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Educational Note Supplement

Guidance for Assumptions for Hypothetical Wind-Up and Solvency Valuations Update – Effective September 30, 2016, and Applicable to Valuations with Effective Dates Between September 30, 2016 and December 30, 2016

Document 216111

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MEMORANDUM

To: All Pension Actuaries

From: Pierre Dionne, Chair
Practice Council

Simon Nelson, Chair
Committee on Pension Plan Financial Reporting

Date: November 17, 2016

Subject: **Educational Note Supplement: Guidance for Assumptions for Hypothetical Wind-Up and Solvency Valuations Update – Effective September 30, 2016, and Applicable to Valuations with Effective Dates Between September 30, 2016 and December 30, 2016**

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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 August 17, 2016. This guidance applied for valuations with effective dates on and after June 30, 2016 (but no later than December 30, 2016).

The PPFRC has conducted its quarterly review of group annuity pricing conditions as at September 30, 2016 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 September 30, 2016 (but no later than December 30, 2016).

Additional information is contained in this educational note supplement. The guidance contained in this educational note supplement is consistent with the preliminary communication dated October 21, 2016.

Due Process

The Policy on Due Process for the Approval of Guidance Material Other than Standards of Practice and Research Documents 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 June 30, 2016 (but no later than December 30, 2016), an appropriate discount rate for estimating the cost of purchasing a non-indexed group annuity, prior to any adjustment for sub- or super-standard mortality, 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 90 to 130 basis points (bps), in conjunction with the 2014 Canadian Pensioners' Mortality Table (CPM2014) combined with mortality improvement scale CPM Improvement Scale B (CPM-B) with no adjustments for sub- or super-standard mortality (CPM2014Proj). 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 six insurance companies on illustrative blocks of business using pricing conditions as at June 30, 2016, supplemented by data from certain actuarial consulting firms on actual group annuity purchases and bona fide quotations during the second quarter of 2016. 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 September 30, 2016 from six 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 September 30, 2016	8.7	11.4	14.0
Approximate premium at September 30, 2016	$19 million	$25 million	$26 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 2.65% / Estimated Purchase Price at 2.66%) – 1] / 0.01%

where 2.65% is equal to the CANSIM V39062 yield of 1.55% at September 30, 2016 plus 110 bps and where the estimated purchase price is calculated using mortality rates equal to the 2014 Canadian Pensioners' Mortality Table (CPM2014) combined with mortality improvement scale CPM Improvement Scale B (CPM-B) with no adjustments for sub- or super-standard mortality

(CPM2014Proj), 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 third quarter of 2016.

The hypothetical quotations at June 30, 2016 and September 30, 2016 may be summarized as follows:

Average of the Three Most Competitive Hypothetical Quotes (Using CPM2014Proj Mortality Tables)						
	June 30, 2016			**September 30, 2016**		
	Low duration	**Medium duration**	**High duration**	**Low duration**	**Medium duration**	**High duration**
Discount rate	2.49%	2.73%	2.92%	2.33%	2.56%	2.70%
Spread over CANSIM V39062	+ 86 bps	+ 110 bps	+ 129 bps	+ 78 bps	+ 101 bps	+ 115 bps

The spread over CANSIM V39062 based on the average of the three most competitive hypothetical quotes decreased across all durations during the quarter. As of September 30, 2016, the variability between the most competitive hypothetical quotes was small, but the variability increased since the previous quarter. In addition, the average spreads for actual purchases and bona fide quotations during the quarter were generally more favourable than the averages quoted above at all durations.

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 to the data collected on actual annuity purchases and bona fide quotations.

Guidance for Non-indexed Pensions

The PPFRC has concluded that effective September 30, 2016, the cost of purchasing non-indexed annuities, prior to any adjustment for sub- or super-standard mortality, 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 2.65% (CANSIM V39062 plus 110 bps at September 30, 2016) and CPM2014Proj mortality rates.
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 2.65% discount rate**	**Spread above unadjusted CANSIM V39062**
Low duration	8.7	+ 80 bps
Medium duration	11.4	+ 110 bps
High duration	14.0	+ 120 bps

If the duration of the portion of the liabilities assumed to be settled through the purchase of annuities is lower than 8.7 or higher than 14.0, the actuary would make a reasonable assumption regarding the appropriate spread.

The PPFRC believes that groups with durations higher than 14.0 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 8.7. As of September 30, 2016, the PPFRC believes that one reasonable approach would be to assume that the spread for durations lower than 8.7 is +80 bps, and the spread for durations higher than 14.0 is +120 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 CPM2014Proj.

   The PPFRC believes that rounding of the interest rate resulting from following the guidance outlined in this educational note supplement to the nearest five or 10 basis points is a reasonable and appropriate approach. Each actuary would use discretion in determining whether to round the interest rate, and 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 September 30, 2016, up to December 30, 2016, 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 June 30, 2016 (but no later than December 30, 2016), 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 70 bps, in conjunction with CPM2014Proj.

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

Analysis

A subset of the contributing insurers also provided hypothetical quotes for the illustrative blocks on a CPI-indexed basis as of September 30, 2016. The hypothetical quotations as at June 30, 2016 and September 30, 2016, for the medium-duration illustrative block may be summarized as follows:

Average of the Three Most Competitive Hypothetical Quotes (Using CPM2014Proj Mortality Tables)		
	June 30, 2016	**September 30, 2016**
Discount rate	-0.31%	-0.41%
Spread over CANSIM V39057	- 61 bps	- 60 bps

The spread below CANSIM V39057 based on the average of the three most competitive hypothetical quotes was stable during the quarter for the medium-duration illustrative block; however, the spreads were somewhat less favourable for the high-duration and low-duration illustrative blocks.

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 was no quantitative data obtained either on actual fully- or partially-indexed annuity purchases or on bona fide quotations in cases where the transaction did not proceed during the third quarter of 2016.

Guidance for Fully CPI-Indexed Pensions

Considering the pricing received, as well as the lack of bona fide quotations during the third quarter, the PPFRC has concluded there is insufficient data to warrant a revision to the previous guidance, and 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 70 bps, in conjunction with CPM2014Proj.

The PPFRC believes that rounding of the interest rate resulting from following the guidance outlined in this educational note supplement to the nearest five or 10 basis points is a reasonable and appropriate approach. Each actuary would use discretion in determining whether to round the interest rate, and 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 September 30, 2016, up to December 30, 2016, pending any further guidance or other evidence of change in annuity pricing.

Example

As at September 30, 2016, the unadjusted yield on Government of Canada real-return long-term bonds (CANSIM series V39057) was 0.19%. Therefore, an applicable underlying discount rate would be determined as 0.19% - 0.70% = -0.51%.

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 29, 2016, modified to reflect the revised guidance contained in this memo.

Mortality Basis

The PPFRC does not have access to the mortality assumptions used by insurers for purposes of pricing group annuities. The assumed mortality table and assumed future mortality improvements used to establish the discount rate guidance in this educational note are the 2014 Combined Canadian Pensioners' Mortality Table (CPM2014) in conjunction with the CPM Improvement Scale B (CPM-B) with no mortality adjustments (CPM2014Proj), irrespective of the basis used by insurers when submitting quotes. This is the mortality table promulgated for the computation of pension commuted values for calculations from October 1, 2015 in accordance with subsection 3530 of the Standards of Practice.

The choice of the mortality assumption used for this guidance is unlikely to materially affect the estimated cost of purchasing an annuity, since the guidance is derived by solving for the discount rate that along with the selected mortality table produces the price of an annuity.

Mortality Adjustments

The hypothetical quotes were requested to be based on an assumption that the priced group's life expectancy is typical of a group annuity purchase. The hypothetical quotes were also requested to be based on typical pension sizes, irrespective of the underlying data. That is, no adjustments for sub- or super-standard mortality were to be made due to the size of the pensions, or other factors, in the illustrative block.

Insurers are increasingly considering occupational and demographic factors in establishing mortality assumptions for the pricing basis of specific group annuities, as are pension actuaries for establishing liabilities for other purposes, including going concern valuations. The factors an insurer may consider are similar to those that pension actuaries consider in establishing liabilities, such as the credibility of experience, the experience of similar plans, published mortality studies, plan provisions that expose the group to anti-selection or tail risk, and possible adjustments based on characteristics such as collar type, industry, and pension size.

An adjustment to regular annuity purchase assumptions would be expected where there is demonstrated substandard or super-standard mortality or where an insurer might be expected to assume significantly shorter or longer-than-average pension plan longevity based on the above factors. In such cases, the actuary would be expected to make an adjustment to the mortality assumption in a manner consistent with the underlying annuity purchase basis. The adjustment may include using a different underlying mortality table, developing a broad adjustment to the underlying mortality table (e.g., 90% or 110% of the standard table rates), or, in some cases, different adjustment factors may be used for a range of ages. Other approaches for making an adjustment may also be reasonable.

Further guidance on the nature of adjustments for plan characteristics can be found in the March 2014 Educational Note Selection of Mortality Assumptions for Pension Plan Actuarial Valuations.

Validity of April 29, 2016 Educational Note

Except as noted above, actuaries would continue to reference the April 29, 2016 educational note for guidance with respect to the selection of assumptions for hypothetical wind-up and solvency valuations with effective dates between December 31, 2015 and December 30, 2016.

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 and the factors outlined in the section titled “Mortality Adjustments”, some of the other factors that may affect pricing of a particular purchase include, but are not limited to, the following:

- The overall size of the purchase;
- The proportion of deferred vested members included in the group being purchased;
- 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 September 30, 2016, 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 September 30, 2016, up to December 30, 2016, 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, but 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 modified blocks.

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.

Appendix A – Summary and Links for Historical Guidance

The following is a summary of the historical guidance issued by the PPFRC. The summary is provided for reference, and actuaries are directed to refer to the respective published educational note or educational note supplement.

Educational Note/ Supplement	Mortality table[1]	Non-indexed Immediate and Deferred *Duration: Spread relative to unadjusted CANSIM V39062*			Fully CPI-Indexed *Spread relative to unadjusted CANSIM V39057*
		Low duration	Medium duration	High duration	All durations
Sep 30, 2016	CPM2014Proj	8.7: + 80 bps	11.4: + 110 bps	14.0: + 120 bps	- 70 bps
Jun 30, 2016	CPM2014Proj	8.6: + 90 bps	11.3: + 120 bps	13.8: + 130 bps	- 70 bps
Mar 31, 2016	CPM2014Proj	8.5: + 90 bps	11.1: + 120 bps	13.6: + 130 bps	- 70 bps
Dec 31, 2015	CPM2014Proj	8.5: + 60 bps	11.1: + 100 bps	13.6[illegible] bps	- 70 bps
Sep 30, 2015	CPM2014Proj	8.4: + 80 bps	11.0: + 110 bps	1[illegible]4: + 120 bps	- 70 bps
Jun 30, 2015	UP94Proj	8.3: - 20 bps	10.9: + 30 bps	13.[illegible] + 60 bps	- 120 bps
Mar 31, 2015	UP94Proj	8.5: + 0 bps	11.3: + 30 bps	14.0: + [illegible] bps	- 120 bps
Dec 31, 2014	UP94Proj	8.2: + 0 bps	10.9: + 30 bps	13.5: + 60 bps	- 120 bps
Sep 30, 2014	UP94Proj	8.1: + 0 bps	10.6: + 30 bps	13.[illegible]: + 50 bps	- 120 bps
Jun 30, 2014	UP94Proj	8.0: + 0 bps	10.5: + 40 bps	12.9: + 60 bps	- 110 bps
Mar 31, 2014	UP94Proj	7.7: + 50 bps	[illegible]0.1: + [illegible] bps	12.3: + 100 bps	- 100 bps
Dec 31, 2013	UP94Proj	7.6: + 50 bps	9.[illegible] + 70 bps	12.1: + 80 bps	- 110 bps
Sep 30, 2013	UP94Proj	7.6: + 60 bps	[illegible].9: + [illegible]0 bps	12.2: + 90 bps	- 100 bps
Jun 30, 2013	UP94Proj	7.8: + 40 bps	10.[illegible]: + 60 bps	12.5: + 70 bps	- 120 bps

Ed. Note / Supplement	Mortality table	Non-indexed *Spread relative to unadjusted CANSIM V39062*		Fully CPI-Indexed *Spread relative to unadjusted CANSIM V39057*
		Immediate	Deferred	All purchase sizes
Mar 31, 2013	UP94Proj	+ 70 bps		+ 0 bps
Dec 31, 2012	UP94Proj	+ 70 bps		+ 0 bps
Sep 30, 2012	UP94Proj	+ 70 bps		+ 0 bps
Jun 30, 2012	UP94Proj	+ 80 bps		+ 0 bps
Mar 31, 2012	UP94Proj	+ 90 bps		+ 0 bps
Dec 31, 2011	UP94Proj	+ 90 bps		+ 0 bps
Sep 30, 2011	UP94Proj	+ 90 bps		+ 0 bps
Jun 30, 2011	UP94Proj	+ 70 bps		+ 0 bps
Mar 31, 2011	UP94Proj	+ 70 bps		+ 0 bps
Dec 31, 2010	UP94@2020	+ 100 bps		+ 0 bps
Sep 30, 2010	UP94@2020	+ 110 bps		+ 0 bps
Jun 30, 2010	UP94@2020	+ 70 bps		+ 0 bps
Mar 31, 2010	UP94@2020	+ 40 bps		+ 0 bps

[1] "CPM2014Proj": 2014 Canadian Pensioners' Mortality Table (CPM2014), combined with mortality improvement scale CPM Improvement Scale B (CPM-B) with no adjustments for sub- or super-standard mortality; "UP94Proj", "UP94@2020", "UP94@2015": UP94 mortality table, combined with mortality improvement scale AA on fully generational basis or static basis to indicated year.

Dec 31, 2009	UP94@2020	+ 40 bps		+ 0 bps
Jul 31, 2009	UP94@2015	+ 10 bps to + 50 bps[2]		- 40 bps to + 0 bps[2]
Oct 31, 2008	UP94@2015	+ 100 bps to + 140 bps[2]	+ 100 bps	- 40 bps to + 0 bps[2]
Feb 29, 2008	UP94@2015	+ 70 bps to + 110 bps[2]	+ 70 bps	- 40 bps to + 0 bps[2]

[2] Higher (Lower) rate applies to purchases with a total premium over $15 (of $0) million at the valuation date. Linear grading of the 40 bps difference applies for purchases with a premium under $15 million.