

Memorandum

To: All Fellows, Affiliates, Associates, and Correspondents of the Canadian Institute of Actuaries and Other Interested Parties

From: Jim Christie, Chair
Actuarial Standards Board
Michael Banks, Chair
Designated Group

Date: September 18, 2013

Subject: **Final Standards: Revisions to the Practice-Specific Standards for Pension Plans – Assumptions for Hypothetical Wind-up and Solvency Valuations**

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INTRODUCTION

Revisions to subsections 3240 and 3260 of the Standards of Practice were approved by the Actuarial Standards Board (ASB) on September 11, 2013.

The revisions change subsections 3240 and 3260 of the Practice-Specific Standards for Pension Plans with respect to the selection of assumptions for hypothetical wind-up and solvency valuations to better accommodate alternative settlement methods.

BACKGROUND

The ASB created a designated group (DG) that is responsible for developing these revisions to the Standards of Practice. The DG includes Michael Banks (Chair), Gavin Benjamin, Serge Charbonneau, Lucie Dutil, Conrad Ferguson, Geoffrey Melbourne, Manuel Monteiro, Marc-Antoine Morin, and Catherine Robertson.

A [notice of intent](#) (NOI) on this topic was issued on October 15, 2012. A [draft educational note](#) prepared by the Committee on Pension Plans Financial Reporting Committee (PPFRC) of the Canadian Institute of Actuaries (CIA) related to the same subject matter was issued on December 14, 2012. An [exposure draft](#) was issued on April 3, 2013.

SUMMARY OF COMMENTS ON EXPOSURE DRAFT AND DG RESPONSE

Four comment letters were received on the exposure draft, one from an actuarial consulting firm, one from an individual actuary, one from an individual with an actuarial background, and one from the Canadian Association of Pension Supervisory Authorities (CAPSA).

Key comments from the four letters are as follows:

- One commenter expresses substantial concern about the latitude permitted by the proposed changes that may enable valuations which either understate liabilities—resulting in reduced funding and security for plan members—or inflate liabilities, which may result in an inappropriate reduction in distributable surplus in a partial wind-up situation.
- One commenter indicates that:
 - The exposure draft and related draft educational note are developed in response to the practical problems of a lack of markets for very large annuities and annuities that have been indexed based on changes in the Consumer Price Index.
 - Approaches have been developed to deal with these issues in the last few years. However, some actuaries have been pressured by their clients to develop approaches with a specific aim of decreasing hypothetical wind-up liabilities. We should not be amending the standards to enable such methods, and the practical issues can be addressed by only two changes:
 - Allow the assumption of annuity pricing without regard to capacity limitations; and
 - Allow the assumption of fixed indexing in lieu of indexing based on changes in the Consumer Price Index.
- One commenter is generally supportive of the changes and indicates that for pension plans with benefits that are readily insurable, the standards and related educational notes should continue to guide actuaries towards group annuity prices as a benchmark for hypothetical wind-up valuations. This commenter indicates that for other situations, the standards should provide latitude for alternative settlements that would be reasonable in the circumstances, and should make it clear that unreasonable expectations, such as a degree of security consistent with insured annuities or a degree of liquidity consistent with real return bonds, are not intended.
- CAPSA indicates that some jurisdictions may elect to regulate or restrict the use of some or all of the alternate settlement methods outlined in the draft educational note. As a result, the proposed changes to the standards will likely necessitate more regulation and reduced harmonization across the various jurisdictions.

With regard to these comments, the DG responds as follows:

- The standards generally, and for pensions specifically, are principles-based rather than rules-based and provide a framework for the application of professional judgment rather than prescribing specific methods and assumptions. There is an

appropriate exception for pension commuted values that is required to ensure comparable value of pensions among individuals electing commuted value transfers.

- While the revisions allow for some flexibility, assumptions will still need to be selected in accordance with section 1700 of the general standards, which includes substantive recommendations and guidance for the selection of appropriate assumptions.
- It is anticipated that the PPFRC will continue to provide educational guidance regarding assumptions for hypothetical wind-up and solvency valuations.
- The revisions allow for an appropriate range of actuarial practice but in no way preclude additional legislation or regulations regarding the preparation of solvency valuations or the issuance of related regulatory policies and guidance.

The comment letters also include more specific comments that are summarized, with the DG's responses, in the appendix.

Considering the comments received, the only change made to the revisions proposed in the exposure draft is in paragraph 3240.16 to refer to “. . . a settlement method permitted by law . . .” rather than “. . . any settlement method permitted by law . . .” There are also a few minor editorial changes.

DUE PROCESS AND IMPLEMENTATION

The Actuarial Standards Board's Policy on Due Process for the Adoption of Standards of Practice was followed in the development of these revisions to the Standards of Practice.

The revisions are effective immediately and early implementation is permitted such that the revisions may be applied to any report that has not been completed at the date of publication, regardless of the calculation date.

JC, MB

APPENDIX: SUMMARY OF COMMENTS ON EXPOSURE DRAFT AND DG RESPONSE

1. Revision of paragraph 3240.05—the actuary MAY assume that the wind-up date, the calculation date, and the settlement date are coincident

Comments Received

One commenter indicates that this provision may be overly flexible if it is construed to permit an assumption of lower annuity pricing at future dates not consistent with financial market conditions at the calculation date, and suggests that the provision be clarified to preclude such assumptions.

Another commenter indicates that this provision is not necessary in regard to the possibility of purchasing annuities over time, since the present value of the annuities purchased over time would be the same as the estimated purchase cost at the calculation date (without regard to capacity limitations).

DG Response

Permitting the actuary to reflect settlement over time reflects the reality that actual wind-ups are settled over time. At the same time, permitting the assumption of coincidence allows for a simplification of approach in straightforward cases with an appropriate result.

2. New paragraph 3240.05.1—the actuary may assume that benefits would be settled by the purchase of annuities regardless of capacity limitations

Comments Received

One commenter indicates that it is not demonstrated that very large non-indexed group annuities could not be purchased. It may be that such annuities could be purchased but pricing may be less favorable than for non-jumbo-sized group annuities. Thus, this provision should be focused on permitting the actuary to use assumptions consistent with those available for non-jumbo group annuities.

DG Response

This paragraph will indeed permit the actuary to use assumptions consistent with those available for non-jumbo group annuities for very large plans.

3. New paragraph 3240.15—a hypothetical wind-up valuation requires the actuary to make assumptions about the method of settlement

Comments Received

One commenter indicates that this paragraph is redundant as it repeats paragraph 3320.01, which is incorporated into paragraph 3240.01.

DG Response

The DG acknowledges that this paragraph is not strictly required but believes it is useful to provide context for the following paragraphs.

4. New paragraph 3240.16—the actuary may assume any settlement method permitted by law or any relevant regulatory policy or guideline

Comments Received

One commenter indicates that this provision, which may support the assumption of a “permitted” settlement method even if the actuary might otherwise consider such settlement method inappropriate or unlikely in the circumstances, is unnecessary and could be deleted. If additional guidance regarding assumed settlement methods is required, it should be included in section 3300 in the context of actual wind-up situations.

DG Response

When selecting assumptions for settlement methods permitted by law or any relevant regulatory policy or guideline, the actuary will also need to consider section 1700 of the general standards, which includes substantive recommendations and guidance for the selection of appropriate assumptions. This paragraph has been changed from the exposure draft to refer to “. . . a settlement method permitted by law . . .” rather than “. . . any settlement method permitted by law . . .”

5. New paragraph 3240.17—the actuary may assume settlement by means of a replicating portfolio

Comments Received

One commenter indicates that the reference to “if permitted by law or any regulatory policy or guideline” should be deleted since the standards are intended to be drafted generally without regard to laws, and compliance with law is presumed.

One commenter indicates that additional guidance in the standards or in educational notes is needed regarding the “appropriate level of security” given that it is not practical to achieve security equivalent to that of purchased annuities in a replicating portfolio.

Another commenter indicates that an appropriate level of security would require assumption of investments equivalent to those underlying group annuity pricing and loads for expenses risk and profits at least as great as those incorporated in group annuity pricing. This means that the resulting settlement value would be at least as high as that based on group annuity pricing (without regard to capacity limitations). Given that the proposed paragraph 3240.05.1 permits an assumption of annuity pricing (without regard to capacity limitations), this paragraph could be deleted.

DG Response

The reference to “if permitted by law or any regulatory policy or guideline” in this paragraph is required to distinguish other situations where a replicating portfolio may also be assumed. It is not possible to replicate the security underlying the purchase of annuities through a replicating portfolio and the level of security provided by any particular assumed replicating portfolio will necessarily require judgment that may be supported by educational guidance. The selection of assumptions regarding replicating portfolios will be subject to section 1700 of the general standards.

6. New paragraphs 3240.18—the actuary may incorporate assumptions as to the exercise of regulatory discretion, a change in law, or a plan amendment to enable practical settlement of benefits—and 3240.19—an assumption of fixed indexing may be substituted for indexing based on changes in the Consumer Price Index

Comments Received

CAPSA indicates that actuaries must comply with, and not merely “consider”, relevant regulatory policy or guidance. It suggests that if an actuary finds the legislation or a particular regulatory policy difficult to comply with, the actuary should consult with the regulator and discuss the situation before submitting the valuation report.

One commenter indicates that the standards should not permit assumptions regarding changes in law or to assume that a regulator will permit something not currently permitted. The same commenter does indicate that an assumption of substituting fixed indexing for indexing based on changes in the Consumer Price Index should be permitted and that, in this situation, the indexing assumption should be derived on the basis of the commuted value assumptions in section 3500.

Another commenter indicates that additional guidance is needed as to the determination of the fixed percentage rate of comparable value to indexing based on changes in the Consumer Price Index.

DG Response

As noted in response to comments on the NOI, the DG is of the opinion that it is not appropriate for the Standards of Practice to require compliance with regulatory guidance that is not otherwise legally binding. In practice, actuaries would give considerable weight to relevant regulatory guidance and would welcome changes in law to permit practical settlements in all cases.

The DG remains of the opinion that this proposed change is necessary as it is not possible, in some cases, to postulate realistic methods of settlement that are fully consistent with current law and plan terms. In the event of an actual wind-up in these circumstances, exercise of regulatory discretion, a change in law, and/or plan amendments would have to occur to enable completion of the wind-up. In preparing a hypothetical wind-up valuation, it is necessary for the actuary to make assumptions regarding these matters. The selection of this type of assumption would be subject to and is consistent with the requirements of section 1700 of the general standards.

The DG is of the view that the standards should not prescribe specific assumptions for the rate of fixed indexing that could be provided in lieu of indexing based on changes in the Consumer Price Index. The standards do not prescribe specific assumptions for other aspects of hypothetical wind-up and solvency valuations. Educational guidance may be appropriate in regard to the selection of this assumption.

7. Paragraph 3260.18.1—description of settlement assumptions and related limitations.

Comments Received

One commenter indicates that a requirement should be added to paragraph 3260.05 requiring the actuary to describe the method of settlement used in determining the liabilities in a hypothetical wind-up or solvency valuation with consequent revisions to the proposed paragraph 3260.18.1.

DG Response

The DG is of the view that description of assumptions regarding the method of settlement is covered by the existing requirement of paragraph 3260.05 to “describe the methods used to determine the reported liabilities” and to “describe the assumptions used to determine the reported liabilities and provide the rationale for each assumption that is material to the actuary’s advice”.

8. Use of “may” in recommendations

Comments Received

One commenter indicates that the permissive “may” should not be used in the italicized recommendations of the standards as in the revised paragraphs 3240.05 and 3240.05.1.

DG Response

The use of “may” in a recommendation is necessary where, as here, it allows the actuary to do something that would not otherwise be permitted by the standards.