Investing Special Financial Assistance Program Assets

by | **Brian Bruzda**

The Special Financial Assistance (SFA) program affords troubled multiemployer pension plans an opportunity to significantly improve their health. This article reviews the rules on permitted investments, examines various portfolio allocation policy alternatives and offers considerations for trustees.

Following approval to receive a payment through the Special Financial Assistance (SFA) program, trustees of multiemployer plans face an important decision—how to invest that money.

This article will review the final permissible investments rules issued by the Pension Benefit Guaranty Corporation (PBGC) and examine possible investment portfolio asset allocation frameworks. It will also highlight other considerations that SFA-recipient plan trustees might contemplate when structuring their investment portfolios.

SFA Program

PBGC issued final rules governing the SFA program in July 2022.[1] The program was created by the American Rescue Plan Act (ARPA) of 2021 and is expected to provide between $76 billion and $91 billion in direct financial payments to approximately 200 troubled multiemployer defined benefit (DB) pension plans, which collectively cover more than three million participants.[2] The primary goal is to ensure that plan beneficiaries receive their earned pension benefits through 2051. Following a comment period, PBGC, which administers the program, set the final rules and regulations in July 2022, including specific guidance on how SFA proceeds may be invested.

Upon PBGC application approval, eligible plans will receive a one-time, lump-sum payment. If future returns meet the current actuarial return assumptions, the SFA payment plus future contributions are intended to enable plans to satisfy their benefit payment obligations through 2051.

In contrast to the interim rules published in 2021, two of the final rules that went into effect in August 2022 materially affect both the amount of assistance that eligible plans may receive and how those proceeds can be invested:

- The final rules stipulate lower expected investment returns for both the SFA and legacy investment portfolios for the purpose of determining the lump-sum assistance payment.[3] These lower prescribed expected returns, or interest rates, will result in plans receiving more financial assistance upon application approval.
- Whereas the interim rule limited the investment universe to only investment grade fixed income (IGFI) securities, PBGC amended the schedule of permissible investments for the SFA proceeds to allow for return-seeking assets (RSA). This added flexibility allows plan sponsors to structure the SFA portion of their portfolio to potentially earn higher investment returns. The assets of some eligible plans will consist entirely of the SFA proceeds, but most plans have existing investment assets. PBGC does not mandate how these legacy investment assets are invested.

SFA Portfolio Permissible Investments Rules

ARPA Section 4262.14 details the program's specific permissible investments rules and regulations:[4]

- SFA assets and any subsequent reinvested earnings must be segregated from legacy assets. In practice, this entails a separate custody account to hold the mutual funds, exchange-traded funds (ETFs), collective trusts and/or other securities. The governing investment policy statement for each recipient plan will need to be modified to memorialize this asset segregation.
- Plans may allocate up to 33% of SFA proceeds to RSA, which may include publicly traded U.S. dollar-denominated equities, Rule 144A fixed income securities and SFA-eligible fixed income securities that were investment grade at the time of purchase. This guideline allows reasonable flexibility for the percentage of RSA to exceed the 33% maximum threshold if it is attributed to the automatic reinvestment of earnings and/or investment appreciation (periodic rebalancing provides a mechanism to ensure ongoing

takeaways

- The Special Financial Assistance (SFA) program created by the American Rescue Plan Act (ARPA) provides a one-time, lump-sum payment for troubled multiemployer pension plans.
- The program is expected to provide between $76 billion and $91 billion in direct financial payments to about 200 multiemployer defined benefit (DB) pension plans. The SFA payment plus future contributions are intended to enable plans to satisfy their benefit payment obligations through 2051.
- SFA assets and subsequent reinvested earnings must be segregated from legacy assets. Plans may allocate up to 33% of SFA proceeds to return-seeking investments (RSA). The remainder must be allocated to investment grade fixed income (IGFI) securities and/or cash.
- Plans may allocate or increase their allocations to private assets within the legacy portion of their portfolio as long as doing so is not inconsistent with meeting their liquidity needs.

compliance with the 33% RSA rule). Plans must attest to compliance with the 33% maximum RSA threshold on at least one day during a rolling 12-month period following initial receipt of the SFA proceeds, as well as whenever RSA are purchased.

- The remaining 67% of SFA proceeds must consist of U.S. dollar-denominated IGFI securities and/or cash. IGFI securities include U.S. Treasury and U.S. government agency issues, municipal bonds and corporate bonds rated as investment grade by agencies such as S&P and Moody's.[5]
- Permitted investment vehicles include individual securities, mutual funds, ETFs, collective trusts and single client accounts.
- Derivative instruments (e.g., options and futures) are permitted only if their use does not increase risk (e.g., to replicate the return and risk characteristics of cash securities or to equitize frictional cash holdings).[6] This means derivative instruments are not permitted when expressly used to potentially lever or amplify investment returns.

In addition to the permissible investments rules and regulations, Section 4262.14(c) stipulates that except for plans facing insolvency within a year, money sufficient to meet one year of benefit payments must be held in IGFI securities and/or cash.

The program does not specify whether benefit payments and/or administrative expenses should be paid from the SFA or legacy assets. The choice is left to the trustees. This means that plans may exhaust SFA proceeds before legacy assets or vice versa, thus allowing plan sponsors flexibility to increase investment risk within their legacy investment portfolios in pursuit of higher returns.[7] However, for the purpose of determining the amount of assistance granted, PBGC assumes that benefits will be paid from the SFA proceeds until they are exhausted.[8]

Plan sponsors may invest SFA proceeds in passive (i.e., indexed) or active investment mandates as long as they otherwise follow the program rules. In summary, the rules strike a balance between the potential for higher returns and protecting SFA proceeds from outsized investment risk.[9]

Asset Allocation Frameworks

The following portfolio asset allocation frameworks illustrate the effects of the SFA rules in practice.

Because the program governs only how the SFA proceeds may be invested, plans are free to restructure their legacy investment portfolios. This might entail reallocating only among existing investments or may extend to adding new asset classes, including alternatives. The following analyses lim-

TABLE

Asset Allocation Scenarios for Special Financial Assistance (SFA) Recipient Plans

		SFA Only	Legacy	Two-Thirds SFA— One-Third Legacy			One-Third SFA—Two-Thirds Legacy			
				Combined		Mix 1	Combined		Mix 2	Mix 3
Public Markets	Stocks	33%	60%	41.9%	Minimum of 44.9% to investment grade fixed income (IGFI) securities	50%	51.1%	Minimum of 22.1% to IGFI securities	55%	40%
	Bonds	67%	30%	54.8%		45%	42.2%		25%	25%
Private Markets	Real estate	0%	10%	3.3%		5%	6.7%		5%	7.5%
	Private equity	0%	0%	0%		0%	0%		5%	10%
	Private debt	0%	0%	0%		0%	0%		5%	10%
	Infrastructure	0%	0%	0%		0%	0%		5%	7.5%
	Expected return	4.6%	5.9%	5.1%		5.4%	5.5%		6.3%	6.6%
	Risk	5.5%	11.1%	7.2%		8.8%	9.2%		11.3%	10.6%
	Total fund percentage of private markets	0%	10%	3.3%	N/A	5%	6.7%	N/A	20%	35%
	Legacy percentage of private markets*	N/A	N/A	10%	N/A	15%	10%	N/A	30%	52.5%

Includes a 15% allocation to real estate.

its alternatives to real estate, private equity, private debt and infrastructure.

The scenarios shown in the table on page 17 are not meant to be exhaustive but rather starting points.[10]

SFA Only

In the SFA-only portfolio, RSA are limited to 33% with the balance allocated to IGFI (i.e., no less than 67%). In this portfolio, the RSA are invested in public market U.S. equities. This SFA-only portfolio may be thought of as a baseline for asset allocation decisions.

Legacy

A portfolio consisting of 60% stocks, 30% bonds and 10% real estate is representative of many multiemployer DB pension plans.[11] The mix has a higher expected return and higher risk than the SFA-only portfolio. This makes sense since the stock allocation is nearly double that of the SFA-only allocation, and the scenario also includes real estate, which is projected to deliver higher returns than IGFI. For this mix, real estate should be viewed as a semiliquid asset class which, in practice, typically affords liquidity on a quarterly basis. However, real estate can become illiquid depending on market and/or manager circumstances.[12]

Two-Thirds SFA/One-Third Legacy

This scenario assumes that the SFA proceeds make up two-thirds of the plan's total investment assets. The column labeled "Combined" shows the combination of the SFA-only plus the legacy portfolios. As shown in the column labeled "Mix 1," the expected return for the portfolio could be increased by putting all of the plan's IGFI in the SFA portfolio and all of the assets in the legacy portfolio into riskier assets (note that in this example, the legacy assets are modeled to include 15% real estate). The expected return for the combined portfolio is 5.4% versus 5.1% for the portfolio that combined the SFA-only with the legacy portfolio.

One-Third SFA/Two-Thirds Legacy

This scenario analyzes two potential mixes, each allocating proportionally more to private markets. This is possible because the SFA portion of the overall portfolio is smaller than in the previous scenario. To comply with the regulations, the allocation to IGFI must be at least 22.1%. (See the section below for information about calculating the minimum allocation to IGFI.) If the allocation to IGFI is rounded to 25%, that leaves as much as 75% that can be invested in RSA in the combined portfolio. Mix 2 projects an expected return of 6.3% through allocating 30% of the legacy assets to private markets (20% of the total plan). Mix 3 achieves a higher expected return of 6.6% by allocating 52% of the legacy assets to private markets (35% of the total plan). Mix 3 is expected to have lower risk than Mix 2 because of its lower allocation to public stocks. However, modeling investment risk is imprecise, and the illiquidity of private markets is not captured in standard measures of volatility. While Mixes 2 and 3 are in line with the range of actuarial assumed returns for many multiemployer DB pension plans, investment proceeds can satisfy benefits only if they are liquid when needed.

Calculating a Plan's Minimum Allocation to IGFI

Each plan receiving SFA proceeds is unique, including the percentage of SFA assets in relation to the total assets (SFA + legacy). To find a plan's minimum allowed allocation to IGFI, trustees can multiply the portfolio's percentage of SFA assets by 67% (the minimum required allocation to IGFI).

Examples include the following.

- If SFA proceeds are expected to comprise 80% of a plan's total assets, the minimum allocation to IGFI will be 53.6% (0.80 x 0.67 = 0.536). This means the plan could allocate the remaining balance (allowed RSA within the SFA portfolio plus all of the legacy assets), or as much as 46.4%, to RSA.
- If SFA proceeds are expected to comprise 20% of total assets, the minimum allocation to IGFI will be 13.4% (0.20 x 0.67 = 0.134). That means the plan could allocate the remaining balance, or as much as 86.6%, to RSA.

learn more

Education

Investments Institute
April 24-25, New Orleans, Louisiana

Visit *www.ifebp.org/investments* for more details.

Alternative Investment Strategies
July 18-20, San Francisco, California

Visit *www.ifebp.org/altinvest* for more information.

Liquidity Considerations

Allocating to private market investments injects a degree of complexity into any investment portfolio. Within the context of this analysis, a key concern is managing ongoing liquidity needs. That encompasses planning for benefit and expense payments, the liquidity characteristics of each private markets mandate and the ability to rebalance the portfolio.

To account for these factors, investment consultants often prepare and periodically update a pacing study, the primary goal of which is to project future commitments to private assets. The study is used to develop a plan that maintains asset class allocations through time that are in line with the plan's investment policies. The inputs to a pacing study analysis include:

- **Current inputs: plan status, portfolio and policies**
  - –Estimated benefit payments and expenses
  - –Current private market capital commitments
  - –Amount of capital remaining to be called from existing commitments
  - –Current and longer term target asset allocations
- **Projected inputs**
  - –Rates of return for all asset classes, both liquid and illiquid
  - –Timing and amounts of future commitments for each type of private asset
  - –Timing and amounts of capital calls from current and future commitments
  - –Timing and amounts of future capital distributions from current and future commitments.

Another consideration is the expected life span of each private market investment. Most "core" real estate managers are structured as open-end, or perpetual, life vehicles. They can provide liquidity on a quarterly basis (usually), but the funds can impose gates or queues that suspend redemptions for an indefinite period. This often occurs during periods of systemic market stress when plans most need liquidity. In contrast, private equity vehicles are usually closed-end, often with projected life spans of ten years or more (the general partners often request extensions beyond the initial projected life span). The universe of private markets is also evolving. Hybrid vehicle structures are being developed that have shorter lock-up periods and, as a result, may provide more liquidity sooner.

The key consideration is that private markets may offer plans differentiated and often higher return opportunities as well as diversification benefits—but they must be managed prudently. In the context of a plan that receives SFA proceeds, any and all private market investments must be held within the legacy portfolio. A portfolio consisting of an inordinately high level of illiquid assets could result in the plan sponsor having to liquidate public market assets at an inopportune time or being forced to sell illiquid investments at a discount in the secondary market.

Matching Liabilities

Should bonds in the SFA proceeds be matched to liabilities? The SFA rules require that assets be invested so that there are sufficient liquid assets to meet the plans' expected cash needs for the next 12 months. Some investment managers proposing strategies specific to SFA assets suggest going beyond the one-year requirement. They propose cash flow matching approaches whereby individual bonds' interest and maturity payment schedules align with plan cash flow needs. That approach essentially divides the SFA portfolio into two components: one structured to match several years of upcoming cash flows and the remainder to maximize total return within the SFA guidelines.

This is one viable strategy and could be incorporated into an overall investment program. It ensures that there will be cash available to meet near-term cash needs without a risk of having to sell assets at an inopportune time. In addition, as SFA assets shrink, they could all be invested in a liability-matching manner. One downside of the cash flow matching approach is that it limits return potential.

Other Considerations

Plan trustees may also ask the following questions about their asset allocation approach.

- Does the RSA investment portfolio allocate to both U.S. and non-U.S. equities?
- Are liquid investments managed passively (i.e., indexed) or actively?
- Should fixed income securities in the legacy portfolio include below investment grade issues?
- Does the plan already have commitments to private markets and, if so, do they limit the options otherwise available?

In short, there is not a one-size-fits-all allocation: Each plan's circumstances are unique and so should be its implementation.

benefits MAGAZINE

Reproduced with permission from *Benefits Magazine,* Volume 60, No. 2, March/April 2023, pages 14-20, published by the International Foundation of Employee Benefit Plans (www.ifebp.org), Brookfield, Wis. All rights reserved. Statements or opinions expressed in this article are those of the author and do not necessarily represent the views or positions of the International Foundation, its officers, directors or staff. No further transmission or electronic distribution of this material is permitted.

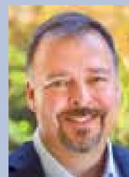
Interest Rate Environment

It should be noted that market interest rates for bonds were significantly lower when ARPA was originally passed in 2021. The investment landscape is dramatically different now. Stocks appear more fairly valued than in 2021, and bonds are for the first time in recent memory yielding meaningfully impactful returns. Because of how the SFA assistance is calculated, the higher current interest rates will result in recipient plans receiving marginally lower proceeds. Yet the expected future investment returns for both the SFA and legacy assets are higher now than at any time in the more recent past. The future landscape will present different investment opportunities than when the final rules were published.

Conclusion

The SFA program contains definitive rules yet provides flexibility for plan sponsors to structure and manage their investment portfolios to last not only to, but beyond, 2051. Plan sponsors should structure and manage both the SFA and legacy asset portfolios holistically. SFA recipients still face the same investment issues as other multiemployer DB pension plans, so trustees should be mindful to balance return needs, investment risks and liquidity requirements. The SFA proceeds, combined with an effective overall investment portfolio, can help to ensure that participants receive their earned pension benefits and strengthen the value proposition these plans offer to their members both now and in the future.

bio



Brian Bruzda, CFA, is a managing senior consultant at Alan Biller and Associates, an institutional investment consulting firm, and is an expert in the development and ongoing maintenance of institutional investment programs. He was previously an area vice president at Arthur J. Gallagher & Co. and a vice president and senior consultant at Segal Rogerscasey. Bruzda has predominantly served Taft-Hartley plan sponsors as lead consultant to defined benefit, defined contribution, welfare and VEBA funds both regionally and nationally. He holds the CFA designation and is a member of the CFA Society of Cleveland. He holds a B.S. degree in business administration from Chancellor University.

Endnotes

1. "Special Financial Assistance by PBGC." Vol. 87 No. 130 Fed. Reg.; pages 40968-41024 (July 8, 2022). Available at www.federalregister.gov/documents/2022/07/08/2022-14349/special-financial-assistance-by-pbgc.
2. Employee Benefits Security Administration, July 9, 2021. U.S. Department of Labor Statement on PBGC "Special Financial Assistance" Interim Final Rule for Eligible Multiemployer Plans [Press release]. Available at www.dol.gov/agencies/ebsa/laws-and-regulations/laws/arp/dol-statement-on-pbgc-special-financial-assistance-interim-final-rule.
3. Segment rates for the purpose of establishing the SFA assistance are published by the Internal Revenue Service (IRS). www.irs.gov/retirement-plans/pension-plan-funding-segment-rates#table-3a-2022.
4. "Special Financial Assistance by PBGC." Vol. 87 No. 130 Fed. Reg.; §4262.14 Permissible investments of special financial assistance (July 8, 2022). Available at www.federalregister.gov/documents/2022/07/08/2022-14349/special-financial-assistance-by-pbgc#sectno-reference-4262.14.
5. Fixed income strategies that invest predominantly in investment grade issues are commonly referred to as "core."
6. Particularly as it relates to commingled/collective investment vehicles, managers are often in receipt of unplanned cash proceeds that are ultimately invested in specific individual securities. During this interim period, managers regularly "equitize" the cash by purchasing instruments to mimic the return and risk characteristics of their overall portfolio. This practice is done primarily to minimize what is referred to as a "cash drag" on a portfolio.
7. Since non-SFA assets should earn higher investment returns, exhausting the SFA assets first provides more time for the non-SFA assets to grow before being needed to satisfy ongoing benefits and expenses.
8. Pension Benefit Guaranty Corporation. July 28, 2022. Special Financial Assistance Final Rule: Special Considerations for Plans That Applied Under the Interim Final Rule and Other Plans Currently Eligible to Apply. Available at www.pbgc.gov/sites/default/files/documents/sfa-final-rule-practitioner-briefing-28-july.pdf.
9. In January, PBGC announced additional relief for SFA plans related to withdrawal liability, however withdrawal liability calculations are outside the scope of this article.
10. Projections of asset class risks and returns are based on proprietary survey-based, midyear, long-term asset class assumptions. Allocations rounded to 5% increments.
11. Real estate managers who comprise the NFI-ODCE universe: www.ncreif.org/globalassets/public-site/news-page/news-articles/snapshots/2022q3/odce_snapshot-20223.pdf.
12. Real estate managers may raise gates or "queues" limiting withdrawals for an undetermined amount of time.

pdf/323