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Stable-value wrap coverage disappearing

DC executives find it's more difficult to hire new managers

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David Toerge
Renegotiating: Keith Overly said wrap providers have become more risk averse.

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Wrap capacity for stable value funds has evaporated, leaving DC plan executives scrambling to find insurance for new assets flowing into these funds as many wrap providers are under financial pressure.

"The marketplace for wrap coverage has completely dried up," Edward Lilly, executive director of the $7.9 billion New York State Deferred Compensation Plan, Albany, said at a conference in New York late last month.

Mr. Lilly, who was not available for an interview, noted the plan had recently hired a new stable value manager but was still negotiating with wrap providers. "It's very difficult to get wrap capacity right now," he said, "and it's more difficult than in the past to bring a new manager on."

The wrap market has gotten "very tight," as some providers have left the market while others are not expanding their existing businesses, said Keith Overly, executive director of the $6.8 billion Ohio Public Employees Deferred Compensation Program, Columbus. "Wrap providers have generally become more risk averse and are renegotiating fees and terms and conditions."

Wraps are contracts provided by insurers, banks or other financial companies that protect stable value funds' bond portfolios from wild swings in interest rates, guaranteeing participants will receive the funds' book value even if the market value falls. They are used by stable value managers and sponsors of plans that offer stable value as an investment option. Large plans often arrange the contract directly with the wrap provider, while smaller plans usually buy collective trusts from large money managers, who have the insurance contract with the provider.

But as insurers and other providers look to shore up their balance sheets and reduce risk, they are reluctant to provide additional wrap coverage.

One area of concern: The market value of underlying securities has fallen in many stable value funds, increasing the pressure on wrap providers to make up the difference. The average stable value fund tracked by research firm Hueler Analytics Inc., Minneapolis, had a market value that was 95.6% of its book value as of March 31, compared with 99.4% at the end of 2007, said President Kelli Hueler.

Plan participants had about $642 billion in stable value funds through 167,000 defined contribution plans as of year-end 2008, according to Gina Mitchell, president of the Stable Value Investment Association, Washington.

As of March 31, stable value accounted for 35.6% of DC plan assets, according to Hewitt Associates Inc., Lincolnshire, Ill.

UBS, Rabobank out

UBS AG and Rabobank Group are exiting the wrap business, while the future of American International Group Inc.'s wrap business remains unclear given the firm's financial troubles, said Ms. Mitchell. Those three companies accounted for an estimated 10% to 15% of the market, she said. Representatives from UBS and Rabobank did not

return calls seeking comment.

The dozen or so remaining providers — including Aegon Group, J.P. Morgan Chase & Co., Bank of America Corp. and ING Group — have been reassessing their risk profiles and are demanding more from stable value funds, including tighter investment guidelines, she said.

“There's been so much pressure on liquidity and capital that some wrappers are simply not stepping up to wrap new cash,” said James King, vice president and head of Prudential Retirement's stable value markets group in Hartford, Conn.

A survey of 10 wrap contract providers by Pacific Investment Management Co. LLC, Newport Beach, Calif., found that none had capacity at “typical” levels as of the first quarter 2009, and all were uncertain as to when they would be adding capacity.

As a result, defined contribution plan executives and stable value managers are having a difficult time replacing wrap providers that have left the business or have stopped accepting new business.

The lack of capacity also has prevented plans from replacing stable value managers because that might require renegotiating wrap contracts.

“There's no doubt capacity has pretty much dried up over the past week or two,” said Christopher Tobe, a consultant at Breidenbach Capital Consulting LLC, Louisville, Ky.

“I'm hopeful it will slowly pick up again in six months, but right now all the providers are very capital conscious. It's a really serious problem,” he said.

But the Stable Value Investment Association's Ms. Mitchell said: “Overall the ice is starting to melt, but it's a slow process.” She said association officials have been in talks with several companies that are interested in entering the wrap market to add capacity, but declined to disclose their names. “There's a reassessment of risk at all financial companies, so potential newcomers to the wrap market have internal management hurdles to deal with, as well as regulatory hurdles,” she said.

Metropolitan Life Insurance Co., MassMutual Financial Group and The Hartford Financial Services Group Inc. are considered top candidates for stepping in to provide more capacity, said Mr. Tobe.

David Richardson, managing director at $76.3 billion stable value manager Dwight Asset Management Co. LLC of Burlington, Vt., said Dwight executives have also been in contact with other firms that aren't now in the wrap business. One enticement, he said, is that wrap fees, which were “unsustainably low” a couple years ago at about six to eight basis points, have more than doubled this year.

“A lot of the market supply issues will hopefully be solved through the changes in pricing,” he said. “We really see wrap capacity to be a short-term challenge.”

Still capacity

Rebecca Cohen, spokeswoman for Vanguard Group Inc., Malvern, Pa., said there is still capacity in Vanguard's stable value portfolios and that they are still wrapped. “We do not have to give up that capacity, and can continue to take participant contributions, although new money may be directed into money market securities,” she wrote in an e-mail response to questions. “The tone in the market has improved since March, and we are optimistic that stable value providers will be able to work with issuers to provide additional future capacity.”

Pacific Investment Management Co. is hoping to launch its PIMCO Stable Value Trust Nov. 1, confirmed Steve Ferber, senior vice president and account manager, but he added, “it's a much tighter environment” right now for wraps. “We think wrappers are going to continue to be more selective about which investment managers they'll work with,” he said. “But we're actively speaking with wrap providers about wrapping our stable value fund, and are deep in conversations with two companies.”

In the meantime, defined contribution plan executives can seek alternatives to so-called “synthetic” wraps, in which participants own the invested assets. For example, insurance company separate account guaranteed-interest contracts can offer the same principal protection and similar features as wrap contracts, but are generally more expensive for plans, said Mr. Tobe.

Cynthia Mallett, vice president of corporate benefit funding at MetLife in New York, said she has seen an uptick in demand in recent months for such separate accounts. “There has been a circling of the wagons, and many plan sponsors are looking at the GIC structure in concert with other stable value options.”

Ms. Hueler agreed. “We encourage plan sponsors to consider the whole spectrum of products, from general account products to separate accounts,” she said. “One structure may be more beneficial than another, depending on the plans.”

For stable value managers, Gerry Katz, senior vice president at Diversified Investment Advisors Inc., Purchase, N.Y., said those funds with strong market-to-book ratios will have an easier time finding wrap providers than funds with weaker ratios.

“A proven track record, particularly managing through the fixed-income market last year, will make it easier to attract what little wrap capacity there is out there,” he said.

Mr. Katz also predicted reinsurance companies may step in and back up existing wrap contracts, allowing existing providers to take on more capacity.

Michael T. Halpin, executive director of the $2 billion Maryland Teachers & State Employees Supplemental Retirement Plans, Baltimore, said improved wrap capacity will ultimately depend on an economic recovery. “As markets stabilize, the capacity issue will take care of itself,” he said. ?

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