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Commission des services financiers de l'Ontario

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Note: Where this guidance note conflicts with the Financial Services Commission of Ontario Act, 1997, S.O. 1997, c. 28 (FSCO Act), the Pension Benefits Act, R.S.O. 1990, c. P.8 (PBA) or Regulation 909, R.R.O. 1990 (Regulation), the FSCO Act, the PBA or Regulation govern.

Note: The electronic version of this guidance note, including direct access to all linked references, is available on FSCO's website at www.fsco.gov.on.ca. All pension policies and guidance notes can be accessed from the **Pensions** *section of the website through the* **Pension Policies** *link.*

This guidance note sets out FSCO's expectations of an administrator of a defined benefit pension plan (administrator) with respect to the investment of pension plan funds in buy-in annuities which constitute an investment held in an unallocated fund of a person authorized to carry on a life insurance business in Canada (Canadian life insurance companies) in respect of all or part of the pension entitlements associated with a specific group of members, former members or retired members (covered members).

Administrators may also invest pension plan funds in buy-in annuities issued by persons who are not Canadian life insurance companies (foreign insurance companies), however, such investments are subject to different treatment under the PBA and Regulation, and administrators should exercise additional due diligence when entering into such transactions (see Section 7.0 Foreign Insurance Companies below).

1.0 Structure of the Investment

Buy-in annuities are similar to traditional or "buy-out" annuities; however, instead of issuing individual certificates to covered members and paying pensions to them individually, the insurer makes periodic payments to the pension plan fund equal to the aggregate pension amount covered by the policy.

The buy-in annuity is an investment of the pension fund and covered members have no greater claim to such payments than to any other specific assets of the pension fund.

The responsibility for administering benefits remains with the administrator.

It is not necessary that a buy-in annuity cover every member of the plan, every member of a certain class of plan members or the entire benefit of every covered member. For example, a buy-in annuity might exclude certain groups of retired members, active members as a class, or the indexing component of the pension benefit.

If assets of the plan fund are invested in a buy-in annuity, the administrator nonetheless remains responsible for ensuring that all benefits covered by the buy-in annuity are paid from the plan fund, regardless of whether the insurer makes the required annuity payments.

2.0 Prudent Investing and Due Diligence

An administrator may only invest plan funds in a buy-in annuity issued by a Canadian life insurance company if the investment is permitted under the terms of the pension plan, the statement of investment policies and procedures and all applicable statutory requirements (including the prudent person rule in section 22 of the PBA and the Federal Investment Regulations, as defined in section 66(1) of the Regulation).

The purchase of a buy-in annuity is considered an investment of the pension plan. All decisions made with respect to buy-in annuities must be made by the administrator in accordance with its standard of care and its fiduciary obligation to invest the plan fund's assets in the best interests of the plan's beneficiaries.

2.1 Application of Section 43 of PBA

Buy-in annuities are not subject to section 43 of the PBA and administrators do not require the approval of the Superintendent of Financial Services to purchase buy-in annuities; however, if the buy-in annuity were converted to a buy-out annuity, in full or in part, while the plan was ongoing, section 43 of the PBA would apply and the conversion would have to comply with the PBA and Regulation, including the requirement to obtain the approval of the Superintendent of Financial Services, where applicable.

2.2 Pricing and Transaction Costs

The administrator should conduct appropriate due diligence when negotiating the pricing of buy-in annuities and should not rely solely on the pricing provided by a particular insurer. One method for determining fair pricing is to hold a competitive bidding process with multiple insurers submitting prices; however, at minimum, appropriate due diligence will include soliciting quotes from different insurers.

Administrators should consider the pricing of buy-in annuities compared to other similar investment options. Given the specialized nature of these products, it would be appropriate in most cases to retain independent expert advice.

It is the responsibility of the administrator to consider the costs involved with any investments in buy-in annuities and to ensure that those costs are incurred prudently and in the best interests of the plan members. Such costs may include legal, actuarial, and consulting fees.

2.3 Counterparty Risk and Coverage

The administrator should consider the security of the investment including the counterparty risk (i.e., the risk that the insurer will not fulfil the terms of the buy-in annuity contract). The administrator should consider whether it is reasonable and appropriate in the circumstances to diversify the investment by entering into separate buy-in annuity contracts with multiple insurers.

The administrator should determine the extent of coverage available to the plan (e.g. through Assuris) in respect of the buy-in annuity in the event that the insurer becomes insolvent, and consider whether the coverage provides adequate protection for the plan fund. The administrator should consider what terms may need to be included in the buy-in annuity contract relating to any future change in coverage that may occur.

2.4 Contract Terms

It is the responsibility of the administrator to ensure that the terms of any buy-in annuity contract are clear and permit the administrator in all circumstances to administer benefits in accordance with the plan terms and fully comply with all applicable statutory requirements, as they may change from time to time. In particular, administrators should consider contractual terms related to portability options, early retirement provisions, pre-retirement death benefits, optional forms of payment, and pension division or lump sum transfer on breakdown of a spousal relationship. The administrator should also carefully consider the ability to modify or terminate the buy-in annuity contract.

An investment in a buy-in annuity must not result in members being treated inequitably on wind up of the pension plan. In other words, the terms of the buy-in annuity contract must not purport to provide covered members with greater benefit security than other beneficiaries of the plan. It is the responsibility of the administrator to ensure that the terms of the buy-in annuity contract permit liquidation, or partial liquidation, at the option of the administrator, in the event that the plan is wound up and there is a funding shortfall.

3.0 Plan Wind Up

The buy-in annuity contract should clearly specify the administrator's rights on a plan wind up to terminate the contract and the method to be used to determine the settlement value on termination, as well as any other options available to the administrator in respect of the buy-in annuity on wind up of the plan.

If a plan is wound up and there is no funding shortfall, the buy-in annuity may convert to buy-out annuities, in accordance with the approved wind up report, and the insurer may issue individual certificates to covered members and begin paying pensions to retired members directly. Members and former members may receive deferred annuities.[1]

[1] Any conversion to individual buy-out annuities is subject to a member's exercise of portability rights under section 73.

If a plan is wound up and the benefits payable to covered members are subject to a reduction in accordance with the approved wind up report, the buy-in annuity may convert to buy-out annuities paying reduced amounts to the individual covered members.[2] The difference between the full value of the buy-in annuity and the aggregate value of the reduced buy-out annuities would be made available to the plan as a refund to the plan or a credit towards the purchase of additional buy-out annuities, in accordance with the approved wind up report.

4.0 Actuarial Funding Valuation Reports

An acceptable method of valuing a buy-in annuity to be included in the assets of an actuarial funding valuation report would be to set the asset value equal to the value of the pension benefits covered by the buy-in annuity (if the buy-in annuity provides an exact hedge to the covered pension benefits), calculated on both a going concern and solvency basis. This could result in the asset value of the buy-in annuity being different under the going concern and solvency valuations.

If the buy-in annuity does not exactly hedge the covered pension benefits, then the asset value of the buy-in annuity should be adjusted to reflect any differences. For example, in the event of a plan wind up, if the contract provides for a value to the plan that is different from the value calculated on a wind up basis (e.g. fees or expenses applied, portability options not provided, etc.), then it would not be appropriate to set the asset value of the buy-in annuity equal to the liabilities of the related pension benefits. The buy-in annuity could expose the plan to an additional funding shortfall due to the difference between the contracted value of the buy-in annuity and the liabilities of the covered pension benefits. In this situation, FSCO would expect the actuary to calculate this shortfall in each actuarial valuation funding report and determine its effect on the required funding for the plan. This may result in additional funding requirements for the sponsor in respect of the liabilities covered by the buy-in annuity.

If the going concern or solvency valuation uses an asset smoothing method, the value of the buy-in annuity should be excluded from the asset smoothing calculation. For clarity, the value of the buy-in annuity should be included in the determination of the going concern assets and liabilities and of the solvency assets and liabilities of the plan.

5.0 Financial Statements

For the purpose of filing financial statements for the pension fund or plan, measurement and disclosure of the buy-in annuity should comply with section 76 of the Regulation, generally accepted accounting principles and the disclosure expectations set out in FSCO Guidance Note FSGN-100 (Disclosure Expectations for Financial Statements Filed Pursuant to Regulation 909 s. 76).

The valuation techniques used in the fair value measurement of a buy-in annuity must comply with generally accepted accounting principles. Since the payments from a buy-in annuity are directly linked to the payments in respect of the covered pension benefits, FSCO would accept a value that is equal to the actuarial present value of the covered pension benefits, adjusted to the

[2] See footnote 1.

extent that it does not provide for an exact hedge. The valuation techniques and inputs used to develop fair value measurement should be fully disclosed in the financial statements.

6.0 Pension Benefits Guarantee Fund

Because a buy-in annuity contract is an investment of the plan fund and does not affect the liabilities of the plan, every covered member of a buy-in annuity must be included in the calculation of the plan's Pension Benefits Guarantee Fund assessment base for those plans to which section 37 of the Regulation applies.

7.0 Foreign Insurance Companies

Should the administrator decide to invest in a buy-in annuity issued by a foreign insurance company, in addition to the guidance on prudent investing and due diligence (above), FSCO would expect the administrator to consider additional factors related to the risk of the investment. Some of these factors include:

- a consideration of the regulatory regime to which the foreign insurance company is subject;
- any applicable capital or solvency requirements;
- any coverage or guarantee fund available in the case of insurer insolvency;
- the legal ability of the foreign insurance company to enter into the contract;
- the enforceability of the contract in the foreign jurisdiction (and the cost and difficulty of enforcement); and,
- the exchange rate risk if the payments under the policy will be made in a currency other than Canadian dollars.

Investments in buy-in annuities issued by foreign insurance companies do not fall within the exceptions contained in Schedule III of the Federal Investments Regulations.[3] In particular, section 9 of Schedule III, the "10% rule," would apply to a buy-in annuity issued by a foreign insurance company.[4]

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[3] The FIR are defined in section 66 of the Regulation as sections 6, 7, 7.1 and 7.2 and Schedule III to the "Pension Benefits Standards Regulations, 1985" made under the Pension Benefits Standards Act, 1985 (Canada) as they may be amended from time to time.

[4] The 10% rule would also apply to buy-in annuities issued by persons authorized to carry on life insurance business in Canada if the annuities were not investments in unallocated general funds of such persons.