May 13, 2022

Via email: pensions@osfi-bsif.gc.ca

Ben Gully
Assistant Superintendent, Regulation Sector
Office of the Superintendent of Financial Institutions
255 Albert Street, 12th Floor
Ottawa, ON K1A 0H2

Dear Ben Gully:

**Re: Pension Investment Risk Management**

The Canadian Bar Association Pension and Benefits Law Section (CBA Section) is pleased to comment on the Consultation Paper on Pension Investment Risk Management (Consultation Paper) released by the Office of the Superintendent of Financial Institutions on March 17, 2022.

The CBA is a national association of over 36,000 members, including lawyers, notaries, academics and students across Canada, with a mandate to seek improvements in the law and the administration of justice. The CBA Section contributes to national policy, reviews developing pensions and benefits legislation, and promotes harmonization. Our members are involved in all aspects of pensions and benefits law and include counsel who advise pension and benefit plan administrators, employers, unions, employees and employee groups, trust and insurance companies, pension and benefit consultants, and investment managers and advisors.

## 1. Overview

The Consultation Paper introduces investment management risk principles that OSFI believes are relevant for federally regulated pension plans exposed to increased risk, while acknowledging that some principles may not be relevant to all types of pension plans.

The CBA Section welcomes and supports OSFI's efforts to offer best practices on investment risk management for pension plans. We believe that greater guidance from regulators on their expectations for prudent risk management practices will promote better governance and risk management practices.

In this letter, we begin by offering general comments that should inform the final guidance on prudent investment risk management for pension plans. We then respond to several specific questions raised in the Consultation Paper.

**Importance of Proportionality and Flexibility**

As acknowledged in the Consultation Paper, there is no one-size-fits-all model of risk management appropriate for all pension plans. In our view (as set out in greater detail below), proportionality and flexibility are important principles when attempting to articulate prudent pension investment fund and risk management practices, and these overarching principles animate our detailed comments below.

The best practices discussed in the Consultation Paper appear to be directed at larger defined benefit (DB) pension plans (or employers), or plans that have extensive resources. Not all pension plans have these resources available. For a defined contribution (DC) pension plan, where members pay expenses, or for smaller DB plans, these best practices may not be necessary, and the cost of implementing specific risk management practices must not outweigh their benefits. All guidance should recognize this reality.

**Best Practices versus Prudent Practices**

Under common law, it has been established that prudence, in the context of pension investments, is determined largely by the fiduciary's process to select and manage investments—a flexible standard that depends mainly on the facts of each situation. Any guidance flowing from the Consultation Paper should recognize this principle and acknowledge that flexibility is needed. What is prudent for one pension plan may not be for another type of plan. The Consultation Paper should not seek to substitute a "tick the box" exercise for sound judgment and flexible practices for investment risk management.

While we agree that implementing investment risk management best practices is "consistent with" the requirement for pension plan administrators to invest pension assets prudently, we caution that best practices are not (and should not be) held out as minimum standards.

## 2. Responses to Specific Sections and Questions Raised in the Consultation Paper

**Q.3 OSFI believes that an independent assessment of pension plan investment risk is a sound principle. However, not all plans have the level of risk that would merit an internal independent pension risk expert. How should pension plans with less complex investment strategies achieve the benefits of this principle in an effective way?**

While we generally agree that independent assessment of pension plan investment risk is a sound principle, any guidance should be principles-based, as excessively prescriptive requirements (including related governance structure requirements) may be overly burdensome for smaller, less complex pension plans.

**Section 4. Comprehensive Portfolio and Risk Reporting**

With one exception, we agree with the statements in Section 4.1 (Scope) on the scope of portfolio reporting to support prudent investment monitoring practices. The exception is the following statement: "It should also provide sufficient look through to the underlying holdings of investment funds to permit the plan administrator to understand the plan's risk exposures." We have three concerns with this statement:

- It could be interpreted as creating an obligation of full transparency to the underlying holdings of an investment fund on an ongoing "as needed" basis to support decision making.

If this is the intent, such transparency and immediate access to information is neither practical nor necessary to prudently manage pension funds. Due diligence on the investment strategy in place and satisfaction that reasonable limits and parameters on investment activities are in place should be sufficient to invest a portion of a pension fund in an investment fund. It is not necessary for the administrator to have knowledge of an access to each investment held by the investment fund.

- It would help to acknowledge that periodic reporting from an investment manager/fund is appropriate and give guidance on OSFI's views on how often reporting is necessary (e.g., monthly reports with quarterly meetings).

- The implementation considerations in section 4.2 should be clarified on how OSFI believes that such principles would apply to pension plan investments in investment funds, private investments (private equity and real estate) and/or alternative investments (hedge funds) where full transparency on underlying investments is often not available. The Consultation Paper seems to suggest that making investments in such funds/vehicles without full transparency would not be prudent, yet we believe such investments are common and access to data/information is often restricted.

**Q.4 What do you consider to be the key risk limits for pension plans?**

We recommend that new guidance on risk limits be general and consistent with current guidance on related plan documents.

OSFI's current Guideline for the Development of Investment Policies and Procedures for Federally Regulated Pension Plans (OSFI SIP&P Guideline) identifies credit risk and various market risks (e.g., interest rate, currency and price) as key risks. Notably, the OSFI SIP&P Guideline supports a wholistic approach to prudent portfolio management recognizing that "risks that would be unsupportable for an individual investment may be suitable for a well diversified portfolio."

CAPSA Guideline No. 7 – Pension Plan Funding Policy Guideline (CAPSA Guideline No. 7) identifies the articulation of risk appetite as an important component of a funding policy and suggests that the risk appetite would inform changes to risk management tools or plans. However, CAPSA Guideline No. 7 also states that it does not intend to "be prescriptive of these future risk mitigation plans" (p. 11 of CAPSA Guideline No. 7). With respect to volatility, CAPSA Guideline No. 7 simply identifies investment volatility as a major factor to consider for the plan for funding policy purposes, but otherwise leaves the matter largely unprescribed.

Should specific risk limit guidance be adopted, we recommend that this guidance consider how the relevance of certain risk limits, or risk limits in general, would vary based on the type of asset and other circumstances. For example, if a plan administrator determined to make certain long-term illiquid investments based on their projected returns over time, the plan could consider the utility in adopting and tracking a risk limit for those investments based on an analysis of "market shocks" (see Consultation Paper p. 10). On the other hand, in situations where a plan has a lower solvency funding ratio, the plan administrator may find it appropriate to track risk limits more closely.

**Q.5 How do pension plans anticipate implementing risk limits?**

Pension plans are generally expected to implement risk limits in accordance with current legislation and guidance on plan documents. Review of a plan's risk limits could occur annually,

during the annual review of a SIP&P (in accordance with s. 7.2 of the Pension Benefits Standards Regulations).

The OSFI SIP&P Guideline recommends that a SIP&P establish limits on a plan's exposure to credit risk and to market risks, considering exposure under a variety of potential scenarios. However, no specific measurements of volatility risk, other than solvency ratio, rate of return, or contributions volatility, are identified in the OSFI SIP&P Guideline.

With respect to the measurement of volatility for purposes of a funding policy, CAPSA Guideline No. 7 identifies the potential usefulness of both deterministic and stochastic models in terms of relative ease in a stakeholder's understanding, and long versus short-term decision making, but is not prescriptive.

To the extent the Consultation Paper contemplates a plan administrator implementing funding policy elements, such as risk appetite and mitigation, it is worth noting that those determinations are commonly made by a plan sponsor, or by a dual sponsor/administrator acting in their sponsor role. Importantly, CAPSA Guideline No. 6 – Pension Plan Prudent Investment Practices Guideline indicates that the "sponsor is not held to a fiduciary standard of care" in developing the funding policy and highlights the importance of communications between plan administrator and sponsor, where those are separate entities. We believe guidelines overlapping funding policy guidance should be developed in light of these different roles, standards of care and issues of interaction.

**Q.6 How will the implementation of risk limits impact the investment management activities of pension plans, if applicable?**

In accordance with current guidance on the establishment of a plan's governing documents, we believe that flexibility is key, particularly to respond to market changes.

While not explicitly mentioned in the Consultation Paper, we expect there would be mutual effects between the implementation of risk limits and management of environmental, social and governance (ESG) considerations. The 2022 federal budget announced the government's plans to move forward with ESG-related disclosure requirements for federally regulated plans. Similarly, new guidance should take overlapping considerations into account.

**Q.7 What are key tasks that a plan administrator should carry out to identify which risk limits should be in place and how often they should be monitored?**

We expect that guidance on key tasks would be developed in accordance with legislation and current guidance. For example, the OSFI SIP&P Guideline outlines the tasks of establishing and monitoring the following elements of a SIP&P, which are required by s. 7.2 of the Pension Benefits Standards Regulations:

- categories of investments and loans, including derivatives, options and futures
- diversification of investment portfolio
- asset mix and rate of return expectations
- liquidity of investments
- lending of cash and securities
- retention or delegation of voting rights attached to investments
- valuation of investments not regularly traded at a public exchange
- related party transactions.

In accordance with CAPSA Guideline No. 6 and with prudent delegation practices, we expect the plan administrator would delegate and monitor such tasks where it lacks the required processes, resources, knowledge, skills or expertise.

**Q.8 What controls do plan administrators have in place to ensure that portfolio and risk reporting is comprehensive?**

Plan administrators and their advisors (investment consultants and accountants) are best suited to discuss appropriate controls for a pension fund and/or actual practices regarding portfolio and risk reporting (i.e., what is generally available in the market). Nevertheless, based on our collective experience advising pension plan administrators, we offer the following observations:

- Practice varies in large part based on the type of pension plan (e.g., DC or DB) and the size (and resources) of the pension plan.
- Smaller plans tend to outsource more investment risk management functions and rely more on third parties. Larger plans (or employers) with internal expertise and resources are often able to secure (and negotiate) better transparency and reporting by investment funds and managers.
- Controls on portfolio and risk reporting will be largely determined by contract and expert advice on the nature and timing of data and information necessary to monitor investments.
- Most plan administrators will regularly receive reports on investment performance and on compliance with investment guidelines (and require prompt disclosure of any non-compliance). The frequency of this reporting and oversight varies from plan to plan.

**Q 9. How do plan administrators manage data limitations relating to investment funds?**

Access to data on investment activities and holdings of investment funds is typically determined by the offering memoranda, an investment management agreement or subscription agreement for publicly traded investments. Part of an administrator's due diligence in selecting an investment fund/manager would involve an assessment of any data limitations or lack of transparency.

For private investments, data limitations are more common and are a matter of (contract) negotiation. For larger plans/investors, who have more leverage, they can often negotiate greater rights to disclosure of investments.

As noted above, for many types of investments (private equity and hedge funds in particular) full transparency regarding underlying investments is often not available. The Consultation Paper seems to suggest that making investments in such funds/vehicles without full transparency would not be prudent, yet we believe these investments are common and can be part of a prudently managed portfolio even though access to data/information is often restricted.

**Q.11 During periods of market stress, how do plan administrators ensure that third-party valuations (e.g., investment funds) reflect fair market value?**

The CBA Section agrees with OSFI that it is important for plan administrators to be able to determine reliable valuations of plan assets, including alternative assets which are more likely to be illiquid and inherently more difficult to value.

In our view, the best approach to ensuring reliable asset valuations is for the plan administrator to ensure that it fully understands each investment, including how and how frequently it will be

valued, prior to making the investment. This will normally involve the administrator conducting thorough due diligence on the investment and, where necessary, retaining the appropriate external advisors to assist in the due diligence prior to making the investment.

To the extent it is determined (in the context of a particular investment) that more frequent than normal or one-off special valuations may be needed in certain circumstances, such as times of market stress, the right to have the valuations performed and provided by the investment or fund manager should be negotiated into the investment documents or related side letters. Before entering into the investment, the key is for the administrator to fully understand how it will be valued and to negotiate all necessary provisions on valuation issues.

We urge OSFI to avoid issuing guidance suggesting that plan administrators have an obligation to perform their own valuation of assets outside of the valuations performed by the applicable fund or investment manager in accordance with the fund or investment documents. In our view, requiring a plan administrator to perform an independent valuation of assets, particularly assets held in an investment fund, is fraught with difficulties, including:

- As noted in Section 5.2 of the Consultation Paper, alternative asset valuations may be subject to highly localized market conditions and often require specialized expertise to value. The manager of the particular fund holding the assets will in most situations be best positioned to determine the value of the assets. It would be unusual for an independent advisor retained by a plan administrator to be in a position to more accurately value an asset than the fund or investment manager. The plan administrator, even with the assistance of external advice, is unlikely to be in a position to properly second guess the manager's valuation of the assets held within a fund.
- If the plan administrator were to conduct an independent valuation of a particular asset and the valuation is different from that provided by the investment or fund manager, it is not clear what the administrator should do with the alternative valuation. The administrator would then be left to determine whether the valuation from its independent advisor is more reliable that the valuation from the fund or investment manager. It is not clear how the determination should be made. Would a third valuation from another independent advisor be necessary to confirm which of the two valuations is more reliable? It is also not clear whether the pension fund trustee or custodian would accept an asset valuation provided by someone other than the fund or investment manager. In our view, this approach could very well leave the administrator in an untenable position.
- OSFI must recognize the significant cost that an administrator may incur to have an independent valuation performed on alternative assets. Due to the inherent difficulty in valuing such assets, including highly localized market conditions, in many situations it may be difficult to even find an independent advisor who could provide a reliable valuation of the asset without conducting thorough due diligence, which could be an expensive undertaking.
- Proportionality considerations (described in Section 6 of the Consultation Paper) lead to the conclusion that no one-size-fits-all approach is appropriate for asset valuation policies. The Consultation Paper indicates that investments in alternative asset classes have increased as a proportion of total pension assets in Canada based, at least in part, on the fact that the investments have attractive investment characteristics for long-term investors such as pension funds. Plans of all sizes are seeking the diversification, lower volatility and potential for enhanced risk-adjusted returns over the long term that may be achieved through alternative asset investments. Smaller plans that would often access alternative asset investments through pooled funds may simply not be in a position to second guess the asset valuations provided by the fund or investment manager.

Given the foregoing, we suggest that any guidance from OSFI on the valuation of alternative assets focus on the importance of the plan administrator conducting appropriate due diligence before entering into the investment, including retaining necessary external advice, and negotiating appropriate terms in the investment documents to comply with the administrator's fiduciary duties. In our view, second guessing valuations of alternative investments after the investment has been made is not an appropriate approach to addressing asset valuations.

**Q.13 How should smaller plans that pursue less complex investment strategies implement the risk management principles described in this consultation paper?**

There is no one-size-fits-all governance structure for smaller plans. Pension governance structures vary from plan to plan. CAPSA Guideline No. 4 – Pension Plan Governance Guideline acknowledges this point and recommends principles-based guidelines for plan administrators. For example, some smaller plans maintain a senior management pension committee oversight body. Other small plans perform most of the oversight responsibility at the Board of Directors or Board of Trustee level. As a result, there is no one-size-fits-all investment risk management oversight structure for smaller plans.

Possible investment risk management oversight structure for a smaller plan could include:

- ensuring that the pension oversight body (pension or Board committee) expressly includes risk management as part of its pension investment oversight responsibilities. This is expressly stated in Principle 7 of CAPSA Guideline No. 4
- tasking a specified member of the pension committee to monitor pension plan investment risk
- tasking a senior executive (e.g., CFO) who is not a member of the pension committee to monitor pension plan investment risk.

Again, we strongly support the position that the final proposals and guidance adopted by OSFI or CAPSA be flexible and principles-based so that plan administrators can implement processes that are appropriate, efficient and cost-effective given the size of the plan, complexity of the investments and resources available.

**Q.14 What controls or practices can be put in place to ensure that plan administrators of smaller and less complex pension plans are kept informed when their pension plan is approaching levels that are outside of their risk tolerance?**

This varies from pension plan to pension plan. For example, many smaller pension plans engage independent investment advisors, whose mandate includes monitoring and reporting on the status of a pension plan's investments. Other pension plans achieve a similar result through investment management agreements and their investment manager's mandate, as required by their SIP&P. However, not all plans are as sophisticated, requiring reporting of specific risk factors, such as credit or liquidity risk. Guidance should be sufficiently flexible to allow pension plan administrators to tailor their risk monitoring to their specific circumstances.

**Q.15 What are examples of risk management strategies implemented for defined contribution plans that address the principles described in this consultation paper?**

Under most Canadian DC plans, members are responsible for directing their accounts within a range of investment options selected by the employer/legal plan administrator. These DC plans are usually administered by insurance companies who offer a platform of investment fund options,

managed by third party investment managers, that have been vetted by the insurer prior to selection for the insurance company's DC platform. Employers then typically review the investment options offered on the insurer's platform before selecting the funds under a particular plan. CAPSA Guideline No. 3 – Guidelines for Capital Accumulation Plans and Guideline No. 8 – Defined Contribution Pension Plans Guideline note investment risk as a relevant factor to consider when selecting the offerings of investment options under a DC plan.

We recommend that any final proposals and guidance adopted by OSFI or CAPSA on pension investment risk management apply to only DB plans. A review of investment risk for DC plans is imbedded in the current Canadian landscape through the layers of due diligence. And CAPSA has already issued guidance on investment risk management for DC plans.

### 3. Conclusion

The CBA Section appreciates the opportunity to offer these comments. We trust they are helpful, and we would be pleased to offer further details if necessary.

Yours truly,

*(original letter signed by Marc-Andre O'Rourke for Level Chan)*

Level Chan

Chair, CBA Pensions and Benefits Law Section