ACPM/ACARR
The Association of Canadian Pension Management
L'Association canadienne des administrateurs de régimes de retraite

September 10, 2004

Mr. Mathew Ou
Senior Policy Consultant, Pension Division
Financial Services Commission of Ontario
5160 Yonge Street, Box 85
North York, ON
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Dear Mr. Ou,

RE: Proposed Risk-Based Investment Monitoring Model For Supervising Defined Benefit Pension Plans

Thank you for the opportunity to provide feedback to the Proposed Risk-Based Monitoring Model for Supervising Defined Benefit Pension Plans. We applaud the continued collaborative relationship FSCO encourages with the pension industry.

The Association of Canadian Pension Management (ACPM) is the national voice of private and public sector pension plan sponsors in Canada, as well as the professional advisory firms they retain. The ACPM represents pension plans with $300 billion in assets and over three million plan members.

ACPM's mission is to promote the growth and health of Canada's retirement income system by championing the following principles:

- clarity in pension legislation, regulation and arrangements;
- good governance and administration; and
- balanced consideration of stakeholder interests.

We have organized our comments to address general overall observations and questions, followed by comments specific to each section of the Proposal.

General

The ACPM has a general concern with the appropriateness of the model. At a time when DB plan sponsors are dealing with a number of complex issues arising from the regulatory environment, including the Monsanto decision and the repercussions of the Transamerica case, this model will only add to their burden both in terms of time and costs. This model has the potential to capture, for more detailed review, plans that are being prudent in their circumstances and that are complying with the legislation, but happen to adopt a less common investment approach. There is the danger that it may prevent plans from pursuing investment options that may be wholly appropriate but perhaps non-traditional. The determination of plan solvency should be viewed in a much broader context than is proposed by this model. This context should include a longer term horizon and the liabilities of the plan. As suggested by the Pension Investment Association of Canada (PIAC) in their response, the Ontario pension regulations (Reg. 909 s.14.(2) & (3)) provide a method for an initial screening for solvency. A subsequent filing of the IIS could then take place for those plans that do not meet the solvency ratio requirement.

There is also a general concern about the potential liability of plan administrators and auditors arising out of responses to the Investment Information Summary (IIS). This may increase costs of third party services, such as audits, as greater risk potential will be associated with the certification process.

Finally as an overall observation, much of the material requested in the IIS is sensitive. Consideration should be given to granting special confidentiality protection to the information.

Section 2 – Regulatory Objectives

In our view the Objectives outlined on Page 8 of the Consultation Paper raise some issues. There is overlap between the first and second objective – one could consider a "governance process" to be a "framework". The third objective leads us to believe that FSCO will be the judge of whether pension fund investments are appropriate or not. In addition, the third objective indicates that appropriate pension fund investments should be consistent with the nature of pension plan liabilities. One could argue, and some do, that to be consistent with pension liabilities, the assets should be invested mainly in bonds. However, many disagree with this strategy.

Section 3 – Proposed Investment Monitoring Model

Excluded Plans - The Consultation Paper does not make it clear why FSCO considers "designated plans under the federal Income Tax Act and plans fully invested in insured contracts" to be low risk, resulting in them being excluded from the investment review stage of the proposed process. In addition, it is not clear why excluded plans would have to complete the IIS, an exercise that may add considerable stress to already overloaded plan administrators. The ACPM is aware that FSCO is sensitive to unnecessarily increasing the administrative workload of pension plan administrators.

Imprudence in Fund Governance - In describing the stages of the "Selective Review Process", the second stage discusses the investment review process, including desk reviews of pension fund related information such as the asset allocation strategy, to determine if there are any material concerns with the pension fund investments. Included in the review would be non-compliance with investment rules, non-compliance with investment policies and imprudence in fund governance. ACPM questions whether, at present, FSCO has the expertise and/or resources in-house to evaluate imprudence in fund governance. If FSCO does not currently have the expertise, will they be hiring someone or contracting out? How will the cost be funded? Further, should FSCO's judgement be viewed as superior to that of the plan administrators and their advisors who are making investment decisions in real time?

Consequences - If a plan becomes the subject of the follow up stage and FSCO seeks further information, what is the potential range of results? Does FSCO intend to take remedial action? The industry should be made aware of what the possible consequences will be if FSCO determines that a pension fund's investments are being imprudently managed.

Diversification - The proposal states that the review will focus on how investment risks are effectively managed through diversification. Does FSCO have benchmark diversification standards it will be assessing against, other than legislative compliance?

What level of diversification will be sufficient? This can be highly variable depending on the circumstances of the pension fund.

Risk Characteristics - FSCO proposes to target DB plans that exhibit certain risk characteristics. We assume the characteristics are those that are described in Appendix C through the assignment of primary points and secondary points. If not, this principle needs to be expanded upon so that plan sponsors understand what they have to do to minimize the likelihood of being made subject to a further review.

Third-Party Certification - FSCO states that it would be useful to have an independent third party certify information. The proposal then proposes obligations only on one third-party, the plan auditor. There will be significant cost implications to having third parties certify information in the IIS with limited benefit. Even the auditor will have difficulty giving a meaningful certification of many of the requirements. For example, the 10% diversification rule (it must aggregate holdings in affiliated and associated companies) and the 30% voting share rule (there are a number of structures which employ fine legal distinctions to achieve compliance with this requirement). The ACPM considers that certification by the administrator alone should be sufficient. The administrator can obtain any professional advice it requires to make the certification.

Section 4 – Issues To Be Addressed

There are a number of good questions in this section, most of which we have addressed in our comments above. One exception is the appropriateness of the proposed criteria for determining a pension plan's investment risk profile. We refer FSCO to the response submitted by PIAC. The ACPM agrees with PIAC's assessment and resulting comments on the criteria. Another question we have not addressed is 4(b) concerning the screening out of "small plans". Risk is not dependant on size. All plans should be assessed in terms of their future ability to meet their liabilities. Those plans at risk should be required to submit additional information.

Appendix B – Proposed Investment Information Summary (IIS form)

Part 2 - There is an issue regarding liability for incorrect statements.

Part 3 – As a general comment, it appears that a number of these items would not be apparent from the financial statements. In addition, we are not sure how an administrator of a plan invested in pooled funds would provide responses to some of the items. For example, how would the administrator respond to section 3.2 - Decrease in Assets (Including Payables) if invested in a pooled fund? How would a plan's portion of the pooled fund expenses be allocated to it?

Part 4 - We have several comments:

- The amounts are reported at fair market value whereas a number of the statutory tests are based on book value numbers.
- The financial information will not be helpful for many of the diversification tests as the numbers disclosed will be aggregate numbers.
- There is no reference to any smoothing of asset values and it is not clear under the liability section whether the liabilities for accrued pension benefits (as opposed to amounts relating to pensions in pay) are to be disclosed.

Part 5 – We have a number of questions and observations:

- Why is there heavy emphasis on derivatives?
- Should the rate of return (time weighted) in item 5.2 be calculated in a uniform manner?
- Items 5.4 and 5.5 seem to be overlapping.
- The reference to "notional value" in item 5.6 should be clarified. If it is the notional amount of the derivative transaction, it is not reflective of the pension fund's economic exposure.
- We question the value of questions 5.9 to 5.15. These questions cannot be answered without more detailed review. We expect that all pension plan administrators would simply answer "yes" to all questions.
- In item 5.21, it may be useful to specify the actual asset allocation as well.

Appendix C – Proposed Criteria for Determining First Stage Preliminary Pension Plan Risk Assessment Scores

As already indicated the ACPM refers FSCO to PIAC's response with respect to the appropriateness of some of the risk criteria specified in this section. In addition, the ACPM has a few specific comments on certain areas of this section:

2.2.8

- In this section there is a lot of emphasis on performance, yet the Proposal talks about how the appropriate investment of plan assets is about process not results. Why include this?
- What will happen to a plan where the investment returns are +/- 5 percentage points from benchmark? In the Rationale for Criteria section of 2.2.8 it states that FSCO will "seek an explanation for the deviations" – from whom? What will be the process for seeking an explanation?
- Who will determine whether this is "momentum or fad investing"? Momentum investing is a recognized investment process. What if the plan hired a manager with that mandate?
- This seems to be getting away from process and into the very grey area of judging what is a good or bad investment result. The ACPM is concerned that the evaluation being proposed will encourage a trend to the mean. There may be a disincentive to seeking superior returns. The "Rationale for Criteria" seems to imply that superior returns are indicative of an imprudent investment strategy.
- In any event, the criteria focus on short term investment returns. A short term under or over performance can lead to increased scrutiny. It is long term performance that is really most important, since one can have short term variability but superior long term returns.

2.2.15

- Who set these fee levels? What was the basis for them?
- Why are consulting, recordkeeping, custodial, etc. fees excluded?
- How will investment expenses be measured in a pooled/mutual fund investment?

In 2.2.16 why is $10 billion set as the level for no secondary points? Size and expertise are not always co-related.

Conclusion

In the ACPM's view, the process being proposed for risk-based investment monitoring in Ontario is too complex, has criteria that are not appropriate for the measurement of risk and has the potential to add greatly to the costs of pension plans. A minimum solvency test for screening potentially risky plans would be much more appropriate and less cumbersome and costly in its implementation.

ACPM would be pleased to discuss any of our comments with FSCO. In addition, we would welcome the opportunity to work with you in developing a more effective risk identification and monitoring process for pension plans.

Yours truly,

Becky J. West

Becky J. West
Chair, Issues Subcommittee, Ontario Regional Council

cc: Mr. Michael Beswick,
Chair, Advocacy & Government Relations Committee, ACPM