.0x |

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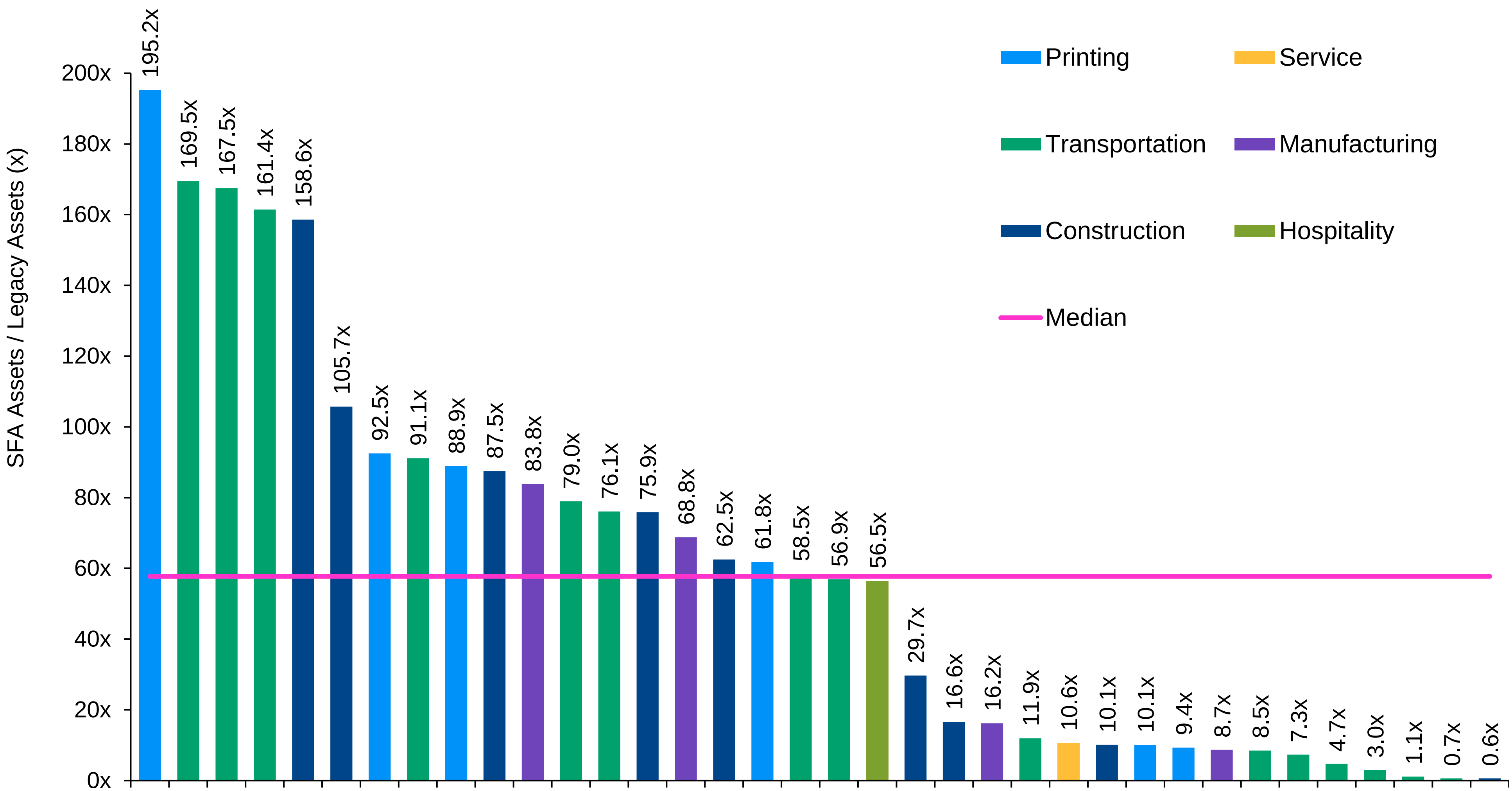
# Applications Thus Far Exhibit a Wide Distribution of Asset Sizing

## Estimated Final Rule: SFA Assets / Legacy Assets Ratio




Source: J.P. Morgan Asset Management, PBGC Website

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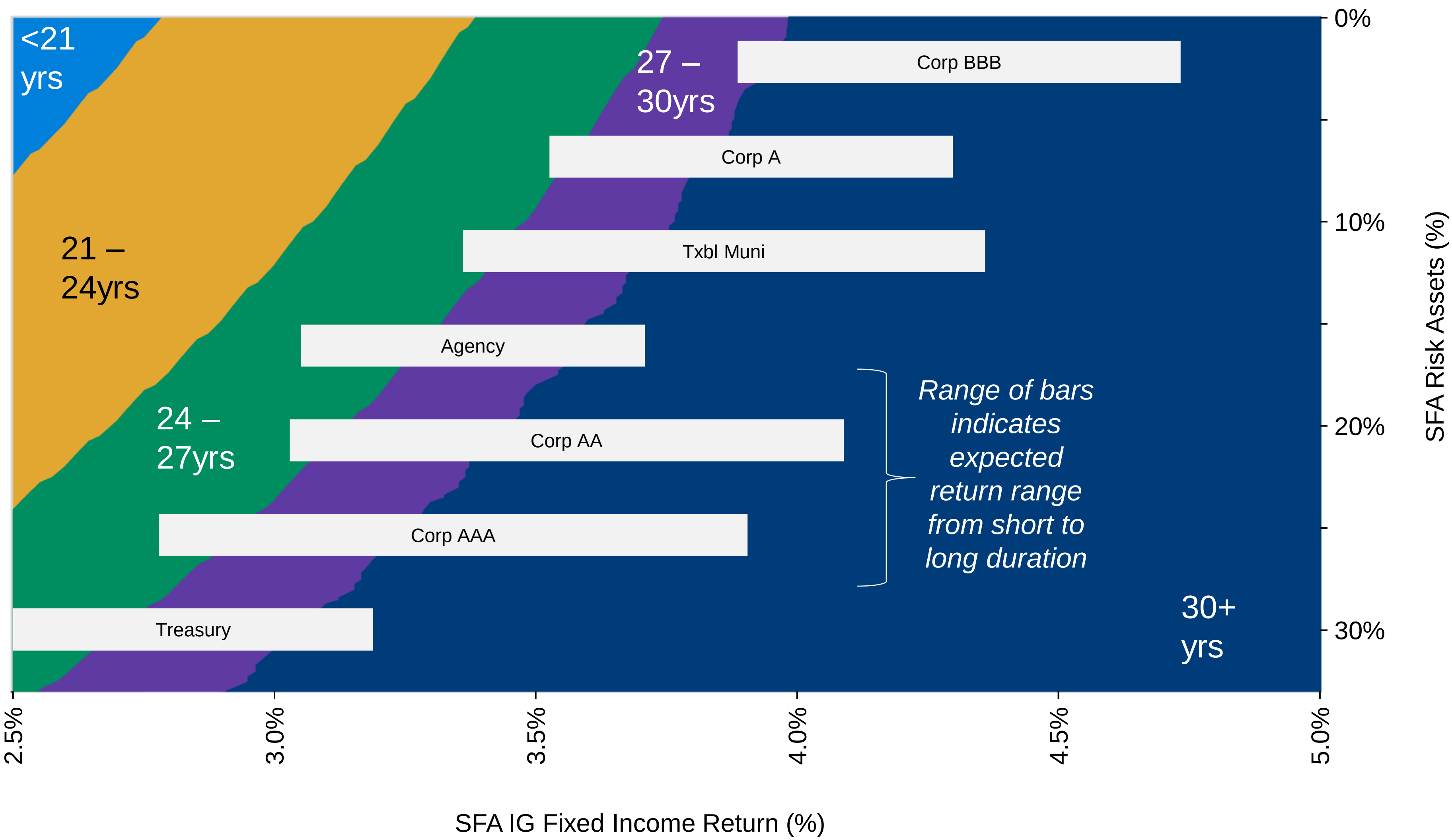
# Many Possible SFA Portfolios Can Get to 30yrs+

Plan XYZ: Expected SFA Lifetime By Varying Risk Asset Weight & IG Fixed Income Return





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