Canadian Institute of Actuaries
Institut canadien des actuaires

Educational Note Supplement

Guidance for Assumptions for Hypothetical Wind Up and Solvency Valuations Update – Effective June 30, 2015, and Applicable to Valuations with Effective Dates Between June 30, 2015, and December 30, 2015

Document 215064

MEMORANDUM

To: All Pension Actuaries

From: Pierre Dionne, Chair
Practice Council

Simon Nelson, Chair
Committee on Pension Plan Financial Reporting

Date: August 4, 2015

Subject: **Educational Note Supplement: Guidance for Assumptions for Hypothetical Wind-Up and Solvency Valuations Update – Effective June 30, 2015, and Applicable to Valuations with Effective Dates Between June 30, 2015, and December 30, 2015**

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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 dated May 5, 2015. This guidance applied for valuations with effective dates on and after March 31, 2015 (but no later than December 30, 2015).

The PPFRC has conducted its quarterly review of group annuity pricing conditions as at June 30, 2015, and has determined that a revision to its previous guidance regarding assumptions for hypothetical wind-up and solvency valuations is appropriate for valuations with effective dates on or after June 30, 2015 (but no later than December 30, 2015). 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

Questions should be addressed to Simon Nelson, Chair of the PPFRC, at snelson@eckler.ca.

PD, SN

1740-360 Albert, Ottawa, ON K1R 7X7 613-236-8196 613-233-4552
head.office@cia-ica.ca / siege.social@cia-ica.ca **cia-ica.ca**

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, 2015 (but no later than December 30, 2015), 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 0 to 60 basis points (bps), in conjunction with the UP94 generational mortality table, with the AA improvement scale (UP94Proj). 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 seven insurance companies on illustrative blocks of business using pricing conditions as at March 31, 2015, supplemented by data from certain actuarial consulting firms on actual group annuity purchases during the first quarter of 2015. 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, 2015, from seven insurance companies 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, 2015	8.3	10.9	13.6
Approximate premium at June 30, 2015	$18 million	$24 million	$25 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 2.51% / Estimated Purchase Price at 2.52%) – 1] / 0.01%

where 2.51% is equal to the CANSIM V39062 yield of 2.21% at June 30, 2015, plus 30 bps, 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 during the second quarter of 2015. The hypothetical quotations at March 31, 2015, and June 30, 2015, may be summarized as follows:

Average of the Three Most Competitive Hypothetical Quotes (Using UP94Proj)						
	March 31, 2015			June 30, 2015		
	Low duration	Medium duration	High duration	Low duration	Medium duration	High duration
Discount rate	1.61%	2.13%	2.42%	1.93%	2.46%	2.78%
Spread over CANSIM V39062	- 20 bps	+ 32 bps	+ 61 bps	- 28 bps	+ 25 bps	+ 57 bps

The spread over CANSIM V39062 based on the average of the three most competitive hypothetical quotes during the quarter decreased slightly for the medium- and high-duration illustrative blocks. The spread below CANSIM V39062 based on the average of the three most competitive hypothetical quotes during the quarter increased slightly for the low-duration illustrative block. As of June 30, 2015, the variability between the most competitive hypothetical quotes was fairly small. In addition, the average spreads for actual purchases and bona fide quotations during the quarter were not inconsistent with the averages quoted above for each block.

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

Guidance for Non-indexed Pensions

The PPFRC has concluded that effective June 30, 2015, 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 2.51% (CANSIM V39062 plus 30 bps at June 30, 2015).
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 2.51% discount rate	Spread above unadjusted CANSIM V39062
Low duration	8.3	- 20 bps
Medium duration	10.9	+ 30 bps
High duration	13.6	+ 60 bps

If the duration of the portion of the liabilities assumed to be settled through the purchase of annuities is lower than 8.3 or higher than 13.6, the actuary would make a reasonable assumption regarding the appropriate spread.

The PPFRC believes that groups with durations higher than 13.6 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 8.3. As of June 30, 2015, the PPFRC believes that one reasonable approach would be to assume that the spread for durations lower than 8.3 is -20 bps, and the spread for durations higher than 13.6 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 UP94Proj.

   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, 2015, pending any further guidance or other evidence of change in annuity pricing.

CPI-Indexed Annuity Proxy

Previous Guidance

The most recent guidance from the PPFRC concluded that for valuations with effective dates on or after March 31, 2015 (but no later than December 30, 2015), 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 Consumer Price Index (CPI) would be the unadjusted yield on Government of Canada real-return long-term bonds (CANSIM series V39057) reduced arithmetically by 120 bps, in conjunction with UP94Proj.

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, 2015. The hypothetical quotations as at March 31, 2015, and June 30, 2015, for the medium-duration illustrative block may be summarized as follows:

Average of the Three Most Competitive Hypothetical Quotes (Using UP94Proj)		
	March 31, 2015	**June 30, 2015**
Discount rate	-1.13%	-0.60%
Spread over CANSIM V39057	-132 bps	-115 bps

The spread below CANSIM V39057 based on the average of the three most competitive hypothetical quotes decreased slightly for the medium-duration illustrative block.

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 2015.

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 120 bps, in conjunction with UP94Proj.

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, 2015, pending any further guidance or other evidence of change in annuity pricing.

Example

As at June 30, 2015, the unadjusted yield on Government of Canada real-return long-term bonds (CANSIM series V39057) was 0.55%. Therefore, prior to rounding, an applicable underlying discount rate would be determined as 0.55% - 1.20% = -0.65%.

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 24, 2015, modified to reflect the revised guidance contained in this memo.

Validity of April 24, 2015, Educational Note

Except as noted above, actuaries would continue to reference the April 24, 2015 educational note for guidance with respect to the selection of assumptions for hypothetical wind-up and solvency valuations with effective dates between June 30, 2015, and December 30, 2015.

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, 2015, 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, 2015, up to December 30, 2015, pending any future guidance or other evidence of change in annuity pricing.

As part of this quarterly review, the PPFRC requested information from insurers as to whether an illustrative block of business that is half the size or five times the size, keeping the same average pension and profile as the current illustrative block, would have a significant impact on price. Based on the information collected, the PPFRC does not currently believe that the guidance should be revised to reflect differing pricing for these blocks.

For subsection 3530 of the Standards of Practice, the Actuarial Standards Board promulgated the use of the 2014 Canadian Pensioner Mortality Table (CPM2014) combined with the mortality improvement scale CPM Improvement Scale B (CPM-B) for pension commuted value calculations, effective October 1, 2015. The PPFRC anticipates adopting the same underlying mortality table for purposes of developing group annuity purchase guidance for valuation dates on or after September 30, 2015. In conjunction with the adoption of the new mortality table, the PPFRC expects to provide additional guidance on adjustments that the actuary would be expected to make to the regular annuity purchase assumptions for plans where there is demonstrated substandard or super-standard mortality or where an insurer might be expected to make adjustments to pricing based on occupational or demographic factors.

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.