Canadian Institute of Actuaries | Institut canadien des actuaires

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Canadian Association of Pension Supervisory Authorities (CAPSA)
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Subject: CAPSA Guideline for Risk Management for Plan Administrators

The Canadian Institute of Actuaries (CIA) is pleased to provide our comments on this important consultation.

The CIA supports the CAPSA initiative to issue a guideline on proper risk management of pension plans. We believe that the proposed framework will result in better risk management and will be used by pension plan administrators, their third-party service providers and plan sponsors. We also note that, given the extensive content included in the draft Guideline, it will take some time for plan administrators and those who advise them to review, understand and adopt the practices identified where appropriate.

We believe the Guideline will result in better understanding of the leading practices in risk management for the pension industry and, in addition to assisting plan administrators and their advisors, should also assist each regulator in defining its own role in risk management of pension plans more explicitly. The CIA supports a regulatory role that is both principles-based and risk-based. We also encourage regulators to increase or enhance their internal knowledge of leading risk management practices and subject areas. We hope that the publication of this Guideline will lead regulators to adopt consistent approaches to risk management issues across the country and encourage regulators to articulate their own views around the sufficiency and quality of risk management of the plans they regulate.

The role of the regulator in risk management should be defined and articulated by each regulator within their legislative and regulatory regimes, since risk management requirements and the role of the regulator in this regard are not currently explicitly described in pension statutes. In particular, it should articulate whether the regulator has the authority to request disclosure of risk management policies and to direct actions to correct inappropriate policy. It may be the case that the current provincial pension legislation should be amended to support this role, which would provide greater clarity on what minimum standards plan administrators must comply with in relation to risk management, and on the regulators' authority in that regard.

We understand that the Guideline is intended to support plan administrators in fulfilling their duties, however the CIA is concerned about the effect the Guideline may have on the interpretation of fiduciary duty and standard of care, and the increased potential for lawsuits against plan trustees and plan administrators. This is a legal issue and we encourage seeking

legal advice on this matter before publication of the Guideline. To expand on this point, we note that some of the content of the Guideline currently appears educational in nature and may go beyond regulatory expectations. We recommend that the Guideline be streamlined to focus on the key risk management principles and regulatory expectations, and that additional background or educational support, if deemed necessary, be provided in a separate manner (not as part of the Guideline).

We note that publication of this Guideline will not address certain existing challenges for pension plans that are structural or inherent in the legislative framework, including, for example, the effect of surplus asymmetry, the rules for obtaining funding relief, the impact of removing solvency funding requirements on benefit security, the confusion on the role of plan administrator vs. sponsor, or the effect of corporate transactions on the security of pension benefits. These matters and the resulting risks should be identified and evaluated as part of good risk management if they are not addressed through legislative action. We suggest adding these risks as examples in Appendix A (Risk Table), since they may have consequences to benefit security and plan sustainability.

We provide more specific commentary on the Guideline, by section, below.

Sections 1-5

Regarding the scope of the Guideline identified in Section 2, we recommend that the risk management guidelines for defined contribution plans be included in the *CAPSA Capital Accumulation Plan Guidelines* (CAP Guidelines), rather than in this document, for ease of use by administrators and sponsors of defined contribution arrangements. The CAP Guidelines are self-contained and already include some topics that are related to risk management. The risk management content added to the CAP Guidelines should be complete, even if it overlaps with information in this draft Guideline.

In both Sections 2 and 5 of the Guideline, a recommendation should be added that administrators should identify and clearly document who bears which risks in their plan. This should be included in the plan's documented risk management framework, and should equally be added to the Funding Policy and SIP&P. This is a foundational step in risk management and could be included in Section 5 under an expanded Step 1 – Identify Plan's Objectives *and Risk Consequences (or Negative Outcomes)*. This is equally important for all the types of plans listed (DB, DC, TPA, Hybrid), but perhaps more so in cases where members bear a greater potential for downside risk.

In Section 2 and in numerous other instances, the term "material risks" is used but not included in the glossary or defined within the document. While we appreciate that each plan administrator (and plan sponsor) will assess materiality in their own context, a brief definition and a framework for evaluating materiality would be useful. In Section 5.3 there is again

reference to material risks, but a more explicit definition or connection to the likelihood and severity assessment process could be added to enhance clarity.

In Section 3, administrators should be encouraged to include in their risk management framework the explicit identification of the roles and responsibilities of those involved in risk management activities. There are parties who identify risks, provide reporting and monitoring on risks, and those who provide or support mitigation implementation. There are also the parties who make the risk-taking or risk-mitigation decisions and oversee all risk management activities (typically the plan administrator). Each party's roles and responsibilities should be clearly articulated, communicated and agreed to in order to ensure understanding and alignment among the parties.

In Section 4, the concepts of risk appetite, risk tolerance, risk capacity and risk limits are introduced. These concepts are relatively new to the pension industry (although they are well ingrained in insurance practices). We suggest including further explanation, diagrams, or examples to help clarify the definitions, perhaps in an appendix. We refer CAPSA to the CIA's *Practice Resource Document: Risk Appetite*, which contains further resources to explain these important concepts.

Section 5 is clear and logical. An additional diagram may be useful in demonstrating that these steps are intended to be iterative – the process does not end at Step 5. In general, there are a number of sections where we believe a diagram or chart would be very valuable in explaining a concept/idea.

Section 6 – Specific Topics

We agree with the approach of providing more detailed information for topic-specific risk areas, however we do note that some topics are still currently evolving (and quickly) and may become outdated, limiting the longevity of this document. As noted above, we encourage CAPSA to craft a guideline that will focus on regulatory expectations and principles for proper risk management and therefore not require frequent updating (similar to the Governance Guidelines). In addition, CAPSA could consider publishing separate topic-specific information (not necessarily as guidelines) as subject areas continue to evolve, which can be done on a timely and more frequent basis.

An additional important (and foundational) topic area that should be added is funding risk management (sometimes referred to as asset/liability mismatch risk). Plan administrators should identify, quantify/measure, and assess their plans' funding risks, taking into account the risk appetite and risk capacity of those bearing the risks. For example, plan members and employers can bear contribution level and volatility risk, depending on the nature of the plan. Plan members also often bear benefit security risk. In either case, the pension plan itself is subject to the risk of not being able to pay benefits as they fall due in all circumstances (e.g.,

on wind-up). Regulators will likely have a viewpoint on the degree of funding risks undertaken in the plans they regulate and should communicate with plan administrators to share those views and to understand how plan administrators are addressing these risks.

Another potential specific topic to consider addressing is the use of illiquid assets (as a subsection of Investment Risk). Investments in illiquid assets are becoming more prevalent in mid- and smaller-sized plans, and they present unique risks compared to traditional publicly traded securities. The Guideline could identify regulatory expectations for the types of questions plan administrators should be asking, before and while they are investing in illiquid assets.

In terms of overall importance, we suggest re-ordering the sub-sections (if retained) as:

- Funding / Asset-Liability Mismatch Risks (NEW)
- Investment Risk [~~Governance~~]
- Use of Leverage (which could be included as a sub-section of Investment Risk, given that it is an investment decision)
- ESG Issues
- Third-Party (Outsourcing) Risk
- Cyber Security

The section on target pension arrangements (TPAs) does not fall into the category of a specific risk area, but rather identifies additional considerations which might apply to one specific type of pension plan. We note, however, that there are many other types of plans with unique considerations for risk management which are not called out explicitly in the Guideline, for example: jointly sponsored/funded plans, multi-employer plans which are not TPAs, hybrid plans where risk-bearing lies with both the members (in a defined contribution component) and the employer (in a defined benefit component).

We encourage CAPSA to rationalize why TPAs, (whether single employer or multi-employer) are called out and not other types of plans. We further note that both FSRA and BCFSA have published documents identifying leading practices for multi-employer pension plans (which could include TPAs). The risk management sections of these publications are in alignment with the general content (Sections 1-5) of the Guideline. As an alternative to a standalone section for TPAs, the specific risks listed in this section could be included in Appendix A, with a reference that they apply particularly to TPAs (if they are unique to such plans).

We also suggest that the structure of each of the subsections could be made more consistent.

6.1 Third-Party (Outsourcing) Risk

Section 6.1.1 (Background) mentions outsourced activities, functions and services and the use of independent professionals. The distinction between these is not clear and may not be useful or necessary. For example, is the preparation of an actuarial valuation report an outsourced activity or the use of an independent professional? The same question could be asked of a third-party administrator.

Section 6.1.3 (Integrating Third-party Risk in Governance and Risk Management) should focus specifically on risks not addressed more generally. For example, the bullet “does the plan administrator understand that it remains responsible...” belongs in the primary guidance.

Expecting plan administrators to self-adjudicate on whether they are asking informed questions to gauge the reasonableness of the advice given may not be possible. Better guidance might be to have administrators consider if they understand the factors that were considered in the advice they receive and if there are any relevant factors omitted.

There are several bullet points related to due diligence in the selection, contracting and monitoring of third parties that could be reduced to one bullet point. The need for administrators to consider a third-party service provider’s business continuity plans and management of data security, along with supporting information on how to evaluate such plans should be included in the Key Considerations bullets (it is already mentioned in 6.1.2).

6.2 Cyber Security

We are supportive of the content in this section and do not have any commentary to provide.

6.3 Environmental, Social, Governance (ESG)

The topic addressed in section 6.3 (in particular climate risk) is a rapidly evolving issue that presents new research findings and developments from across academia and public research bodies. We suggest that the Guideline acknowledge the evolving nature of this risk. Rather than attempting to operate in a vacuum by defining an all-encompassing guideline, it should provide pertinent information while acknowledging and calling out external (public) organizations and publications, for example:

- OSFI B-15 Guideline
- ISSB Standards S1 and S2 released in June 2023 (and the subsequent adaptation by the CSSB to the Canadian context)
- UN Principles for Responsible Investment (PRI) framework
- NGFS, TCFD
- Regulations and guidance from securities regulators (CSA, SEC)

- Collaboration to Align and Refine ESG Terminology (CARET) involving the UN Principles for Responsible Investment, the Global Sustainable Investment Alliance and the CFA Institute

Further, we suggest that the Guideline be limited to a short description of this complex issue and that more extensive guidance on ESG be in a separate document that would be amended following the evolution of the best practices in this field. These proposed ESG guidelines should incorporate recommendations we provided to CAPSA in response to the June 2022 consultation on the topic.

We also recommend that the wording around fiduciary duty of a plan administrator be reviewed and balance expectations with resources available to plan administrators across the Canadian pension plan spectrum. If ESG guidelines must make reference to a potential breach in the fiduciary duty of an administrator, we suggest that any such reference is supported by an appropriate legal analysis. Additionally, because of the confusion surrounding the integration of ESG factors in the investment decision process of pension funds, consideration be given to an amendment in legislation or regulations to support such approach, if it is done to optimize the risk/return trade-off for the benefit of plan participants. Further, we suggest that a review of the wording be conducted for key non-defined terms that are used in the section and consider defining them in the glossary, e.g., ESG Factors, ESG Information, ESG Risks and Opportunities and ESG Considerations. The use of these defined terms should be consistent throughout the document and not be used interchangeably if their meanings differ.

We are supportive of the three principles outlined in this section but suggest that details of how these are implemented should be left to plan decision-makers. For example, in Principle 3 “plan member statements” are called out specifically but may not be the ideal place to include this information. We suggest generalizing the phrase to reference only “in plan member communications.”

Although scenario analysis is mentioned in 6.3.4, we would like to see more emphasis on climate scenario analysis as the main tool available to plan administrators to identify and quantify transition and physical risks associated with climate change on both plan assets and liabilities. This in turn helps the administrator with investment, funding and assumption-setting decisions. We acknowledge that this is also an area of rapid evolution, and that best practices in this field are still emerging.

We suggest differentiating between ESG factors that may affect the risk/return profile of a pension plan portfolio vs. climate-related risks which affect both assets and liabilities. The Actuarial Standards Board is working toward establishing a Designated Group on climate change to assist actuaries on how these concepts can be incorporated in actuarial work.

In this rapidly evolving area of ESG, we expect pension legislation and regulatory activities to evolve and adapt, taking into account the emerging knowledge and recommendations arising from specialists in this field. It would be most helpful for plan administrators (and other involved parties) to receive clear communications about the minimum standards and regulators' expectations that will ensure fiduciary duties are being met.

6.4 Use of Leverage

In Section 6.4, we note that the content focuses on larger pension plans that issue their own notes or commercial paper, or which have direct investments that result in recourse/non-recourse exposure from a borrowing standpoint. We suggest the section would benefit from clear delineation of relevance to smaller vs. larger pension plans.

We also suggest clarification of the reference to "plan's liabilities" in section 6.4.3 under Market Risk. Specifically, it is unclear whether the reference is to a plan's investment liabilities stemming from the issuance of debt or to the impact on actuarial liabilities through setting of actuarial assumptions.

Finally, given the importance of liquidity risk in the context of the use of leverage, we suggest that reference to a metric such as the liquidity coverage ratio be made in section 6.4.8.

6.5 Target Pension Arrangements

We provide comments here on the TPAs section in the main document as well as in Appendix D. We suggest that the additional information included in Appendix D would be better placed if it were included and integrated into the main body of section 6.5, for ease of use by readers. See also our general comment about this section, above, under the title "Section 6 – Specific Topics."

The risks identified in section 6.5.2 (What Types of Risks Should TPA Plan Administrators be Aware of?) are focused on plan members (governance and employee communication risks were identified) whereas risks participating employers face in the event of a pension benefit reduction were omitted. Despite the risk-bearing allocation of TPAs, employers are still exposed to risks, which in turn can lead to actions that affect the plan. If, for example, benefits are reduced, employer/employee relations may be impacted, there may be pressure for employers to increase contributions and employee decisions may be affected (e.g., retirement may be deferred due to benefit reductions) which impact employer resourcing. This may lead to employers exiting from plan participation, which could affect the plan directly depending on the relative size of the employer. We suggest consideration be given to adding employer risks for completeness of the discussion.

In the governance commentary of section 6.5.3 (Addressing Risk in Funding, Governance and Communications) we suggest removing references to plan administrators' fiduciary duty to

pension plan beneficiaries, as this has already been covered in the general sections of the guidance and is not unique to TPAs.

The primary tool identified in Appendix D to address funding risks is the use of a Provision for Adverse Deviation (PfAD). PfADs have emerged as a specific margin added to liabilities and/or cost of benefits. This is a very narrow application of including a level of conservatism in the actuarial basis. We believe the guidance should be more broad-based referring to adopting a prudent actuarial basis reflecting the risks the plan faces and the risk appetite/capacity of the relevant parties, with the PfAD being one such approach.

The funding section of Appendix D includes a recommendation to develop a policy ladder for benefit adjustments. This is not a funding issue but a benefits policy issue. The Guideline comments that developing such a policy will improve benefit stability. Such a policy does not improve benefit stability but rather indicates in advance how the TPA benefits will not be stable. We suggest removing this comment. We agree that there should be a predetermined process of benefit adjustments. The details of the process should be left to the trustees including how different classes may be affected. The existence of a predetermined process will provide greater confidence in the trustees by plan members.

The guidance in Appendix D on communications with plan stakeholders is too broad. The guidance is appropriate for plan beneficiaries but not for all stakeholders. For example, employers whose sole obligations are to provide data and remit contributions typically do not want or need information on the plan. Such communications can cause confusion. Not all service providers need to know about significant changes to plan benefits or contribution levels. We suggest the guidance provide more specific expectations on communications with specific stakeholders rather than broad-based guidance.

6.6 Investment Risk Governance

We suggest reviewing section 6.6.2 and the reference to “less sophisticated investment strategies” to encompass all pension plans that invest through third parties. Portfolio complexity can vary significantly across the spectrum of pension plans even within those who are not direct investors.

We also suggest taking proportionality into consideration when referring to the required level of reporting. The guidance notes that “all plan administrators must possess the capacity to produce portfolio and risk reporting, whether internally or through an outsourcing arrangement.” The capacity of smaller plans without dedicated risk teams, or sufficient resources, to provide this level of detailed reporting should be considered.

Finally, in section 6.6.4, it may be appropriate to adjust the title to call out that the section is in reference to investment risk and not risks more broadly.

Appendices

Appendix A – Risk Table

The introduction to this section could be improved by providing additional context. For example, not all risks listed in the table are risks faced solely by the plan administrator (as currently described), some are risks faced by other plan parties such as the plan sponsor or plan members. A title of “Example Risk Categories, Risks and Descriptions” could help orient the user to the fact that this is not a comprehensive Risk Register. Although it is mentioned that the list is non-exhaustive, it could still be helpful to include certain risks of importance, particularly those that are listed as part of Section 6 of the document, such as Third-Party Risk (which is not currently mentioned in the Risk Table).

Some of the risk descriptions imply that the risk is simply a result of negligence or poor/ inadequate/inappropriate governance or performance. However, many risks that plans face are due to the external environments (economic and other) which plans operate in. Good plan governance can help mitigate against them, but not necessarily eliminate them. Some rephrasing of the descriptions could provide plan administrators this useful context.

Appendix B – Risk Assessment Tools

We are supportive of the content in this section and do not have any commentary to provide.

Appendix C – Sample Heat Map

The examples would be more helpful if they included more than one risk, to provide context around relativity and prioritization in risk assessment. It would be helpful to include in the example a couple of financial risks.

Appendix D – Tools for Addressing Target Benefit Risk

Comments on Appendix D were addressed above as part of Section 6.5

Appendix E – Independent Risk Management

This Appendix makes several references to “operational management” and “operational risk,” suggesting that this section’s focus is on operational risks only. We suggest removing references to “operational” generally in this section, and specifically to change the phrase “operational risk, including investment risk” to simply refer to “risks.” Investment risk is not a subset of operational risk, and we note that both operational and investment risk are separate defined terms in the Risk Table under Appendix A.

The Guideline may be overly prescriptive in dictating who risk management should report to and in specifying that risk management’s compensation not be tied to the fund’s performance. Across the Canadian pension universe, differences exist in the reporting structures between

investment and corporate teams as well as in the determination of compensation. Further, the risk management function has an important role to play in investment decisions (and thus the risk-adjusted returns of the fund), particularly with respect to setting guardrails around strategic asset allocation, as well as management of other key investment risks noted in the Guideline.

Finally, on the three lines of defense model, we suggest a review to consider that it is typically the second line that sets the limits within which the first line operates. In addition, we suggest that the third line of defence may also include external independent review depending on the type of risk in question, and particularly if there is no internal audit function.

Conclusion

Actuaries are currently involved in pension risk management with plan administrators in a variety of ways beyond just preparing statutory actuarial valuations: actuaries prepare forward-looking analysis/stress-testing/stochastic studies, assist with plan design/re-design, support the development of investment strategy and asset allocation analysis, as well as advising on certain administration areas. Actuaries are well suited to assist plan administrators with overall risk management initiatives, given their professional training and expertise.

We support CAPSA's initiative in publishing risk management guidelines for pension plan administrators and other audiences. We believe that, by clearly outlining regulators' expectations regarding prudent risk management, plan administrators and their advisors will have a better perspective on what prudent risk management looks like. We believe that the Guideline will improve pension plans' risk management practices.

The CIA appreciates the opportunity to provide feedback on these issues, and we would welcome further discussion with you throughout this process.

If you have any questions, please contact Chris Fievoli, FCIA, Actuary, Communications and Public Affairs, at 613-236-8196 ext. 119 or chris.fievoli@cia-ica.ca.

Sincerely,

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