

Pension Benefit Guaranty Corporation

Special Financial Assistance by PBGC

RIN 1212-AB53

JPMorgan Comments on Interim Final Rule (IFR)

- The interest rate limit used to calculate the amount of Special Financial Assistance (SFA), the 3rd segment rate of the 24-month average corporate bond yield curve, without the 25-year corridor, plus 200 basis points, presents several issues.
- This interest rate limit is currently just under 5.5% and will apply to the vast majority of eligible applicants (those with an investment return assumption in excess of the interest rate limit).

Issues With SFA Discount Rate

- By its very construction, this interest rate limit is extremely difficult to earn with investment grade fixed income. The 3rd segment rate is based on yields of investment grade bonds with a maturity of 20 years or greater. It is also smoothed over a period of 24-months.
 - o **Maturity Mismatch:** The average expected life of SFA funds is considerably less than 20 years for most plans. Purchasing bonds with a maturity of 20 years or greater, to better align with the discount rate, would entail taking on significant interest rate risk.
 - o **Timing Mismatch:** The 24-month smoothing of the discount rate also creates a mismatch between the size of SFA funds and the market yields available for investment at the time. For example, as of July – 2021 the 3rd segment rate, averaged over 24-months, was 3.42% (excluding the 200 basis points additional spread). If market yields were to drop by 100 basis points the following month, the smoothed segment rate would only drop by 7 basis points to approximately 3.35%. Thus the gap between investable yields and the SFA discount rate would further widen. This example illustrates that interest rate volatility can impact the ability of sponsors to earn the SFA discount rate in a meaningful way.
 - o **Level Mismatch:** In addition to the maturity and smoothing mismatch, the additional 200 basis point spread is very difficult to achieve through active management. Any attempt to generate this additional return will necessitate significant risk taking within the portfolio.
- Given the current proposed investment restrictions on SFA funds, there is an extremely low probability that sponsors will be able to earn the SFA discount rate and to even have a chance at earning the SFA discount rate sponsors would need to take considerable risk. Given the limitations on SFA investments to public investment grade fixed income, this risk taking would most likely come in the form of interest rate risk and maximizing credit risk (i.e. maximizing allocations to the lowest quality investment grade issuers). This risk taking, in the pursuit of earning the SFA returns, would result in high levels of portfolio volatility, which can be particularly destructive when experienced concurrently with large asset withdrawals for benefit payments. Thus steps which enable sponsors to enhance SFA performance with low to moderate portfolio volatility should be undertaken.

Implications of SFA Discount Rate

- We acknowledge that sponsors don't necessarily need to earn the SFA discount rate with their SFA funds in order to remain solvent through 2051 or even indefinitely if existing assets can be restructured to make up the difference in earnings.
 - o As of July – 2021 the yield on the U.S. Aggregate Index was 1.36%, which is a reasonable approximation of its forward looking expected return and abroad representation of the investable investment grade fixed income universe. For example, a plan currently 30% funded on actuarial basis, earning 1.36% on their SFA funds, would need to earn over 9.0% on their existing assets to remain solvent indefinitely. By

our estimation, there is not a single U.S. pension plan across public, corporate or Taft-Hartley that has an expected return of 9.0% or greater.

- Several plans have almost no existing assets and thus are completely limited to the investment grade fixed income opportunity set.
- Thus, underperforming the SFA discount rate with SFA funds will often cause plans to fail given the difficulty of increasing returns on existing assets, and frequently fail prior to the 2051 target.

Change in SFA Investment Opportunity Set to Improve Probability of Achieving Legislative Objectives

- In order to improve the probability of achieving the objective of solvency through 2051, and in the absence of a significantly larger allocation of SFA funds, the investment opportunity set for SFA funds should be expanded. Asset classes should be included such that a diversified portfolio can be constructed to earn the SFA discount rate with as little expected volatility as possible. In order to achieve this, we believe the following asset classes should be permissible for SFA fund investments:
 - **Public Investment Grade Fixed Income:** Currently permitted under the IFR, we want to confirm the breadth of exposures allowed. These should include, but not be limited to, U.S. Treasuries, U.S. Corporates, Municipals, Agency Debt, U.S. Non-Corporate Credit, Emerging Market Debt (Corporate, Local Currency and Sovereign), Securitized Debt (Agency and Non-Agency) and Convertible Debt
 - **An “At-Purchase” Sub-Investment Grade Fixed Income Allocation of at least 15%:** Currently only 5% of the portfolio is eligible for fallen angels – those bonds purchased at investment grade which are subsequently downgraded. Much research has shown that forced selling of bonds at the time of downgrade reduces return, and we support this provision. However, we also believe there should be a permissible allocation to sub-investment grade fixed income at purchase. These asset classes include High Yield Bonds and Leveraged Loans. These asset classes can enhance returns and improve diversification by offering a differentiated set of issuers, sectors and risk exposures in comparison to investment grade corporates. Furthermore, leverage loans have a low interest rate duration profile, which can be a useful tool for portfolio construction
 - **Public Traded Equities:** Not currently permitted under the IFR, public equities will be critical to achieving the SFA discount rate. JPMorgan’s Long Term Capital Market Assumptions for 2021 project a long term expected return of 5.10% for Global Equity, which itself falls short of the current SFA discount rate estimate. In order to improve the chances of meeting objectives, the full spectrum of liquid public equity investments should be permitted. These should include, but not be limited to, US Large Cap Equity, US Small Cap Equity, EAFE Equity, Emerging Market Equity, Real Estate Investment Trusts (REITs) and other publicly traded Real Asset exposures.
- Taken together, this expansion of the permissible SFA investments improves the probability of earning the SFA discount rate with SFA funds and thus remaining solvent through 2051 and allows sponsors to do so with lower levels of volatility than under the current IFR.