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New Opportunities For Pension Plan De-Risking In Canada: Longevity Risk Hedging Contracts

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Pension plans in Canada and around the world are increasingly facing liability challenges, in part due to increasing life expectancies. Defined-benefit pension plans provide a pension payment to pensioners until their death, and these pension plans rely on mortality assumptions to predict future liabilities. Pensioners living longer than would be expected based on mortality assumptions can therefore result in higher-than-expected payments, which is known as longevity risk. Some observers expect life expectancies to continue increasing, at least in the medium term. For example, Canadian life expectancy has increased from 74.9 years in 1979 to 81.1 years in 2009.[1] As a result, many sponsors of defined-benefit pension plans in Canada are now focusing on strategies for reducing longevity risk, including the use of longevity insurance contracts and longevity swaps (referred to as longevity risk hedging contracts).

There is a relatively well-developed market in the United Kingdom for longevity risk hedging contracts, which aim to mitigate longevity risk. Longevity risk hedging contracts transfer longevity risk to a third party such as an insurance company or a bank, providing greater predictability of future liabilities for pension plans.

In Canada, there is a well-established buy-out annuity market, and buy-in annuities have also been implemented by a number of pension plans in different jurisdictions across Canada. The Canadian federal pension and financial institution regulator (the Office of the Superintendent of Financial Institutions—OSFI) has published a general policy that addresses issues such as the characterization of a buy-in annuity as an investment for the purposes of pension legislation and the treatment of a buy-in annuity contract for the purposes of a pension plan actuarial valuation.[2]

While the use of longevity risk hedging contracts is still at an early stage in Canada, we are aware of growing interest in these arrangements, and they represent an opportunity for Canadian pension plans to achieve longer-term sustainability. OSFI published a policy advisory in June 2014 stating its position on longevity risk hedging contracts.

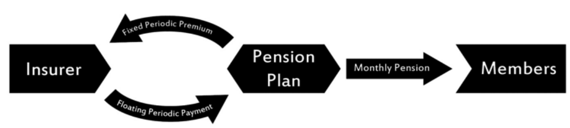
This article summarizes some of the regulatory considerations for Canadian pension plans considering the use of longevity risk hedging contracts.

HOW LONGEVITY RISK HEDGING CONTRACTS WORK

Briefly, longevity risk hedging contracts are financial arrangements in which a pension plan provides periodic fixed payments or premiums to a third party such as an insurance company or a bank (the counterparty). In exchange, the counterparty provides periodic floating payments to the pension plan. A longevity risk hedging contract may take either the form of an insurance contract, structured as an indemnity contract, or the form of a swap derivative.

There are generally two types of floating payments: 1) floating payments based on the pension plan's actual mortality experience (indemnity-based), which may be part of an insurance contract; or 2) floating payments based on an agreed-upon mortality index (index-based) or other contractual basis that closely replicates the plan's actual experience, which may be part of a swap contract. Generally, payments between the pension plan and the counterparty will be netted. Payments to pensioners will continue to be made directly from the pension plan and will remain an obligation of the plan unlike, for example, a buy-out annuity where the annuitant would have a contractual or statutory claim against the insurer. An example of a structure of a longevity risk hedging contract is set out in Figure 1.

Figure 1: Structure of a Longevity Risk Hedging Contract



Should the plan's actual mortality experience or the agreed-upon mortality index (or other agreed-upon measure) have longer-than-predicted life expectancies, the pension plan's fixed payments to the counterparty will remain constant while the increase in payments will be borne by the counterparty. Conversely, should the plan's actual mortality experience or the agreed-upon mortality index be lower than predicted, the pension plan's payments will remain the same while the counterparty's floating payments will decrease. The periodic fixed payments by the pension plan (to the counterparty) provide predictable outlays since the counterparty has assumed the longevity risk, i.e., increased payments due to pensioners living longer than expected.

The general structure of longevity risk hedging contracts can have some similarities to that of buy-in annuities. However, unlike a buy-in annuity where a lump-sum premium is paid for in exchange for periodic payments by a counterparty, the pension plan continues to be obligated to make the periodic fixed payments to the counterparty for the term of the longevity risk hedging contract and therefore in effect continues to retain investment risk, i.e., the risk that there will not be sufficient pension fund assets. As well, longevity swaps would typically involve collateral being pledged for the net obligation, which may secure the longevity risk hedging contract. Collateralization may be required by both the pension plan and the counterparty, depending upon the terms of the longevity risk hedging contract. Pension plans posting collateral should ensure that this is done in compliance with the plan's terms and applicable pensions or income tax legislation that contains, among other things, limitations on the ability of a pension fund to borrow money.

LEGAL FRAMEWORK

Notably, the use of a longevity risk hedging contract does not change the legal relationship between the pensioners and the pension plan. Pensioners will continue to receive their pensions in accordance with the terms of the pension plan and from the pension plan. The pension plan is still ultimately responsible for paying pension benefits. The pension plan administrator remains subject to all requirements under governing legislation and the common law including meeting its standard of care.

As mentioned above, a longevity risk hedging contract may be structured either as an indemnity-based insurance contract or a swap derivative. This structuring is very important as it will have implications for the applicable regulatory regime with respect to insurance compared to for derivative contracts, as well as tax implications. A contract of insurance would be regulated under provincial insurance laws while a derivative contract may be regulated under provincial securities law as well as insurance or banking laws that may apply to the counterparty.

Counterparties may transfer all or some of their assumed longevity risk by means of reinsurance agreements with one or more reinsurers. These reinsurers are often large global reinsurers who hedge longevity risk against their mortality risk portfolios. As a result, it is the global reinsurance industry that has been taking the lead in developing products for pension plans and insurers who are faced with longevity risk, and they can accordingly be an important driver of the pricing of longevity risk transactions. Generally, neither the pension plan administrator nor sponsor would need to be a party to these separate reinsurance transactions.

As a consequence of Canada's federal structure, private Canadian pension plans are supervised by either a federal or provincial regulator. We briefly discuss each of these regimes below.

Federally Regulated Pension Plans

The Canadian federal regulator, OSFI, released a policy advisory (the policy) on longevity risk hedging contracts on June 9, 2014. In brief, the policy provides information and guidance to administrators of federally regulated pension plans who are considering entering into insurance or swap contracts to hedge longevity risk. The policy identifies the following risks associated with longevity risk hedging contracts:

- *Counterparty risk*—This is the risk that the counterparty will not live up to its contractual obligations, which may be mitigated through

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LONGEVITY RISK HEDGING CONTRACTS ARE AN OPPORTUNITY FOR CANADIAN PENSION PLANS TO WORK TOWARD DE-RISKING WITH RESPECT TO LONGEVITY RISK.

collateralization or similar means, such as the taking of a security interest. The strength of the counterparty should be assessed including its credit rating and the regulatory regime governing the counterparty.

- *Rollover risk*—Where longevity risk hedging contracts are entered into for a shorter period of time than the liabilities covered, the cost of entering into a new contract may be greater as the actual mortality experience diverges from mortality expectations.
- *Basis risk*—This is the risk that an index-based longevity risk hedging contract may differ from the actual mortality experience of the pension plan. This risk would not occur in the case of an indemnity-based longevity risk hedging contract as payments from the counterparty are based on the actual experience of the plan.
- *Legal risk*—Longevity risk hedging contracts may be complicated and plan administrators should seek legal advice to fully understand the terms and risks.

The policy also provides that when considering a longevity risk hedging contract, plan administrators should consider the cost, acceptability pursuant to the plan's terms and Statement of Investment Policies and Procedures (the SIP&P), compliance with statutory requirements, administrative complexity, duration and liquidity of the longevity risk hedging contract, and implications on actuarial valuations.

Notably, the policy states that OSFI's view is that a longevity risk hedging contract is a permissible investment provided that it is consistent with the terms of the pension plan and the plan's SIP&P, that it complies with the *Pension Benefits Standards Act* and its Regulations, including Schedule III of its Regulations,[3] and that the plan administrator exercises proper due diligence. As well, there is neither a requirement that plan administrators obtain OSFI approval prior to entering into such a contract nor any specific requirement to inform plan beneficiaries of the existence of the contract.

In particular, the policy provides that plan administrators are expected to understand the impact of longevity risk on their pension plans, determine whether the longevity risk hedging contract is in the best interests of beneficiaries and offers value for the cost of entering into the contract, consider the risks and adequate controls and oversight, ensure that applicable laws are followed, and understand the longevity risk hedging contracts.

Provincially Regulated Pension Plans

Canadian provinces have separate provincial pensions legislation and regulators. We have focused our discussion on Ontario and the Ontario pensions regulator, the Financial Services Commission of Ontario (FSCO). To our knowledge, none of the provincial pensions regulators, including FSCO, have issued formal written guidance on the use of longevity risk hedging contracts.[4]

Pensions legislation in most of Canada's provinces, including Ontario, incorporates the federal investment rules found in Schedule III by reference for pension plan "investments." The policy provides that it is OSFI's view that longevity risk hedging contracts are investments, and we would expect that FSCO and other provincial regulators would similarly follow suit. As discussed above, longevity risk hedging contracts have some similarities in their structure to buy-in annuities. Analogously, OSFI previously released guidelines on buy-in annuities, which provided that OSFI would consider buy-in annuities to be investments of a pension plan. Accordingly, we would expect that pensions subject to provincial regulation would also have to comply with the federal investment rules found in Schedule III when entering into longevity risk hedging contracts.

We would also anticipate that the expectations and guidelines of provincial regulators for longevity risk hedging contracts would be similar to the policy. Administrators of provincially regulated pension plans would also have to ensure compliance with requirements of provincial legislation and common law duties. In addition to the requirements as set out by the policy, plan administrators should also ensure that any trust agreements are complied with (or appropriately amended), and, finally, that the provisions of the *Income Tax Act* (Canada) are met, including the limitations on a pension fund's ability to borrow money.

CONCLUSION

Longevity risk hedging contracts are an opportunity for Canadian pension plans to work toward de-risking with respect to longevity risk. It is clear that while OSFI is watching longevity risk hedging contracts market developments, longevity risk hedging contracts are permitted in Canada for federally regulated pension plans. We anticipate longevity risk hedging contracts will similarly be permitted for provincially regulated pension plans and expect that Canadian financial institutions will be taking a closer look at the new opportunities offered by such products. ■

ENDNOTES

1 http://www4.hrsdc.gc.ca/.3ndic.1t.4r@-eng.jsp?iid=3.

2 http://www.osfi-bsif.gc.ca/Eng/pp-rr/ppa-rra/inv-plc/Pages/bap_let.aspx.

3 Schedule III of the Pension Benefits Standards Act Regulations sets out investment restrictions on pension plan investments, known as the "federal investment rules."

4 The authors have been advised verbally by FSCO that: "We are currently considering the issue of longevity insurance and longevity swaps for pension plans, but we do not as yet have a published position on these matters, and it is not clear when we will publish a position on these matters."