Understanding and evaluating stable value investment options

A common-sense approach

While investment selection is just one of the many decisions that plan fiduciaries make, the market volatility and investment performance of the past decade have opened myriad discussions regarding appropriate asset allocation strategies, diversification, and the need for principal protection. Plan sponsors, plan participants, and their advisers are in a position to use investments that seek to add stability, liquidity, yield, and principal protection to retirement plan portfolios.

Stable value products continue to infuse retirement plan portfolios with these qualities for millions of plan participants. This article will provide a synopsis and a comparison of prevalent stable value product structures, as well as possible considerations in evaluating stable value providers.

Choosing the stable value solution that may be best for a plan sponsor and plan participants requires analysis of the different types of stable value options available. While most stable value options seek to preserve capital and provide competitive returns, the most common stable value options offered today differ significantly.

Two common types of stable value products

1 Guaranteed insurance accounts

Assets are invested directly with the insurer. The invested assets are held in the insurer's general account or insulated separate account. The insurer is both the investment manager and the guarantee provider. The insurance company issues a direct guarantee to the plan through a group annuity contract.

2 Collective investment trusts

A diversified portfolio of fixed income securities that is protected from movements in interest rates by wrap contracts from banks and insurance companies. The wrap contracts are issued directly to the collective trust, not the plan. The wrap providers serve two purposes: book value accounting, which stabilizes volatility, and to pay plan participants if underlying assets are not sufficient to cover withdrawals.

The following page provides a deeper comparison of these two options.

Comparison of the Lincoln Stable Value Account (guaranteed insurance account) and a typical collective investment trust

Asset class	Lincoln Stable Value Account[1]	Typical collective investment trust
Objective	To provide safety of principal, liquidity, and a stable rate of return	To provide safety of principal, liquidity, and a stable rate of return
Structure	Insurance company general account or separate account offered through a group annuity contract (depending on plan sponsor's election)	Bank collective trust
Guarantees	Insurance company bears the risks of underlying asset default and market fluctuations in the value of securities held.	A combination of third party insurance and bank providers bear the risk.
Crediting rate known in advance	Yes. The interest rate is declared in advance.	No. The rate of return fluctuates daily.
Crediting rate guarantee period	Yes. The rate is guaranteed for a six-month period.	No. The rate of return fluctuates daily.
Guaranteed minimum interest rate	Yes. The crediting rate will never fall below a contractual guaranteed minimum interest rate of 1% in most states.[2]	No. There is typically no guaranteed minimum interest rate for the collective investment trust in aggregate.
Book value participant withdrawals for qualifying events and transfers	These are guaranteed to be paid at book value (full principal and interest) with industry-standard equity wash and similar provisions to protect remaining participants.	The return of principal and interest isn't guaranteed under certain conditions.
Transfers to competing funds allowed	Yes. Transfers are subject to the industry-standard equity wash restriction to protect remaining participants.	Yes. Transfers are subject to the industry-standard equity wash restriction to protect remaining participants.
Wrap capacity	Wrap capacity is ample and is provided by The Lincoln National Life Insurance Company or Lincoln Life & Annuity Company of New York. The group annuity contract and associated guarantees are issued directly to the plan or trust.	Wrap capacity is dependent on external insurance companies and banks to provide guarantees. Book value contracts are issued to the collective investment trust, and the terms are not disclosed to a plan.
Underlying investments	High-quality, well-diversified portfolio of fixed income instruments, primarily intermediate-term public bonds, private placement bonds, and commercial mortgages with a duration of three to seven years	Fixed income instruments, primarily intermediate-term public bonds, insurance company guaranteed investment contracts (GICs), synthetic GICs, and cash with a duration of two to four years
Plan-level termination	Book value payout can be immediate or over time, depending upon the plan's election. The Stable Value Account remains fully benefit-responsive upon contract termination, and discontinuance fees do not apply.	Book value cash-outs may be delayed up to 12 months.
Fees	None. The rate is net of fees with no additional expenses.	Fees are typically stated as an expense ratio and vary by fund.

[1] Stable Value Account features for contracts issued after October 1, 2014.

[2] Principal and interest are guaranteed by The Lincoln National Life Insurance Company or Lincoln Life & Annuity Company of New York.

Evaluating stable value investments

Collective investment trusts experienced a number of challenges during and following the 2008–2009 financial crisis. Prior to that, wrap fees had been driven into the single digits with banks dominating the marketplace. As credit spreads then widened and market-to-book ratios plunged into the mid 80s to low 90s, many wrap providers became aware of the riskiness of the contracts they had written and have since exited the market.

The removal of wrap capacity from the market caused some funds to close down for new deposits or terminate completely. This diminished capacity has been filled by new entrants with higher fees and contract terms that are more protective of the wrap providers and potentially punitive to fund participants for plan sponsor initiated events or changes in regulation.

Insurance company single-provider annuity contracts are primarily challenged with one issue — single-provider risk. In other words, it may be risky to select a product managed and guaranteed by a single-provider because that provider may not be able to pay.

Worries about single-provider risk may make sense on the surface, but this risk is present in any single-provider insurance or investment product. We already rely on single-provider products for other insurance needs like homeowners insurance or car insurance. In a single-provider annuity contract, the insurer backs the guarantee, but the insurance regulatory system actively monitors and regulates the financial solvency of the insurance companies, as well.

Perhaps the critical question we should be asking is how one can develop a useful and flexible framework for evaluating the financial strength of an insurance carrier that backs a guaranteed or stable value solution. Consider looking first at the ratings assigned to insurance companies by the ratings agencies. Additionally, the defined benefit (DB) plan marketplace may provide some useful guideposts for prudent defined contribution (DC) plan practitioners to consider.

Although these authorities do not speak squarely to the question of how a plan sponsor should evaluate a stable value investment option, they may help provide a framework to guide a plan fiduciary's analysis of an insurance company provider.

Lessons learned from defined benefit plans

In 1995, the Department of Labor issued DOL Interpretive Bulletin 95-1 (DOL 95-1) to provide guidance concerning certain fiduciary standards applicable to the selection of an annuity provider for the purpose of benefit distributions from a DB pension plan when that plan intends to transfer liability for benefits to an annuity provider. DOL 95-1 outlines six core decision-making criteria that DB plan fiduciaries must consider. They are as follows.

1. **Quality and diversification of the annuity provider's investment portfolio**

   Items for consideration: below-investment-grade bonds, stocks, alternative investment holdings, and out-of-favor assets (that is, subprime, European bonds)

2. **Size of the insurer relative to the proposed contract**

   Item for consideration: Larger contracts may be more appropriately suited for larger insurers.

3. **Level of insurer's capital and surplus**

   Items for consideration: mutual company versus stock company, total surplus versus risk-based capital, and surplus and risk-based capital volatility

4 Business lines of the annuity provider and other indications of exposure to liability

Items for consideration: variable annuity with guaranteed living benefits exposure, affiliated statutory insurance companies, affiliated noninsurance company businesses, property and casualty, and health insurance exposure

5 Structure of the annuity contract and guarantees, such as the use of separate accounts

Items for consideration: participating versus non-participating guarantee, general account versus separate account, discontinuance provisions, transfer restrictions, crediting rate methodology, and guaranteed minimum interest rate (GMIR)

6 Availability of protections through state guaranty associations and the extent of those guarantees

There are state guaranty associations that make available certain protections. The National Organization of Life & Health Insurance Guaranty Associations (NOLHGA) provides additional information at nolhga.com.

It's important to note that although the DOL 95-1 criteria are some of the factors a plan fiduciary may want to consider when evaluating annuities, they weren't meant to be an exhaustive list. This gives fiduciaries the flexibility to customize their evaluation analysis and process without a rigid "bright line" type of mandate. Aside from identifying these key criteria, DOL 95-1 also interjected some helpful guidance to plan fiduciaries:

- It's not sufficient to rely solely on insurance company ratings.
- Fiduciaries that don't possess the expertise to conduct a thorough and objective analysis need to obtain the advice of an independent expert.
- There may be more than one safest available annuity provider.
- It may be acceptable to select a provider other than the safest available if that decision is made for the exclusive benefit of participants (that is, a carrier who is only marginally less safe but provides stronger administrative service capabilities).

While DOL 95-1 wasn't issued directly for the DC marketplace, the approach outlined above represents a potential best practice rather than a legal requirement. Nevertheless, the initial DB guidelines in DOL 95-1 may offer DC plan stakeholders a thoughtful and time-tested framework to consider as they evaluate their own process for analyzing, selecting, and monitoring guarantees provided under fixed rate or stable value funds.

Safe harbor for defined contribution plans

In 2007, the DOL issued DOL Regulation Section 2550.404a-4 to establish a safe harbor for the selection of annuity providers for the purpose of benefit distributions from individual account plans covered by Title I of the Employee Retirement Income Security Act (ERISA). The final rule was effective on December 8, 2008, and was focused on DC plans. The safe harbor relief conditions are met if the plan fiduciary:

- Engages in an objective, thorough, and analytical search for the purpose of identifying and selecting providers to purchase annuities from
- Appropriately considers information sufficient to assess the ability of the annuity provider to make all future payments under the annuity contract
- Appropriately considers the cost of the annuity contract, including fees and commissions, in relation to the benefits and administrative services to be provided under the contract
- Appropriately concludes at the time of the selection that the annuity provider is financially able to make all future payments under the annuity contract and the cost of the annuity contract is reasonable in relation to the benefits and services to be provided under the contract
- If necessary, consults with one or more appropriate experts for purposes of complying with the requirements of the safe harbor

Similar to DOL 95-1, this regulation doesn't apply to a plan fiduciary's selection of a fixed rate or stable value investment. However, it may provide some helpful guideposts a plan sponsor can consider to evaluate this type of investment.

Concluding thoughts

Plan sponsors, their advisers, and plan participants are in a position to use investments that add stability, liquidity, yield, and principal protection to retirement plan portfolios.

Stable value infuses retirement plan portfolios with these qualities. While most stable value options seek to preserve capital and provide competitive returns, the most common stable value options offered today differ significantly. An important part of the stable value selection process is understanding these differences and working with stable value providers who have experience and success managing stable value assets through varying market conditions.

For over 30 years, the risk-controlled approach to stable value management offered by Lincoln Financial Group has been an attractive solution for plan sponsors and participants seeking stability, liquidity, yield, and principal protection.

At Lincoln, we've employed a disciplined, conservative investment approach that spans more than a century. Most importantly, we're fully committed to the stable value category. As in the past, we'll continue to view stable value as a cornerstone to our ability to help support better outcomes for plan sponsors and plan participants.

Lincoln is a premier provider of stable value solutions and has offered risk management expertise, financial strength, and attractive contract provisions to defined contribution plan sponsors for over 30 years.

Want to know more about our stable value solutions?

Please contact your Lincoln retirement plan representative or call our sales desk at **855-533-2170**.

Or, go to **LincolnFinancial.com/StableValue**.

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