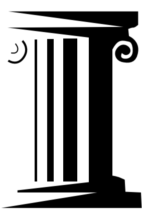


Stable Times

Newsletter of the Stable Value Investment Association

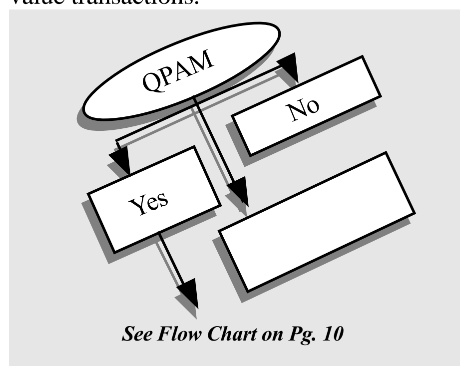
Volume 2; Issue 2 March 1998

The QPAM Exemption in Stable Value Transactions: Its Uses and Limitations

Part Two

by Lazarus N. Sun, Esq., Jeffer, Mangels, Butler & Marmaro LLP

Yes, there is more to say about the QPAM Exemption! So take a deep breath and get comfortable (cup of coffee in hand), as we delve into some of the finer nuances of applying the QPAM Exemption to stable value transactions.



See Flow Chart on Pg. 10

To recap Part One of this series, what we are talking about is Department of Labor Prohibited Transaction Exemption 84-14, a class exemption which allows employee benefit plans governed by ERISA to enter into transactions with financial institutions and other persons deemed to be "parties in interest" to such plans, that otherwise would be prohibited because of such "party in interest" status. The viability of the QPAM Exemption in a stable value transaction (usually one where a wrap on assets is involved) depends on whether the plan can act through a "qualified professional asset manager", or "QPAM", which must be an entity meeting the "entity requirements" discussed in the first part of this article. Furthermore, we have chosen to focus on four key conditions (the "Exemption conditions") that any stable value transaction seeking to rely on the QPAM Exemption must meet. These are discussed in the remainder of this article.

Making Sure The Manager is a QPAM

The first step, logically, in determining whether the QPAM Exemption is available for a given transaction is to determine that the outside investment manager is indeed a QPAM. Although this may seem obvious, it should not be overlooked. There have been transactions where the existence of QPAM status was assumed by all the parties (including the manager!), when in fact later scrutiny exposed this to be not an entirely safe assumption, to the chagrin and embarrassment of all.

(Continued on Page 10)

Pricing Trends in the Traditional GIC Market

by John Milberg, Pacific Life Insurance Co.

Overview

The traditional GIC market has undergone a number of changes over the past several years. Stable value market participants are keenly aware that traditional products continue to lose market share to synthetic GICs and other structures that have found their way into stable value funds. Another significant trend is the changing pattern of spreads, or price, that has occurred. This article examines that pattern and provides data that suggests that the future might bring additional change.

Yield Comparison of GICs vs. Other Asset Classes

When comparing different fixed income asset classes, one place to begin is by examining yields over time. The basic question is "What did the instrument yield, and how does it compare to alternative instruments?" The three instruments compared in this article are two- and five-year traditonal GICs, U.S. Treasury notes, and Baa1 industrial bonds. The reason for choosing two- and five-year maturities is that the Baa1 bond and Treasury yields for these maturities were readily available from *Bloomberg*.

(Continued on Page 8)

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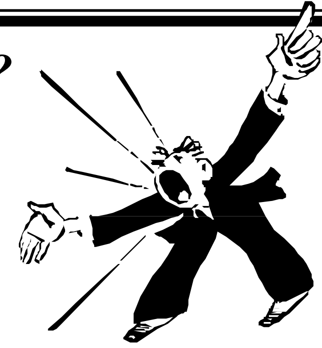
Editor's Corner: Now What?

by Allan Fen, Fidelity Managed Income Group



With three issues behind us, the feedback so far indicates that ***Stable Times*** is off to a good start in carrying out its mission of disseminating a wide range of analysis, research, and other useful information related to stable value. And a noble mission it is. There is always room for improvement, however. I thought it would be fun and exciting to analyze these early issues to see if anything stands out that might help us in the future.

The table below classifies the contributors to these first three issues by the types of organizations to which they belong. Regular features such as the "Message from the President," "Editors Corner," and "Press Sightings" were not included.

At this point, some of you are thinking, "Get a life, Mr. Editor." While it's too late for that, I can make some observations about who is and who is not contributing to ***Stable Times.*** Insurance companies and stable value managers have provided the most frequent contributions, which isn't surprising given the stakes they have in the business. On the other hand, bond managers and wrap issuers also have significant commitments to stable value, yet have been underrepresented as far as newsletter contributions. It shouldn't be too difficult to get more contributions from these organizations.

While disappointing, the scarcity of plan sponsor contributions isn't really surprising. For the corporate treasury and HR professional whose stable value responsibilities are often only a small portion of the job, writing an article on stable value generally won't be at the top of the priority list. Nevertheless, with plan sponsors being our closest link to the actual stable value investors, we should do everything possible to make sure their perspective is adequately represented.

Other observations:

- No contributions yet from benefit and investment consulting firms (not focused primarily on stable value) and rating agencies.
- Nine of the twenty articles authored by members of the Stable Times editorial staff.
- Yet to receive a letter to the editor.

Not to be a party pooper. All in all, the launch of Stable Times has gone extremely well. But for those of us who believe that a wide variety of perspectives from throughout the industry is the key to having an interesting, provocative publication, there's still some work to do.

Org. Type	# Contributors	# Articles	Topics
Insurance Company	4	5	TIPS(2), Stable Value 100, Performance, GIC spreads
SV Manager	4	4	Bond Benchmarks, Placement Considerations, Communicating Returns, Credit
SV Consultant	2	3	Pooled Funds(2), Duration
Bond Manager	1	2	Duration, Guidelines
Plan Sponsor	1	2	Performance, Strategic allocation
Bank/Wrap Issuer	1	2	Index Amortizing Notes, CMT Floaters
Law Firm	1	2	QPAM
Total	14	20	

A Message from the President

As we move forward into 1998, I would like to outline the Association's major initiatives for the calendar year. This list represents an ambitious agenda but one that supports the Association's strategic objectives, particularly in the areas of public education and media promotion.

Communications and Education Campaign

The Association continues to support a vigorous media campaign on behalf of the industry to educate the public on the benefits of stable value as a long-term, fixed income investment and promote its role in successful retirement planning.

Defined Contribution Asset Allocation Study

The Association has undertaken a project to establish an objective methodology to integrate stable value and company stock into asset allocation and financial planning models.

The "Nifty 50"

The Association is constructing a rate of return series using actual historical plan-by-plan credited interest rates to create a long-term rate of return performance record for stable value.

Regional Program Activities

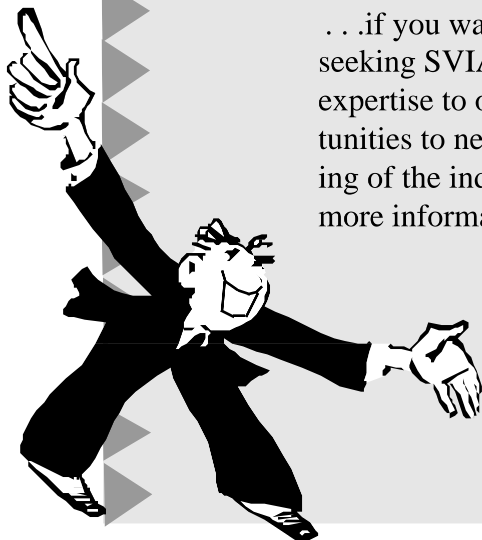
The Association is sponsoring an outreach program targeted to the plan sponsor community. The objective of the program is to develop one-half and one-day regional day seminars on topics of interest to plan sponsors, both members and non-members.

Speakers Bureau

The Association has undertaken the development of an organized group of member volunteers to serve as speakers on stable value issues at various conferences and other functions. These members can support the education and communications program by disseminating accurate information and messages about stable value in a variety of venues.

Coalition Building

The Association continues to become more involved in activities with other associations involved in Social Security reform and retirement planning investing.



Raise Your Hand . . .

. . .if you want to become more active in the Association! We are currently seeking SVIA members who would like to donate some of their time and expertise to one or more of SVIA's member committees. These are great opportunities to network with your peers, gain increased knowledge and understanding of the industry, and move forward the agenda and activities of SVIA. For more information please call SVIA at (202) 463-9044.

Or fax us at (202) 463-7590

STABLE *times*

A Performance Measurement Standard for Stable Value Funds

by Klaus O. Shigley, John Hancock Financial Services

A special task force of the Stable Value Investment Association has been laboring for roughly nine months to develop a practical framework for performance measurement of stable value funds. If the effort is successful, a good outcome would be a generally recognized performance measurement methodolgy for evaluating stable value managers and stable value fund performance.

Although stable value funds have existed for almost twenty years, no consensus has developed on how stable value fund performance should be measured. For conventional fixed income asset classes, "return" comparisons between funds, management firms, and against benchmarks are the primary means of evaluating performance. However, a straightforward application of these conventional techniques to stable value funds, with their primary emphasis on the book value account, is not all that obvious.

What Are Some Problems?

1. How do we define performance? Do we use book or market?
2. If we use book, how do we score the duration of the blended rate lag?
3. If we use market, how do we score the options exercised by participants?
4. How do we value the wrap?
5. Do we measure the performance of the fund? Or do we measure the returns delivered to participants? Over what time frame? Which participants? The ones who are still in the fund or the ones who just cashed out at book greater than market?

Do We Really Need Performance Measurement Standards?

As the old adage goes, "If it ain't broke, don't fix it." However, maybe a better slogan for stable value is, "If you can't measure it, you don't understand it." Unfortunately, the absence of an objective, measureable performance standard is a major contributing factor to a persistant image of stable value as obscure, mysterious, and not really mainstream. Plan fiduciaries, in particular, will tend to be a little reluctant to embrace this option if they don't understand it. And because of this shortcoming, consultants and other investment professionals will often go so far as to question the legitimacy of this asset class.

As the old adage goes, "If it ain't broke, don't fix it." However, maybe a better slogan for stable value is, "If you can't measure it, you don't understand it."

What Are The Benefits?

1. The ability to make meaningful performance comparisons between funds and with accepted benchmarks will allow plan fiduciaries to objectively evaluate the performance of the fund and its manager.
2. It will encourage and reward good investment decisions, providing the proper motivation for fund managers, which will benefit plan participants. GICs vs. synthetics? Active vs. buy-and-hold? STIF vs. ladders? These are issues where it's time to replace impressions and noise with measureable demonstrations.
3. Stable value managers will be able to compete on performance instead of marketing prowess.

These benefits will help stable value prosper and be recognized as a legitimate asset class.

Plan sponsors, stable value managers, issuers, and asset managers are all represented. Our process revolves around biweekly conference calls and shared e-mail drafts. Our objective is to complete an Exposure Draft, which outlines a framework for performance measurement of stable value funds, by the end of March. The exposure draft will be then be circulated on the SVIA's web site and discussed at the April GIC Conference.

Tentative Conclusions Reached

1. The focus of this project is on measuring manager performance, in contrast to measuring returns to participants (which are at book). These are two complementary, not mutually exclusive, approaches to measuring investment performance. They serve different needs.
2. The consensus view for measuring manager performance is to use an "economic value" based approach. The consensus view for measuring participant returns is a "book value" based approach.
3. Whenever possible, we have tended to favor approaches already developed and used in measuring fixed income and equity performance **and adapting them to stable value**, rather than blazing a new trail. In areas such as time-weighting of returns and establishing benchmarks, much of what has been applied in those asset classes can easily be extended to stable value.
4. Some complications, and compromises, arise because of the benefit responsive options which are granted (liabilities) and the wraps (assets) which are bought to manage them.

Your input to this effort is welcome, and if you would like to receive copies of any of the preliminary drafts, please send your request via e-mail to: drotondi@jhancock.com.

Communicating Stable Value Returns to Participants

by Pete Chappelear, JP Morgan Investment Management

How do participants decide how to allocate their dollars among the various investment options in their plan? Surely there are those that really understand the many aspects of investing and look at things such as asset class, risk profile, beta, alpha, convexity, correlation, fees, and returns**;** however**,** there are probably many others that don't ever really read the basic plan communications material, and simply choose based on name recognition, e.g., Magellan. I'm convinced others read the communications closely, maybe looking for examples or sample portfolios which they simply replicate, or lifestyle or life-strategy funds which they select and forget about. Of all the different participants, I wonder how many truly understand the uniqueness of a stable value fund.

Let's consider performance returns for example, since they seem to be reported in most every plan communication material package. What gets reported for each option is usually something like 1-month, year-to-date, 1-year, 3-year and 5-year returns. Those returns are almost always accompanied by the friendly footnote that "past performance is not a guarantee of future results". This statement is also true for stable value. However, does the past performance of a stable value fund have *any* bearing on its future performance? More than likely. However, it's not necessarily the past **performance**, but the prior **purchases** remaining in the fund that mainly determine returns for the near future, due to blended rate mechanics.

So what can be said about stable value funds with regard to returns that can separate it from the other investment choices? How about a second footnote, or a note in the fund description, that explains that although past performance can't guarantee future returns, the fund manager can typically predict them within a fairly narrow band for a given period of time (three months—assuming quarterly resets/purchases.) Absent defaults, participant cash flows will be the only real variable. These cash flows typically are quite small relative to the size of the fund, and have little impact (a few basis points at most) on returns during a quarter. A plan sponsor could communicate an estimated return, with a wide range of say ± 25 basis points, with near certainty of staying within the range. Participants, on the other hand, would view a 50-basis point range as quite narrow (a good thing).

How does this predictability of returns compare with that of other options, such as money market funds, bond funds, and equity funds?

> A decision to invest in a fund involves an implicit bet on future performance or returns. . . Stable value fund investors essentially "buy a rate" when they like it, and stop when it becomes unattractive in their eyes.

Money market fund returns are also quite predictable, but for much shorter time intervals than stable value funds, due to the short nature of the fund. Money market fund returns, unlike stable value fund returns, will change rapidly as rates move.

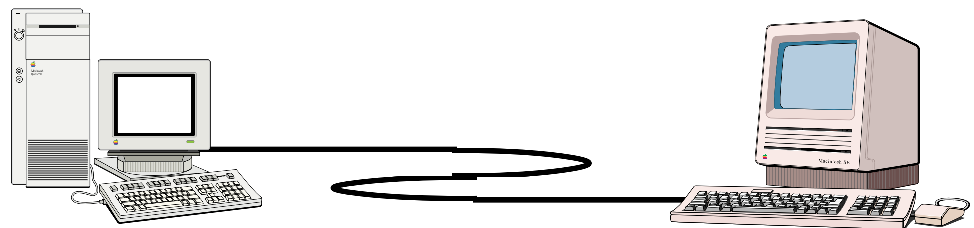
Bond fund returns have some predictability based on the yield-to-maturity (YTM) at time of investment. The YTM falls at the center of a bell-shaped curve of expected returns. The problem here is the high degree of volatility, or standard deviation, of returns. Also, the YTM of the fund will change over time, creating a moving target of expected returns, and negative returns are certainly a possibility.

Equity fund returns are even harder to predict than bond fund returns. The volatility of equity returns is greater, and the time horizon for achieving an average or expected return is much longer. Obviously, negative returns are also a possibility for equity funds.

A decision to invest in a fund involves an implicit bet on future performance or returns. For stable value, the bet is a very safe one. In all likelihood, the participant will receive the expected return for the period, and can expect small, if any, changes in returns from period-to-period. Stable value fund investors essentially "buy a rate" when they like it, and stop when it becomes unattractive in their eyes. For bond and equity funds, the bet is far different. The potential for higher returns exists, but the likelihood of achieving expected returns, at least over short time intervals, is small, and the risk to principal is ever present.

So, should plan sponsors communicate expected returns or a range of returns for stable value funds? I can understand some hesitation to do so. Most sponsors want to keep consistency across all fund options. They probably don't want to do anything different for any one particular fund. Also, the fear of not achieving the expected returns might be a deterrent. Both are valid points, but I believe are outweighed by the benefits.

Supplying participants with all the available relevant information to make informed investment decisions is an obligation. This information is a material fact that a participant would think he or she has a right to know. Moreover, the information is crucial for participants to form the basis for a risk/reward trade-off between investment options.



Life Insurance Industry Trends Remain Positive

by Allan G. Richmond, T.Rowe Price

Overall, the news is good on the life insurance company front. Surplus growth remained strong, rising 5.1% in the third quarter of 1997 and 11.7% for the first nine months of the year, versus 2.3% and 7.1% respectively for the same periods in 1996. Moreover, commercial mortgage delinquency rates continued to drop, while the significant increase in operating earnings has reversed the decline in return on equity.

Financial Results for the Third Quarter of 1997

Statutory gain from operations increased 3.6% between the third quarters of 1996 and 1997, and rose 14.5% for the first nine months of the year. The significant improvement in 1997 was attributable to a 30 to 40 basis point decline in 2- to 30-year Treasury yields during the quarter, versus only a 0 to 5 basis point drop over the same period in1996. Moreover, for year-to-date 1997, interest rates declined by 5 to 30 basis points compared to a rise of 90 to 110 basis points in 1996. The more favorable interest rate environment in 1997 enabled insurers to widen spreads on interest-sensitive life and annuity policies. Spreads had declined in 1996 because portfolio yields lagged the higher rates on repriced business..

Net capital gains increased dramatically in the third quarter of 1997 over 1996, from $1.3 billion to $4.8 billion, and for the first nine months of 1997 versus 1996, from $4.5 billion to $9.4 billion. The above-referenced interest rate environment in 1997 versus 1996 accounts for a majority of the improvement.

Surplus continued to flow out of the life insurance industry, as companies moved capital to other subsidiaries that have higher returns on equity, although the pace has slowed. Shareholder dividends <u>**less**</u> paid-in surplus dropped from $0.9 billion to $0.2 billion between the third quarters of 1996 and 1997, and from $3.2 billion to $2.1 billion respectively for the nine months year-to-date.

The impact of these factors resulted in an annualized return on equity for the first nine months of 1997 of 9.1%, above the 7.1% for 1994, 9.0% for 1995, and 8.8% for 1996, and comparable to the average of 9.3% for the 1990-1996 period. In addition, the ratio of capital-to-assets at 9/30/97 is 11.3%, more than 50% above the 7.3% level at 12/31/90.

Asset Quality

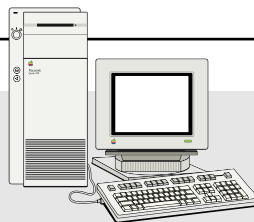
Below investment grade bonds increased from 3.7% to 4.6% of general account assets between 9/30/94 and 9/30/97. The increased allocation to this asset class is due to the need to boost portfolio yields to maintain or improve spreads and to the tight spreads to Treasuries in the investment grade corporate bond market. Companies appear to be willing to take on additional credit risk,

Net capital gains increased dramatically in the third quarter of 1997 over 1996, from $1.3 billion to $4.8 billion

while decreasing their exposure to mortgage-backed securities and collateralized mortgage obligations whose duration and average lives shorten when interest rates decline, which making asset/liability matching more difficult to manage.

The commercial mortgage delinquency rate declined to 1.33% of the portfolio in the third quarter of 1997 from 1.56% in the second quarter of 1997, and from 2.51% and 3.22% one and two years prior. In addition, restructured loans fell for the eleventh straight quarter, to 5.64% of the loan portfolio in the third quarter of 1997, a significant decline from 7.54% and 8.80% one and two years ago. Moreover, foreclosures on commercial properties for the first nine months of 1997 were 28% below the 1996 level for the same period, 54% below the 1995 level, and 78% below the 1992 level, which was at the height of the real estate recession.

The continued favorable results in the mortgage loan asset class reflect both the low vacancy rates in the Office Building sector **and** sales of properties to REITs. The growth of the REIT market has resulted in the disposal of marginal properties which, in turn, have improved the overall quality of the mortgage portfolios. Moreover, there is strength in all property type sectors and geographical regions of the market, as evidenced by the fact that all seven commercial property types and all nine geographical regions had improved delinquency rates at 9/30/97 versus 9/30/96. The remaining major concern is central business district office buildings, with upcoming lease rollovers and more aggressive pricing by insurers, coupled with narrower spreads for new loan originations of comparable credit quality.



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It's full of late-breaking news about what's happening in the stable value industry, as well as downloadable text of monographs and newsletters.

STABLE times

Current Industry Issues: The "Year 2000" Problem

As the year 2000 approaches, insurance company computer systems will need to be modified to be able to test whether 1/1/00 is January 1, 1900 or January 1, 2000. It is a simple problem to describe, but a difficult one to correct due to the millions of lines of computer code which need to be reviewed to make the necessary modifications. If not corrected, companies will not be able to bill policyholders properly, pay agent commissions, and value their contracts for financial reporting purposes. At this point, companies are at various stages of completion in addressing the problem, with most insurers attempting to complete all modifications by the end of 1998, so that 1999 can be used to test that the changes will work as anticipated.

The U.S. Government has recently become involved in this area with regulatory proposals which attempt to manage the problem. In October, the SEC issued a staff bulletin indicating that companies must disclose "year 2000" problems if either the cost of making the changes or the cost of failing to make the changes is likely to have a material financial impact on the company.

In addition, a bill introduced in November in the U.S. Senate would require publicly traded companies to disclose details about their ability to successfully resolve their "year 2000" problem and how they plan to manage any failures that occur in that area. Specifically, the bill would require the SEC to require corporations to disclose (1) the company's progress in addressing the issue, (2) the costs already incurred and those expected to be incurred to make the needed changes, (3) an estimate of the expected litigation costs in defending lawsuits attributable to the "year 2000" problem, (4) the existence of any insurance policies to cover "year 2000" failures, and (5) whether the company has developed contingency plans to ensure its continued operation if there is a computer failure by the company itself or by one of its vendors or business partners.

Note: *The above figures are for 129 U.S. life insurance companies, which comprise 85% of industry assets.They were obtained from (1) The Townsend and Schupp September 30, 1997 LIBRA Review and (2) the ACLI Mortgage Loan Portfolio Profile report as of September 30, 1997.*

Stable Value ... Sightings in the Press!

by Julie H Dennis, New York Life Insurance Company

Since the last issue of ***Stable Times***, stable value activity within the qualified plans market have accelerated. Over seventy five sightings were recorded between September and January. Some of them were on trends in new investment options, new products, and general stable-value education.

Among my personal favorites and recommended readings were:
December 8,1997, Carlos Tovar "GICS Are Like Bonds Are Like GICS", appeared in **Pension & Investments (P&I)** with an excerpt from Fred Williams' September 1st, pg. 38 article (Bernstein diversification). The article attempts to discuss, how does one determine the relative attractiveness of bonds compared to guaranteed investment contracts?

USA TODAY Personal wealth column on November 4, 1997. "Fixed-income funds can cut risk in 401(k)s". The message that appears to be getting through is that stock funds are good and low-yielding stable - value funds are bad. "That's the wrong message' says Anne Willette. "Why, return on stable-value funds is largely independent on the stock market, while bond and stock prices often move in tandem." "Such funds are popular in 401(k)s because its highly unlikely you'll lose the money you put in."

10/13/97 **National Underwriter Life & Health -Financial Services Edition** featured Jim Connolly in the on-going debate- at issue is just how to classify an unallocated annuity.

Financial Planning October 1, 1997, Jenifer Lea Reed detailed a six page write up entitled "GICs Try To Polish A Tarnished Crown Guaranteed." Investment contracts, once the darling of defined contributions plans, are having a hard time attracting investors. According to Jenifer the good news for stable value is "Despite losing out to equity market, GIC products have held their own against other fixed-income investments with similar characteristics, and some asset management firms that handle GIC investments have boosted their staff in anticipation of greater interest from employee retirement plans.

Other sightings of general interest to employees-

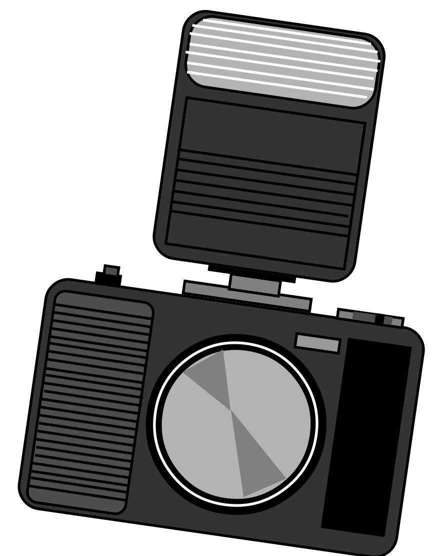
Wall Street Journal, February 11, 1998, "Employer Stock May Be Risky For Nest Eggs"

Orange County Register, December 28, 1997 "Employers Keep Adding 401-k Options"

Fort Worth Star-Telegram, February 1, 1988 "Determining One's Temperamental Tolerance for Risk"

Financial Post, January 10, 1998 "Time-Frame Dictates Strategy"

To submit mentions of stable value (positive or negative) in the media or for assistance locating an article, contact Julie H Dennis, New York Life, Stable Value Group at (973)331-2595 or email julie_dennis@am.newyorklife.com

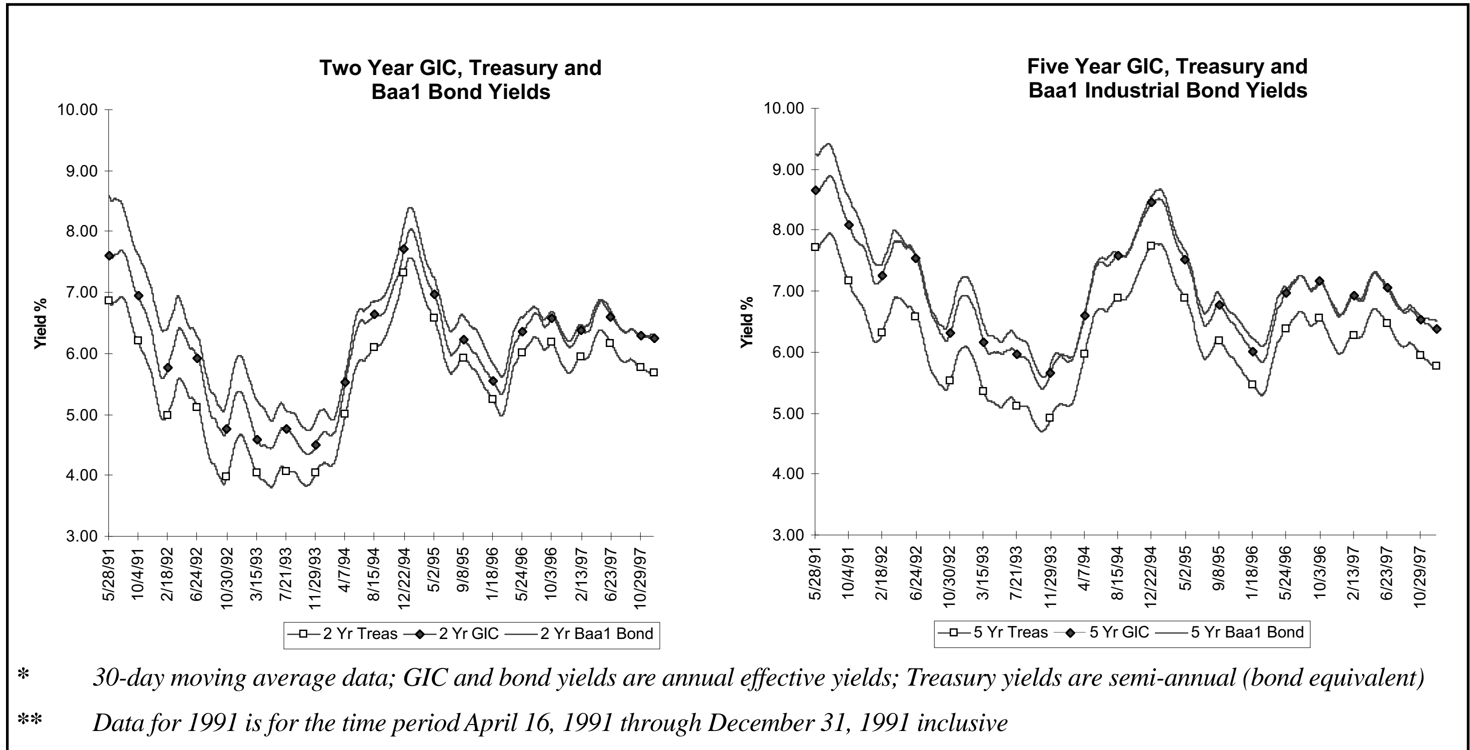


Pricing Trends

(Continued from page 1)

There remains, however, the problem with comparing yields on traditional GICs to other fixed income instruments since there is no universally recognized benchmark for comparisonpurposes. The yields furnished by T. Rowe Price and published in the ***Wall Street Journal*** were readily available; they were chosen for use in this article to represent yields in the traditional GIC market over time. T. Rowe Price furnishes GIC high, low, index and top quartile yield data, and the **high** data were selected for this article. The trends illustrated are not materially affected when any of the other data series are chosen.

Chart 1: GIC and Bond Yields*, 1991**- 1997



* *30-day moving average data; GIC and bond yields are annual effective yields; Treasury yields are semi-annual (bond equivalent)*

** *Data for 1991 is for the time period April 16, 1991 through December 31, 1991 inclusive*

With this as background, the yields for the 1991 to 1997 time period for two- and five-year maturities for the three instruments are shown in Chart 1 above. Although the data points on these graphs may be difficult to read, the data shows that yields on the three asset classes have moved together over the seven-year period.

Spread Comparison of GICs vs. Other Asset Classes

Table 1 compares the spreads for GICs and Baa1 industrial bonds versus Treasuries for the same time frame. The data shown is the average data for the given year: *(see table 1)*

Over this time period, the spread versus Treasuries for both the indu”t“ial bonds and the GICs has declined significantly. Note, however, that the reduction in spreads for the bonds has been much more dramatic than the reduction for the GICs. The changing pattern of these spreads was another significant trend highlighted in the first paragraph; from the perspective of an issuer of traditional GICs, this trend is of concern from a profitability standpoint.

Table 1: Spreads vs. Treasuries*

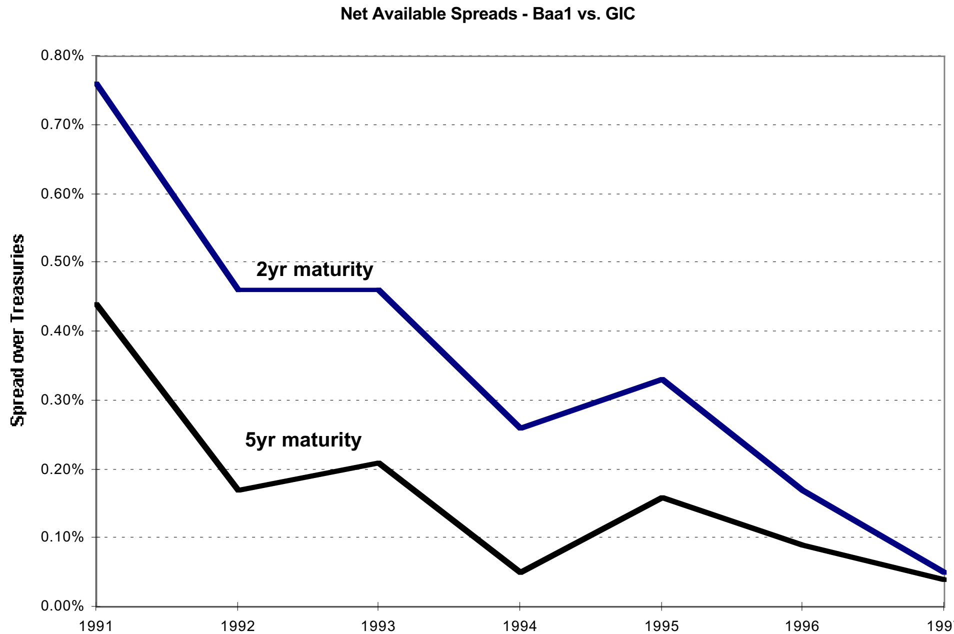
	Two-Year Data		Five-Year Data	
Year	**Baa1 Bond**	**GIC**	**Baa1 Bond**	**GIC**
1991	*1.50%*	*0.74%*	*1.40%*	*0.96%*
1992	*1.25%*	*0.79%*	*1.07%*	*0.90%*
1993	*1.03%*	*0.57%*	*1.01%*	*0.80%*
1994	*0.75%*	*0.49%*	*0.76%*	*0.71%*
1995	*0.68%*	*0.35%*	*0.77%*	*0.61%*
1996	*0.55%*	*0.38%*	*0.66%*	*0.57%*
1997	*0.53%*	*0.48%*	*0.63%*	*0.59%*

**The spreads shown are the difference between the annual effective GIC and bond yields and the semi-annual Treasury yields*

Profitability Issues

The decline in asset spreads highlighted above has also occurred among other asset classes that are typically used to fund traditional GIC liabilities in the general accounts of issuers. While it is unrealistic to assume that issuers of two- and five-year GICs would fund them exclusively with two- and five-year Baa1 industrial bonds, it is worthwhile to examine the impact on profitability if such a strategy is followed. Chart 2 shows the net spread available for expense, risk and profit for the last seven years, having used such a strategy:

Chart 2: Net Available Spreads



The net spread (difference between bond and GIC spreads in Table 1) is before charges for default losses, insurance and investment expense and profit on the capital the issuer is required to hold in support of the contract guarantees.

Implications for the Future

The number of issuers of traditional GICs has declined. Some companies have been forced to exit the business due to the way they managed the asset risks in their portfolios. Others have exited because of the profit profile that the GIC business presents them. Other companies have used a wider variety of investment classes, including private placement securities and investments with imbedded options, in a prudent manner in order to offer a competitively priced product. In addition, the latter companies have used strong asset/liability techniques to manage their risk and produce acceptable levels of return on the capital they commit to back the guarantees in their GIC contracts. It might prove difficult in the future, even for these well-managed companies, to continue their current strategies if GIC spreads over Treasuries continue to be wide relative to spreads available on assets acquired to fund liabilities.

SVIA To Present Two Regional Conferences for Plan Sponsors

The Stable Value Investment Association is pleased to announce a new program initiative, designed to provide additional value to plan sponsors around the country. The Stable Value Investment Association will be presenting two, one-day conferences covering topics of interest to plan sponsors and regional benefit consultants. Topics will include: 1) Quantifying stable value's role in the asset allocation decision; 2) Communicating the stable value option to employees and senior management; and 3) Evaluating stable value managers and legal and regulatory issues affecting the stable value industry.

The conferences will be held in different regions of the country and have been designed to have a small registration fee to encourage plan sponsor attendance. The first conferences will be held in Chicago on June 3 and Atlanta and June 11. If they are over-subscribed, additional conferences may be held at a later date in New York and Los Angeles.

More information about this exciting opportunity will be sent to SVIA members and the wider plan sponsor community in the near future. If there are any questions regarding the upcoming conference, please contact Darryl Street, Conference Coordinator, at 818-763-0433.

STABLE times

The QPAM Exemption

(Continued from page 1)

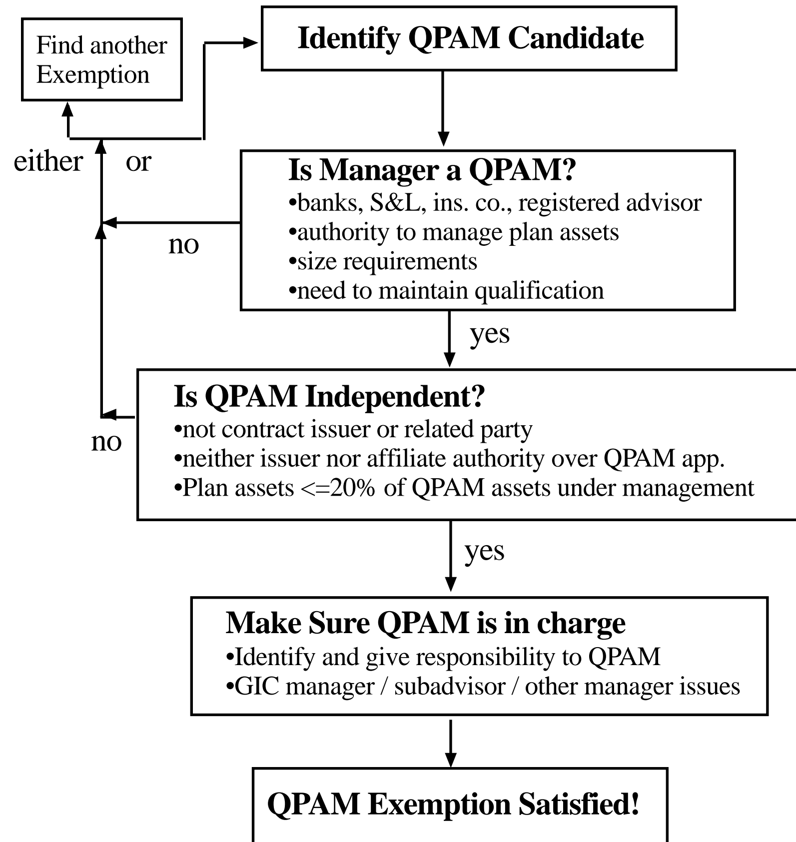
Entity Requirements

The QPAM Exemption's entity requirements may be viewed analytically as covering two basic concerns: (1) the manager's authorization, and (2) the manager's size. With respect to the manager's authorization, the parties must satisfy themselves that the manager is either a bank, savings and loan or insurance company with the authority to manage plan assets, or an investment adviser registered under the Investment Advisers Act of 1940. In this regard, both a plan and a contractual counterparty can obtain from the manager (and possibly from public records) the manager's organizational documents, licenses, Form ADV and other filings, as applicable. With respect to the manager's size, entities other than registered investment advisers must have equity capital or net worth in excess of $1 million, and registered investment advisers must have total client assets under management in excess of $50 million, and generally, equity in excess of $750,000 (with the ability to take into account equity of certain types of guarantors, as set forth in Part One of this series). In this regard, financial statements of the manager can be obtained. In addition to doing due diligence, a plan and a contractual counterparty can also protect themselves by asking for representations from the manager that it qualifies as a QPAM.

Another point to note regarding this issue is that QPAM qualification must be maintained at all times. In particular, the applicable equity, net worth and assets under management requirements must be met as of the last day of each fiscal year. If there is any doubt concerning the maintenance of QPAM status, the due diligence can be brought up to date. As a practical matter, obtaining an ongoing representation or covenant from the manager regarding the maintenance of QPAM status is usually sufficient.

For a relatively new or smaller investment manager, the peg to the last day of each fiscal year may be important, if the manager has just managed to "hit" the applicable numbers within the last twelve months. In such a case, the manager may be well served to consider the establishment or amendment of its fiscal year so that the last day of its most recent fiscal year will coincide with a date on which the numbers were "hit". That way, the manager may be able to sooner avail itself of the benefits of QPAM status.

Navigating the QPAM Exemption Step by step



Making Sure the QPAM Is Independent

Three of the four Exemption conditions address the issue of the QPAM's independence. In the context of a stable value transaction, these conditions protect the plan from the risk that its investment manager may be acting on behalf of the plan under the influence of competing loyalties toward either the contract issuer or the plan sponsor.

Two of the Exemption conditions relate to the QPAM's independence from the contract issuer. First, the contract issuer must not be the QPAM or a person related to the QPAM. For this purpose, the issuer and the QPAM are "related" if either of them (or a person controlling or controlled by either of them) owns 5% or more of the other. Second, neither the issuer nor its affiliate may have, nor may such person have exercised during the one year period preceding the transaction, the authority to hire or fire the QPAM with respect to **any** of the plan's assets (not just the assets of the plan's stable value investment option) or to negotiate the terms of the QPAM's management agreement with the plan. For this purpose, "affiliate" includes persons directly or indirectly controlling, controlled by, or under common control with the issuer, directors and certain key employees of the issuer, and named fiduciaries of the issuer's benefit plans. For purposes of both of these Exemption conditions, "control" means the power to exercise a controlling influence over the management or policies of an entity.

In evaluating these two Exemption conditions, it is usually a relatively simple matter to get comfortable that the QPAM and the

issuer do not have any **direct** relationship with each other that would result in a failure to meet these conditions. However, due to the expansiveness of the definitions, **indirect** relationships may be a matter of concern. Such an indirect relationship could arise through individuals, not just business entities. For example, if a high-level officer of the issuer who may be deemed to "control" the issuer also owns 5% or more of the QPAM, the issuer may be deemed a person "related" to the QPAM, violating one Exemption condition. Or, if a director of the issuer also sits on the counterparty plan's fiduciary committee that makes decisions on hiring and firing the plan's investment managers, an "affiliate" of the issuer may be deemed to have the authority to hire or fire the QPAM, thereby jeopardizing another Exemption condition.

Due diligence regarding affiliations and relationships may be appropriate, depending on the following:

1) Who the various parties to a stable value transaction are and how they are organized and structured;

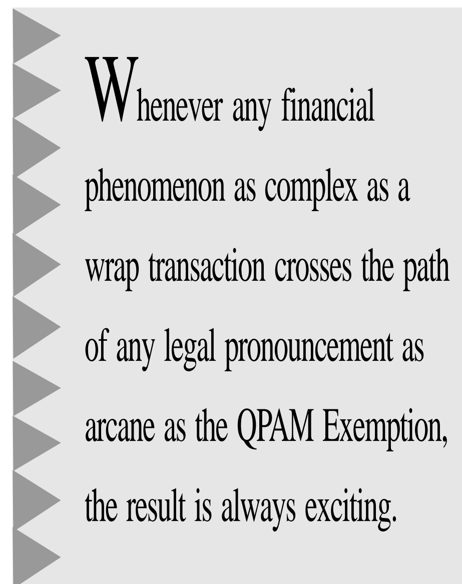
2) The breadth of contractual representations regarding the satisfaction of the Exemption conditions and who is making those representations.

In any event, where the manager is being asked to take contractual risk by making representations regarding the applicability of the QPAM Exemption, that manager should be cognizant of the extent to which such representations implicate these affiliation and relationship issues.

With respect to the QPAM's independence from the plan sponsor, another Exemption condition states that no more than 20% of the QPAM's total client assets under management may be the assets of the plan sponsor's plans (taking into account **all** such plans, not just the plan entering into the stable value transaction). For this purpose, plans of certain affiliates of the plan sponsor are also considered. This could create problems for newer or smaller investment managers, such as, for example, a recently established trust or asset management arm of a bank, whose business may be heavily dependent on a few clients. This is only a problem for the plans that exceed the 20% limit, and does **not** make the QPAM Exemption unavailable for a stable value transaction where the plan involved does not exceed such limit. It is incumbent on each manager seeking to qualify as a QPAM to conduct its operations so as to periodically monitor whether any plan whose assets it manages exceeds the 20% limit.

Making Sure the QPAM is In Charge

The fourth Exemption condition we are covering requires that both the decision to enter into a transaction, and the negotiation of the terms of the transaction, be acts of the QPAM, or if of another party, be under the QPAM's "watch", with the QPAM retaining full fiduciary responsibility.



Where a QPAM by itself has full discretionary authority over a portfolio of assets, including the selection of the wrap issuer and the negotiation of the wrap contract, this Exemption condition has clearly been met. However, today's stable value marketplace is seeing a growth of structures involving two or more managers working on some sort of collaborative basis. For example, it is common practice for a plan to turn over the overall management of its stable value fund to a single "GIC manager". One way to define the GIC manager's role is to view the GIC manager as an extension of the plan's "named fiduciary", employing its expertise in the stable value area to assist the named fiduciary in structuring the stable value fund, and in selecting asset managers for the wrapped portion of the fund, leaving intact the simple arrangement wherein each asset manager is solely responsible for its own portfolio and the portfolio's wraps. Such a role would make the GIC manager more of a "consultant" than a truly discretionary investment manager.

Frequently, however, the GIC manager is vested with discretionary powers, some of which may overlap with the powers respecting the wraps typically reserved for the asset managers. For example, GIC managers will frequently be involved in the wrapper bidding and selection process, and even in contract negotiations. In such cases, it is important for the named fiduciary to make a conscious decision regarding who is really in charge of the wrap component, and to delimit and document the roles of the respective managers accordingly. (Independent of QPAM issues, this should always be done as a matter of complying with ERISA's fiduciary standards.) If the GIC manager is intended to have responsibility for the wraps (with the asset managers' discretionary management being limited to the underlying assets), then it is also the GIC manager that must qualify as QPAM and with respect to whom the Exemption conditions must be met.

On the other hand, if it is intended that the asset managers have responsibility for the wraps, great care must be taken not to have the process so taken over by the GIC manager that the asset managers can no longer be deemed to be ultimately responsible for, and in control of, the selection of wrap providers and the negotiation of wrap contracts. This is especially critical if the GIC manager, as an entity, was never set up to qualify as a QPAM in the first place. Needless to say, the proper parsing out of roles is also important to make certain that the wrong person (i.e., the manager that is not responsible for the wrap) does not end up as the issuer's counterparty in the wrap contract, making representations that it is the QPAM!

Scaling down from the entire stable value fund to the level of an individual portfolio within the fund, deals have also been done in which such a portfolio is run by an asset manager who also handles all aspects of the wrap, but one or more other asset managers or "sub-advisors" are delegated certain responsibilities with respect to the management of the underlying assets. In such a

(Continued)

situation, there should be no question that the "main" manager is the QPAM for purposes of the wrap, and all actions and documentation should be consistent with that fact.

Similar issues, at an escalated level, arise in connection with another stable value concept that is being much studied, and in varying degrees implemented, in recent days, namely, the "global wrap". In a global wrap, rather than having individually wrapped portfolios within the plan's stable value fund, the entire fund, or a significant portion of it, is covered under a single wrap (with a single book value and a single crediting rate) participated in ratably by multiple wrappers. Because it is to be one wrap, all of the wrap contracts should be as similar as possible (and, in fact, identical with respect to certain features).

If the globally-wrapped fund is divided into portfolios run by multiple asset managers, then the task of achieving unity on such a complex structure becomes exponentially more challenging as the number of players grows. In that case, parsing out among the managers the various roles respecting asset management and the wrap transaction (including ongoing monitoring, reporting, exercise of rights and decision making under the wrap transaction) becomes especially critical, while also proving to be exasperatingly difficult! The permutations of how this parsing could be done are beyond the scope of this article. Suffice it to say that anyone descending into the labyrinth of a multi-manager global wrap must solve, among many other puzzles, the riddle of who is the QPAM, and how can we make the QPAM Exemption work (without saddling any one manager with undue exposure). Good luck to all of you hardy souls who are now about this task!

No Renting a QPAM, But What About INHAM?

To wrap up (no pun intended) the discussion about making sure the QPAM is in charge, two relatively recent developments are worthy of mention. One is the statement by the Department of Labor in a footnote to a proposed prohibited transaction individual exemption (McClane Company, Inc. Profit Sharing Plan and Trust, 62 FR 27625, May 20, 1997) that "the retention of a QPAM solely to approve a specific transaction presented for its consideration by a plan sponsor at the time of its engagement is inconsistent with the underlying intent of the exemption, i.e., the transfer of plan assets to an independent, discretionary manager free from the undue influence of the sponsor." This statement squarely addresses a question that has been debated for years, namely, can a plan "rent" a QPAM to basically "rubber stamp" a transaction that the plan sponsor (or any other fiduciary that is not a QPAM) has already decided to do? The Department of Labor's answer clearly appears to be "no." This underscores the warnings given above about making certain that the intended QPAM has an active, discretionary, and leading role in wrapper selection and contract negotiation, and is not serving as QPAM in name only.

The second matter is the Department of Labor's issuance, in 1996, of Class Exemption 96-23, the so-called "INHAM Exemption", which provides relief similar to that provided by the QPAM Exemption in cases where a plan's investments are made by an in-house asset manager, or "INHAM", meeting that exemption's requirements. Although so far the INHAM Exemption has not been used much in stable value transactions, and although its own set of requirements may be impossible or unduly onerous for most plans to meet, it does offer a potential solution to the multiple manager conundrum discussed above. In brief, a wholly-owned subsidiary of a plan sponsor or of the plan sponsor's parent which registers as an investment adviser under the Investment Advisers Act of 1940 and manages at least $50 million of assets of plans of the plan sponsor (and its affiliates), qualifies as an INHAM. Assuming such an entity is established and is willing and able to meet all of the requirements of the INHAM Exemption (including the requirement of an annual "exemption audit"), that entity could take over the responsibility for the wraps on the stable value fund, and rely on the INHAM Exemption to protect the wrap transactions from ERISA's prohibited transaction rules. Such an approach could make sense for in-house managers that already have stable value expertise and some proclivity toward involving themselves in the wrap procurement process.

Some Special Considerations for Bank Collective Funds

Because many stable value contracts are issued to collective investment funds maintained by banks ("Bank Collective Funds"), a word on the application of the QPAM Exemption to such funds may be appropriate before concluding this article.

In general, Bank Collective Funds are entitled to relief from ERISA's prohibited transaction rules under a separate Department of Labor Class Exemption, namely Exemption 91-38 ("PTE 91-38"). To obtain the full scope of relief under PTE 91-38, however, no plan in the Bank Collective Fund may have an interest therein that (when aggregated with such interests of all

other plans of the plan sponsor) exceeds 10% of the total of all interests in the Bank Collective Fund. For start-up Bank Collective Funds, there may be a period during which one or more plans may exceed that 10% limit. However, it may be possible that no plan has total assets under the management of the Bank Collective Fund trustee that exceed 20% of such trustee's total client assets under management, thus meeting one of the QPAM Exemption conditions (the "20% test"). Therefore, if the trustee qualifies as a QPAM and the other Exemption conditions are met, the QPAM Exemption becomes an alternative to PTE 91-38.

An interesting situation arises if the QPAM Exemption fails due to the inability of the Bank Collective Fund trustee to meet the 20% test. In such a case, one possible solution may be to hire another investment manager (which may be an affiliate of the trustee), who does meet the 20% test, to take over discretionary responsibility for the Bank Collective Fund's assets and its wrappers. Such an approach became a discussion topic last year because of an amendment to the Comptroller of the Currency's regulations. That amendment modified the requirement that a bank maintaining a Bank Collective Fund have "exclusive management thereof" by providing an exception allowing delegation where prudent. Confusion still remains over whether this approach is viable, however, because it is unclear whether the Securities and Exchange Commission would adopt a similar "delegation where prudent" allowance under the applicable federal securities law exemptions.

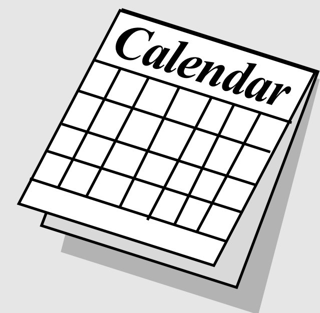
The SEC has held a long-standing position that Bank Collective Funds qualify for these exemptions only if the banks acting as trustees of such funds exercise substantial investment responsibility over such funds. Thus, parties wishing to wrap smaller Bank Collective Funds may be challenged either to reconcile the positions of the Comptroller and the SEC, or to find other ways to obtain relief from ERISA's prohibited transaction rules, or to structure their funds so as to qualify for other exemptions under the federal securities laws.

Conclusion

I must confess that writing this two-part series on the QPAM Exemption has been an educational, enjoyable and perhaps cathartic exercise in reflecting on and crystallizing years of doing stable value deals. I believe I have touched on many of the key, and currently relevant, issues involving the QPAM Exemption in the context of the stable value marketplace. Limitation of time and space has required that certain others be omitted.

No doubt, the QPAM Exemption is here to stay in the stable value world. Whenever any financial phenomenon as complex as a wrap transaction crosses the path of any legal pronouncement as arcane as the QPAM Exemption, the result is always exciting (I dare use that word, assuming my readership has acquired the taste for such matters). And with a market as dynamic as stable value is, we can expect the excitement to continue for a long time to come.

MARK YOUR CALENDARS!



The 1998 Stable Value Investment Association National Forum will take place October 28-29 at the ANA Hotel in Washington, DC. Don't miss what is sure to be a must-attend event. In addition, SVIA is offering Forum Sponsorhips, which can provide additional opportunities to promote your products and organization.

For further information call SVIA at (202) 463-9044.
Or fax us at (202) 463-7590

STABLE *times*

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POSITION AVAILABLE:

A leading active fixed income manager based in Newport Beach, CA seeks a Stable Value Account Associate for a client service and technical support position. The individual must have stable value experience, including familiarity with stable value fund management principles and products, including synthetic GICs, wrap contracts, and crediting rate formulas. Fixed income exposure helpful. Microsoft Excel proficiency and good interpersonal skills are also necessary. Relocation required. Fax resume to (714) 717-7270, attention “Stable Value Team.”

*SVIA has created this newsletter section as a networking service to members searching for employees or positions in the stable value industry. If you are interested in posting a job classified, please submit to SVIA **Stable Times** editor as a “blind” ad, with point of contact either a PO box or a phone/fax number.*

December 1998 crossword answers

L	I	F	E		F	S	A		B	I	L	L	I	O	N
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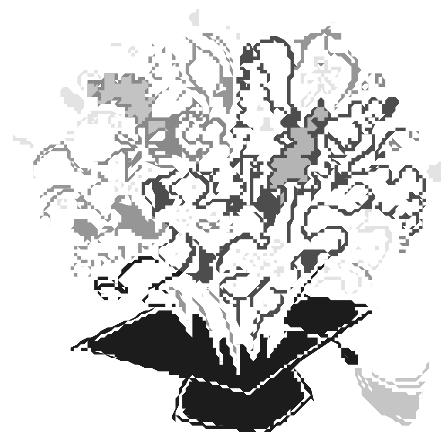


Successful Puzzlers:

1) Staff- Fiduciary Capital Management, Inc.
2) Paul Reisz - Transamerica Asset Management
3) The Bid Desk- Diversified Financial Products
4) Jeff Mohrenweiser, CNA

Entry Form
1998 Market Triathlon Contest

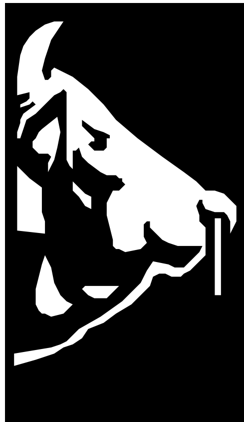
Name: ______________________________

Company: ______________________________

Phone: ______________________________

Event	Projected December 31, 1998
91- Day T-Bill yield at the close of the last business day of 1998 (12/31/97 value = 5.34%)	______________
30-Year T-Bond yield at the close of the last business day of 1998 (12/31/97 value = 5.92%)	______________
The level of the Dow Jones Industrial Average at the close of the last business day of 1998 (12/31/97 = 7,908.25)	______________
Tie Breaker - 1998 NCAA Division I National Champion in football (1997, Nebraska)	______________

All yields are on a bond equivalent basis. Official source is Bloomberg, page CIS as of 12/31/98. Winners to be announced in the March 1999 issue of Stable Times. Prizes will be selected by editorial staff.



Send or fax your entries to:

Lisa Cole
SVIA
1701 K St. NW Suite 300
Washington, DC 20006

Fax: 202-463-7590

Thank You and Good Luck!

Entries must be received by April 10, 1998

With this issue of **Stable Times**, we are proud to launch our new logo, which you see printed above. The "growth curve" depicted in the new logo reflects the upward-rising curve associated with the "growth of a dollar" graph using stable value historical returns. This new logo will be instrumental in establishing our message and our image to the press, as well as to the general public, providing a visual cue that links the Association's goals and objectives to its printed and on-line material. We look forward to being able to use our new "look" in many new and creative ways to further advance the interests of SVIA members.

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