Plan Investments

Possible Impact of Fair Value Accounting on Retirement Plans' Investments in Mortgage Securities and Alternative Investments

Financial Accounting Standard 157, which mandates fair value accounting, is in the throes of being adopted, debated and reviewed. Among the questions is how FAS 157 applies to pension plans. In March 2008, the board members of Financial Accounting Standards proposed for discussion how fair value accounting may be applied to FASB Statement 132(R), Employers' Disclosures about Pensions, and Other Postretirement Benefits.

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Under fair value accounting there are three levels of financial assets that have different accounting treatments:

- Level 1—positions with active market prices;
- Level 2—securities where there are price indications, perhaps prices for similar securities that can serve as a reliable guide in estimating prices; and
- Level 3—securities that do not have active prices or prices for similar securities to provide a benchmark from which to estimate a price and are, therefore, priced based upon a model.

The controversy surrounds Levels 2 and 3, but particularly Level 3. How does one value an asset that has no quoted market or an asset whose quoted market is based upon a small, distressed sale? The mortgage market is huge: about 45 percent of all non-financial domestic debt outstanding at the end of 2007 was mortgage debt and most issues trade little after the initial offering period. So discerning "fair value" is difficult at best. The increasing use of alternative investments in pension plans also raises questions about valuation of illiquid and unquoted assets. Key to the proposals is the requirement for more disclosure of the methodology used to estimate values for Level 2 and Level 3 assets.

The proposed changes to FASB Statement 132(R) cover the following major asset categories:

- Cash and equivalents;
- Equities;
- Debt securities issued by:
  - — Federal, state, and local governments, and
  - — Corporations;
- Asset-backed securities, such as those backed by mortgages, credit cards, auto loans, etc.;
- Structured debt and derivatives;
- Hedge funds;
- Private equity funds, including those investing in venture capital and buy-outs etc.; and
- Real estate.

In addition to the requirements covering valuation, management is required to discuss risk within the plan's investment assets. Risk includes concentration risk, market risk, credit risk, and liquidity risk.

Readers of the financial press are well aware of the turmoil in the mortgage securities market and its impact on financial institutions. We have had not only an issue with the credit quality of mortgage-related bonds, but also a crisis of confidence that has caused liquidity to evaporate. The little trading that occurs tends to be at distressed prices. Sellers who are compelled to sell take whatever price they can get. Aware of distressed sale conditions in the market place today, buyers tend to bid the lowest price possible to do the trade. Buyers may bid knowing that there may be no sale, but are willing to wait patiently for the desperate seller. The desperate seller is one compelled to raise cash; for example, to meet margin calls or fund share redemptions. These distressed prices may force asset write-downs, which (in the case of leveraged investors) may cause more margin calls resulting in a treacherous downward spiral that impacts bond portfolio values. However, pricing services may ignore distressed sale prices if so identified. But, this may create more confusion about "fair value."

The mortgage crisis has its roots in the desire for growth. Financial intermediaries of all kinds—-mortgage brokers, savings and loans, banks, and securities brokers—had been under pressure to increase earnings. Monetary policy until the fall of 2007 was easy. Lending standards were lax. The American dream of home ownership was espoused by all. Meanwhile, home prices were rising at a faster clip than typical, so home owners were quick to tap into the rising values with the aid of new types of financing. Historical business and lending practices were compromised in pursuit of growth and new instruments, such as CMOs of Alt A and subprime loans, and drove underwriting standards even lower.

Financial engineering made it possible to shift the risk of repayment from the lenders to the owners of the securities that were made up of all types of home-related borrowing instruments. Under pressure to generate investment returns, investors were also eager lenders through the purchase of new types of securities that carried higher returns. Few, whether lenders or borrowers, appear to have asked what could go wrong. And few imagined that so many things might go wrong at the same time. In addition, many investors appear to have relied on the rating agencies and did not understand the structure of many of the new types of mortgage-related securities.

Because implementation of FAS 157 begins with those reporting periods after November 2007, quarterly reports are just now beginning to shed light on and raise questions about the application of "fair value accounting" on the interim statements of public companies. So far, little has been said about the application of FAS 157 to pension funds, and only limited professional writing has discussed proposed modifications to FASB Statement 132(R).

Assume two typical pension allocations to fixed income securities: 30 percent fixed and 40 percent fixed. Assume further that 45 percent of the fixed income allocation is invested in mortgage securities, in line with the overall value of mortgage-related securities as a percentage of all investment-grade, non-financial domestic debt outstanding, and about the same percentage of the Lehman Aggregate Bond Index, a widely used fixed income benchmark. Further assume that half are GNMA securities that carry US government guarantees. While GNMA issues may trade infrequently, the yield premium/price discount to a Treasury bond is generally small. Given the recent decision resulting from the newly enacted legislation to explicitly back Fannie Mae and Freddie Mac, these agency issues should also be easy to value. The private mortgage securities are the area of concern and trepidation when one attempts to estimate a value. If one assumes that private mortgage debt is only 10 to 20 percent of the mortgage debt owned in the fixed income portfolio, then the area of problematic pricing might only be 2 to 5 percent of the total portfolio. Although the amount of price discount in the current market environment might be as much as 50 to 70 percent from the original issue price, the impact on the overall value of the pension assets would be relatively small: mark-downs in the neighborhood of 1 to 3 percent of the total fund's assets.

In addition to hard to value mortgage related securities, pension funds have increasingly been investing in so-called "alternative investments" such as hedge funds, private equity funds, and real estate. While no hard data exist, good guestimates indicate that the amount might be in the vicinity of 10 percent of total investment assets. In July 2008, the Boston office of the Department of Labor stated in a letter to a plan fiduciary, which was first reported on *Pension & Investments'* Web site, that a plan's "failure to have an established process by which the fair market-value of alternative investments can be determined violates the Employee Retirement Income Security Act" (ERISA). The letter goes on to indicate that a plan fiduciary cannot simply accept the value provided by a general partner of a fund in its regular report and should independently arrive at fair value. The industry is challenging this interpretation based upon the cost to implement, the questionable ability to arrive at any better estimate of value, and the burdensome workload that implementing this would require.

Assuming that 10 percent of total plan assets are invested in "alternative investments" and 2 to 5 percent are invested in private mortgage securities, the result is 12 to 15 percent of assets invested in Level 2 and Level 3 assets. As noted above, some of these assets may have estimated values that could be worth as little as 30 to 50 percent of the book value in the current market environment, based upon the values being ascribed to Level 3 assets owned by financial corporations. However, some of the alternative investments could also be worth more, notably the private equity investments. Hedge fund investment values tend to be more discernable and vary with the manager.

Most pension plans will not report on the value of assets until after the plan year, most likely with release of a company's financial statements. How the values will be affected will depend upon market conditions at the date of the financial report, the construction of each plan's portfolio, and how much is invested in hard to value assets. The new rules provide for more disclosure. As a result, we should be better equipped to evaluate the amount of market risk in a pension fund. However, plan fiduciaries have significantly greater burden in the valuation of plan assets and disclosure of the process used to arrive at the values. Between now and year-end, when most plans are valued, plan fiduciaries and their advisors will be seeking more clarity from regulators and establishing a process to arrive at "fair value" that can be explained to investors, regulators, and plan beneficiaries. ■