Understanding the Turmoil in Financial Markets...

Even the most sophisticated institutional investors have been hit by the meltdown of the subprime lending market. Here’s a primer on some of the hidden risks that triggered the problem after housing price declines rippled through an increasingly unregulated system.

The early mortgage market: A regulated depository institution such as a bank or savings and loan receives deposits from savers. It then lends money to home buyers and records the loan as a debt.

As protection against defaults, the lender holds a mortgage that allows it to collect what it’s owed through foreclosure. The lender bears the risk that the foreclosure proceeds won’t be enough to cover the outstanding debt.

Later model: So-called government-sponsored corporations are created (originally government agencies, they’re now federally chartered but owned by private shareholders). First came the Federal National Mortgage Association (known as Fannie Mae), and, later, the Federal National Mortgage Corporation (known as Freddie Mac). They create a secondary market for home loans by buying them from primary lenders. The two companies set criteria for the loans they buy, such as how large they can be and how much of a down payment is required. They hold some of the loans and make a profit from the difference between their costs and the revenue they receive from them. However, they package most into residential mortgage-backed securities (RMBSs), which means they issue bonds backed by the loan package. While they guarantee payment on the bonds, they aim to make a profit by setting the bond’s price and interest rate so that what they receive from the mortgage will exceed what they pay out to bondholders, taking into account their overhead and the default rate of the mortgages in the package.

Because the banks and other lenders have sold the loans, they no longer appear on their balance sheets and they don’t bear the risk that home owners will default. The lenders can use the proceeds to lend to still other home buyers. The banks and other lenders earn a profit from making and selling the home loans (so-called “origination fees”). Some also may make money from collecting the interest and principal payments from home owners on behalf of Fannie and Freddie (so-called “servicing fees”).

In this scheme, the risk of default is borne first by Fannie and Freddie, who guarantee payment of interest and principal on the RMBSs, though ultimately by investors who purchase the mortgage-backed bonds they issue in the seemingly unlikely event that Fannie or Freddie would ever be allowed to fail.

Today’s model: A new market for asset-backed securities has been built by Wall Street investment banks and other financial firms such as mortgage banks and mortgage brokers which are all much less regulated than commercial banks, savings and...
loans, and Fannie and Freddie. So, for example, they are free to issue securities backed by loans made without regard to the criteria set by the government-sponsored corporations. Historically, loans purchased by Fannie and Freddie had been “prime” loans, meaning the borrowers were highly likely to repay them. By contrast, the new securitizers package an increasing number of subprime and so-called Alt-A loans, made to borrowers with less than stellar credit who may be less likely to repay.

The explosion of subprime and other riskier loans is accompanied by Wall Street investment banks and other firms creating an alternative kind of asset-backed security called a collateralized debt obligation (CDO). These typically are issued in tranches that carry different risk levels. So if mortgage defaults rise, holders of the first tranche get first claim on any available assets. After they’re made whole, second-tranche owners get repaid, and so on throughout all tranches if there are any assets left to pay them. Holders of the first tranche bear the least risk and receive the lowest interest rate. Each successive tranche gets a higher rate in proportion to the risk of their claim.

In principle, the new securitizers sell many of the securities without a guarantee. Often, they create separate unregulated special purpose vehicles (SPVs), frequently off-shore, which hold the underlying assets so that no debt appears on their balance sheets and they seem no longer to bear any risk. But those who buy the new securities protect against risk by looking to credit rating agencies. Without an investment grade rating, most pension funds won’t buy CDOs. However, the credit agencies have been criticized for having inadequate risk models and for conflicts of interest, because they sell advice to CDO issuers about how to design the securities to get the ratings needed so would-be purchasers will buy them.

Institutional investors also mitigate risk by purchasing “credit enhancements,” or guarantees from insurance companies, banks and investment firms, akin to those sold for state and local government bonds. In addition, CDO purchasers seek protection through so-called credit-default swaps, in which a third party in effect promises to make up losses if the flow of payments from the new securities slows or their price drops.

Hedge funds, pension funds, insurance companies, and other investors seeking high returns purchase the new securities. Hedge funds are among those that buy the higher-yielding risky tranches. Some ramp up returns even more with debt that can reach as much as six times equity.

Several factors converge to drive the expansion of these schemes. Among them: low short-term interest rates, which give the new securitizers access to cheap cash; massive capital flows from the United States and abroad in pursuit of investment opportunities; and something of a self-fulfilling spiral of expectations of ever-increasing home prices.

What kinds of things went wrong?

Banks and other less regulated mortgage lenders make loans to prospective homeowners who are poorly qualified to pay them back.

Home owners’ ability to repay begins to falter due to rising long-term interest rates and stresses on household income from job losses and rising prices. Some walk away from their homes after plunging housing prices leave them owing more than the market value. These factors all drive up foreclosures.

Confidence in residential loan CDOs drop, buyers vanish, and CDO prices fall. Because CDO structures are so complex, there are uncertainties as to how to fairly value the securities.

As a result, the values of hedge-fund and other portfolios fall as well. The investment banks and other lenders that typically extend short-term debt to hedge funds demand greater collateral, forcing some to sell CDOs, which further drives down CDO prices. Others find no buyers at all and unload other assets, such as stocks, which puts downward pressure on share prices. In some cases, the lenders refuse to renew loans to hedge-funds, or offer them on conditions that the funds can’t meet, driving some out of business because they lack the money to operate.

With mortgage-backed CDO prices so uncertain, the investment banks and other new securitizers are unable to sell new securities they already hold in the pipeline. They have to write-off or sell the CDOs at depressed prices, weakening their balance sheets.
The securitizers also come under pressure to bring the devalued CDOs onto their own balance sheets, even though they’re nominally carried only on the SPVs’ books. They may have offered some kind of guarantee in connection with the deals they made, or they may experience reputational pressure to stand behind the securities they sold even if they don’t have a strict legal obligation to do so. As a result, their financial position is weakened further.

This prompts the securitizers to hoard liquid assets and to cease not just new home mortgages but also other kinds of loans. Some even stop making loans to other banks, as they commonly have done. Meanwhile, institutional investors, which are only allowed to invest in highly rated securities, are forced to sell the downgraded ones, further diminishing CDO prices and hurting investment bank finances.

All these factors undercut the financial positions of companies that originate and sell home loans as they have greater difficulty in selling the ones they’ve made. In turn, banks and other firms that have lent them money become reluctant to continue doing so, placing the companies under even greater pressure. Some fail.

In turn, home owners who run into trouble find it more difficult to refinance. Many who don’t succeed reduce or stop their payments, at the risk of foreclosure.

Fewer buyers puts more downward pressure on housing prices, making it more unlikely that existing home owners will repay their loans, squeezing everyone else in the chain.

At the same time, insurance companies, sellers of credit swaps, and others that sold CDO protection are swamped with demands to cover the losses. Because some of these players originally had only been in the business of insuring state and municipal bonds, their financial deterioration undermines confidence in the state and municipal bond market. In turn, those investors are forced to sell those securities, causing prices to fall. Banks, too, come under tremendous stress because they have failed to implement adequate risk models.

**...What To Do**

The foregoing is a sketch of a rapidly evolving scenario whose outcome remains opaque at this point. Popular reports differ wildly about the role of pension funds in these events and about the impact of those events on pension funds. For example, some suggest that they may face billions in losses through hedge funds from problematic debt securities, while press accounts of specific funds suggest that their exposure may be modest. However it turns out, pension funds, both individually and as a group, must make important decisions that take into account their own past conduct and what today’s market turmoil demands.

Individual funds face issues about whether they learned enough about the risk characteristics of securitized debts they bought or of investment vehicles, such as hedge funds, through which they may be exposed to those securities. There are, of course, related questions about investors’ possible misplaced reliance on credit agency ratings as a substitute for their own due diligence. More generally, funds probably would benefit from a review of the models they use to assess financial stress on fund portfolios.

Pension funds also need to consider issues of possible wrongful conduct by the financial services industry. For example, some funds already have brought securities class action suits against investment banks, mortgage originators, and credit rating agencies for allegedly false and misleading disclosures. A spate of complaints also have been filed against investment banks and mortgage originators that, it is contended, breached their duties as ERISA fiduciaries.

Other efforts, typically pension fund driven, have focused on reforming problematic corporate governance by financial services companies. These include attempts to prevent the re-election of audit committee and other directors, insistence on company explanations for failure to control risk exposure, attempts to control executive pay incentives, and demands for independence of directors from company management.

More generally, pension funds have a vital stake in the financial system’s regulatory framework as it bears on everything from the problematic practices by credit rating agencies to the failure of...
agencies to Wall Street’s risky trading practices, use of leverage, and financial incentives. Calls for systemic reform pre-dated the current financial turmoil but were largely ignored. Now, when problems prophesied by some have become a reality and threaten to compound, there has been a chorus of demands for meaningful change. Pension funds’ voice needs to be heard.

401(k)s Fall Short of Funding an Adequate Retirement

Not long after Congress authorized 401(k)s in 1978, critics began arguing that such defined-contribution (DC) plans would not provide retirement security as effectively as traditional defined-benefit (DB) pensions. In 2006, Congress finally stepped in to address some of the concerns with measures aimed at spurring employers to automatically enroll employees in 401(k)s and similar DC plans.

The law and subsequent regulations encourage employers to adopt automatic enrollment and set minimum contribution levels that rise over time, while allowing employees to opt out whenever they wish. Employers also can direct the contributions to default investment programs if employees make no investment choices on their own. Three kinds of default investments – life-cycle or targeted-retirement-date funds (TRDF), balanced funds, and professionally managed accounts – are attractive to employers because such funds afford them more protection against breach of fiduciary duty lawsuits arising out of investment losses.

To date, TRDFs have been most popular with employers, growing so rapidly that by the fall of 2007 they had already garnered about $170 billion in assets. Generally speaking, these funds allocate contributions accord-
market.” The simulated market involves constructing a model which generates returns that could be produced by different kinds of assets and the probabilities that those levels are reached. Participants are assumed to use one of four asset allocation investment strategies. Three range from an aggressive mix with a high proportion of equities to a conservative one with more bonds and cash. The fourth is termed “smart” and involves the widest range of assets, including REITs and high yield debt.

The results are discouraging. Participants fall short of the $400,000 target nearly a quarter of the time even with the “smart” investment strategy; and 5% of those employing this approach wind up far short, with no more than $260,000, which would leave them with an overall replacement income of about 62%. The results are much worse for participants using the most conservative investment strategy, who fail to reach $400,000 nearly a third of the time.

Although the study doesn’t tally up the aggregate shortfall – sort of an unfunded self-liability at retirement – it would appear to be substantial. For example, the lowest quartile of workers using the “smart” investment strategy might end up with an average of something like $100,000 short of $400,000. For 2,500 workers, this amounts to $250 million. If the roughly 58 million full-time, full-year wage and salary workers, ages 21-64 who participated in DC plans in the United States in 2007 had comparable career-end salaries and adopted this approach, the bottom quartile of 14.5 million would face a total unfunded retirement goal of $1.45 trillion.

Another new study sheds light on the second question, regarding the impact of the new legislation on retirement savings.** The paper, by the Vanguard Center for Retirement Research, suggests that it’s no panacea. The study compares about 50 Vanguard DC plans with automatic enrollment to some 500 voluntary ones. It looks at what happens over time to new hires, who typically are the ones employers sign up automatically. Sure enough, predicted participation for the automatic enrollees starts out at 91% vs. just 32% among new hires in voluntary plans. But after three years, enrollment shifts to 82% and 59%, respectively, as workers opt out of the automatic plans and opt in to the voluntary ones.

The convergence is even more striking if existing employees are included, since many workers eventually do sign up voluntarily even if it takes them years to get around to it. Participation in the automatic plans comes to 87% vs. 79% in the voluntary ones.

Even more surprising, automatic enrollment actually produces lower contribution rates. New hires who don’t opt out contribute on average just 2.9% of their annual salaries vs. 5.0% among those who sign up under a voluntary plan. Presumably, this stems in part from the default contribution rates employers set for automatic enrollees, which may be too low.

What lessons can be drawn from all of this? Clearly, automatic enrollment and contribution levels as currently practiced aren’t enough to fix the drawbacks of DC plans, even if employers adopt what’s claimed to be the best investment strategy. To increase the likelihood that such plans will produce adequate retirement income, more steps are being proposed, such as higher employee contribution levels, restrictions on withdrawals, automatic annuitization at retirement, and more elaborate default investment options.

It also may be necessary to require employers to install automatic enrollment schemes, which the 2006 law doesn’t do. There’s also the problem of the roughly half of American workers who at any given time are not offered a 401(k), other DC, or any other plan at all.

The broader question is where we’d get to if we took all these steps. At some point, there would cease to be much difference between these souped up DC plans and DB ones. But then, one important difference would be that employees, rather than employers, shoulder the risk of an investment shortfall, while paying for multiple layers of service provision for each feature added.


Can VEBAs Alleviate Retiree Health Care Woes?*

The 2007 negotiations between the United Auto Workers (UAW) and Detroit automakers have focused national attention on a potentially innovative response to the decline in retiree health insurance in the United States. The union agreed that an independent (or stand-alone) trust called a Voluntary Employees’ Beneficiary Association (VEBA) will assume responsibility for some $100 billion of future UAW retiree medical costs at the three automakers. Although the use of VEBAs is hardly new, other unionized employers now are looking at these kinds of stand-alone employee VEBAs as a way to free themselves from burdensome health-care legacy costs. An analysis
of the largest one, at General Motors Corporation, suggests that the concept is a second-best option for unions able to retain employer-paid retiree coverage. However, it may be a viable alternative for those unable to fend off unilateral elimination by an employer.

Absent some form of national health care, unions and employers in both the public and private sectors are searching for ways to alleviate the burden of soaring retiree medical costs. The task has become more urgent for public funds as accounting changes take effect that compel them to include projected health-care costs on their books, as private employers were required to do in the early 1990s. One approach is pre-funding, which involves setting aside money that can earn investment returns just as pension funds do, thereby reducing the long-term cost. The VEBAs being set up in Detroit are one form of pre-funding. Both private- and public-sector unions and employers can draw important lessons from the methods the UAW employed to distribute the costs and the risks of this approach amongst the company, workers, and retirees.

The UAW only agreed to stand-alone VEBAs because the auto makers left it little choice. Once these tax-exempt trusts are up and running in 2010, they will assume responsibility for UAW members’ retiree health costs in the future (although workers hired after the start of the 2007 contract won’t be included). The union took such a drastic step because the car makers threatened to cut or eliminate coverage if it didn’t. The UAW knew the automakers stood a fair chance of prevailing in court with such a move. It also knew that even if the companies had lost, they could have declared bankruptcy to abrogate their retiree health obligations.

The UAW took two key steps to mitigate the impact on its members. First, it sought to make sure that the companies agreed to reasonable assumptions about how much medical inflation would increase costs over future decades, and about how much money the Veba trust fund could be expected to earn to cover those costs. These factors determined how much would be needed to fund the VEBAs trusts so as to minimize the possibility that retirees will face benefit cuts down the road.

Second, the UAW gained the companies’ agreement to split both the costs and the risks involved. The principles were laid out in the deal the union cut with GM, which set the pattern for the other two companies. The two sides estimated that the price tag for retiree coverage would amount to about $38 billion over the life span of current UAW members. Of that, GM will pay $30 billion. Active UAW members will pay for the remaining $8 billion by diverting future pay hikes into the Veba. (Retirees already had sacrificed, too, back in 2005 when their co-pays and deductibles were increased.)

When employers pay for retiree health, they bear the cost of future medical inflation. With a stand-alone Veba, workers and retirees do.

The union shared a portion of the funding risk by accepting about $4.4 billion of the $30 billion as a GM note convertible to stock. Retirees thus will share in any gains the company might enjoy, although they could face benefit cuts if GM continues to flounder.

Independent employee VEBAs like these present several problems for unions. They do offer several advantages over employer-provided insurance. The most significant: They put workers in the driver’s seat. As a stand-alone entity independent of GM, the VEBA there will be controlled by a board of five UAW-appointed trustees and six public ones whose sole responsibility will be to the beneficiaries. The trustees can choose a mix of benefits that best suit workers’ needs, without input from GM. Such VEBAs also help protect both active and retired union members from cutbacks by employers. In addition, they offer a fair degree of insulation from bankruptcy.

However, the disadvantages may well outweigh these gains. When employers pay for retiree health, they bear the cost of future medical inflation. With a stand-alone Veba, workers and retirees do. If trust assets don’t earn enough to keep pace, unions will need to make the painful decisions about how to cope. Employees also must deal with any financial deficiencies or even failures caused by mismanagement of an employee Veba.

Employee VEBAs lead to even more risk if they’re set up with insufficient funds. Nonetheless, even less than fully funded stand-alone VEBAs may be better than the
alternative. Given the legal uncertainties involved in employer threats to eliminate retiree health, unions that choose to fight a determined employer in court run a risk of losing all coverage. Depending on the strength of the union’s legal position at a particular employer, even a partially funded VEBA may be a safer bet.

*A full report with the same name is available at:

**Effective Labor Representation on Pension Boards**

Although all pension fund trustees share the same fiduciary duties to the plan, the diverse composition of boards, which often include labor appointees, reflects the fact that individuals bring to bear knowledge of the particular concerns of those whom they represent. Two recent research papers highlight the critical need for unions to strengthen their support for labor trustees so they can be effective representatives.*

While the studies focus on Canadian funds, their findings may have broad relevance to unions and trustees in the United States, the United Kingdom, Australia, and other countries where labor plays an active role in employer-sponsored retirement plans. Both papers identify the challenges to effective labor representation on boards and what needs to be done to meet them. To provide background and context, the authors of one study conducted in-depth interviews with 20 Canadian trustees at 14 public funds and 6 private ones. The other study collected mail and Internet responses from 117 trustees who were members of 43 unions and 75 public and private funds.

The studies concluded that unions must make several sets of decisions to help trustees effectively represent labor’s interests. First, the union must decide if it even wants to get involved. While many public funds are large, unions often represent workers at dozens or hundreds of private employers, each of which may have a separate plan. Some unions feel the cost and effort to put trustees on so many boards is prohibitive. A few object on principle, such as the Canadian Auto Workers, which believes it should bargain for pensions but not expose itself to potential compromise by agreeing to jointly administer the funds.

If unions do decide they want fund trustees, they must figure out how trustees can acquire the financial background they require. In addition, labor must decide whether trustees should advocate alternative investment policies such as the consideration of environmental, social, and governance (ESG) factors.

The authors spell out a number of steps unions might take to achieve these goals.

(1) Trustee selection. “(S)election procedures are typically not tied to competencies or qualifications that are based on the [trustee] job description, characteristics, or purpose of the trustee role.” The authors suggest an approach that marries the political process unions use to fill any position with a traditional human resource model, which chooses the best-qualified people from a pool of candidates recruited based on a description of the job.

(2) Training and education. The trustee interviews and survey found that most receive training provided by the financial community which lacks a critical perspective does not focus on goals of interest to labor. The programs tend to be short and introductory and often are filled with jargon. While most trustees attend conferences, too many are “industry gab fests’ where trustees get schmoozed and further indoctrinated.” They do take specialized courses, though they are more likely to cover investment and finance issues from a traditional finance perspective. The authors stress the importance of courses that look beyond providing technical information to spur critical thinking and alternative viewpoints.

(3) Mentoring and networking. The papers found that mentoring by experienced labor trustees is limited, as is contact with other labor trustees on the same or other boards. Their contacts with trustees outside of the union environment may be even more limited. Many trustees said they feel isolated from other board members in ways that undermine their confidence and their ability to develop the skills needed to fully participate in decision-making. The authors suggest that unions set up formal networks that would allow labor trustees to meet regularly with each other, supplemented by union-provided online resources and other communications.

(4) Defined roles. Labor trustees face challenges
most other pension-fund board members do not. The relationship between their union and an employer often is characterized by an “us-vs.-them” mentality, so they must decide how much of that perspective to bring to the role of fund fiduciary. Because many labor trustees have limited training in finance and investing, they can feel intimidated by other trustees and professional staff, leaving them less room to figure out how to represent the union’s views. The authors warn that those who don’t solve the problem of role ambiguity may be so inhibited as to end up as passive “rubberstamps” in board decision-making.

(5) Institutional support. The studies found that the connections between labor trustees and their unions often are weak. There’s a virtual lack of “answerability of labor trustees to their unions or the plan beneficiaries.” This might be appropriate if the union “wants a purely fiduciary monitoring role for itself.” However, trustees need more support from union officials if they’re expected to raise labor concerns at trustee meetings. All too often, the authors conclude, unions only express interest about a narrow range of issues, such as use of a surplus.

The studies conclude that the challenges unions face with pension fund management are similar to those involved in expanding labor’s role in corporate governance more broadly. Labor trustees, they propose, “will be more effective members of the pension plan board of trustees if they arrive at the table with a clearly defined role, a well articulated purpose, and sufficient support through training and social networks.”

A number of unions have attempted to address the issues raised in these studies. Some have developed in-house trustee education programs, networks of member-trustees, and principles and polices for trustees to pursue.**
