

A Buy-in: A New Way to Manage Risk in a Defined Benefit Pension Plan

By Vernon Holleman III and Michael Devlin

CEOs and CFOs continue to look for ways to control the risk associated with their defined benefit pension plan. Besides investment risk, plan sponsors also face interest rate, longevity and credit risks. If they are not being kept up at night over the matter, it is certainly waking them up early. The market drops of 2008 certainly exacerbated this problem, but the Pension Protection Act of 2006 (PPA) also impacted the way plan sponsors view and evaluate their pension plan. The PPA required plans to fully fund their target liability in seven years. Further, it curtailed “asset smoothing,” which led to volatility in contributions, and restrictions were imposed on plans which fell below certain funding thresholds. Plan Sponsors have also struggled with having their pension liability disclosed on their balance sheet.

A “buy-in” is a relatively new strategy that offers some real advantages to plan sponsors and is worthy of examination. This year, the buy-in strategy has become a new option for plan sponsors to consider, as U.S. life insurance carriers have become comfortable with the strategies’ fundamentals. It could reshape how plan sponsors manage their pension risk.

The table illustrates how the fair value of pension assets and projected benefit obligation have shifted dramatically at times over the last fourteen years and shows how plan sponsors have experienced tremendous difficulty controlling their pension risk. Between 1999 and 2002, aggregate funding status of plans shifted from being overfunded by 28% to being underfunded by 19%. Plans contributed \$274 billion between 2002 and 2006 to close this funding gap

Before the PPA, a common strategy used to mitigate risk was to execute a buy-out that would irrevocably transfer certain blocks of liability to an insurance carrier which satisfies the safest-annuity-provider requirements outlined in Department of Labor Interpretive Bulletin 95-1, thereby eliminating all risks associated with that particular block of liability. Although such a strategy remains available after PPA, the effect on funding levels, balance sheet and other areas can cause concern and may make it a less attractive alternative for plan sponsors.

The trend in 2008 and 2009 of using the buy-out to settle a portion of liability has evolved to a new trend



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in 2010 and probably for years to follow. Facing record market losses, many companies have come to the conclusion that they are not going to be in a position to terminate their pension plan any time soon and are looking for ways to de-risk their pension plan as they position themselves to terminate when market conditions are more favorable. Plan sponsors have year-to-year capital market volatility that has put their cash resources at significant risk.

How a Buy-In Works

The buy-in presents plan sponsors many of the same risk-mitigating advantages as the buy-out, but without some of the disadvantages. In a buy-in transaction, the plan sponsor:

- Identifies segments of the population for which immunization or isolation of liabilities makes sense, typically retiree or terminated vested populations. These are often the blocks of participants that represent the highest risk (cost) to the plan sponsor due to age,
- Purchases a revocable, non-participating annuity contract that satisfies DOL IB 95-1.
- Transfers assets to the insurer and holds the ownership of the contract as an ongoing asset of the plan, thus creating a perfect asset liability match for the chosen obligations.

In the event the plan terminates in the future, the contract typically could be converted to an irrevocable contract and distributed to the participants.

The United Kingdom market has led the trend in de-risking through pension buy-in, buy-out and longevity swaps. Roughly \$15 billion of transactions have taken place in the U.K. since 2007—Royal Sun Alliance, BMW and Cable &

Buy-Out vs Buy-In

Plan Sponsor

- Pension Plan shifts assets and liability to insurance carrier
- Insurer pays Retirees
- Settlement charge on balance sheet
- PPA funding level changes
- Estimate PBGC and Admin. costs

Plan Sponsor

- Pension Plan adds annuity to Plan that matches Retiree liability
- Insurer pays the Plan
- No settlement charge
- PPA funding level stays the same
- Retain PBGC and Admin. costs

Wireless to name a few. By hedging the risk in its plan, the plan sponsor

- Reduces the overall risk profile of the plan.
- Reduces the future volatility of cash contributions to the plan.
- Owns an asset that moves with the liability.
- Reduces exposure to mortality improvements (plan participants, or survivors living well beyond life expectancy).
- Remains in contact with the employee/retiree while outsourcing the financial risks to a well-capitalized insurer.

In addition, the plan sponsor has not affected the funding percentage or the company's balance sheet; the annuity is simply now treated as an asset of the plan.

The buy-in can help diversify and balance the asset strategy of the plan and be a part of a longer-term strategy for transferring a portion of the plan's liability to the insurance carrier. This could be done during ideal moments over a number of market cycles.

Two issues that have held companies back from implementing the buy-out strategy are a settlement charge under GAAP, and an unrecognized

gain, or loss, on the balance sheet that would ultimately affect earnings. These are both mitigated by implementing a "buy-in" strategy. The buy-in simply treats the annuities as an asset of the plan. Furthermore, since it is revocable, it should not trigger settlement accounting.

The other key issue that is addressed by a buy-in is the effect on the plan's funding levels. PPA forces plan sponsors to address their funding levels. Plans whose target liability funding falls below 60% have full benefit restrictions on benefit accruals, plan payments, and other features. Plan sponsors who fall below 80% have partial benefit restrictions. While a buy-out strategy removes assets and liabilities from the plan, there is potential for the funded status of the remaining plan to fall below one of these thresholds. In contrast, the annuity contract purchased under a "buy-in" is treated as a plan asset, so it does not affect the funding levels.

There are investment, administration and funding issues to consider carefully before entering into this type of transaction. The annuity purchase connected to a buy-in transaction is considered an accelerated form of payment under PPA and, therefore, is unavailable for

plans whose funding levels require partial or full restrictions. In addition, although the contract is revocable, the insurer will typically include onerous financial penalties for revocation.

Therefore, companies that are not willing to either make a long-term commitment to the contract or do not plan to convert the contract with the same insurer upon plan termination should fully understand the risks. Finally, as noted, the contract is held

as an asset of the plan, and the liabilities remain with the plan. PBGC premiums, reporting and administration duties are not eliminated with a buy-in as they are with a buy-out equally important, is the timing of such a transfer (buy-in or buy-out). Having a consultant track the best possible time to do so, for a specific company's circumstances, is ideal.

Plan sponsors are searching for new ways to control their pension risk and

create a strategy to exit the defined benefit pension space over the next few years. A buy-in gives them a strategy that will help achieve the ultimate goal of plan termination while reducing risk in the interim. Whether a buy-in, buy-out or other strategy is the best course for your plan depends on your unique circumstances. The good news is there are options worth exploring.