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BRIEFING ON BUY-IN ANNUITY CONTRACTS

The second-ever buy-in and the largest one to date in the US — for which Mercer was advisor — has sparked market interest.

Retirement plan sponsors are showing growing interest in using *buy-in annuity contracts* as a mechanism to reduce pension plan risk. In 2014, Mercer provided advisory services for and ultimately facilitated the placement of the second-ever buy-in in the United States, which was the largest US buy-in to date. What exactly is a buy-in? Could this new approach be the right choice for your plan? What factors should you consider in deciding whether a buy-in could work in your circumstances?

Buy-ins and buyouts are both effective ways for plan sponsors to transfer investment and longevity risk for some or all of their pension liabilities.

However, buy-ins usually do not lead to an immediate accounting settlement charge, which sponsors may prefer. The sponsor gains the ability to control the timing of a potential future conversion of the buy-in to a later buyout, as well as associated accounting and HR implications.

WHAT IS A BUY-IN?

A buy-in is a group annuity contract under which an insurance company agrees to meet the benefit payments for a covered group of participants and beneficiaries for the rest of their lives. Most of the investment and longevity risk associated with the covered participants and beneficiaries is transferred to the insurance company.

WHAT IS THE DIFFERENCE BETWEEN A BUY-IN AND A BUYOUT?

Both a buy-in and a buyout involve the purchase of a group annuity contract. However, under a buyout, the insurance company takes over responsibility for paying participants directly. In a buyout, the sponsor is relieved of any obligation to the covered participants and beneficiaries, and does not include the liability in the company accounting or for minimum funding calculations.

In a buy-in, on the other hand, the plan sponsor retains the formal, contractual obligation to the participants and beneficiaries. The sponsor is responsible for the transactions and continues to make the monthly benefit payments, as plan administrator, but is reimbursed by the insurance company for the exact amount paid out each month. The sponsor continues to include the liabilities in the company accounts and includes the annuity contract as a corresponding asset.

A buy-in can be considered a liability-driven investment (LDI) solution that hedges not only the investment risk but also the longevity risk. Like other LDI solutions, it does not eliminate ongoing administrative costs or Pension Benefit Guaranty Corporation (PBGC) premiums. In the United States a buy-in, unlike a buyout, includes an option for the plan sponsor to unwind the contract at a later stage, although surrender options may be restricted and surrender penalties typically apply. A buy-in contract typically allows conversion to a buyout at a later stage for no additional premium (although premium taxes would be payable at the time of conversion). However, at the eventual buyout date, plan fiduciaries would need to ensure that the insurance carrier meets their security standards.

HOW MUCH DOES A BUY-IN COST?

As with a buyout, the cost of a buy-in depends on the liability profile of the group covered, and pricing will vary from plan to plan. The Mercer US Pension Buyout Index tracks buyout pricing for a sample retiree plan on a monthly basis. Typically this index has shown estimated annuity prices to be less than 110% of the related accounting liability. However, pricing can vary by plan. It is also important to bear in mind that this index value reflects average plan sponsor practices with respect to actuarial assumptions, including mortality. We have seen very attractive pricing for retiree groups recently, especially when compared to an accounting liability after incorporating the new mortality tables proposed by the Society of Actuaries.

Pricing for a buy-in is generally expected to be similar to that of a buyout, but the additional flexibility of the unwind provision can add a premium over a buyout.

WHAT ARE THE ACCOUNTING IMPLICATIONS OF A BUY-IN?

Buyouts — for example, in the context of a plan termination — typically trigger one-time “settlement charges.” With a buy-in, this typically is not the case.

Under US Generally Accepted Accounting Principles (GAAP), a settlement is an irrevocable action that relieves the employer of primary responsibility for a pension benefit obligation (PBO). Because a buy-in can be unwound and the plan remains formally responsible for making benefit payments to participants, no settlement has occurred for GAAP purposes. Similar logic applies under International Financial Reporting Standards (IFRS) and leads to the same conclusion. A buy-in is not classified as a settlement, so there is no immediate settlement charge, although there can be a settlement charge if the buy-in is converted to a buyout at a later stage. Any unrecognized losses under US GAAP remain as a balance sheet liability and continue to be amortized into earnings following the usual schedule.

The ongoing accounting treatment is different under US GAAP and IFRS. Depending on the accounting treatment, there can be an initial drop in funded status, but going forward the size of unexpected changes in funded status would typically be smaller as a result of the buy-in. There may be other accounting effects as well, including a different pattern of future gains or losses or a reduction in the rate of return expected on plan assets, which reflects the proportion of the plan’s assets committed to the buy-in.

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WHAT ARE THE FUNDING IMPLICATIONS OF A BUY-IN?

Under Internal Revenue Service (IRS) rules, the liabilities would continue to be determined using corporate bond rates. On the asset side, the insurance company would report a contract value that would be used for the valuation of assets, which at the start of the contract would match or be very close to the premium paid. Funded status, therefore, would not receive an immediate material impact. There could be some disconnect between the movement of liabilities and assets over time, particularly for plan sponsors who are using the temporary 25-year average interest rates permitted under IRS funding rules to value their liabilities. Sponsors who use the "full yield curve" approach would experience much less volatility; however, moving from the temporary 25-year rates to the full yield curve approach would typically result in a one-time reduction in funded status. Of course, each sponsor's circumstances are unique, depending on the plan's funded position and the interaction of that funded position with the various IRS requirements, so a thorough review of funding implications should be carried out before proceeding.

WHY WOULD A SPONSOR WANT TO PURCHASE A BUY-IN?

- The sponsor can significantly reduce market, interest rate, and longevity risk.
- These risks can be reduced without an immediate, current-year effect on reported earnings.
- The sponsor may be able to achieve the above objectives for a small premium relative to the PBO.
- The sponsor can control the timing of a future conversion to a buyout. A well-prepared sponsor can then execute quickly on that conversion when the accounting and HR implications are acceptable.
- From a participant's perspective, there is no change in the way benefits are provided. Participants continue to benefit from the support of the sponsor and the backing of the PBGC.

One potential drawback of a buy-in is that, until the point of conversion to a buyout, the plan would continue to have ongoing expenses, such as administrative fees and PBGC premiums. Sponsors may therefore consider a buy-in as a shorter-term solution — an intermediate step on the path to a buyout.

WHAT HAPPENS IF A SPONSOR WANTS TO TERMINATE AT A LATER STAGE?

At plan termination, all liabilities would need to be settled and assets would need to be distributed. For participants covered by the buy-in, usually the simplest approach is to convert the buy-in to a buyout. Alternatively, the buy-in contract could be surrendered and annuities purchased with another insurer, although surrender penalties would apply.

CONCLUSION

A buy-in annuity contract is one option to manage pension risk that has existed for years but has rarely been used. However, we are seeing an uptick in sponsor interest in this option and have seen very attractive pricing from insurers relative to accounting liabilities, particularly when allowing for the proposed new mortality tables. Buy-ins offer the ability to significantly reduce market, interest rate, and longevity risk without an immediate P&L hit and set the stage for a sponsor to make a later conversion to buyout. As sponsors consider actions to reduce risk, a buy-in is an option that merits serious investigation.

CONTACT

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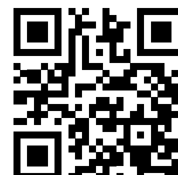

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