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DB SOLUTIONS Industry Watch

LONGEVITY RISK FOR EMPLOYERS

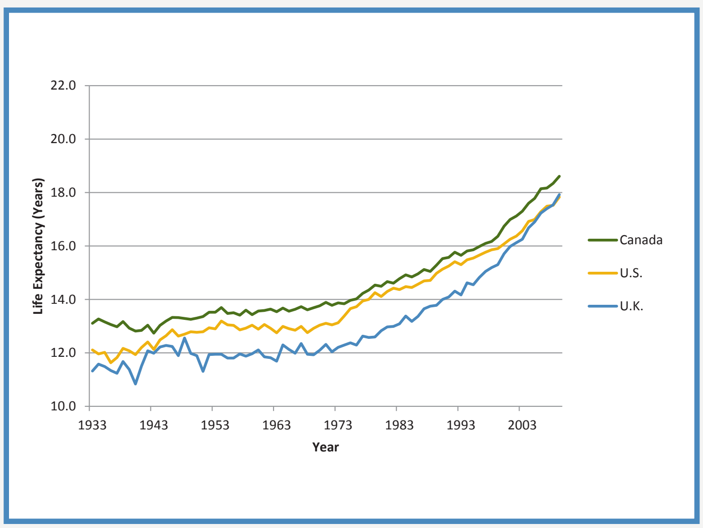
Despite tastes for beaver tails and poutine, Canadians are living longer than ever before. And if you're an employer with a defined benefit (DB) pension plan, it probably means that you'll be paying pensions to your retirees for longer than you expect.

These additional pensions mean an increase in going concern and accounting costs–possibly of 5% to 10% according to a recent Canadian Institute of Actuaries (CIA) webcast. This increase in costs is the result of current longevity assumptions not keeping up with actual experience.

WHAT DO THE NUMBERS TELL US?

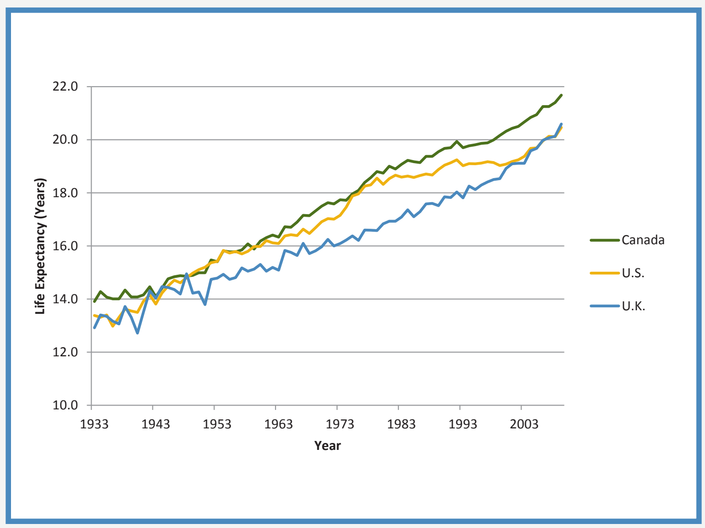
Whenever we talk about life expectancy, it's helpful to look at what's actually going on around the world. The accompanying charts show actual male and female life expectancy at age 65 for Canada, the United States and the United Kingdom over the last 80 years.

Population Life Expectancy (Males – Age 65)



Source: The Human Mortality Database

Population Life Expectancy (Females – Age 65)



Source: The Human Mortality Database

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A FEW INTERESTING OBSERVATIONS:

- Canadians continue to outlive our cousins in the U.K. and the U.S. At age 65, Canadian men are living about 0.8 years longer than American men and about 0.7 years longer than U.K. men. At age 65, Canadian women are living about 1.2 years longer than American women and about 1.1 years longer than U.K. women.

  Both the U.S and the U.K. have come out with new longevity assumptions in the last year. These new longevity assumptions result in longer life expectancies than the assumption that most Canadian pension plans are using. That is, even though Canadians are actually living longer than folks in the U.S. and the U.K., our longevity assumption implies we are not living as long!

- The rate at which Canadian life expectancies are increasing is higher than it's been before. That is, the life expectancy line is becoming steeper and steeper. When the current Canadian longevity assumption was created close to 20 years ago, this trend wouldn't have been as obvious as it is today.

Given these two observations, it's not surprising that the current Canadian longevity assumption hasn't kept up with actual experience and needs to be updated.

THE CURRENT CANADIAN LONGEVITY ASSUMPTION

The charts on Page 1 show that a 65-year-old who retires today will live longer than a 65-year-old who retired 20 years ago. Pension plans realize this and most are assuming that members will continue to live longer in the future. The tricky part is estimating exactly how much longer members will live.

For the past 20 years, the only real choice that plan sponsors had was to use Scale AA to project future increases in life expectancy. Scale AA was developed in 1994 by looking at U.S. experience between 1977 and 1993. As mentioned above, it hasn't kept pace with recent experience.

As such, the CIA is producing a new table using more recent Canadian data. The new table is expected to be released in 2013 and could result in an increase in going-concern and accounting costs of between 5% and 10% depending on the plan's characteristics. The increase in solvency costs is expected to be lower as many insurance companies are already reflecting increased life expectancies when they provide input for the annuity proxy guidance.

MANAGING LONGEVITY RISK

The good news is that there are several solutions available in Canada to help plan sponsors protect themselves from future life expectancy surprises:

A **buy-out annuity**—an annuity contract that transfers the pension plan's liabilities to the insurance company. The insurance company makes pension payments directly to plan members and takes responsibility for all investment and longevity risk associated with them.

A **buy-in annuity**—a newer development in Canada that shares many of the same characteristics of annuity buy-outs, including the transfer of longevity and investment risk to the insurance company. Under the buy-in, no top up contribution is required for an underfunded pension plan, and an accounting settlement is not triggered (although each plan sponsor should confirm this with their auditors).

Longevity insurance—it's becoming quite common in the U.K., but is rarer in Canada. It allows a pension plan to protect itself from unexpected increases in longevity for a group of plan members. If plan members live longer than expected, the pension plan receives payments from the insurance company to cover the cost of the additional pensions payable. This solution is ideal for plan sponsors who are comfortable with their plan's investment risk, and are only looking for longevity protection.

With Canadians living longer and the rate of future longevity improvement unknown, employers will have to spend more time thinking about longevity risk and ways to make it less of an issue for their pension plans.

For more information about Sun Life Financial's de-risking solutions for defined benefit pension plans, please contact:

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