Instruction guide

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Introduction

The Office of the Superintendent of Financial Institutions (OSFI) is responsible for administering a number of federal statutes, including the statute applicable to the regulation of federal private pension plans, the *Pension Benefits Standards Act, 1985* (PBSA).

OSFI also issues instruction guides to communicate specifications and expectations related to certain requirements under the PBSA and the Pension Benefits Standards Regulations, 1985 (PBSR) and to assist administrators in meeting their legislative and regulatory requirements.

Purpose

Various strategies are available to administrators to limit exposure to risks faced by pension plans, including investment and longevity risks. The purpose of this instruction guide (the Instruction Guide) is to assist administrators of pension plans with defined benefit provisions that are registered, or have filed an application for registration, under the PBSA with respect to the considerations and reporting requirements of one such strategy: the purchase of a buy-in annuity.

Application

The Instruction Guide applies on and after March 27, 2023. Early adoption is permitted.

The Instruction Guide supplements requirements for actuarial and termination reports set out in the Instruction Guide for the Preparation of Actuarial Reports for Defined Benefit Pension Plans (the Actuarial Guide) and the Instruction Guide for the Termination of a Defined Benefit Pension Plan (the DB Termination Guide).

The Instruction Guide does not supersede the requirements of the PBSA, the PBSR, or the Directives of the Superintendent pursuant to the Pension Benefits Standards Act, 1985 (the Directives). In the event of discrepancies between the information included in the Instruction Guide, the Directives and the federal pension legislation, the latter shall prevail.

1.0 Background and administration of the pension plan and fund

Under a buy-in annuity contract, the life insurance company makes periodic payments to the pension fund equal to the aggregate pension amount covered by the contract in exchange for payment from the pension fund. The pension plan retains the ultimate responsibility for paying pension benefits directly to the covered individuals, including in the event that the insurance company fails to make the agreed upon contractual payments to the pension fund. The buy-in annuity contract may cover in whole or in part the pension benefits of members, former members with deferred vested pensions as well as retirees and survivors.

A buy-in annuity is not considered an immediate or deferred life annuity under section 26.1 of the PBSA. Therefore, the purchase of a buy-in annuity does not require the consent of the Superintendent and is not subject to section 9 of the Directives.

Other de-risking products may be offered by life insurance companies, which raise similar considerations to the purchase of a buy-in annuity. While the Instruction Guide does not address these products specifically, OSFI expects administrators to apply the considerations and reporting requirements in this guide, where relevant, alongside any other applicable publication issued by OSFI on these products.[1]

1.1 Investment considerations

The purchase of a buy-in annuity is considered an investment of the pension plan and therefore the administrator must satisfy itself that the investment with the life insurance company is in accordance with the PBSA, and permissible under the plan's statement of investment policies and procedures (SIP&P).[2]

The administrator must invest the assets of the pension fund in accordance with the PBSA and the PBSR.[3] It is the responsibility of the administrator to adopt appropriate risk management practices when administering the pension fund.[4] This applies to the buy-in annuity contract as well as to all other assets in the pension fund, which must continue to meet the requirements of the federal pension legislation after the purchase. The administrator should, on a regular basis, monitor and review its investments and determine whether the use of a buy-in annuity remains appropriate and in the best interest of all plan beneficiaries. This should be documented.

If the administrator invests in a foreign buy-in annuity (i.e., one purchased from an insurer not authorized to carry on a life insurance business in Canada) the potential additional risks and associated costs should be considered, such as the probability of default, exchange rate risk, inability to convert to a buy-out annuity and risks related to the geo-political or foreign regulatory environment. Foreign buy-in annuity transactions are subject to legislated quantitative limits.5

1.2 Administration considerations

The administrator has a fiduciary responsibility under the PBSA to act in the best interest of all plan beneficiaries (i.e., plan members, former members with deferred pensions, retirees, and survivors) and administer the pension plan and pension fund with the standard of care that a prudent person would exercise in dealing with the property of another person.6 OSFI expects the administrator, prior to purchasing a buy-in annuity, to:

- consider the current investment structure and risk tolerance of the pension plan;
- understand the impact of investment and longevity risks on the pension plan (e.g., via stress testing);
- determine whether the timing is appropriate for entering into an annuity contract;
- verify that membership data is complete and accurate, including making appropriate efforts to locate and confirm survival of former members with deferred vested pensions, retirees and survivors;
- determine whether the annuity contract value is commensurate with the cost of entering into the contract;
- plan the logistics of the payment for the annuity contract and consider the risks related to paying in cash or transferring assets in-kind (e.g., liquidity risk)
- consider risks to the pension plan associated with the annuity contract (e.g., counterparty risk);
- follow all laws concerning data privacy;
- understand the annuity contract (e.g., terms including in-force and termination provisions, associated costs, collateral, strength of counterparty, and benefits covered);
- verify that the terms of the annuity contract allow for the administration of the pension benefits in accordance with the plan provisions and applicable legislation;
- include individuals with an appropriate level of knowledge in the review and decision-making process; and
- develop adequate controls and oversight to monitor and manage the buy-in annuity associated risks.

The administrator should, on a regular basis, monitor and review the membership of the annuity contract so it remains complete and accurate. This should be documented.

The administrator has the responsibility to provide annual written statements[7] to plan members, former members, and their spouse or common-law partner. Among other things, the annual statement must include a list of the ten largest asset holdings based on market value and the target asset allocation, each expressed as a percentage of the total assets.[8] A buy-in annuity contract is considered an asset holding of the pension plan for this purpose.

Members, former members with deferred vested pensions, retirees and survivors who are covered by a buy-in annuity contract continue to participate in the pension plan. Therefore, they should be included as members or beneficiaries on the Annual Information Return, and in the calculation of the pension plan's annual assessment to OSFI.[9]

2.0 Actuarial funding reports

OSFI expects actuaries to value assets and liabilities in accordance with accepted actuarial practice, i.e., to follow the Canadian Institute of Actuaries (CIA) Standards of Practice (CIA Standards) and to consider their application as illustrated in CIA Educational Notes (CIA Guidance). The Superintendent may specify how actuarial reports are to be prepared and may direct that appropriate changes be made to a report if of the opinion that the report has not been prepared on the basis of actuarial assumptions or methods that are adequate and appropriate.[10]

Actuarial assumptions developed by the actuary should be best estimates reflecting future expectations while taking into account the provisions of the buy-in annuity. The actuary should select a set of actuarial assumptions which are appropriate in aggregate for the purpose of the valuation as well as independently reasonable. For solvency valuation purposes, the approach should be appropriate for the termination scenario.[11]

The nature of the assumptions and methods used or whether an assumption is needed will depend on materiality for the purpose of the valuation. The rationale for the selection of each assumption and method should be provided in the actuarial report.

2.1 Valuation of liabilities

For both the going concern and solvency valuations, the liabilities related to the buy-in annuity should be equal to the actuarial present value of the pension benefits covered by the contract. Generally, the discount rate[12] for this purpose would be determined without reference to pension benefits not covered by the buy-in annuity contract or to other assets of the pension fund. The approach used may be the same or different under the going concern and solvency bases.

OSFI expects liabilities for pension benefits covered by the buy-in annuity contract to be determined using one of the following approaches:

- Assumptions that reflect annuity purchase rates at the valuation date determined in accordance with CIA Guidance (i.e., annuity proxy)
- An actual quotation provided by a life insurance company[13]
- Assumptions that reflect the yields on fixed income investments and consider the expected future benefit payments covered by the contract at the valuation date, including a replicating portfolio approach[14]

For a pension plan already using a replicating portfolio approach as an alternative settlement method, such approach may be used to value benefits covered by the buy-in annuity contract for solvency valuation purposes as well as under a going concern basis. If such approach is used under a going concern basis, OSFI expects that a confidence level similar to that used for the solvency valuation be also used to determine the provision for adverse deviations for economic and non-economic risks.

2.2 Value of assets

For both the going concern and solvency valuations, the asset value related to the buy-in annuity should reflect the fair value of the investment. Generally, this should be equal to the market value or the actuarial present value of the pension benefits covered by the contract.[15] The approach used to determine the asset value should be consistent with that used to value the corresponding liabilities. As such, the buy-in annuity assets should not be valued using an asset smoothing method. The asset value may differ from the liabilities as there may be adjustments due to costs and risks or other aspects of the annuity contract not considered in the liabilities.

For solvency valuation purposes, the termination scenario should stipulate whether the buy-in annuity contract will be converted into individual annuities or terminated for a surrender value on plan termination. If the latter, the asset value should be equal to the surrender value of the buy-in annuity. The provision for termination expenses related to the buy-in annuity should be disclosed separately in the actuarial report and include settlement charges and related expenses for converting the contract from a buy-in to a buy-out annuity, as applicable.

2.3 Disclosure

When a pension plan holds a buy-in annuity contract, OSFI expects assets and liabilities relating to the pension benefits covered by the contract to be disclosed separately in the actuarial report.[16] The value of both the assets and the liabilities should be included in the going concern and solvency balance sheets and reflected in the calculation of the solvency ratio and the average solvency ratio.[17] Membership data with respect to pensions for members, former members with deferred vested pensions, retirees and survivors covered in whole or in part by the buy-in annuity contract should also be disclosed separately in the actuarial report.[18]

3.0 Plan termination

In the event a pension plan is terminated, in whole or in part, the administrator must file a termination report with the Superintendent.[19] Assets of the plan cannot be applied towards the provision of any benefits until the termination report is approved by the Superintendent.[20]

Upon the Superintendent's approval of the termination report, a buy-in annuity contract may be converted to a buy-out annuity contract, in which case the life insurance company would issue individual certificates to the members, former members with deferred vested pensions, retirees, and survivors covered by the contract and pay their pension benefits directly.[21] Alternatively, the buy-in annuity contract, to the extent permissible by its terms, may be terminated for the surrender value for the purchase of annuities with another life insurance company or the establishment of a replicating portfolio of assets to cover the associated pension benefits. Settlement charges and related expenses should be included in the provision for termination expenses, as applicable.

In the event that pension benefits covered by the contract are subject to a reduction in accordance with the approved termination report, the buy-in annuity may be converted to a buy-out annuity paying the reduced

amount. The life insurance company would determine the value of the difference between the full amounts payable under the buy-in annuity contract and the reduced annuity payments under the newly established individual contracts. This value would be made available to the pension plan to be distributed in accordance with the approved termination report. The buy-in annuity contract should address how this value would be calculated. Depending on the terms of the contract, the value may include a credit for the purchase of additional annuities, which may not be available to the plan if there are no additional annuities to purchase.

1 See Guidance by Topic (Defined Benefit Plans) for more information.

2 See Guideline for the Development of Investment Policies and Procedures for Federally Regulated Pension Plans for more information.

3 Subsections 8(3) through 8(4.1) of the PBSA and Schedule III of the PBSR.

4 See Pension Plan Prudent Investment Practices Guideline (PDF) from the Canadian Association of Supervisory Authorities (CAPSA) for more information.

5 See section 9 of Schedule III of the PBSR for more information.

6 Subsections 8(3) and 8(4) of the PBSA.

7 Subsection 28(1) of the PBSA.

8 Paragraph 23(1)(r) of the PBSR.

9 See Assessment of Pension Plans Regulations and OSFI's website for more information.

10 Subsections 9(2) and 12(3.1) of the PBSA.

11 See section 2.7.3 of the Actuarial Guide for more information.

12 See paragraph 3230.02 of the CIA Standards for more information.

13 See CAPSA Guidance on Solvency or hypothetical wind-up liabilities based on actual life insurance company annuity quotation (PDF) for more information. This approach could generally be considered for the first actuarial valuation following the actual quotation used for the annuity contract, if appropriate.

14 See section 2.7.4 of the Actuarial Guide.

15 See paragraph 3210.18 of the CIA Standards for more information.

16 Sections 2.8.1 and 2.8.2 of the Actuarial Guide.

17 As defined in subsection 2(1) of the PBSR.

18 Section 2.4 of the Actuarial Guide.

19 Subsection 29(9) of the PBSA. See the DB Termination Guide for more information.

20 Subsection 29(10) of the PBSA.

21 If provided for by the terms of the pension plan, members and former members with deferred vested pensions may elect another form of benefit settlement in accordance with subsections 26(1) and 26(2) of the PBSA.