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Insight  
INVESTMENT

JULY 2021

# INSTANT INSIGHTS

## UPDATE ON THE BUTCH LEWIS ACT

The Butch Lewis Act (the Act) was signed into law as part of the ‘American Rescue Plan’ in March 2021. It contains the Special Financial Assistance (SFA) program for certain multi-employer pension plans facing severe economic challenges (see: [The Butch Lewis Act: A Solutions-Based Perspective](#) for more).

On July 9, 2021, the Pension Benefit Guaranty Corporation (PBGC) announced its interim final ruling on the Act. The 123-page document is available [here](#).

### WHAT DID WE LEARN FROM THE RULING?

Table 1: Summary of Butch Lewis Act interim final ruling<sup>1</sup>

Element of legislation	Clarification
Size of SFA	Based on consideration of <b>all</b> projected resources and obligations; determined as the difference in present value of all ‘obligations’ less all ‘resources’ though plan year ending in 2051. <ul style="list-style-type: none"><li>• <b>Obligations include</b> benefit payments and administrative expenses.</li><li>• <b>Resources include</b> assets, contributions, withdrawal liability payments and income.</li></ul>
Discount rate	No change. Confirmed as <b>lesser of</b> : <ul style="list-style-type: none"><li>• Most recent plan interest rate assumption prior to January 1, 2021, or</li><li>• 3<sup>rd</sup> segment rate + 200bp<sup>2</sup></li></ul>
Permitted investments	US dollar investment grade (IG) fixed income assets. <ul style="list-style-type: none"><li>• 5% limit on bonds downgraded to high yield (must be IG at time of purchase)</li><li>• Foreign issuers allowed if the debt is denominated in US dollars</li><li>• At least one-year of obligations must be held in “permitted investments”</li><li>• Derivatives allowed, but no leverage permitted</li></ul>

<sup>1</sup> For illustrative purposes only

<sup>2</sup> Under the legislation, the discount rate is based on assumptions used in a plan’s most recent status determination filing from before January 1, 2021 subject to a cap based on the Treasury “third segment rate” for the applicable month plus 200bp.

<b>Priority groups</b>	<p>'Priority group' system to manage the flow of applications for the SFA</p> <ul style="list-style-type: none"> <li>• Designed to focus on most severely impacted plans and participants first (i.e., 'priority groups' 1 &amp; 2, respectively)</li> <li>• Application window opens July 9, 2021, for insolvent plans and those projected to become insolvent before March 11, 2022 (i.e., 'priority group' 1 plans)</li> </ul>
<b>Next steps</b>	<p><b>PBGC 30-day comment period.</b> PBGC seeking input on:</p> <ul style="list-style-type: none"> <li>• Permitted investments</li> <li>• Requirement to hold one-year of obligations in "permitted investments"</li> </ul>

**Request for comment period**

The PBGC will now hold a 30-day comment period on these elements, concerning potential unintended consequences on plan health and potential benefits of allowing synthetic fixed income securities, insurance contracts, hybrid securities, preferred stock and other vehicles.

**Insight and its ultimate parent company, Bank of New York (BNY) Mellon, intend to respond with supporting data as requested, consistent with our early support of the Act and our discussions with the PBGC, the Department of Labor, the Department of the Treasury and the Department of Commerce prior to the final interim rule.**

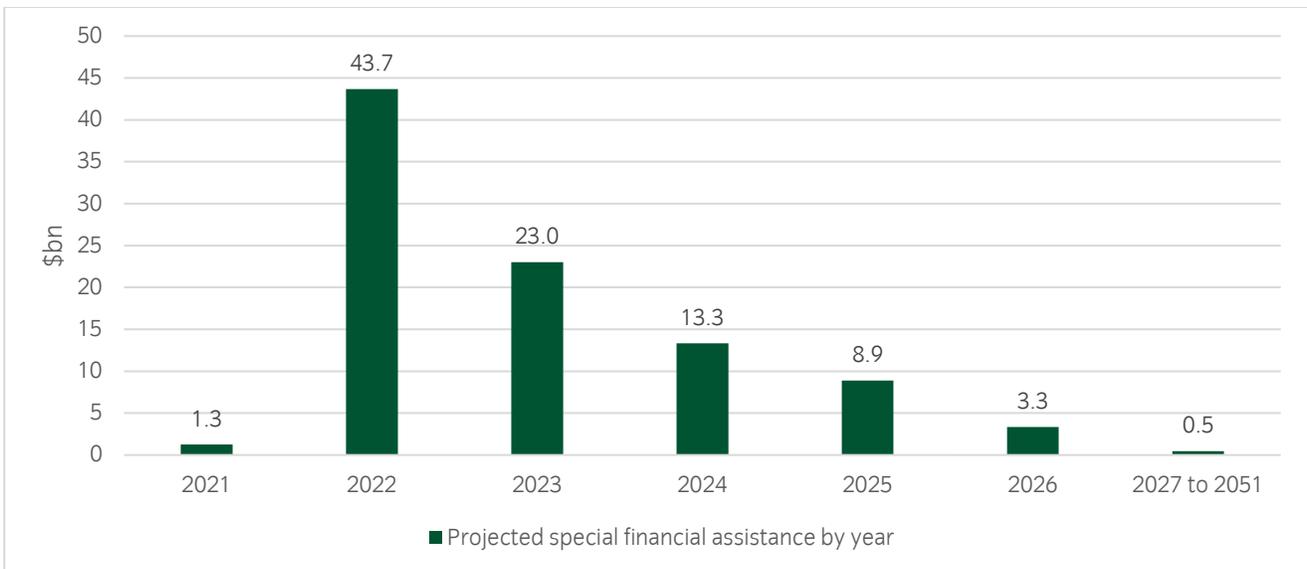
**CLARIFICATION ON AMOUNT OF SFA FUNDS**

The lump sums under the SFA are still designed to cover obligations through the plan year ending in 2051 and will need to be segregated from existing assets.

However, the SFA lump sums will be based on a one-time projection of the plan's net 'obligations and resources', thus will need to factor existing assets, contributions and withdrawal liability payments into the application for funding.

The PBGC's projection of overall assistance remains high, currently at ~\$94bn to over 200 plans (Figure 1).

**Figure 1: PBGC estimates of SFA payments per year<sup>3</sup>**



<sup>3</sup> PBGC, July 2021

## POTENTIAL CHALLENGES GIVEN THE RULE CLARIFICATIONS

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### 1) Significant risk of funds being exhausted prior to 2051

The new interpretation of lump sums under the SFA make it more likely the funds will be exhausted prior to 2051, rather than last through 2051, as intended.

A key consideration is that poor investment performance in the early years of the SFA program may result in increased insolvency as plans experience regular outflows to meet obligations (see [The Butch Lewis Act: A Solutions-Based Perspective](#)).

This also implies inequalities for younger, active workers who are left with no benefits despite years of participation and contributions. This possibility, and the precedent now set by the Act, effectively leaves the door open for a second round of SFA in 10 to 20 years.

### 2) Most plans receiving relief will have SFA calculated with a ~5.5% discount rate

Insight and BNY [advocated for a lower liability discount rate](#) under the Act. However, as the current rules are mandated by statute, the regulators had no option to adjust it.

As such, **we estimate a ~5.5% pa discount rate for most plans** (in line with the third segment rate plus 200bp)<sup>4</sup>. However, some plans (such as Central States Pension Fund), have disclosed a lower rate in form 5500, and thus will use discount rates **closer to ~3% pa**<sup>4</sup>.

IG bond yields are currently ~3%, meaning that plans with lower discount rates can potentially fully immunize their liabilities until 2051, using their segregated SFA portfolio. However, plans with higher discount rates will need to take additional risk to try to generate higher returns consistent with the 2051 end date.

### 3) No guidance on existing assets

A potential option for plans that need higher returns is to 're-risk' their existing (non-SFA segregated) assets. This is concerning to us particularly given multiemployer plans are moving into the ['decumulation' phase of their lifecycle \(resulting in regular outflows\)](#) and equity valuations are near all-time highs. The PBGC has not provided any guidance on non-SFA allocations.

However, the PBGC has understood the concerns raised by commenters, including Insight, and has stated it is seeking an appropriate balance between investment 'certainty and safety' and plan flexibility.

## POTENTIAL INVESTMENT STRATEGY IMPLICATIONS FOR ELIGIBLE PLANS

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As plans begin the application process, we continue to believe it is important for them to balance the need to generate return, manage liability risks and generate cashflows to maximize the certainty that the assets will last through 2051.

Corporate bonds across different maturity profiles, non-US developed and emerging market bonds, global structured credit and / or interest rate overlays can play a role in meeting these needs.

**Plans with lower discount rates:** Those plans that have valuation interest rate assumptions in line with current market yields (~3%) will benefit from larger SFA grants and increased flexibility to pursue high-certainty liability-driven investing approaches. With a liability-driven investing approach, investors can hedge liability interest rate risks using IG fixed income assets within their SFA allocation.

**Plans with higher discount rates:** For plans with high interest rate assumptions, the amount of SFA received may not be sufficient to meet long-term obligations given current market yields; we believe this will be the case for the majority of plans. In this situation, plans will need to consider higher return and, consequently, higher risk strategies. Investors may wish to consider equity downside protection strategies, to increase the certainty of meeting the plans' required returns by protecting the downside against 'Black Swan' events.

In either case, a cashflow-driven investing approach, where a plan's investment income matches its cash obligations, is essential in our view. This reduces the possibility of being forced to sell assets during a downturn (which would crystallize losses), allowing the market to realize long-term returns and thus reducing the risk of plans becoming insolvent.

*We welcome the opportunity to discuss implications of the Butch Lewis Act with you. If you are interested, please do not hesitate to get in touch.*

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<sup>4</sup> Public data, Insight calculations. Under the legislation, the discount rate is based on assumptions used in a plan's most recent status determination filing from before January 1, 2021 subject to a cap based on the Treasury "third segment rate" for the applicable month plus 200bp. The discount rate cap is expected to apply in most cases. Source BAML curve data at June 30, 2021 before investment and other expenses are deducted. For illustrative purposes only.

## FIND OUT MORE

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