

FIDUCIARY

STABILITY AMIDST UNCERTAINTY

- Investment losses have driven down the value of equities in U.S. pension portfolios by roughly \$4 trillion.
- Mark-to-market accounting, if applied to pension plans, will wreak havoc with traditional pension funding levels.
- Claims are moving upward: we have seen an increase of 70% in the number of claims over last year.
- Pricing is stable, with competition possible on superior risks.

The global financial crisis is creating challenges for pension fiduciaries worldwide that will last through 2009. With the value of portfolios shrinking, funding and investment strategies are receiving attention from stakeholders of all kinds:

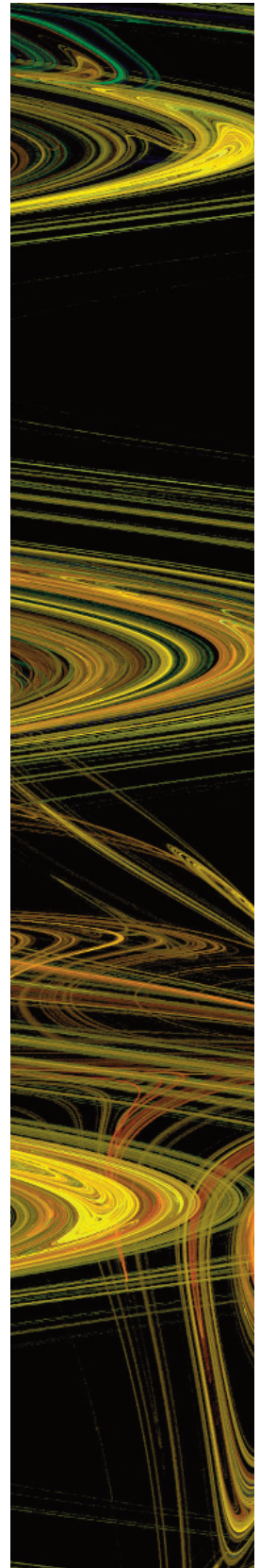
- The companies that sponsor corporate pension plans
- The company's debt and equity holders
- Plan beneficiaries, past, present and future
- Regulators and enforcement agencies
- The financial markets themselves, as pension plans are institutional investors capable of a sizable impact when they shift strategy

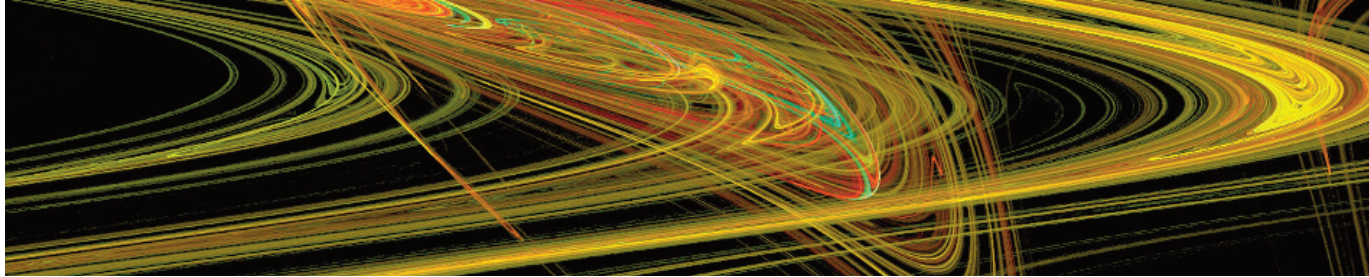
These often competing groups all have an interest in how pension assets are handled.

One result is increased claims. Many of the firms facing stiff D&O claims face parallel or tagalong ERISA fiduciary claims as well. In the midst of this volatility, however, the marketplace for buyers remains fairly calm.

SHIFTING THE PAIN

In addition to the magnitude of the losses to portfolios, what distinguishes this market downturn from those of the past is that individuals, as opposed to corporations, may bear "the full brunt of market turmoil" because of the broad ongoing shift from defined benefit (DB) and defined contribution (DC) plans.¹ No one is immune, including the





ultimate insurer for U.S. defined benefit plans, the Pension Benefit Guarantee Corporation, which is facing staggering losses in its own investment portfolio just as it is likely to see a surge in plans and plan participants needing coverage.²

Further complicating matters are minimum funding standards here and abroad, including reforms under the Pension Protection Act of 2006, which could drain corporate cash as companies are forced to pull funds out of operations to make plan contributions.³ For company plan sponsors and in-house fiduciaries, this would potentially pit their constituencies against each other: shareholders and bond holders vs. pension plan participants. Unless Congress acts to hold off these changes, companies may freeze their defined benefit plans or eliminate matching contribution into 401(k) plans to limit the financial consequences of the increased funding requirements.⁴

GOVERNMENT TO THE RESCUE?

Just as we have seen actions taken to protect certain corporations from the ill effects of the financial crisis, intervention is occurring or being contemplated both locally and globally in the pension arena. Pension supervisors across the globe have stepped up their oversight of pension fund reporting, increasing the frequency of stress tests on asset liability strategies, according to the International Organisation of Pension Supervisors (IOPS). Officials from 30 pension supervisory bodies recently held discussions with the Organization for Economic Cooperation and Development (OECD) to

review the regulatory frameworks across vastly different systems and regimes.⁵ Increased scrutiny during a period of heightened risk may not, however, be warmly welcomed by those on the receiving end.

SECURITIES LENDING

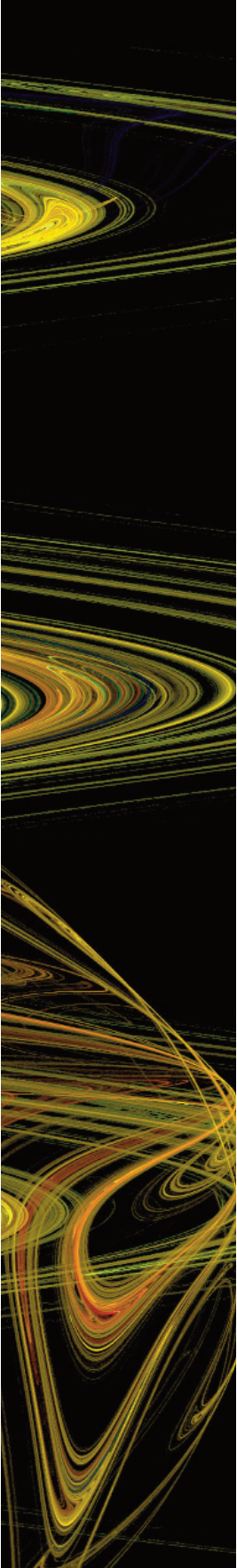
Securities lending is an investment strategy in which investors make short-term loans of their securities to generate incremental revenues from their portfolios. Securities lent typically include an array of equities as well as fixed-income securities, such as government and agency securities and corporate bonds.⁶ Largely undisclosed in the pension area, securities lending programs are often set up to increase plan performance and offset expenses associated with maintaining the pension portfolio.

At the end of 2008, the fiduciaries of several retirement plans sued a financial institution for breach of its fiduciary duty, alleging that imprudent securities lending activities caused pension plan losses.⁷ Prudent pension fiduciaries are now reevaluating the risks assumed in their securities lending programs.⁸

FEE DISCLOSURE

The Department of Labor's ongoing concerns about (excessive) undisclosed 401(k) fees can be seen in its current proposal to increase mandatory fee disclosures for plan participants. To prove the adage that there's nothing that can't be improved by more legislation, some members of Congress are considering jumping on the bandwagon on 401(k) fees.⁹

Meanwhile, the plaintiffs' bar is not waiting for regulations to be approved or laws to be passed. A raft of ERISA litigation has been launched against plan sponsors, fiduciaries and service providers on the issue of fees. So far, results are mixed in these high-stakes cases: defendants have prevailed in a number of these cases while class action status has been granted in others.



BALANCING THE SCALES

Fiduciaries and plan sponsors celebrated recent decisions regarding cash balance plans. The U.S. Supreme Court turned aside a request to rule whether cash balance plans were age biased. This let stand a Court of Appeals holding that any difference in benefits that employees of different ages received under a cash balance plan was not discriminatory but “merely the result of the time value of money.”¹⁰ Combined with the cash balance provisions in the Pension Protection Act of 2005, it appears that the worst is over for most fiduciaries when it comes to expensive and time-consuming cash-balance plan litigation.

ERISA CASES

In 2008, we reached a high water mark in the number of decisions on the Employees Retirement Income Security Act (ERISA) from the Supreme Court, including some we expect to be still discussing a decade from now. First, the Court astounded many with the language in its *LaRue* decision, where, it broke with earlier Court precedent in recognizing an individual’s right to pursue a breach of fiduciary duty claims as respects a 401(k) plan (see our March 2008 *Executive Risks Alert*). Later, the Court considered what standard of review to apply when the person making a benefit decision is the one who ultimately bears the financial responsibility for paying benefit claims. Writing for the majority, Justice Breyer held that dual-role situations create a “conflict of interest,” but hesitated to go further. Unfortunately, the likely result of this decision is more indecision as it provides little framework for future litigation in this fertile line of cases.

THE MARKETPLACE

Historically, there have been fewer experienced and committed insurers for Fiduciary Liability than for other Executive Risks lines. Few of the carriers that entered the Executive Risks marketplace over the past three to five years have been willing to underwrite Fiduciary Liability insurance. It appears that there will be less market turnover in this line of coverage than in others. As we look toward 2009, pricing is stabilizing rather than remaining soft, with competition still possible on what are viewed as superior Fiduciary Liability risks. This select group generally includes those with little or no employer securities in their plans; demonstrated, exceptional disclosure and governance; and stable company financials.

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¹“US schemes hit by \$3.9trn equity fall,” Global Pensions, globalpensions.com, October 23, 2008

²“PBG’s Stock Investment Losses Exceed \$3 Billion”, *BenefitsLink Newsletters*, October 23, 2008

³“Underfunded U.S. pensions may drain corporate cash,” *Business Insurance Online*, October 29, 2008

⁴“GM suspends payments into 401(k) plans,” *Business Insurance*, Oct. 23, 2008

⁵“Pension supervision intensifies as crisis takes hold,” IPE.com, 30 October 2008

⁶http://www.esecending.com/about_securities/lending101.php

⁷“Collateral Damage?” *The News Dash*, Plansponsor.com, October 28, 2008

⁸“Securities Lending Issues,” *Cypen & Cypen Newsletter*, July 24, 2008

⁹“401(k) Fees on the Front Burner for DOL, Congress,” *Employee Benefit News*, July 2008, Vol. 22

¹⁰“Time Trial,” *The News Dash*, Plansponsor.com, October 8, 2008