Fidelity Workplace Consulting

The 5 Most Critical Questions to Ask When Considering an Annuity Buy-In for Your Defined Benefit Plan

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In the last decade, many plan sponsors looking to reduce their ERISA-sponsored defined benefit (DB) plan risk have employed two primary techniques: voluntary lump sum offers and annuity buy-outs. The exact approach in employing these techniques have varied from sponsor to sponsor – for example, one round of lump sum offers vs. multiple rounds, annuity buy-outs for the full retiree population vs. those with small benefits, etc. But by and large, derisking actions have been of these two flavors.

Sponsors are now beginning to explore a third approach: annuity buy-ins. Buy-ins present an opportunity to realize much of the derisking benefits of annuity buy-outs without incurring the associated downsides.

This paper addresses the five most critical questions to ask when considering whether a buy-in is right for your DB plan.

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- What other considerations are there to executing on a buy-in?

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The 5 Most Critical Questions to Ask When Considering an Annuity Buy-In for Your Defined Benefit Plan

1 What is a buy-in?

"...each month as benefits come due, the insurer provides the associated payments to the plan sponsor, who in turn makes the payments to the participants."

An annuity buy-in is a contract to cover benefit payments due to a group of plan participants. The contract is between the pension plan and an insurer. Once the contract is in place, each month as benefits come due, the insurer provides the associated payments to the plan sponsor, who in turn makes the payments to the participants. In that way, the contract functions like any other plan investment, in the sense that it does not provide payments directly to participants but instead provides the means by which the plan does so.

Similar to buy-outs, a buy-in contract can be structured to cover all or a subset of retirees, as well as active and deferred lives (if the insurer is willing to assume these obligations, of course).

Buy-in contracts typically allow for conversion to a buy-out at a future date at the plan sponsor's discretion at no additional premium. However, the additional flexibility for conversion to buy-out may add an additional premium for the buy-in's cost.

2 How is a buy-in different from a buy-out?

An annuity buy-in differs in several key ways from an annuity buy-out:

First and foremost, as noted above, the plan still makes the payments to the participants. As a result, the participants covered by the buy-in contract are still pension plan participants. This has several implications, including continuing to pay the Pension Benefit Guaranty Corporation (PBGC) flat rate premium for these participants.

If the buy-in contract insurer were to become insolvent, the pension plan would be on the hook to continue making the payments. This is different from a buy-out where the affected individuals are no longer members of the plan and thus would have to seek relief from state guaranty associations.

A buy-in contract includes an exit clause that can be triggered by the plan sponsor. This clause is necessary to be included in the contract, as otherwise the contract would essentially be permanently irrevocable (i.e., a buy-out). Usually there is a cost to trigger this exit clause (e.g., 5% of the buy-in contract value), and there may be limits to the circumstances under which a sponsor can trigger the exit clause (e.g., in the event of a full plan termination).

Because the participants are still plan participants, and because there are exit clauses potentially available to the plan sponsor, the purchase of a buy-in contract does not trigger a settlement under accounting rules. As a result, there are no P&L charges created from the purchase of a buy-in. (The future conversion of a buy-in to a buy-out would be the point at which a settlement would be deemed to occur.)

Since no settlement is triggered, buy-in assets and liabilities are still treated as part of the overall plan for funding and accounting purposes. This means that executing on a buy-in will not change the plan's funded status for these purposes. The potential deterioration of funded status is a concern that sponsors of underfunded plans often have with taking derisking actions. With buy-ins, that issue is avoided.

3 What benefits does a buy-in offer have that aren't available from buy-outs (or from just managing the risk through liability-driven investing)?

Purchasing an annuity contract—be it a buy-in or buy-out – reduces three key risks.

Investment Risk

The risk that plan assets do not change at the same rate as plan liabilities. This isn't all that different from the protection that could be obtained by investing in fixed income instruments with a similar duration and structure to the liabilities.

Longevity Risk

The risk that participants will outlive expectations. With an annuity contract purchase, this risk is transferred to the insurer.

Downgrade and Default Risk

This is an underappreciated risk but one whose effects can add up over time. This is the risk that can arise if a plan sponsor holds fixed income assets to hedge liabilities, and those fixed income assets are then downgraded. Liabilities are valued based on AA corporate bond rates. If a corporate bond is downgraded from AA, it's removed from the liability calculation. So, a downgrade of a particular bond may have little to no impact on your liability. If you hold that same bond in your portfolio, however, it is likely that the downgrade would reduce the value of the bond. In pension terms, you'd experience a decrease in assets with no corresponding decrease in liabilities. With an annuity contract, this all becomes the insurer's problem to manage.

The benefits a buy-in offers that a buy-out does not are primarily the ability to avoid a settlement and its associated one-time P&L charges as well as the ability to derisk without a significant negative impact to funded status. A buy-in can also be a first step toward either a buy-out or a full plan termination. Executing a buy-in in advance of those actions gives the sponsor more time to prepare for larger action.

The table below compares the implications of buy-ins, buy-outs, and liability-driven investing (LDI). Note: buy-ins do not eliminate the PBGC premiums and administrative expenses like buy-outs do, but there are several other advantages that buy-ins have over the other offers. See table below.

	LDI	Buy-outs	Buy-ins
Avoid settlement / P&L charge?	✓		✓
Reduce/Eliminate investment risk?	✓	✓	✓
Eliminate longevity risk?		✓	✓
Eliminate downgrade & default risk?		✓	✓

4 What do you do with the buy-in after you've bought the contract?

Perhaps a better way to phrase it is "What's the end game with buy-ins?"

With buy-ins, given that the exit clauses embedded in the contracts usually involve a financial penalty for exit, we would expect buy-ins to be most attractive to organizations who are philosophically committed to plan termination but may not be ready in the short-term.

In that framework, buy-ins allow for a more structured approach to the plan termination process, by removing some of the uncertainty – specifically annuity pricing. And by planning in advance for a termination through these actions, there is also potentially the ability to tactically take advantage of positive developments – be it asset movements, insurance pricing, or other factors – to reduce the overall cost of termination.

5 What other considerations are there to executing on a buy-in?

In evaluating whether a buy-in is right for a particular plan, or evaluating the structure of a buy-in, there are a number of factors worth considering:

Fiduciary Standards

In a formal plan termination or annuity buy-out, the process is subject to the guidelines of Department of Labor (DOL) Interpretative Bulletin 95-1, which lays out the fiduciary standards under ERISA when selecting an insurer. Buy-ins are not typically subject to 95-1, but since conversion to buy-out is a likely outcome, and the DOL guidance would be required to be evaluated at conversion, following the guidance at buy-in is a good idea.

Accounting considerations

For plan sponsors that report under US GAAP, settlement charges for a buy-out are likely to be meaningful, since these would include a portion of unrecognized losses on the company balance sheet – and given declines in interest rates over the last decade-plus, these losses can be sizable. Alternatively, plan sponsors can mitigate settlement charges by systematically converting a portion of the contract which does not exceed their settlement threshold over the course of a fiscal year.

For sponsors under other accounting rules, or for sponsors that have adopted mark to market accounting, the outcomes may be different. For example, under international standards (IFRS), the settlement charge is only the difference between the obligation on the books (DBO) and the purchase price. For some purchases, this could be very close to zero – in which case avoiding a settlement may not be a key driver for buy-ins.

Population covered

Careful planning can pay dividends in the long-term. For example, one mistake we have seen is when a plan sponsor purchases a buy-in contract to cover all the retiree obligations for their plan. This may have some short-term benefits. But in preparing for plan termination, this also creates real issues because the remaining plan is all non-retirees – which is very unattractive to insurers. In a plan termination, it is very possible that no insurers may bid on this group. In such a case, the sponsor may be confronted with two bad choices:

1. unwind the buy-in contract – and pay the associated penalty – and re-shop the entire plan; or
2. try to get the buy-in insurer to take on these additional obligations. With this latter option, the insurer has all the leverage. And in either case, odds are that the total cost of termination would be more than if the sponsor had approached it more thoughtfully.

Next Steps

Our consultants at Fidelity have worked with plan sponsors in exploring the benefits of a buy-in – and in some cases assisted in executing on a buy-in contract. They can help you explore in more detail the specific benefits (and drawbacks) of a buy-in for your plan. We can assist with the analysis and experience to help you get to the right answer.

For More Information

For more information on this topic, please contact your Fidelity Relationship Manager or contact us directly.

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