Discharge for Purchase of Annuities: Proposed Regulations

CONFIDENTIAL

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Ministry of Finance

Income Security and Pension Policy Division

Ontario

Purpose

- To brief the Minister on proposed regulations that will define which annuities will provide a discharge of pension liabilities to plan administrators of single-employer defined-benefit (DB) pension plans.

A "discharge" terminates a member's involvement in a pension plan.

For administrators, it ends their pension obligations towards plan members, including the duty to make pension payments, provide disclosure statements and make payments into the Pension Benefits Guaranteed Fund (PBGF).

For plan members, it ends their pension rights, including receiving pension payments and disclosure statements. It also ends their coverage under the PBGF.

Context

- The policy decision to encourage the purchase of annuities has received support from all stakeholders, including employers, employee and pensioner associations, public organizations and associations involved in the administration of pensions.

- On May 12, 2017, Cabinet approved complimentary measures to the Funding Review Framework that would "provide plan administrators with a discharge when they purchase buy-out annuities to provide pensions for former members and retired members, if the buy-out annuity satisfies prescribed conditions."

- In the 2017 Fall Bill, the government acted on this initiative by introducing enabling amendments to the *Pension Benefits Act* (PBA).

- Regulations are required to determine the conditions that must be met before a discharge is granted.

Legislation

- The statutory amendments introduced in the 2017 Fall Bill included the following rules:
  1. Annuities eligible for a discharge would be limited to those purchased for deferred and retired members of single employer plans.
  2. The annuities would be required to replicate the benefits provided by the pension plan.
  3. Annuitants would retain their existing right to surplus, if the plan is wound up.
  4. Administrators would be required to provide notice to affected members.
  5. Administrators would be required to file, with the regulator, a certificate signed by an actuary certifying that all applicable requirements for discharge have been met.
  6. Annuities would need to meet other prescribed requirements, including minimum funding requirements.
  7. Already purchased annuities that replicate pension benefits or that are adjusted to replicate pension benefits would be eligible for a discharge. The discharge will be provided only on a prospective basis and subject to funding requirements.

- A description of proposed regulations will be posted on the regulatory registry for consultation in December.

- If approved by the legislature, these amendments will be proclaimed when regulations are enacted, with the goal of having the annuity discharge in place for July 1, 2018.

Proposed Regulations

Guiding Principles

- The development of the regulations has been guided by the following <u>principles</u>:
  1. **A discharge should not change the entitlements of plan beneficiaries.**
  2. **Plan funding levels should be maintained so that remaining plan members are not affected.**
  3. **As discharge involves the termination of pension obligations, solvency funding requirements are more appropriate than going concern requirements.**

Funding Requirements for Annuity Purchases

- Sponsors would be required to ensure that a plan's solvency funding level does not deteriorate because of an annuity purchase.
  - This ensures that members who remain in the plan are not disadvantaged by an annuity purchase.

Funding Requirements for Discharge

- A plan's solvency funding ratio must be at least 85% at the time of discharge.
  - This funding level would be consistent with the minimum solvency funding threshold being developed under the Funding Review Framework.

Proposed Regulations (cont’d)

Requirements for Already Purchased Annuities

- If a sponsor adjusts an already purchased annuity in order to meet the requirements for discharge, such as replication of a specific benefit, the sponsor would be required to ensure that the plan’s solvency funding level does not deteriorate after the adjustment is made.
  - This would ensure that members who remain in the plan are not disadvantaged by an adjustment.

Notice Requirements

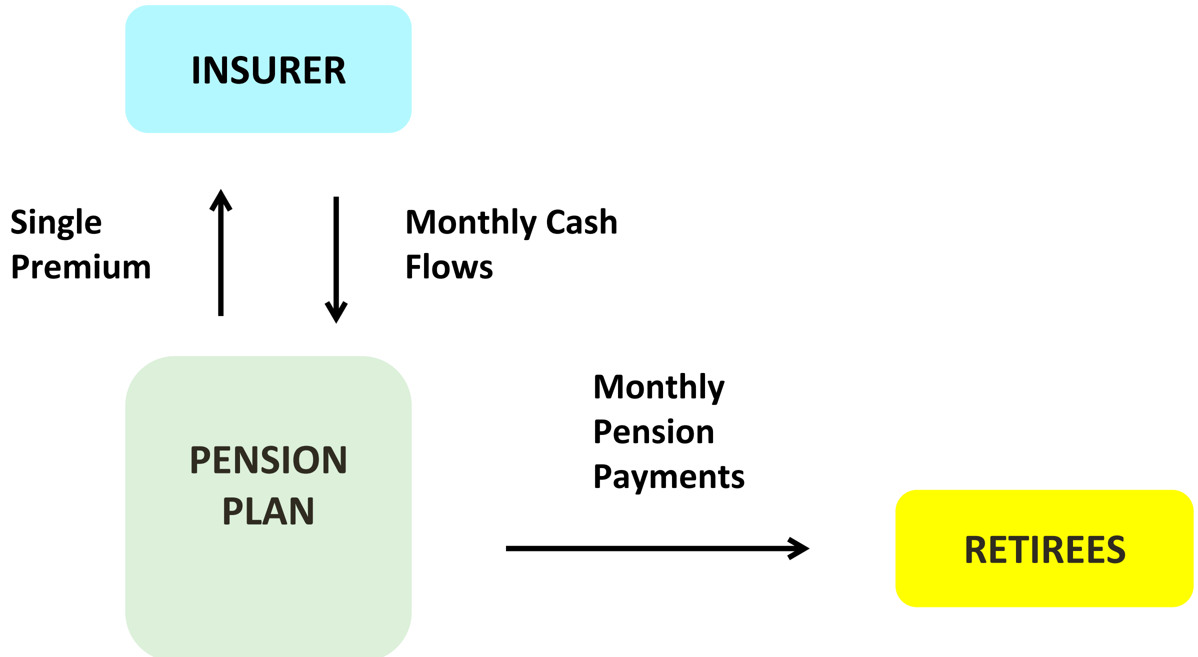
- An administrator would be required to give the following notice to affected members:
  - Confirmation that the annuity replicates the form and amount of the member’s pension entitlements;
  - The name and contact information of the insurance company providing the annuity;
  - Notice that the administrator is discharged of all pension liabilities owed to the member.

APPENDIX

Appendix 1: Definition of Annuity

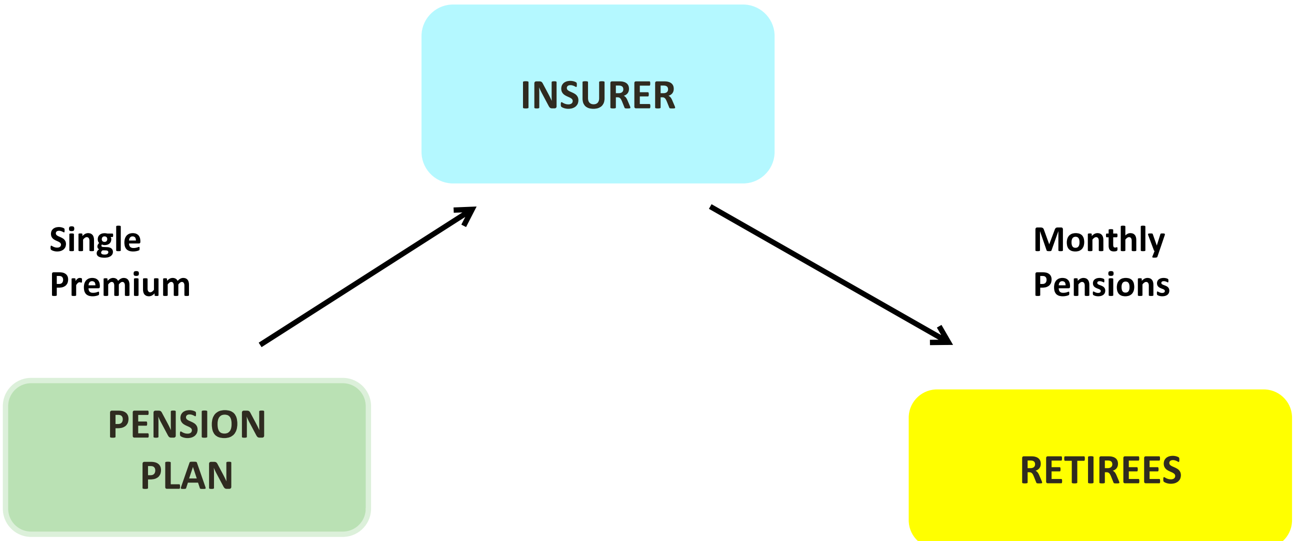
- An annuity is a contractual product sold by an insurance company that is designed to accept a lump sum from the buyer, and pay out a stream of payments to a designated beneficiary immediately or at a later point in time. There are two types of annuities (see next two slides).
  - Under the PBA pension annuities can only be bought from life insurance companies, for whom annuities are a hedge for the longevity risk in their insurance products.
  - Annuities turn a lump sum into a steady cash flow, similar to a stream of DB pension payments.
  - They can be designed to mimic the pension plan terms (e.g., survivor benefits or indexation provisions).
- Currently, if permitted by their plan, a former member of a pension plan can request that an annuity be provided when they terminate from the plan; a discharge of liability is provided to plan administrators in these circumstances.
- Employers can reduce pension risk by purchasing annuities. These annuities are currently considered as investments under the plan. Consequently:
  - Pension obligations remain on the employers' balance sheets, even when the responsibility to make payments is transferred to an insurance company;
  - Employers are required to continue paying PBGF assessments on annuitized benefits; and,
  - Responsibility to make pension payments reverts back to the plan if the insurance company defaults or becomes insolvent.

Appendix 2: Types of Annuities — Buy-In Annuities (BIAs)



- BIAs consist of the purchase of annuities with plan assets, where a single annuity contract is issued to the pension fund and is considered an asset of the plan.
  - In actuarial funding valuation reports, FSCO requires that the asset value of a BIA be equal to the value of the pension benefits covered by the BIA, calculated on both a going concern and solvency basis.
- Payments from BIAs are made to the plan rather than an individual beneficiary.
- The plan remains responsible for administering the pension benefits.
- BIAs allow employers to transfer longevity and investment risks to insurers.

Appendix 3: Types of Annuities — Buy-Out Annuities (BOAs)



- BOAs consist of the purchase of annuities with plan assets, whereby annuity policies are issued in the name of each member.
- Annuity payments are made directly to the individuals specified in the purchase agreement.
- The insurance company selling the annuity has the responsibility of administering benefits.
- While an employer can currently purchase a BOA, when this is not done at the request of a former member, the employer continues to retain liability for the pension, and is required to reflect the liability on its financial statements, unless the BOA is part of a plan wind-up.
- Similar to BIAs, BOAs allow employers to transfer longevity and investment risks to insurers, but the insurers also take on the administrative role of issuing payments to beneficiaries.

Appendix 4 — Advantages of Providing Discharge

- Employers are increasingly deciding to close and/or wind-up their DB plans in order to relieve themselves of pension obligations. Allowing a discharge of liabilities for BOAs would help employers de-risk plans without a wind-up by removing:
  - Pension liabilities from the financial statements of employers;
  - The requirement to pay PBGF assessments on annuitized benefits;
  - Regulatory reporting requirements; and,
  - The obligation for the plan to pay pensions if the insurance company becomes insolvent.

- A discharge on BOAs could change the demographic profile of a pension plan, effectively making the plan younger and reducing current pension liabilities.
  - A plan with a younger membership profile can adjust its investment strategies with the objective of earning higher returns.

Appendix 4 — Advantages of Providing Discharge (cont'd)

- A discharge on BOAs can also provide greater benefit security to members because they transfer the responsibilities to insurance companies, which have a lower risk of insolvency than an individual employer.
  - Insurance companies have more stringent capital requirements than pension plans, are better focused on managing risk, and have sophisticated risk management systems and asset-liability management teams.
  - There have been far fewer insurance company failures in Canada than pension plan sponsor failures. In the event of insolvency, annuity insurance (through Assuris) provides coverage of the higher of $2,000 or 85% of monthly benefits)
    - It should be noted that providing discharge for BOAs would result in lower contributions by plan sponsors into the PBGF and may add pressure on the sustainability of the Fund, given that healthier plans are more likely to have the funds required to buy-out their members.
- This policy concerns ongoing plans. It is not related to the issue of annuitizing plans that are winding up.