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SECTION: Actuarial Guidance Note

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TITLE: Alternative Settlement Methods for Solvency Valuations

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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), Pension Benefits Act, R.S.O. 1990, c. P.8 (PBA) or Regulation 909, R.R.O. 1990 (Regulation), the FSCO Act, PBA or Regulation govern.*

*Note: The electronic version of this policy, including direct access to all linked references, is available on FSCO's website at [www.fSCO.gov.on.ca](http://www.fSCO.gov.on.ca). All pension policies can be accessed from the **Pensions** section of the website through the **Pension Policies** link.*

## **Purpose**

Under the PBA and Regulation, the administrator of a pension plan that provides defined benefits is required to file, on either an annual or triennial basis, actuarial valuation reports to establish the funding requirements of the plan in accordance with the Regulation. The reports and certificates required under the PBA and Regulation must be prepared by an actuary, who must use methods and actuarial assumptions that are consistent with accepted actuarial practice.

The PBA provides authority for the Superintendent of the Financial Services Commission of Ontario (FSCO) to require the preparation of a new actuarial valuation report if FSCO concludes that the methods or assumptions used in the preparation of a report in respect of the plan are not consistent with accepted actuarial practice, or are inappropriate.

The Actuarial Standards Board of the Canadian Institute of Actuaries (CIA) introduced revisions to subsections 3240 and 3260 of the CIA Standards of Practice – Practice-Specific Standards for Pension Plans (Standards of Practice), which became effective September 18, 2013. Concurrently, the CIA issued an educational note, Alternative Settlement Methods for Hypothetical Wind-Up and Solvency Valuations (Educational Note) prepared by the Committee on Pension Plan Financial Reporting (PPFRC). The Educational Note provides guidance to

actuaries who decide to use alternative settlement methods for hypothetical wind-up and solvency valuations. FSCO is of the opinion that the use of some alternative settlement methods may not be appropriate for an actuarial valuation report filed under the PBA and Regulation.

This Actuarial Guidance Note describes FSCO's expectations when an actuary assumes an alternative settlement method in the preparation of an actuarial valuation report to be filed with FSCO for purposes of the PBA and Regulation. For clarity, the guidance note does not apply to actual wind-up situations, and FSCO would not accept the use of any alternative settlement methods for actual wind up situations.

## **General**

When reviewing actuarial valuation reports filed with FSCO, FSCO considers whether actuarial methods and assumptions for going concern and solvency valuations have been chosen with a level of prudence consistent with the plan's funding objectives, with due consideration to the underlying characteristics of the pension plan obligations.

The Standards of Practice clarify that the assumption of alternative settlement methods for hypothetical wind-up and solvency valuations is limited to situations where it is anticipated that annuities could not be purchased due to group annuity capacity limitations or where it is permitted by law, regulatory policy or guideline. Furthermore, in situations where the plan's liabilities may exceed capacity of the group annuity market, the Standards of Practice permits the actuary to assume that benefits would be settled by the purchase of annuities regardless of any capacity limitations. This assumption would be accepted by FSCO.

In general, the actuary should assume benefits would be settled by the purchase of annuities when performing a hypothetical wind-up or solvency valuation. If an alternative settlement method is used, then the actuary should be prepared to justify and provide adequate support as to why it is not appropriate to value the benefits by assuming that they are settled by the purchase of annuities given that this is permitted by the Standards of Practice.

For the purpose of justifying the use of an alternative settlement method, the actuary may not rely solely on the capacity thresholds stated in the Educational Note (i.e. \$500 million for non-indexed annuities and \$200 million for indexed annuities) as these thresholds may change over time. It should be noted that statistics from the insurance industry (e.g. Life Insurance and Market Research Association, Canadian Life and Health Insurance Association) show that the Canadian group annuity market has exceeded \$1 billion each year since 2007 except for one year. Actual annuity transactions that have taken place, input from insurance companies as well as any updates provided by the CIA to the Educational Note with respect to thresholds should also be considered in estimating the prevailing thresholds.

The Educational Note states that the use of an alternative settlement approach may result in liabilities either higher or lower than those produced by assuming the benefits would be settled through a single annuity purchase. FSCO expects that the actuary will exercise sound judgment when selecting the approach and to ensure that the method is reasonable, supportable and appropriate given the plan's circumstances.

If an alternative settlement method is used, FSCO may request, in addition to the disclosures required in the Standards of Practice and the Educational Note, other information or documentation in support of the rationale for the alternative settlement method assumed.

An alternative settlement method which contemplates an exercise of regulatory discretion or a change in legislation would be accepted by FSCO if the resulting liabilities are no less than the liabilities produced using the prevailing guidance issued by the PPFRC and assuming no capacity constraints. In all other situations, FSCO will consider, on a case by case basis, submissions from the actuary which provide support that the use of an alternative settlement method which varies from the expectations of FSCO as described in this Actuarial Guidance Note, is appropriate for the pension plan.

## **Alternative Settlement Methods**

### **1. Purchase of a Series of Annuities**

In the case where the actuary assumes that the liabilities would be settled through a series of purchases over a period of time, FSCO expects that the liabilities would not be less than the liabilities produced using the prevailing guidance issued by the PPFRC and assuming no capacity constraints.

The actuary should disclose the assumptions made with respect to estimating annuity purchases in the future in addition to justifying the provision for expenses over the duration of the annuity purchases.

### **2. Establishment of a Replicating Portfolio**

Paragraph 3240.17 of the Standards of Practice states that *“the actuary may assume settlement by means of a replicating portfolio”* with the assumption that the *“replicating portfolio would provide for an appropriate level of security for the pension benefits covered”*.

If the actuary is contemplating the use of a replicating portfolio as an alternative settlement method, FSCO would require that the actuary provide appropriate justification for the use of this method including the rationale for the method. The actuary's justification should comment on the relevant fixed income investment market capacity, and provide information about the credit and liquidity profile of the instruments included. In describing the margins for adverse deviations, the actuary should describe each of the key risks considered in setting the margin.

The use of a replicating portfolio is intended to apply only where it is believed that the group annuity capacity limitations will be exceeded. Therefore, the appropriate level of security of benefits covered that is provided by the replicating portfolio should be the same or similar to that of an annuity purchase, if there were no capacity limitations restricting the ability to purchase the annuities.

FSCO would require significant disclosures for a plan applying this alternative approach including but not limited to:

- the allocation of investments in the portfolio and justification of the allocation;
- the mortality experience applied to the expected benefit cash flows and justification if such experience does not reflect plan-specific experience;
- a justification of the level of expenses associated with establishing and maintaining the portfolio;
- the average duration of the liabilities to be settled and the average duration of the portfolio;
- the assumptions regarding the options elected by plan members; and,
- a description of the margins for adverse deviations to ensure a high probability that the pension benefit promises will be met. The actuary should use judgment when considering whether the margins are appropriate for the plan.

The Educational Note specifies that the portfolio would include “*a substantial allocation to high-quality fixed-income investments*”. FSCO expects that to achieve a level of security commensurate with the prevailing guidance, a substantial allocation to fixed-income investments such as bonds issued or guaranteed by the Government of Canada or investment grade bonds issued or guaranteed by the government of a Canadian province would be required. FSCO would require that the actuary provide adequate disclosures with respect to the allocation and the underlying investments.

The Educational Note states that the “*actuary would provide meaningful disclosures regarding the benefit security implications of the settlement method based on either stochastic modelling or stress testing.*” FSCO would generally expect the disclosures to provide adequate information for FSCO to make an assessment of the level of benefit security provided.

### **3. Lump Sum Payments to Members**

FSCO would not accept a method that assumes the settlement of deferred or immediate pension entitlements by lump sum payments, unless permitted by the legislation. For example, lump sum commuted values cannot be paid to retired members, unless specifically permitted by the legislation.

### **4. Assuming Modifications to Benefit Terms**

The valuation should be performed in accordance with the terms of the pension plan at the valuation date. Therefore, unless the plan is amended, FSCO will not accept this alternative settlement method.