GETTING OUT WITH A BUY-IN

How shifting pension risk could be good for business
HISTORY HAS NOT BEEN KIND TO PLAN SPONSORS IN THE U.S.

Twice since 2000, America’s corporate defined benefit (DB) sponsors have watched funded status drop more than 30%. These dramatic declines have led to an increased interest in risk transfer transactions. In fact, 100 of the largest U.S. corporate pension plans have made close to $796 billion in pension contributions since 2000, while still not quite regaining their pre-financial crisis funded status.

It’s clear that sponsors have dedicated real resources to fund pension plans and have seen improvements over the past decade. However, pension plan sponsors have once again been reminded of the fickleness in their funded status with many sponsors making significant progress toward full funding early in the year only to see their gains quickly wiped away. Given the current volatility lessons and those from the past, attention has shifted away from a generation of high returns in favor of preserving funded status.

So how do we keep U.S. companies from watching their funded status erode during the next credit cycle, leading to the diversion of resources away from their core business?
THE BASICS OF A BUY-IN

LOCK-IN FUNDING LEVELS WITH A BUY-IN PRODUCT

Buy-ins offer a turn-key solution that guarantees cash flow matching and removes the idiosyncratic risk of a manager or group of managers underperforming the cash flow benchmark. For those not yet seeking settlement who would like to move risk, the buy-in is a good solution to preserve the valuable gains sponsors have made in funded status.

Unlike a buy-out arrangement, where the insurer takes on all responsibility for paying pensions for the company's participating members, in a buy-in assets remain in the pension plan and under the company's control. Associated liabilities remain obligations of the plan, which means a buy-in will not trigger settlement accounting. Instead, an insurer pays the monthly annuity amount to the plan, which makes pension payments to the plan's participants. Because buy-ins serve as a liability-matching asset of the plan, this type of transaction will transfer all the investment and longevity risk associated with the lives in the contract to the insurer.

An important feature of a buy-in is that it will not impact the overall funding ratio of the plan either at the time of purchase or through future credit cycles. This means buy-ins can help significantly narrow the projected range of contributions a plan sponsor will have to make in the future. This valuation protection comes from the contractual guarantee issued by the underlying insurer, rather than the individual performance of an asset portfolio.

THE POWER OF PRUDENTIAL'S PORTFOLIO-PROTECTED BUY-IN

Prudential's buy-in transaction combines a guarantee with the added protection of an insulated separate account portfolio.

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**Buy-in**

Plan investment matches liability.

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**Plan**

Premium →

Guaranteed Payments ←

Benefit Payments →

Insurer

Participants
THE HYPE OVER HIBERNATION

Some sponsors are turning toward a liability-driven investment strategy (LDI) and hibernation. Hibernation strategies reduce interest rate risk but sponsors can overestimate the benefit they will receive due to the lack of protection from credit downgrades and defaults or longevity risk. While moving to a hibernation strategy and using LDI tactics could reduce a portion of the risk in a portfolio, credit migration has a downside. This downside needs to be acknowledged to implement prudent risk measures that cover more than just one standard deviation of risk.

From 2009 to 2012, the three years following the most recent financial crisis, more than 25% of AA-rated bonds were downgraded to an A and over 10% were downgraded from an A to BBB. There is an unhedgeable basis risk between a bond portfolio and the plan’s liabilities. When a bond gets downgraded, it’s simply removed from the liability discount rate. However, the downgraded bonds not only underperform, they can also lower a plan’s funded status.

This means credit migration can be costly to sponsors. This chart reflects how much return was lost due to downgrades/defaults over the most recent 25-year period. The Barclays U.S. Investment Grade Corporate Index was chosen as an indicator of the bond mix that a hibernation strategy would utilize.

Estimated Annual Cost of Credit Migration (1994-2018)
Bloomberg Barclays U.S. Investment Grade Corporate Index A or Better 10+ Years

As the chart indicates, on average a 1.0 to 1.2% loss was realized annually. Additionally, the worst outcomes occur far more frequently than with a normal distribution. In over 7% of these occurrences, the estimated annual cost of credit migration also cost sponsors an estimated 7% in returns. One standard deviation market downturn scenario is easier to mitigate and typically does not result in large changes to funded status. However, more severe economic conditions beyond one standard deviation could result in setbacks that can take years to recover.

Sponsors must carefully manage hibernation programs utilizing active portfolio management and fundamental credit research to mitigate the risk of credit defaults and downgrade.

*Your LDI Strategy Recession Ready?*, PGIM Fixed Income
Source: Barclays POINT, PGIM Fixed Income. As of December 2018.
*Normal distribution with same mean and standard deviation as the annual estimated cost of credit migration. For illustrative purposes only. Estimates are not actual and may vary.*
THE HYPE OVER HIBERNATION (CONTINUED)

Hibernation strategies alone do not protect against longevity risk. One way for sponsors to enhance an LDI strategy is to complement it with longevity insurance, which protects the plan sponsor from a longevity shock, a scenario in which actual lifespan of participants is different (higher or lower) than expected. Several pension schemes in the U.K. have successfully utilized such an approach. However, longevity hedging solutions are not prevalent in the U.S. market, and we believe that a buy-in offers an alternative to hibernation for U.S plan sponsors—it protects them both against losses from credit defaults and downgrades and from longevity risk.

Historically, the Society of Actuaries (SOA) has published an updated base mortality table roughly once every 10 years. Given the infrequency of these updates, sponsors were forced to recognize significant increases in their liability due to longevity improvements to the tune of 4-9% about once per decade. In 2014, the SOA committed to more frequent updates and while they haven’t updated the base table, they have updated the improvement scale annually. It is true that each of these improvement scales updates since 2014 has reduced the expected improvement in mortality, but it is important to note that improvement is still expected, but is just occurring at a slower pace than once predicted.

For Example

<table>
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<tr>
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<tbody>
<tr>
<td>Life expectancy is:</td>
<td>Life expectancy is:</td>
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<tr>
<td>16.6 years</td>
<td>15.7 years</td>
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<tr>
<td>70-year-old male</td>
<td>70-year-old male</td>
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<tr>
<td>18.4 years</td>
<td>17.4 years</td>
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<tr>
<td>70-year-old female</td>
<td>70-year-old female</td>
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One extra year of life expectancy might not seem like a lot but adding one additional year of payments could increase the present value of expected benefit pay-outs by 3-6%.
THE HYPE OVER HIBERNATION (CONTINUED)

The good news is U.S. residents are living longer. But, without a crystal ball, it’s nearly impossible to know precisely how long each of us will live. We can look at experience to help predict the future but advances in the medical field as well as much-welcome cures for life-threatening diseases can easily affect even the most educated guesses.

Clearly, a buy-in could offer better protection in a credit recession than a hibernation strategy. What decision sponsors will need to evaluate is how much is full risk mitigation worth? It’s important to note sponsors will end up paying out over 100% of their Projected Benefit Obligation (PBO) by keeping the liabilities and utilizing a hibernation strategy. That’s because PBO only measures the promised benefit and is not a true economic cost of holding onto the liability. A hibernation strategy could also cost sponsors 10-30 bps in annual investment fees or 1.0-3.5% in present value over the lifetime of the plan. How does that compare to the cost of a buy-in? According to the Aon Annuity Purchase Tracker, retiree annuity purchases ranged from 101%-104% of PBO in 2018. This is a wide range, but the premium will vary based on actual demographics and assumptions used by the plan.

Comparing Benefits of a Buy-In and Hibernation

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<thead>
<tr>
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<th>Buy-in</th>
<th>Hibernation</th>
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<tbody>
<tr>
<td>Protection of Benefits</td>
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<td>Longevity Protection</td>
<td>+</td>
<td>-</td>
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<tr>
<td>Credit Migration Protection</td>
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<td>Revocability</td>
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<td>+</td>
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<tr>
<td>Up-Front Premium</td>
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<tr>
<td>Retain PBGC Premiums</td>
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<tr>
<td>Guaranteed Cash Flow Matching</td>
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HOW DOES PLAN TERMINATION TIE IN?

A buy-in can provide sponsors with a phased approach to transferring DB risk, as sponsors can eventually convert to a buy-out. This can be particularly useful for sponsors interested in eventually terminating their plan. Because of regulatory requirements, the plan termination process can often take 18-24 months. During this period, the plan is subject to market volatility, which could potentially increase the necessary contributions needed upon termination. Knowing the cost up front eliminates basis risk, or risk associated with imperfect hedging, to the sponsor. It also provides the Board with a level of price certainty prior to beginning the plan termination process.

At the end of the plan termination process, when the sponsor is ready to settle all their liabilities, a buy-in can easily and quickly be converted to a buy-out at no additional cost. They would also not expose themselves to risks like movement in insurer pricing or insurer capacity, which can be particularly important for heavily deferred populations.
OTHER SITUATIONS WHERE A BUY-IN MAKES SENSE

**Delay Settlement Loss:** As stated, a buy-in remains an asset of the plan and will not trigger settlement accounting as a buy-out would. Sponsors can lock in economics with a buy-in immediately and convert to a buy-out at a time that would be more advantageous to the company.

**M&A Transaction:** A buy-in strategy seems particularly well suited for an M&A transaction where the pension deficit will inform the purchase price. By definition, pension deficits change by the hour. A buy-in will realize and preserve the long-term economics of the pension plan and therefore the acquirer can preserve the purchase economics.

**Nonqualified SERP:** A buy-in with a nonqualified plan would transfer the risk and guarantee cash flows just as it would with a qualified plan. This can be particularly useful for executives whose payments are typically large and more volatile. Because payments are made to the company or trust, a buy-in will not establish constructive receipt for the participants in the plan, preventing potentially undesirable tax events.

CONCLUSION

Although buy-ins haven’t been as popular in the U.S. as overseas, interest is growing in de-risking strategies that utilize buy-ins. With the average pension plan’s funded status reaching more than 90% earlier this year, sponsors have found ways to lock in these funding levels. By using the buy-in as a less risky alternative to hibernation, sponsors can preserve value for shareholders. Today’s buy-ins can serve as a hedging mechanism and be part of a semi-permanent asset allocation, or as an intermediate step toward termination. Managing a pension plan can be very challenging in today’s economy and these tools can reduce risk so sponsors can focus on their core business priorities.

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