PLAN RISK

"De-Risking" Picks Up Momentum as Insurers Offer Innovative Products

Lisa Chamzuk
Lawson Lundell LLP

Introduction

There are many ways for a pension plan sponsor to reduce the level of risk associated with the pension plan. Certainly reducing the benefit accrual rate, adopting liability-driven investing strategies, closing a defined benefit pension plan to new members, requiring new members to accrue on a defined contribution basis, and reducing ancillary benefits are all steps the sponsor can take to reduce the amount of risk associated with sponsoring the plan. While plan changes can be effective, they can take time to take effect and some can create risks of litigation. Plan changes can also affect an employer's ability to retain and attract employees.

Plan sponsors have continued to look for other, creative ways of reducing the risk associated with the plans they sponsor. In recent years, we have seen the insurance industry respond with innovative products that address these risks.

Longevity Risk Hedging Contracts

Though not yet common in Canada, one insurance-based option is a longevity risk hedging contract, which (as it sounds) is designed to reduce the risk to the plan of the cost of unfavourable longevity experience. With such a contract, the administrator pays the insurance company fixed payments and the insurance company provides the plan with regular payments based either on the plan's actual mortality experience or an agreed upon mortality table or index. Through this arrangement, the pension plan has more predictable payments out over the term of the longevity risk hedging contract. That is, the risk of the increased longevity is transferred from the plan to the insurance company.

In terms of understanding this type of de-risking strategy, the administrator should carefully review the terms of the contract. In reviewing the terms, the administrator should consider what happens if the contract's term is shorter than the liabilities that are covered by the contract.

The administrator should also consider the risk that arises if the index upon which the payments are made does not match the mortality rates for the plan members.

The Office of the Superintendent of Financial Institutions ("OSFI") has published draft comments on longevity risk hedging contracts and offers the following guidance to plan administrators:

- understand the impact of longevity risk on the pension plan and determine whether this kind of contract is in the best interests of the members;
- determine whether the longevity risk hedging contract offers value for the cost of the contract;
- consider whether the contract creates risks for the pension plan (such as the risk that the liabilities are longer than the term of the contract or that the index is a poor match for the mortality rates for the plan members); and
- understand the terms of the contract and ensure that privacy laws are followed.

The Buy-Out Annuity Option

A more familiar de-risking strategy is the purchase of buy-out annuities. A buy-out annuity purchase allows the pension plan to transfer responsibility for pension liabilities to an insurance company. In exchange for the premium, the insurance company takes on the obligation to pay the retiree the amount due under the pension plan. Purchasing traditional annuities allows the sponsoring entity to reduce the size of the pension plan on its balance sheet.

To ensure the best possible protection for the plan, the plan text should clearly permit the purchase of the annuity and further expressly state that the purchase of the annuity

discharges the plan from all liability for the pension payment to the retired member.

The Buy-In Annuity Option

Traditional (buy-out) annuities involve an insurance company assuming the responsibility for paying the pension amount that is due under the terms of the pension plan. The annuity purchase is treated as a means by which the obligation to pay the pension is satisfied or discharged. While there may be questions about whether there remains a residual obligation to pay the pension if the insurance company is unable to fulfill its obligation to pay the pension (due to an insolvency for example), provided the plan text properly explains that the purchase of the annuity discharges the obligation to pay the pension, the buy-out annuity purchase option is a good one for those seeking to crystallize and transfer the risks arising from the obligation to pay an indefinite pension.

While most of us are familiar with a buy-out, or traditional annuity product, the buy-in annuity product has not been used as frequently. When a buy-in annuity is purchased, the pension plan remains responsible for administering and paying the pension. However, by paying the premium charged by the insurance company, the insurance company commits to paying back to the plan, the amount that will be paid out in pension to those retirees who are covered by the buy-in annuity contract. What is transferred to the insurance company is longevity and investment risk.

Plan funding (the assets in the plan) will be based on assumptions about longevity and investment returns. If retirees live longer or investment returns are lower than expected, the plan will have been shielded from those risks because the insurance company has committed to paying back to the plan, the amount that will have to be paid to those long-living retirees.

Rules Regarding Buy-In Annuities

Buy-in annuities are treated as investments by a pension plan and not discharges of the plan's obligation to pay the pension. There is little regulatory guidance on the use of buy-in annuities, but OSFI has published a document titled "Buy-In Annuity Products" (2012-001). OSFI produced the guidance paper in response to requests to respond on the acceptability of buy-in annuities as a possible pension plan investment. OSFI expressly states that buy-in annuities are permissible and provides the following guidance:

- as an investment, the administrator of the plan could only purchase the buy-in annuity if satisfied that the investment satisfied the prudent portfolio rule under the *Pension Benefits Standards Act, 1985*;
- the administrator would also have to be satisfied that the investment was permitted under Schedule III of the *Pension Benefits Standards Regulations, 1985*;
- the administrator would, as with all investments, have an obligation to monitor the investment, presumably by monitoring to make sure that the annuity payments were made as required; and
- the value of the annuity policy should be equal to the value of the liabilities covered by the policy calculated on a going concern and solvency basis.

In terms of the buy-in annuity contract, it will be important to review its terms. Care should be taken to make sure that the payments made back to the plan from the insurance company match the pension payments made from the plan to retirees. For deferred vested members, this means ensuring that the contract mirrors the terms of the plan. It is also important to carefully review the terms of the contract that concern the payment back to the plan in the event of a wind-up.

Finally, remember that a buy-in annuity does not transfer the obligation to pay the pension – the obligation to pay the pension remains with the pension plan. Because the plan will have paid the premium but remains liable for the pension payment to the retired members, it is important for the plan to consider what protection exists in case the insurance company ceases to be able to meet its obligations such as in the case of an insolvency. Assuris is the not-for-profit organization that provides a layer of insurance in the event that the insurance company fails and it would be useful for the sponsor to understand how that additional protection would be triggered and how much it would provide.