Stable value funds and investment contracts – an overview

Many defined contribution plans today offer a low-risk investment option-often referred to as a stable value fund-to their participants. Defined benefit pension plans also may invest in such stable value investments.

The AICPA Employee Benefit Plan Audit Quality Center has developed this overview of stable value funds and investment contracts to help Center members better understand stable value investments. This document provides information about the nature and characteristics of stable value investments, the risks associated with such investments, and references to the relevant accounting and auditing standards.

Stable value investments

Generally, the investment custodian's report indicates which funds are stable value investments.

Stable value funds offer safety and stability by preserving principal and accumulated earnings. They are similar to money market funds but offer considerably higher returns. Their returns are comparable to intermediate investment grade corporate bonds, without the associated market risk.

Stable value options in participant-directed defined contribution plans allow participants access to their accounts at full "contract value" for withdrawals and transfers as permitted by the defined contribution plan ("plan").

Stable value funds primarily invest in guaranteed investment contracts (GICs) issued by banks or insurance companies, synthetic GICs, or in a common collective trust or mutual fund which invests in these securities.

Guaranteed investment contracts

Stable value investments issued by banks sometimes are referred to as GICs.

A *traditional* GIC is an agreement between the issuer (generally, an insurance company or bank) and the plan, in which the issuer agrees to pay a predetermined interest rate and principal for a set amount deposited with the issuer. The issuer is obligated to repay the principal and interest in its entirety. The issuer generally will use the money to purchase investments to cover the cost of the interest due. The investments in this arrangement are owned by the issuer rather than the plan. As such, the issuer is accepting the risk of interest rate fluctuations.

In a *synthetic* GIC arrangement, the plan itself owns the underlying investments (generally high quality government securities, private and public mortgage-backed and other asset-backed securities, and investment grade corporate obligations) and purchases a "wrapper" (usually from an insurance company) which guarantees full payment of principal and interest. This guaranteed rate-referred to as the crediting interest rate-will never be negative. In other words, the wrapper guarantees that there will be no loss of principal or accrued interest.

Stable value fund or common collective trust

Many defined contribution plans obtain beneficial ownership interests in bank or collective trust funds, allowing several smaller unaffiliated plans to gain the economies of scale necessary to participate in the stable value marketplace.

In a stable value fund or common collective trust (fund), the plan invests in a pooled account with other plans by buying shares or units in the fund. The fund then invests in stable value instruments. Each plan is credited with its proportional earnings. In such arrangements, the securities are owned by the fund rather than by the plan.

Investments (Form 5500 Schedule H, line 4i), may list a stable value investment in one of the following ways:

- GIC
- Stable Value Fund
- Fixed Income Fund
- Income Fund
- Interest Income Fund
- General Account Investment Contracts
- Security Backed Investments

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- General Account Investment Contracts
- Security Backed Investments
  - group term investment contract
  - separate account investment contract
  - synthetic investment contract

Fully benefit responsive investment contracts

Benefit responsiveness affects how investment contracts are reported in the financial statements.

Fully benefit-responsive investment contracts provide a liquidity guarantee by a financially responsible third party of principal and accrued interest for liquidations, transfers, loans, or hardship withdrawals under the terms of the plan, as long as the plan allows participants reasonable access to their funds.

The “fully benefit-responsive” concept is important, as it determines how a contract will be reported in a plan’s financial statements. In accordance with the FASB *Accounting Standards Codification®* (ASC) glossary, an investment contract is considered fully benefit-responsive for financial reporting purposes if all of the following criteria, analyzed on an individual basis, are met for that contract:

- The investment contract is effected directly between the plan and the issuer and prohibits the plan from assigning or selling the contract or its proceeds to another party without the consent of the issuer.
- Either (1) the repayment of principal and interest credited to participants in the plan is a financial obligation of the issuer of the investment contract or (2) prospective interest crediting rate adjustments are provided to participants in the plan on a designated pool of investments held by the plan or the contract issuer, whereby a financially responsible third party, through a contract generally referred to as a wrapper, must provide assurance that the adjustments to the interest crediting rate do not result in a future interest crediting rate that is less than zero. If an event has occurred that may affect the realization of full contract value for a particular investment contract

- (for example, a significant decline in creditworthiness of the contract issuer or wrapper provider), the investment contract shall no longer be considered fully benefit-responsive.
- The terms of the investment contract require all permitted participant-initiated transactions with the plan to occur at contract value with no conditions, limits, or restrictions. Permitted participant-initiated transactions are those transactions allowed by the plan, such as withdrawals for benefits, loans, or transfers to other funds within the plan.
- An event that limits the ability of the plan to transact at contract value with the issuer (for example, premature termination of the contracts by the plan, plant closings, layoffs, plan termination, bankruptcy, mergers, and early retirement incentives) that also limits the ability of the plan to transact at contract value with the participants in the plan must not be probable of occurring.
- The plan itself must allow participants reasonable access to their funds.

Contract value and fair value

The trustee or custodian generally provides the contract and fair values on the Schedule of Assets Held for Investments as of the date of the schedule.

Contract value is the total cost of the investment (amount paid at time of purchase plus or minus any additional deposits or withdrawals) plus accrued interest. This is also referred to as book value.

The fair value of a GIC typically is calculated as the present value of future cash flows. The fair value of a synthetic GIC is equal to the sum of the fair values of the underlying securities plus the fair value of the wrapper contract. The market values of those securities may be determined using the market price on a market exchange if the security is actively traded, or the present value of future cash flows.

In the case of synthetic GICs, the custodian may separately value and disclose the underlying investments and the wrapper on the Schedule of Assets Held for Investments. The underlying investments would be recorded at fair values and the wrapper would be valued at the difference between contract value and fair value, which could result in either a positive or negative valuation for the wrapper.

Average yield vs. credited interest rate

The custodian should be able to provide both the average yield earned and the credited interest rates.

The *average yield* refers to the actual income earned on the underlying investments in the fund. The average yield would include coupon interest accrued, any premium or discount accrued/amortized for the securities, and any realized gain/loss from sales of the securities.

The *credited interest* rate is the actual guaranteed interest rate paid to the participants' accounts per the contract. This rate could change on a predetermined frequency (for example, monthly, quarterly, or semi-annually). The issuer will set the interest rate based on various factors, such as projected interest rates, projected administrative expenses, and realized gains or losses from past periods.

For traditional GIC's, the two rates should be equal as the interest accrued and paid to the plan is merely that of the underlying asset. For synthetic GIC's, the two rates typically are different as the average yield is based on the performance of the various assets in the fund, and the amount paid to the participant is the contract rate. Over time, however, the cumulative yield and credited rates should be similar.

Risks related to stable value investments

As with all investments, stable value investments carry risk, albeit minimal.

For traditional GICs, the main risk relates to the issuer's (the insurance company or bank) financial health. As these contracts are only as good as the issuer's ability to pay, it is important that an issuer have a high credit rating.

In a synthetic GIC arrangement, the plan owns the actual investments and purchases an insurance wrapper to protect the principal from market and cash flow risks. Even so, the plan is not insulated from such risks as default on the underlying bonds, business failures of insurers, plan terminations, or layoffs at the plan sponsor. In other words, the risks are associated with the financial strength of both the insurer and the bond issuer.

For additional information on stable value investments

- Visit the Stable Value Investment Association Web site at www.stablevalue.org
- Consult the *Pension Investment Handbook*, Published by Aspen Publishers

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