Educational Note Supplement

Guidance for Assumptions for Hypothetical Wind-Up and Solvency Valuations Update – Effective June 30, 2014, and Applicable to Valuations with Effective Dates Between June 30, 2014, and December 30, 2014

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Memorandum

To: All Pension Actuaries

From: Bruce Langstroth, Chair
Practice Council

Manuel Monteiro, Chair
Committee on Pension Plan Financial Reporting

Date: August 12, 2014

Subject: **Educational Note Supplement: Guidance for Assumptions for Hypothetical Wind-Up and Solvency Valuations Update – Effective June 30, 2014, and Applicable to Valuations with Effective Dates Between June 30, 2014, and December 30, 2014**

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The most recent guidance from the Committee on Pension Plan Financial Reporting (PPFRC) regarding assumptions for hypothetical wind-up and solvency valuations was provided in the educational note supplement dated May 6, 2014, for valuations with effective dates on and after March 31, 2014 (but no later than December 30, 2014).

The PPFRC has conducted its quarterly review of group annuity pricing conditions as at June 30, 2014, and has determined that a revision to its guidance regarding assumptions for hypothetical wind-up and solvency valuations is appropriate for valuations with effective dates on or after June 30, 2014 (but no later than December 30, 2014). The revisions to the guidance are contained in this educational note supplement.

DUE PROCESS

The Policy on Due Process for the Approval of Guidance Material Other than Standards of Practice was followed in the development of these revisions.

CONTACT INFORMATION

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NON-INDEXED ANNUITY PROXY

Previous Guidance

The most recent guidance from the Committee on Pension Plan Financial Reporting (PPFRC) concluded that for valuations with effective dates on or after March 31, 2014 (but no later than December 30, 2014), an appropriate discount rate for estimating the cost of purchasing a non-indexed group annuity would be determined as the unadjusted average yield on Government of Canada (GoC) marketable bonds with maturities over 10 years (CANSIM series V39062) increased arithmetically by between 50 to 100 basis points (bps), in conjunction with the UP94 generational mortality tables (based on the AA scale). The spread above the CANSIM series V39062 would be determined based on the duration of the liabilities expected to be settled through the purchase of a group annuity.

This guidance was based on hypothetical quotes provided by eight insurance companies on illustrative blocks of business using pricing conditions as at March 31, 2014, supplemented by data from certain actuarial consulting firms on actual group annuity purchases during the first quarter of 2014. Furthermore, this guidance applied to both immediate and deferred pensions, and also applied regardless of the overall size of the group annuity purchase.

Analysis

The PPFRC obtained hypothetical quotes as at June 30, 2014, on the same illustrative blocks of business used to develop the previous guidance. The characteristics of the three illustrative blocks are as follows:

Duration	**Low**	**Medium**	**High**
Duration at June 30, 2014	8.0	10.5	12.9
Approximate premium at June 30, 2014	$10 million	$21 million	$22 million
Average monthly pension	$897	$897	$897
Proportion of liability for deferred members	0%	4%	12%

For the purpose of this guidance, the durations of the illustrative blocks shown above were determined by calculating the impact of a 0.01% change in the discount rate, and using the following formula:

[(Estimated Purchase Price at 3.08% / Estimated Purchase Price at 3.09%) – 1] / 0.01%

where 3.08% is equal to the CANSIM V39062 yield of 2.68% plus 40 bps at June 30, 2014, being the guidance for the illustrative block with medium duration (as described below). Note that the durations of the three illustrative blocks will change over time as discount rates change.

The PPFRC also obtained data from certain actuarial consulting firms on actual group annuity purchases and bona fide quotations in cases where the transaction did not proceed during the second quarter of 2014. In reviewing the data of the three most competitive hypothetical quotes as at June 30, 2014, we noticed some inconsistencies in the hypothetical quotes and the actual purchases for one insurer. Upon further investigation, it was determined that the hypothetical quotes provided by this insurer were not representative of how they would actually price annuities as of June 30, 2014. As a result, this insurer has been excluded from our analysis of the three most competitive hypothetical quotes for this quarter.

The hypothetical quotations at March 31, 2014, and June 30, 2014, may be summarized as follows:

AVERAGE OF THE THREE MOST COMPETITIVE HYPOTHETICAL QUOTES (USING UP94 GENERATIONAL MORTALITY TABLES)						
	31/3/2014			**30/6/2014**		
	Low duration	**Medium duration**	**High duration**	**Low duration**	**Medium duration**	**High duration**
Discount rate	3.63%	3.84%	3.94%	2.46%	2.94%	3.19%
Spread over CANSIM V39062	+ 81 bps	+ 102 bps	+ 112 bps	- 22 bps	+ 26 bps	+ 51 bps

The spread over CANSIM V39062 based on the average of the three most competitive hypothetical quotes decreased materially for each of the illustrative blocks, most significantly for the low-duration block. However, there remains significant variability in the hypothetical quotes provided by the individual insurers, with the most competitive quotes having somewhat higher spreads than the average of the three most competitive quotes indicated above. In addition, actual purchases during the quarter tended to have higher spreads than the averages quoted above, particularly for low-duration groups.

Based on the above information, the PPFRC has concluded that a revision to the guidance is appropriate. In establishing the new guidance, the PPFRC has given some weight to the hypothetical quotes and the data collected on actual annuity purchases and bona fide quotations.

Guidance for Non-indexed Pensions

The PPFRC has concluded that effective June 30, 2014, the cost of purchasing non-indexed annuities would be estimated based on the following process:

1. Determine the duration *of the portion of the liabilities assumed to be settled through the purchase of annuities*, based on a discount rate of 3.08% (CANSIM V39062 plus 40 bps at June 30, 2014).
2. Using the duration obtained in step 1, interpolate using the following table to determine the appropriate spread above unadjusted CANSIM V39062:

Illustrative block	**Duration based on 3.08% discount rate**	**Spread above unadjusted CANSIM V39062**
Low duration	8.0	+ 0 bps
Medium duration	10.5	+ 40 bps
High duration	12.9	+ 60 bps

If the duration of the portion of the liabilities assumed to be settled through the purchase of annuities is lower than 8.0 or higher than 12.9, the actuary would make a reasonable assumption regarding the appropriate spread.

The PPFRC believes that groups with durations higher than 12.9 would likely include a large proportion of deferred vested members. While the higher duration, in isolation, would be expected to result in lower pricing, the PPFRC believes that this impact would be offset by added administrative costs and risks that insurers would incur in assuming these obligations. The PPFRC also believes that it is rare that a group would have a duration materially lower than 8.0. As of June 30, 2014, the PPFRC believes that one reasonable approach would be to assume that the spread for durations lower than 8.0 is 0 bps, and the spread for durations higher than 12.9 is 60 bps. Other approaches may also be reasonable.

3. The cost of purchasing annuities would be estimated using an interest rate determined as the unadjusted CANSIM V39062 increased arithmetically by the spread calculated in step 2, in conjunction with the UP94 generational mortality tables.

   Each actuary would use discretion in determining whether to round the interest rate to the nearest five or 10 basis points. Consistency in the application of such rounding would be followed.

The above guidance applies to both immediate and deferred pensions and also applies regardless of the overall size of the group annuity purchase. It applies to valuations with effective dates on and after June 30, 2014, pending any further guidance or other evidence of change in annuity pricing.

CPI-INDEXED ANNUITY PROXY

Previous Guidance

The most recent guidance from the Committee on Pension Plan Financial Reporting (PPFRC) concluded that for valuations with effective dates on or after March 31, 2014 (but no later than December 30, 2014), an appropriate discount rate for estimating the cost of purchasing a group annuity where pensions are fully indexed to the rate of change in the CPI would be the unadjusted yield on Government of Canada real-return long-term bonds (CANSIM series V39057) reduced arithmetically by 100 bps, in conjunction with the UP94 generational mortality tables (based on the AA improvement scale).

This guidance applied to both immediate and deferred pensions, regardless of the overall size of the group annuity purchase, and regardless of duration.

Analysis

Most of the contributing insurers also provided hypothetical quotes for the illustrative blocks on a CPI-indexed basis as of June 30, 2014. The hypothetical quotations as at March 31, 2014, and June 30, 2014, for the medium-duration illustrative block may be summarized as follows:

AVERAGE OF THE THREE MOST COMPETITIVE HYPOTHETICAL QUOTES (USING UP94 GENERATIONAL MORTALITY TABLES)		
	31/3/2014	**30/6/2014**
Discount rate	-0.11%	-0.30%
Spread over CANSIM V39057	-102 bps	-106 bps

The spread below CANSIM V39057 based on the average of the three most competitive hypothetical quotes remained fairly stable for the medium-duration illustrative block. There was limited variability in the pricing of the most competitive hypothetical quotes.

While there is some indication that the pricing of CPI-indexed annuities may also vary by duration, the PPFRC has concluded that there are insufficient data at this stage to introduce this level of refinement. Consequently, the guidance contained herein is applicable to CPI-indexed annuities regardless of their duration.

There were no quantitative data obtained on actual fully indexed annuity purchases during the second quarter of 2014.

Guidance for Fully CPI-Indexed Pensions

Based on the pricing received, the PPFRC has determined that an appropriate proxy for estimating the cost of purchasing a group annuity where pensions are fully indexed to the rate of change in the CPI would be determined using an interest rate equal to the unadjusted yield on Government of Canada real-return long-term bonds (CANSIM series V39057) reduced arithmetically by 110 bps, in conjunction with the UP94 generational mortality tables (with the AA improvement scale).

Each actuary would use discretion in determining whether to round the interest rate to the nearest five or 10 basis points. Consistency in the application of such rounding would be followed.

The above guidance applies to both immediate and deferred pensions, regardless of the overall size of the group annuity purchase and regardless of duration. It applies to valuations with effective dates on and after June 30, 2014, pending any further guidance or other evidence of change in annuity pricing.

Example

As at June 30, 2014, the unadjusted yield on Government of Canada real-return long-term bonds (CANSIM series V39057) was 0.76%. Therefore, prior to rounding, an applicable underlying discount rate would be determined as 0.76% - 1.10% = -0.34%.

Partially-Indexed Annuities

In situations where pensions are partially indexed, indexed to a measure other than the CPI, or contain a deferred component, the actuary would make appropriate provisions for such situations consistent with the guidance provided in the annual educational note dated April 26, 2014, modified to reflect the revised guidance contained in this memo.

VALIDITY OF APRIL 26, 2014 EDUCATIONAL NOTE

Except as noted above, actuaries would continue to reference the April 26, 2014, educational note for guidance with respect to the selection of assumptions for hypothetical wind-up and solvency valuations with effective dates between June 30, 2014, and December 30, 2014.

ACTUAL ANNUITY PRICING

The purpose of this educational note supplement is to provide actuaries with guidance related to establishing assumptions for hypothetical wind-up and solvency valuations. The pricing for an actual group annuity purchase depends on many factors, with the result that the actual price may differ from the guidance provided herein. In addition to the duration of the purchase, some of the other factors that may affect pricing of a particular purchase include, but are not limited to:

- The overall size of the purchase;
- The proportion of deferred vested members included in the group being purchased;
- The average pension amount for the pensions being purchased;

- The mortality experience anticipated by the insurance companies bidding on the purchase;
- Broad capital market conditions at the time of the purchase; and
- Competitive pressures in the group annuity market at the time of the purchase.

RETROACTIVE APPLICATION

If an actuary has already prepared a funding valuation report with an effective date on or after June 30, 2014, before the publication of this guidance, the actuary would consider paragraphs 1820.30 through 1820.36 of the Standards of Practice to determine whether it is necessary to withdraw or amend the report.

ADDITIONAL COMMENTS

The PPFRC intends to continue monitoring group annuity pricing on a quarterly basis. Actuaries may use the spreads indicated above for valuations with effective dates on and after June 30, 2014, up to December 30, 2014, pending any future guidance or other evidence of change in annuity pricing.

The PPFRC is continuing to review some other aspects of group annuity purchase pricing that may result in revisions to future guidance. In particular, the underlying basis used to express the annuity guidance is being reviewed. Currently, the non-indexed annuity guidance is expressed as a spread over yields on GoC long-term bonds in conjunction with the UP94 generational mortality tables, irrespective of the basis used by insurers when submitting hypothetical quotes. The PPFRC is exploring whether other bases may be more appropriate to provide more stability in the resulting spreads.

It may be noted that the spreads versus GoC long-term bonds for group annuity pricing have been volatile during the past three to four years. Actuaries may wish to be mindful of this volatility when communicating advice related to future hypothetical wind-up and solvency valuations.