CAPSA/ACOR

Canadian Association of Pension Supervisory Authorities
Association canadienne des organismes de contrôle des régimes de retraite

Guideline No. 7

Pension Plan Funding Policy Guideline

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Contents

Context

Financing of defined benefit pension plans is based on their funding, benefit, investment and accounting policies, taking into account legislative requirements. A funding policy is a document prepared by the plan sponsor of a single employer pension plan that outlines how the benefit commitments made in the plan documents are to be achieved.

In the case of a multi-employer or target pension arrangement [1], In the case of a multi-employer or target pension arrangement, the funding policy or benefits policy would be the responsibility of the administrator, which is usually the board of trustees.

This guideline is intended to provide guidance on the development and adoption of funding policies for pension plans that provide defined benefits or target benefits. Some jurisdictions require that a funding policy be prepared. Where such a requirement does not exist, CAPSA encourages plan sponsors or administrators to follow this practice.

The content of the funding policy will depend on the nature (characteristics and complexity) and documents of a pension plan. As the development of a funding policy involves a wide range of issues, CAPSA recognizes that some of the considerations described in this Guideline may not apply to all pension plans.

Pension Plan Funding Principles and Objectives

Funding requirements promote benefit security. The goal of funding single employer pension plans is to ensure that assets together with future contributions and amortization payments are sufficient to deliver the promised benefits on an ongoing basis; and to protect pension benefits in situations that involve investment losses, employer insolvency or bankruptcy.

These same objectives also apply to target pension arrangements, recognizing that as a last resort these plans have the requirement to reduce accrued benefits if the assets are insufficient to fund the benefits that are aimed for as the contribution rates are fixed and do not have to be increased to cover the funding shortfall.

[1] As defined in Section 3570.01 of the Standards of Practice of the Canadian Institute of Actuaries effective December 1, 2020

Funding decisions have a significant impact on pension plan sponsors and beneficiaries (i.e. any person with an entitlement under the plan). These decisions impact the pace of funding, the security of members' benefits, the ongoing viability of the plan itself, and whether employer(s) alone or both employer(s) and plan members bear the risk in the event of a funding shortfall by way of an increase in contributions or a reduction in benefits.

Therefore, funding decisions should not be made on an ad-hoc basis. Practical financing considerations, including capital market movements, and laws and rules that affect pension plans and plan sponsors, may also affect or impose constraints on funding decisions.

Plan sponsors generally seek year-to-year funding requirements that are as predictable as possible, given the variability resulting from investment experience, interest rate changes and other factors.

Purpose of a Funding Policy

The purpose of a funding policy is to establish a framework for funding a defined benefit pension plan taking into account factors that are relevant to the plan.

These factors should include some or all the following:

- Benefit security and the extent to which that is communicated to plan members/beneficiaries.
- Level of benefits.
- Stability and/or affordability of contributions.
- Financial position of the sponsor and competing organizational demands for cash.
- Desire to incorporate an objective or provision and the time frame over which this objective is to be achieved.
- Minimum and desired funded ratio and solvency ratio.
- Demographic characteristics of the plan's beneficiaries.
- Minimum funding requirements under applicable pension legislation (both going concern and, if applicable, solvency funding).
- Financial position of the pension plan.
- Material risks impacting the plan's funding requirements and risk mitigation strategies.

- Limits and requirements under the *Income Tax Act and Regulations* applicable to pension plans.
- Legislative requirements and plan provisions with respect to utilization of funding excess.
- Frequency of preparation of actuarial reports and strategy for statutory filings.
- Terms of the plan documents and any related agreement, such as a collective bargaining agreement, between the employer and plan beneficiaries.
- Strategy and process for dealing with required reductions in accrued benefits for target pension arrangements.
- Tax planning and impact on the plan sponsor's financial statements.

A funding policy should support the decision-making process for financing pension plan obligations. It should also be consistent with the purpose and goals of the pension plan.

These purposes and goals should be outlined in the plan's documents including its governance policy, funding policy and Statement of Investment Policies and Procedures (SIPP). The plan administrator is responsible for developing and implementing the SIPP. Both the funding policy and the SIPP should be aligned with the plan's fundamental beliefs.

It is important to ensure that the two documents are consistent with each other, and changes may be required to either the SIPP or the funding policy to achieve this consistency. Where there are conflicts or inconsistencies the plan administrator and the plan sponsor are responsible for disclosing and resolving them.

Plan administrators may find the CAPSA Guideline No. 6: Pension Plan Prudent Investment Practices Guideline helpful in developing the SIPP.

Role of the Plan Sponsor

While it may not be a requirement under pension legislation in some jurisdictions, it is a good practice and good governance to develop and adopt a funding policy. In the course of activities related to the establishment of a funding policy, where the plan administrator is not the plan sponsor, then the plan sponsor is not held to a fiduciary standard of care.

Role of the Plan Administrator

The plan administrator has certain responsibilities once the funding policy is adopted, such as ensuring that the SIPP is consistent with the funding policy and the required contributions are made. The administrator is responsible for understanding and complying with the funding policy.

The role of the plan administrator should be documented in the funding policy.

Dual Role of the Employer as Plan Sponsor and Plan Administrator

For many pension plans the plan administrator is the employer who is sponsoring the plan. In these situations, the employer is held to a fiduciary standard of care when acting as the plan administrator. The employer also retains certain rights and powers in respect to the pension plan, since it is both the sponsor and plan administrator.

The roles and responsibilities of the plan sponsor are very different from those of the plan administrator. In the plan sponsor role, the employer is entitled to act in its own best interests but it may be subject to an implied duty of good faith.

In the plan administrator role, the employer must also ensure the pension plan and pension fund are administered prudently in accordance with applicable legislation and pension plan documents. As plan administrator the employer is a fiduciary whose actions and decisions must be made in the best interests of the plan's beneficiaries in an even-handed manner.

Developing a Funding Policy

There are a number of advantages in developing a funding policy:

- The exercise of developing a funding policy improves the identification, understanding and management of the risk factors that affect the variability of funding requirements and the security of benefits. Undertaking this exercise should lead to more robust governance.

- The adoption of a funding policy could increase the plan sponsor's discipline around funding decisions. This could contribute to more predictability in funding.

- Having a written summary of the funding policy that is accessible to plan beneficiaries should help to improve the transparency of funding decisions and increase the beneficiaries' understanding of pension funding issues.

- Having a funding policy may also provide guidance to the plan's actuary when selecting actuarial methods and assumptions in accordance with actuarial standards of practice and within the plan's risk tolerance limits.

- The SIPP details the plan administrator's objectives and expectations relating to the investment and management of the plan's assets. The funding policy documents the plan's funding objectives and methods for achieving them.

The party responsible for the adoption and maintenance of the funding policy may vary according to the circumstances of the plan. For most single employer pension plans, the employer is responsible for making funding decisions and should therefore be responsible for the development of the funding policy. For most target pension arrangements and jointly sponsored pension plans, several plan stakeholders may be involved in the development of the funding policy.

The plan actuary may provide valuable input in the development of a funding policy.

Elements of a Funding Policy

When plan sponsors or administrators document the funding objectives of a pension plan, they should outline their understanding of the risk factors that influence future financing obligations, their risk tolerance, and specific policies related to matters that affect the funding of the pension plan.

The following elements as they relate to the pension plan constitute what CAPSA believes is best practice for issues that should be considered in establishing a funding policy.

Other issues may also be relevant, depending on the specifics of the plan. To the extent that some of these elements may be addressed in the SIPP or in a broader benefits policy, it would be reasonable to avoid duplication and refer to these other policies as needed.

It is also understood that these issues do not apply equally to all pension plans and that the funding policy should fit the particular circumstances of the plan.

1. Plan Overview

The funding policy should include an overview of the features of the plan, related financial information and characteristics of the plan sponsor that are relevant to the establishment of the funding policy.

The following could be included in this overview:

- Plan type and governance structure: single employer / multi-employer / jointly sponsored / target benefit arrangement.
- Plan provisions.
- Plan demographic profile, including plan maturity and if the defined benefit provision of the plan is opened or closed to new entrants.
- Size of plan relative to the plan sponsor or employer(s) participating in the plan.
- Industry and comments on cyclicality of the plan sponsor or employer(s) participating in the plan.
- Financial information such as funded status of the pension plan level, fixed contributions for multi employer pension plan

2. Funding Objectives

The funding policy should indicate how the funding objectives integrate with the plan's SIPP, as well as the plan sponsor or plan objectives. These objectives can be stated as they relate, for instance, to benefit security, intergenerational equity, stability of contributions, and to contribution or benefit levels. Plan sponsors or administrators need to take into consideration that some of these objectives may be conflicting. It may be useful to rank the funding objectives and also include considerations and examples on how possible conflicts would be resolved. Considerations should also be given to illustrate the meaning of each objective with respect to key funding decisions.

For example, intergenerational equity could be achieved by funding deficits over a period that would be comparable to the period over which surplus would be spent.

The funding policy could also document circumstances in which funding in excess of the legislated minimum would be considered. Contributions in excess of the legislated minimum may be used to build a reserve that may help attain secondary objectives or maintain a level of contributions in excess of the legislated minimum while complying with limits in the *Income Tax Act and Regulations*.

3. Key Risks Faced by the Plan

The funding policy should describe the key risks that are faced by the plan from the perspectives of various stakeholders. These risks can include:

- Investment risk: investment returns lower than the assumed return.
- Mortality and longevity risk: level and trend experienced by plan membership different than what is assumed in a way that adversely impacts the plan's funded position.
- Mismatch of plan's asset and liability duration.
- Plan maturity as measured by the demographic characteristics of the plan beneficiaries.
- Inflation risk: inflation higher than what was assumed in developing economic assumptions.
- The impact of plan funded status or required contributions on plan sponsor's financial statements or cash flow.
- The financial strength of the plan sponsor or employers participating in the plan.
- Other external macro factors (e.g. impact from a global pandemic, regulatory risk).

- Contribution risk: variation of contributions due to significant decreases in active member population or hours worked.

Due consideration should be given to how these risks may affect the security of beneficiaries' benefits.

4. Risk Appetite

The funding policy should describe the level of risk that the various stakeholders are willing to accept commensurate with the ranking of the funding objectives. It should also describe the main funding objective and the tolerance of attaining/not attaining the other objectives.

Examples include:

- How much contribution volatility can the plan sponsor withstand?
- How much investment volatility can be tolerated?
- Any limits to necessary action, for example: minimum benefit accrual rate, minimum inflation protection, maximum contribution levels.
- Duration over which the risk can be tolerated before mitigating actions need to be stepped up.

5. Funding Volatility Factors and Management/Mitigation of Risks

The funding policy should document the structure and the characteristics of the plan's liabilities and how the different risk factors identified in item 3 above would lead to funded status volatility. The policy should articulate the tools that the plan administrator would deploy to assess the impact of these risk factors. This includes any scenario and stress testing practices, in addition to regular actuarial valuations. Other information which should be included in the funding policy:

- Frequency of valuations and statutory filings.

- Frequency of the stress testing and projection valuations, the timeline for projections and the specific risks that are being evaluated.

- Whether deterministic[2] projection and/or stochastic[3] projections are to be used.

It should be noted that both deterministic and stochastic projections provide valuable insights to plan administrators. Stochastic projections can help stakeholders in the following ways:

- Identify the likelihood of the plan being able to meet its funding objectives.

- Understand the effectiveness of various mechanisms designed to make the plan more resilient to emerging experience and assess the residual risk borne by various stakeholders.

- Understand how risks and rewards are allocated among different generations of plan members over time.

Stochastic projections can assist plan sponsors to set long term policies. On the other hand, deterministic projections could conceivably be easier to understand to most stakeholders and are conducive to short term decision making within the longer-term framework set with stochastic lenses.

The funding policy should also articulate what risk mitigation plans or tools are available to the plan sponsors. The trigger or application of these plans/tools should be commensurate with the plan sponsor's risks expressed under item 4 above. These could include but are not limited to changes in or deployment of:

- Investment strategies.

- Contribution strategies.

[2] In a deterministic projection, one predetermined set of assumptions is used to project the actuarial liabilities and assets to provide a single answer.

[3] In a stochastic projection, a number of random variables are used to forecast the actuarial liabilities and assets which result a range of possible answers. The results are displayed as confidence intervals. It generally entails running a series of random trials.

- Benefit strategies (e.g. changes, either permanently or temporary of benefits – accrued or future, and any accompanying restoration strategies).
- Actuarial techniques such as building of or releasing of any buffers.

It is not the intent to have the funding policy be prescriptive of these future risk mitigation plans; however, awareness and understanding of the availability of any of these tools and the extent to which the tools can be deployed based on the plan specific situation and risk appetite is an important risk management best practice.

6. Funding Target Ranges

Subject to regulatory minimum funding requirements, the funding policy should describe any funding targets, contribution target levels, benefit level targets and any established cost / funding sharing arrangements

Funding targets can be expressed in relation to liabilities for a going concern, solvency, wind-up, or some other measure, depending on the plan's funding objectives. In pension jurisdictions where full or partial solvency funding is required, minimum funding requirements may vary significantly from one valuation to another.

The funding policy can also describe any mechanisms that would allow flexibility in funding and accommodate potential short-term operational requirements.

7. Cost / Funding Sharing Mechanisms

If relevant, the funding policy could include considerations for cost sharing mechanisms between plan beneficiaries and the employer. This could include establishing total target contribution levels and determining the extent to which costs will be shared or benefits adjusted between both parties. This could also include establishing how past or future benefits could be adjusted.

8. Utilization of Funding Excess

While utilization of funding excess is subject to the terms of applicable plan documents and legislative requirements, the funding policy should describe the requirements for using funding excess for an ongoing plan, and if appropriate, could cover its use in the event of a plan termination.

If funding excess can be used for contribution holidays or benefit improvements, the policy should establish the factors that may be considered in deciding how and when to use the funding excess. This includes any desired margins to keep in the plan before using the funding excess while complying with the limits in the Income Tax Act and Regulations.

9. Actuarial Methods, Assumptions and Reporting

The plan funding policy can provide useful guidance to the plan actuary in selecting actuarial methods and assumptions that are appropriate for the risk management approach of the pension plan. This guidance can include the going concern actuarial cost method, desired margins or provision for adverse deviations, acceptable asset valuation methods and ranges of plausible adverse scenarios. The plan administrator would provide information on data, investments, historical experience, etc. to assist the actuary in developing these assumptions and methods. This combined input would normally be reflected in the actuary's selection of methods and assumptions provided they do not lead to assumptions that deviate from generally accepted actuarial practice.

The actuarial report would normally outline the range of contributions that are permitted. This includes the minimum contributions that are required under applicable pension standards legislation and the maximum contributions that are permitted under the *Income Tax Act and Regulations*.

The funding policy assists the plan sponsor or administrator in deciding the level of contributions to be made to the plan.

10. Frequency of Valuations and Filing of Actuarial Reports

The funding policy should establish standards for how often an actuarial report is prepared and filed (including triggers for more frequent filing), subject to any legislative requirements. These are useful for internal monitoring purposes, for attaining the plan sponsor's funding objectives and for the production of actuarial reports that are filed with regulators.

11. Monitoring

Management and implementation issues around the establishment and ongoing maintenance of the funding policy should be documented, including the circumstances or events that should trigger a review or amendment of the policy. This includes documenting the roles, responsibilities and oversight of the funding policy, as well as the frequency of review.

12. Communication Policy

Sharing funding information with stakeholders is strongly encouraged. The funding policy should consider what, to whom and when information would be available. A summary of the plan's funding policy that is accessible to plan beneficiaries can help them understand a number of factors affecting their pension plans. These can include factors that affect the security of beneficiaries' benefits and the variability of funding costs, as well as the risks that are faced by both their pension plan and others.

In addition, the communication policy can help plan beneficiaries appreciate the funding decisions that are made by their plan sponsor or plan administrator. In communicating information on the funding policy to plan beneficiaries, it is understood that the plan sponsor will not communicate information that is counter to its commercial interests.

Special Considerations for Target Pension Arrangements

Some of the elements listed in the previous section do not apply to Target Pension Arrangements (TPAs), which include MEPPs and other arrangements Additional special considerations apply to TPAs only.

For TPAs, benefit levels rather than contribution levels, will typically need to be adjusted to reflect the funding level of the plan. Volatility in the plan's financial position can translate into fluctuating benefit levels. As a result, stronger ties must be established between the funding policy and the benefit policy and how these are communicated to plan beneficiaries.

For TPAs there may be situations where responsibilities are shared between different plan stakeholders, and the funding policy might be covered by more than one document. The funding policy should clearly define the roles the plan sponsor and plan administrator have in its establishment and implementation.

In the case of a MEPP, the plan administrator would typically be responsible for the adoption of the funding policy. In the discussion of other elements of the funding policy for a MEPP any role that is assumed by the plan sponsor would be assumed by the plan administrator. However, the development of the funding policy for a MEPP would recognize that the administrator does not control the level of contributions made to the plan.

1. Funding Objectives:

Given the fixed contributions and ability to adjust benefits to reflect the funding level, the funding objective of the TPAs can often be translated to either providing benefit stability or the highest level of benefit. In this regard, the funding policy should describe the approach followed in setting benefit levels, the associated risks and risk management protocols relating to the use of fixed contributions.

2. Risk Management:

a) Target Benefit Management:

The funding policy should describe how often the plan's financial position should be assessed, how the financial position affects benefit levels and when and in what manner benefit levels may be adjusted. The issues of how to apply an even-handed treatment of various beneficiaries, both the current and future generations, in different circumstances and the policy on benefit reductions or restructuring (when applicable), should also be discussed. Also, the issues related to utilization of excess assets which can be used to restore previously reduced benefits or provide additional benefits should be discussed.

It is recognized that decisions on benefit levels would take into account the circumstances of the plan at the time the decision is made; however, the funding policy can establish the long-term policies of the administrator on these matters.

b) *Actuarial Methods and Assumptions:*

Depending on the objectives of the funding policy, the margin for adverse deviation could be used to improve the likelihood of benefit stability. A smaller margin (or no margin at all) could also be used which may result in frequent benefit adjustment. Articulating the desired outcome in the funding policy will help the actuary set the appropriate actuarial assumptions with the appropriate level of margin to achieve the desired goal.

In addition, using actuarial methods which produce more stable contributions pattern could be another way of achieving stability, hence reducing the risk of benefit adjustments.

c) *Stress Testing and Projections:*

During the plan design phase, assessments are required to establish the appropriate target benefit given the level of contributions and to assess the funding impact of the investment risk which the stakeholders are willing to take. On an ongoing basis, assessments are required to determine whether the target benefit can be maintained or whether benefits will need to be adjusted, subject to legislative requirements. These assessments require stress testing and projection valuations under different scenarios. While a deterministic valuation could conceivably be used, a stochastic valuation may provide more valuable insight, particularly during the design phase. Specifically, a stochastic valuation can help stakeholders:

- Identify the likelihood of the plan being able to meet its targets.
- Understand the effectiveness of various mechanisms designed to make the plan more resilient to emerging experience and assess the residual risk borne by individual members.
- Understand the sources of the plan's resilience in terms of how risks and rewards are allocated among different generations of plan members over time.

The funding policy should articulate the stress testing and projections to be performed, including their frequency and how these should be modeled.

Plan stakeholders must think ahead and come to an agreement respecting the costs they believe to be acceptable, the risks they agree to take, and the degree of intergenerational risk sharing they determine to be fair. The risk profile reflects the desires of the stakeholders and should be appropriately communicated to members.

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