PACIFIC LIFE

In or Out?

Comparing Pension Buy-Outs and Pension Buy-Ins

Both options for defined benefit plan sponsors require careful consideration

(From left) Marty Menin and Russ Proctor.

Defined benefit (DB) plan sponsors interested in reducing plan risk and eventually removing the liability from their company's balance sheet now have more options than just a few years ago. The new possibilities are helpful but also complicate the process of selection. To explore today's solutions, and how to use them, Alison Cooke Mintzer, editor-in-chief of PLANSPONSOR, spoke with Russ Proctor and Marty Menin, both directors of institutional sales at Pacific Life. They explained the difference between the traditional buy-out solution and the newer buy-in solution.

PS: A buy-out of pension liability has been around a long time, whereas, in the U.S., the buy-in concept is relatively new. How are these two similar?

Proctor: A buy-out is a purchase of annuities for all or some of the participants in a defined benefit [DB] plan that transfers all the risk and liability off the plan sponsor's balance sheet to an insurance company. Buy-ins have been used for many years in the U.K. A buy-in, such as our Pacific Secured Buy-In solution, resembles a buy-out in that it transfers the investment risk, interest rate risk, liquidity and longevity risk to the insurance company. And, by the way, we just completed the third buy-in contract ever placed here in the U.S.

PS: Congratulations! So, what makes a buy-in different from a buy-out?

Menin: Under a buy-out contract, the liabilities are transferred to an insurance company and completely removed from the pension plan and the company's balance sheet. The insurance company issues certificates to individual plan participants and directly assumes all future payment obligations.

The key difference with a buy-in contract is that the plan sponsor retains the payment obligation to plan participants and the liability remains on the company's balance sheet. The insurance contract becomes an asset of the plan under which the issuing insurance company is obligated to cover the financial risks and makes covered benefit payments in bulk to the plan sponsor. Individual certificates are not issued to the plan participants and the participants remain in the plan for purposes of actuarial valuations, calculation of PBGC [Pension Benefit Guaranty Corp.] premiums, etcetera.

SPONSORED SECTION *Photography by Melissa Barnes*

PS: Why would a plan sponsor choose a buy-in or buy-out?

Proctor: A buy-out is used when the plan sponsor is either terminating the plan, and has to buy annuities to complete the plan termination, or wants to completely settle a portion of the liability. A buy-in is more of a steppingstone to get *to* a buy-out; the plan sponsor may want to transfer most of the risk now but can't fully settle the liability yet.

One scenario where a buy-in may be helpful is for a plan sponsor that has borrowed money to fully fund the plan. A buy-in lets the plan sponsor lock in the annuity cost now and worry about terminating the plan later when the IRS [Internal Revenue Service] and PBGC approvals are received. This eliminates the risk of having to contribute or borrow more money 12 to 18 months later when unfavorable investment performance may have eroded the funded status of the plan.

It's also fairly common that companies have a large pension loss on their balance sheet, and it may be that completely settling the liability now would require that they recognize the loss on their income statement. A buy-in lets them secure the liability and the risks, transferring those to the insurance company, but leaving the pension liability unsettled until a better time in the future.

Menin: A buy-in is also an opportunity to capitalize on interest rate spikes. The plan sponsor may like where current interest rates are and want to lock that in, then complete the buy-out process later. The buy-in contract gives the plan sponsor more flexibility and time—something we try to emphasize with all our pension risk transfer products.

In the old days, you terminated the plan or you kept the plan. Today, a plan sponsor may desire to dollar-cost average into the interest rates applicable to a buy-out annuity contract. In other words, a plan sponsor may say, "I want to de-risk my pension plan, but I don't want to do it all at once—I'd like to do it over a longer time frame, perhaps in segments."

Another benefit of a buy-in can be removal of longevity risk from the plan. Longevity risk has been in the news a lot lately. A plan sponsor can use a buy-in to transfer the longevity risk to Pacific Life without having to worry about full plan termination. Thus, a buy-in can be used for a longer transfer of risk without necessarily serving as a short-term bridge to a buy-out.

PS: If the endgame for the plan sponsor is a buy-out—as you said, plan termination—how does a buy-in fit into that strategy?

Risk Solutions

	Best Efforts Solutions	Guaranteed Solutions		
	Traditional LDI*	Pacific Insured LDI®	Pacific Secured Buy-In®	Pacific Transferred Buy-Out®
Complete transfer of pension obligations				✓
Benefit option selection (including lump sum option)			✓	✓
Early retirement longevity (mortality)			✓	✓
Credit default		✓	✓	✓
Credit downgrade		✓	✓	✓
Liquidity	✓	✓	✓	✓
Interest rate	✓	✓	✓	✓

*Liability-driven investing

Menin: A buy-in contract lets the plan sponsor decide when to settle the liability and notify participants. Because a buy-in remains a plan asset, the sponsor can put a buy-in contract in place, then complete the regulatory paperwork required in a plan termination. The more plan sponsors seek flexibility in the pension risk transfer market, the more they'll see a buy-in as a creative solution.

PS: Continuing with flexibility, if you decide to pursue a buy-out strategy, how do you exit a buy-in contract, and are there additional fees?

Proctor: For Pacific Secured Buy-In, all the plan sponsor needs to do is provide a letter requesting the conversion to a buy-out. There are no additional charges, administrative costs or any fees. At that point, the liability and assets are completely transferred to Pacific Life and removed from the plan and the company's balance sheet. This may trigger the settlement accounting, but the plan sponsor controls when a conversion and settlement occur.

It is this control and flexibility that makes a buy-in a valuable tool for U.S.-based plan sponsors as they develop their strategy to manage their pension plan risks. ■

Pacific Secured Buy-In is a group annuity contract.

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