DB SOLUTIONS InSights

PENSION PLAN DE-RISKING – IS NOW THE WRONG TIME?

SUPPLEMENT: A BUY-IN PERSPECTIVE

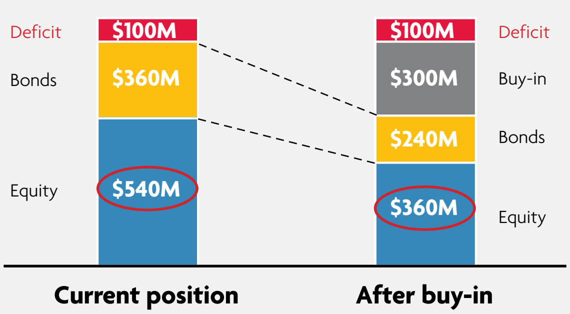
Many plan sponsors have held off de-risking defined benefit (DB) plans due to the current low interest rate environment. An earlier DB Solutions InSights article, *Pension plan de-risking – is now the wrong time,* highlighted that an annuity buy-out solution offers de-risking merits even in a rising interest rate environment.

Many readers were interested in how the de-risking merits play out for the annuity buy-in (i.e., Pensurance™). This supplement reviews the implications for the buy-in solution and considers how it compares to the buy-out approach.

PLAN BACKGROUND

The illustrative DB plan has $1,000M of liabilities and $900M of assets. There is an even number of retiree liabilities and active/deferred liabilities. The asset mix is 60 per cent equities and 40 per cent long-term bonds.

The plan sponsor purchases a $300M buy-in and maintains the 60 per cent equity/40 per cent bond asset mix for the balance of the assets, as shown in the chart below.



Under the buy-in, the de-risk benefits are:

- the dollar equity exposure is reduced from $540M to $360M, so the balance sheet will be less affected by equity market volatility;
- there are $300M fewer assets exposed to the risk of longevity assumption increases;
- there is no top-up contribution required, since the buy-in is a plan asset; and
- there are no accounting settlement issues with the buy-in.

IMPACT OF INTEREST RATE INCREASE

The chart below highlights the impact to the assets and liabilities if there is a one per cent interest rate increase (across the yield curve) for both the current position and after buy-in scenario.

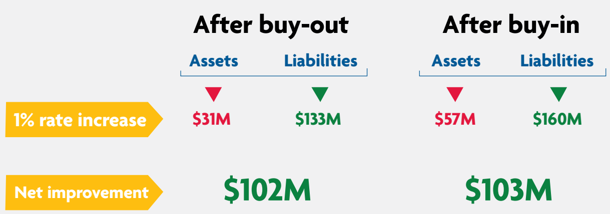
	Current		After buy-in	
	Assets	Liabilities	Assets	Liabilities
1% rate increase	▼ $45M	▼ $160M	▼ $57M	▼ $160M
Net improvement	$115M		$103M	

The financial position of the “after buy-in” scenario represents almost 90 per cent of the improvement of the “current position” scenario.

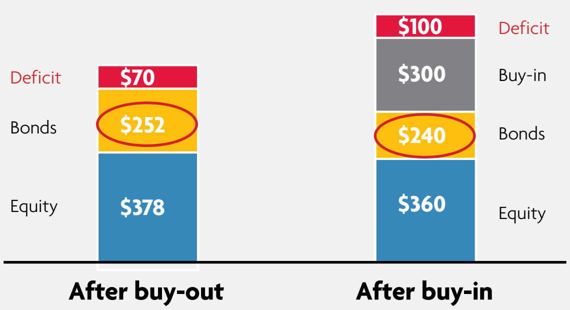
Sun Life Financial

BUY-IN VS. BUY-OUT

The results are very similar for the buy-in and buy-out



The net improvement of the "after buy-in" scenario of $103M is just slightly higher than the "after buy-out" improvement of $102M, because the "after buy-in" scenario had fewer bonds (i.e., $240M of bonds as compared to $252M for the "after buy-out" scenario), as highlighted in the chart below.



The additional $12M of bonds in the "after buy-out" scenario reflects that the company had to make a $30M top-up company contribution to maintain the 90 per cent funded position following the transaction.

The buy-in assets are affected by the change in the interest rates; hence the higher decline in assets for the buy-in. However, there is an equivalent offset with respect to the liabilities, such that there is no impact to the net improvement.

PENSION EXPENSE DIFFERENCES

Many readers were interested in the pension expense differences between the buy-out and buy-in scenarios. A full analysis is beyond the scope of this article, but a few key points are captured below.

The resulting pension expense will be the same under both the buy-out and buy-in scenarios, as the same amount of liabilities have been de-risked under both scenarios. Differences will occur if, for example:

- additional top-up contributions are made under the buy-out scenario, or
- a higher discount rate is chosen under the buy-out scenario due to a higher liability duration, or
- there is a non-zero settlement accounting impact under the buy-out scenario.

The pension expense under the buy-out and buy-in scenarios will, of course, be different than the pension expense reported if de-risking had not occurred.

Whether exploring the buy-out or the buy-in annuity, these solutions offer compelling de-risking benefits to plan sponsors compared to maintaining all of the risks within the DB plan.

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