Category: Investments

Subject: Buy-in Annuity Products

No: 2012-001

The Office of the Superintendent of Financial Institutions (OSFI) has been asked to comment on the acceptability of a potential investment option for pension plans - a group annuity policy referred to as a buy-in annuity. This policy advisory addresses a buy-in annuity policy that covers pensions in pay only.

OSFI has concluded that, provided this investment would be permissible under the plan terms, we would have no objections in principle to a federally regulated pension plan investing in a buy-in annuity issued by a life insurance company for pensions in pay. This policy advisory is intended to inform plan administrators of OSFI's expectations in areas relevant to such a buy-in annuity investment for the plan.

Background

The type of buy-in annuity policy covered in this policy advisory is similar to a traditional annuity; however, instead of issuing individual certificates to the covered retirees and paying pensions to them individually, the policy would make periodic payments to the pension fund equal to the aggregate pension amount covered by the policy. The responsibility for administering the benefits to the retirees would remain with the plan administrator.

The aim of the investment would be to limit the pension plan's exposure to various risks related to the retiree liabilities covered by the policy, including investment and longevity risk.

Investment Considerations

The purchase of the buy-in annuity would be considered an investment of the pension plan and therefore the administrator would have to satisfy itself that the investment with that insurance company was in accordance with the prudent portfolio rule under subsection 8(4.1) of the *Pension Benefits Standards Act, 1985 (PBSA)* and in accordance with *Schedule III* of the *Pension Benefits Standards Regulations, 1985 (Regulations)*. As is the case with all plan investments, the plan administrator would be responsible for continuing to monitor this investment.

An investment in a buy-in annuity would not be considered an immediate or deferred life annuity under section 26.1 of the *PBSA.* Therefore the purchase of a buy-in annuity would not require the consent of the Superintendent and would not be subject to section 9 of the June 2011 *Directives of the Superintendent (Directives).*

If, however, the buy-in annuity policy were converted to a traditional life annuity while the plan was ongoing, section 26.1 of the PBSA would apply and the conversion would have to meet the requirements of section 9 of the *Directives*.

As is the case generally when a plan administrator of an ongoing plan purchases annuities, the plan administrator would remain responsible for ensuring that all benefits covered by the buy-in annuity are paid in the event that the insurance company fails to make the required annuity payments[1].

Value Attributed to the Investment

Subject to the conditions below regarding plan termination, an acceptable method of valuing a buy-in annuity policy would be to calculate the value of the liabilities covered by the policy, on both a going concern and solvency basis, and then set the value of the buy-in annuity policy equal to the value of those liabilities. This would result in the asset value of the buy-in annuity policy being different under the going concern and solvency valuations. If the going concern valuation uses an asset smoothing method, the value of the buy-in annuity should be excluded from the asset smoothing calculation.

As the buy-in annuity does not provide benefits directly to retirees, the value of both the assets and liabilities would be included in the calculation of the solvency ratio and of the average solvency ratio as defined in section 2 of the Regulations.

Plan Termination

In the event a plan is terminated, in whole or in part, the administrator must file a termination report with the Superintendent. Assets of the plan cannot be applied towards the provision of any benefits until the termination report is approved by the Superintendent. Upon the Superintendent's approval of the termination report, the buy-in annuity policy would convert to a traditional annuity policy, and the insurance company would issue individual certificates to the retirees covered by the policy and begin paying their pensions directly.

In the event that benefits payable to the retirees covered by the policy are subject to a reduction in accordance with the approved termination report, the buy-in annuities would convert to traditional life annuities paying the reduced amount. The insurer would determine the value of the difference between the full amount payable under the buy-in annuity and the reduced annuity payments to individually covered retirees. This value

[1] This responsibility does not apply with respect to traditional life annuities purchased as a result of portability options under section 26 of the PBSA..

would be made available to the plan to be distributed[2] in accordance with the approved termination report.

The buy-in annuity policy must address how this value would be calculated. For solvency valuation purposes, in order for the actuary to value the policy equal to the liabilities that the policy covers, the policy must not expose the plan to a potential additional loss at the time of plan termination. That is, the buy-in annuity policy should provide a total value (to the covered retirees and the plan) reasonably equal to the liability that would exist at the time of plan termination for the individually covered retiree liabilities. A suitable basis for calculating the value that must be made available to the plan would be the CIA recommendation for the valuation of liabilities to be settled by the purchase of annuities or the actual cost of purchasing the annuities.

If a different basis is used, the plan could be exposed to a potential additional funding shortfall on termination due to the difference between the total value of the buy-in annuity and the liabilities the buy-in annuity was purchased to cover. In this situation, OSFI would expect the actuary to calculate this shortfall every valuation period and determine its effect on the required funding for the plan. This may result in additional funding requirements for the employer in respect of the liabilities covered by the buy-in annuity.

[2] The value made available to the plan by the insurance company could, depending on the terms of the contract, include a credit for the purchase of additional annuities.