

August 7, 2015

Pension Policy Unit
Financial Services Commission of Ontario
5160 Yonge Street, 8th floor
Toronto, ON
M2N 6L9

Alternative Settlement Methods for Solvency Valuations

Dear Sir/Madam:

The Canadian Institute of Actuaries (CIA) is the national organization of the actuarial profession. The CIA establishes the Rules of Professional Conduct, guiding principles, and monitoring and discipline processes for qualified actuaries. All members must adhere to the profession's Standards of Practice. The CIA follows its Guiding Principles, including Principle 1, which holds the duty of the profession to the public above the needs of the profession and its members. The CIA also assists the Actuarial Standards Board (ASB) in developing standards of practice applicable to actuaries working in Canada.

We are pleased to offer the following comments on FSCO's actuarial guidance note Alternative Settlement Methods for Solvency Valuations, published on July 3, 2015.

The CIA commends FSCO for publishing an actuarial guidance note on this subject. Current Ontario legislation requires that certain benefits be settled through an annuity purchase upon the actual wind-up of a pension plan. However, there are serious questions about the ability of large plans and plans with indexed benefits to purchase an annuity based on the current state of the Canadian market. The reality is that if one of these plans were to be wound up today, in practice a change in legislation would likely be required so that the settlement of benefits could take place in a manner other than through the purchase of annuities. It is important for stakeholders to consider whether the hypothetical wind-up and solvency valuations of these plans should reflect a realistic manner of settling benefits. One of the key reasons that the ASB made changes to the Standards of Practice and the CIA Committee on Pension Plan Financial Reporting (PPFRC) issued the [Alternative Settlement Methods for Hypothetical Wind-Up and Solvency Valuations](#) educational note was to facilitate the use of realistic methods for settling benefits.

Our detailed comments on the draft guidance note are as follows.

Appropriateness of an Alternative Settlement Method

The draft guidance note indicates that the “actuary should be prepared to justify and provide adequate support as to why the benefits could not be settled by the purchase of annuities and why, even if this were the case, it would not be appropriate to assume such settlement given that it is permitted by the Standards of Practice.”

We agree that the actuary should be prepared to justify the assumption that benefits could not be settled via annuity purchase for a particular plan.

Although the Standards of Practice permit the actuary to assume annuities can be purchased for this purpose, this is very unlikely to actually occur in practice for large plans and plans with indexed benefits. In these situations, reflecting an alternative settlement method represents a more realistic scenario than assuming that an annuity could theoretically be purchased for the plan on wind-up, and therefore should be the preferred postulated scenario in a hypothetical wind-up or solvency valuation. While the simplifying assumption that annuities could be purchased would be acceptable actuarial practice in Canada, it would not be best practice in these situations.

Group Annuity Market Capacity Constraints

The draft guidance note says that the actuary should not rely on the annuity market capacity thresholds in the educational note. The educational note was prepared using the best information available to the PPFRC at the time of publication in 2013. We note that the current educational note thresholds are higher than the largest actual single group annuity purchase in Canada to date; while we agree that the group annuity market is evolving and that capacity will likely increase over time, such increases in capacity remain conjectural at this time.

The PPFRC expects to review the thresholds on an annual basis, references these thresholds in its annual [Assumptions for Hypothetical Wind-Up and Solvency Valuations educational note](#), and would anticipate updating the alternative settlement methods educational note to reflect material changes as the market evolves. For many pension actuaries, the best available information on actual group annuity market capacity is the information published by the PPFRC. Hence, we suggest that FSCO should allow actuaries to rely on these thresholds.

Composition of a Replicating Portfolio

Under the replicating portfolio approach, the draft guidance note suggests that the hypothetical portfolio should be constructed using a substantial allocation to federal and/or provincial bonds.

This is inconsistent with how such a portfolio would be constructed in practice. Federal bonds and, to a lesser extent, provincial bonds are highly liquid instruments. Investors are willing to pay a significant premium in order to be able to easily trade these investments. Under a replicating portfolio scenario, the underlying investments do not need to be liquid since they would be expected to be “buy and hold” investments. Consequently, it would be needlessly expensive to construct a portfolio made up predominately from highly liquid bonds.

In practice, we understand that other high-quality (but less liquid) bonds, including corporate bonds, commercial mortgages, and private debt instruments, are commonly used by Canadian

insurers to support their group annuity products. It is reasonable to assume that a plan sponsor establishing a replicating portfolio would give consideration to investing in such securities.

To the extent that FSCO's rationale for imposing this restriction relates to a reduction in benefit security that could result as a result of bond defaults and other risks that may be higher in non-government bonds, in our view this concern could be dealt with through the selection of appropriate margins.

For the reasons cited above, the educational note makes reference to a substantial allocation to high-quality fixed-income investments, but does not specify that such investments are restricted to those issued by the federal or provincial governments of Canada.

Replicating Portfolio Benefit Security vs. Group Annuity Products

The draft guidance note says that the level of security under the replicating portfolio approach should be the same or similar to that of an annuity purchase determined without reference to capacity restrictions.

It is not reasonable to expect pension actuaries to ascertain the level of security involved with an annuity payable from an insurance company. This would require an assessment of the financial health of insurers, an understanding of how an insurance company reorganization or liquidation would occur, etc.

We agree that FSCO should provide its views regarding the level of benefit security that would be required under the replicating portfolio approach. The educational note indicates that the replicating portfolio should "ensure a high probability that the benefit promises will ultimately be met". The most effective approach for FSCO to express this view would be to provide guidance on what should be considered a "high probability".

Lump Sum Payments to Members

The draft guidance note does not permit the assumption that benefits would be settled by providing lump sums to retired members. Given that this approach is actually being used for the Nortel pension plans, the guidance note should permit this approach to be contemplated for plans of similar size and complexity. This is particularly true in scenarios that assume that pensioners would be permitted, but not required, to receive a lump sum payment instead of an annuity.

Assuming Modifications to Benefit Terms

The draft guidance note does not permit the assumption that benefit terms would be modified under the hypothetical wind-up scenario. We note that the published guidance from the Alberta Superintendent of Pensions indicates that this method is acceptable for the solvency valuation of pension plans registered in Alberta and we believe that this approach could also be reasonable for Ontario-registered pension plans. In particular, larger plans that have benefits indexed based on a Consumer Price Index-linked or excess-interest formula, and smaller plans with complex indexation formulas, are expected to have difficulty settling their liabilities through an annuity purchase due to the nature of these benefits. We are aware that FSCO has permitted this approach in an actual wind-up situation. Consequently, we suggest that this

approach be permitted for plans for which a modification to their indexation provisions would likely be required in order to facilitate an annuity purchase.

Conclusion

We recognize that FSCO's primary concern is protecting the security of benefits for plan members. The CIA shares these concerns since we hold the duty of the public above the needs of the profession and its members.

Nevertheless, the CIA believes that it is important that pension plan funding should be based on reality.

The final guidance note should permit actuaries and plan sponsors to assume a realistic method of settling benefits in hypothetical wind-up and solvency valuations. The interests of the public are better served by actuarial reports that reflect realistic methods of settlement for the particular plan rather than being based on a theoretical ability to purchase annuities that is very unlikely to occur in practice.

The CIA hopes its comments provided herein will be of value.

Respectfully submitted,

A handwritten signature in black ink, appearing to read "Rob Stapleford". The signature is written in a cursive, flowing style.

Rob Stapleford
President