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April 2000

MEMORANDUM

To: **Administrators of Federally Regulated Pension Plans**
Pension Industry Representatives

From: **Ronald Bergeron**
Senior Director
Supervision

Subject: **PPPD Investment Policy Guideline**

This guideline presents OSFI's current views on investment management applicable to all pension plans subject to the *PBSA*. It is meant to serve as a guide to promote prudent and sound investment practices and to assist plan administrators in developing an investment policy suitable to their pension plan.

The guideline outlines factors that OSFI expects the administrator of a federally regulated pension plan to consider in establishing a written statement of investment policies and procedures for the pension fund and ensuring that it is effectively implemented and monitored. It should be adapted by each plan administrator to reflect the obligations of the plan, the objectives of the pension fund, and all other factors that may affect the ongoing funding and the solvency of the plan and also the ability of the plan to meet its financial obligations. The administrator should be prepared to explain any deviation from the guideline.

OSFI continues a targeted, proactive inspection of pension plans and retains the authority to direct compliance with the minimum standards of the *PBSA* and *Regulations*. This guideline supports those minimum standards, and also guides OSFI's assessment of risk regarding pension plan investment practices.

Queries with respect to this guideline should be directed to Glenn McAllister, Senior Supervisor, Operations and Policy, Private Pension Plans Division, Office of the Superintendent of Financial Institutions, 255 Albert Street, Ottawa, K1A 0H2, telephone: (613) 990-7865, fax: (613) 990-7394, or e-mail: penben@osfi-bsif.gc.ca.

This document is also available, in both official languages, at OSFI's website at www.osfi-bsif.gc.ca or by phoning (613) 990-7655.

Attach.

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Guideline for the Development of Investment Policies and Procedures for Federally Regulated Pension Plans

April 2000

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1. Intent and Scope of this Guideline

The *Pension Benefits Standards Act, 1985 (PBSA*) and the *Pension Benefits Standards Regulations* (*PBSR*) require that the administrator of a federally regulated pension plan establish a written Statement of Investment Policies and Procedures (SIP&P). This SIP&P must be based on the "prudent person portfolio approach" that a reasonable and prudent person would apply to the investment portfolio of a pension fund. A good SIP&P helps administrators optimize the members' benefits under defined contribution plan provisions and meet the promised benefits under defined benefit plan provisions.

This guideline outlines factors that the Office of the Superintendent of Financial Institutions (OSFI) expects the plan administrator to consider in establishing, implementing and monitoring a SIP&P for the pension fund. It is meant to serve as a guide to assist plan administrators develop investment policies and procedures suitable to their pension plan, without limiting the care plan administrators take in their duties.

This guideline should be adapted by each plan administrator to reflect the obligations of the plan (including regulatory requirements), the objectives of the pension fund, and all other factors that may affect the ongoing funding and the solvency of the plan and also the ability of the plan to meet its financial obligations. The administrator should be prepared to explain any deviation from the guideline.

Appendix I sets out the issues that need to be considered in establishing an investment policy.

Appendix II provides a table summarizing the investment and lending limits prescribed in Schedule III of the *PBSR*.

Appendix III lists other OSFI guidelines and best practices papers that are relevant to investment policy making.

This guideline is based on the following legislative references describing the responsibilities of administrators of pension plans that are subject to the *PBSA*: section 7.4 and subsections 8(3), 8(4) and 8(4.1) of the *PBSA* and sections 6, 7 and 7.1 and Schedule III of the *PBSR*.

2. Statement of Investment Policies and Procedures (SIP&P)

Note: Some of the items and procedures described here may be included in investment manager mandates or other documents dealing with the investment process rather than in the investment policy itself.

2.1 Investment Policies

An investment policy:

- communicates the investment philosophy of the plan administrator to the pension fund managers;
- describes the objectives for the investment and lending programs and the overall risk philosophy for the pension plan;
- documents how investment managers will be chosen, compensated and replaced in a manner that encourages compliance to the policy's goals and procedures;
- communicates the investment strategy to those who evaluate the financial condition of the plan and to those who recommend contributions to the fund; these groups may include the plan actuary, a pension council and OSFI, as well as members of the plan and other beneficiaries who wish to assess the amount and security of their stake in the fund;
- identifies the role of those involved in the investment process and what is expected of them.

As prescribed by section 7.1 of the *PBSR*, the SIP&P must specifically address the following elements:

- 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 addressing these elements, the plan administrator should determine the degree of risk and risk tolerance the plan is able to sustain. Factors such as volatility of contribution and surplus levels should be considered on both a going-concern basis and a solvency basis. The plan administrator should take into consideration the obligation structure of the pension plan, the anticipated demand for funds and the maturity profiles required from the investment portfolio in light of these demands. Therefore, the plan administrator should have a good understanding of the plan’s obligations, the purposes and risks of the investments and the appropriate mix of assets to meet the plan’s obligations.

An investment policy based on the "prudent person portfolio approach" recognizes that risks that would be unsupportable for an individual investment may be suitable for a well diversified portfolio. Such an approach requires plan administrators to regard the whole portfolio of assets in conjunction with the purpose and circumstances of the pension plan.

In addressing these elements in an investment policy, the administrator should establish limits on the plan's exposure to credit risk (a single entity or group of associated entities), and to market risks (interest rate, currency and price). In setting these limits, the plan administrator should consider the plan's exposure under a variety of potential scenarios. The plan administrator should ensure that the pension plan follows a sound investment policy. It should implement a process for ensuring the portfolio structure is consistent with the investment policies and constraints that have been established. As the investment environment and plan obligations evolve, the investment policy should be revised regularly to ensure that it continues to meet the objectives of the plan. Section 7.2 of the *PBSR* requires that the plan administrator review the SIP&P at least annually.

2.2 Procedures

The procedures should:

- identify responsibilities and accountabilities;
- set out the process for recommending, approving, and implementing decisions;
- determine the frequency and format of reporting and of performance measures.

Pension plans should have written procedures outlining how the investment and lending policies will be implemented and monitored. While recognizing that, in certain circumstances, the segregation of duties may not be practical nor cost effective to implement, the procedures should segregate the duties among individuals responsible for making investment decisions, maintaining custody of securities, disbursing and receiving funds, keeping records, confirming positions and reconciliations. The plan administrator should ensure that the SIP&P is implemented by persons, either on staff or under contract, who have the appropriate level of expertise.

In addition, written procedures should describe the method for classifying loans and investments and the basis for valuing loans and investments that are not regularly traded. Written procedures should describe custodial arrangements of these assets. In developing procedures, reference should be made to the *PBSR*.

Procedures should cover monitoring and controlling of the plan's exposure to fluctuations in interest rates, foreign exchange rates, and market prices.

Potential sources of conflict of interest should be identified and procedures should be in place to ensure that those involved with implementing the investment and lending policies understand where such situations could arise and how they should be addressed.

3. SIP&P Approval

The SIP&P is the responsibility of the plan administrator. The plan administrator is not required to have the SIP&P approved by the actuary or OSFI. However, the plan administrator must submit the SIP&P to the actuary and the pension council, if such exists, in accordance with subsection 7.1 (3) of the *PBSR*.

4. Providing Information to OSFI

Plan administrators are not required to file the SIP&P with OSFI on a regular basis; however, the plan's SIP&P must be available for OSFI's review on request.

The plan administrator should maintain information on the plan's investment portfolio presented in a manner that facilitates analysis, such as:

- a comparison of current pension assets against the limits established in the investment policy;
- an analysis of asset quality and concentration;
- an analysis of interest rate and maturity mismatch, including the results of scenario testing as appropriate;
- an analysis of the diversification of income sources.

These issues are discussed elsewhere in the guideline, particularly sections I.4 (Understanding Risks), I.5 (Measuring Risk) and I.6.3 (Asset Mix and Rate of Return Expectations). Maintaining information in this way eases the work of investment managers, actuaries, or any other party who has the right or duty to apprise itself of the plan's investments.

Where information required to perform this analysis is not available through the filing of statutory returns, OSFI may request supplemental information that expands on the areas of greatest risk.

5. Providing Information to Members

The plan administrator should consider disclosure of the investment policy, investment manager mandates and performance information to plan members.

END

Appendix I

Investment Policies And Procedures Guideline

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I.1 Legislative References

This guideline is based on the following legislative references describing the investment responsibilities of administrators of pension plans that are subject to the *Pension Benefits Standards Act, 1985* (*PBSA*): section 7.4 and subsections 8(3), 8(4) and 8(4.1) of the *PBSA* and sections 6, 7 and 7.1 and Schedule III of the *Pension Benefits Standards Regulations* (*PBSR*).

Section 7.4 of the *PBSA* states that the plan administrator must administer the pension fund in accordance with the *PBSA* and the *PBSR*.

Subsections 8(3) and 8(4) of the *PBSA* require that the plan administrator act as a trustee for plan stakeholders (employers, members and beneficiaries) and exercises the degree of care that a person of ordinary prudence would exercise in dealing with the property of another person, that is the "standard of care approach."

Subsection 8(4.1) of the *PBSA* requires that the plan administrator invest the assets of a pension fund in accordance with the *PBSR* and in a way that a reasonable and prudent person would apply to the investment portfolio of a pension fund, that is the "prudent person portfolio approach."

Sections 6 and 7 of the *PBSR* require that the plan assets be invested in accordance with Schedule III of the *PBSR* and held in trust, or with a custodian or in the name of the Canadian Depository or a nominee thereof, for the benefit of the plan.

Schedule III of the *PBSR* sets out the prescribed investment and lending limits applicable to a pension fund, a summary of which is included in Appendix II.

Section 7.1 of the *PBSR* requires that the plan administrator establish a written Statement of Investment Policies and Procedures (SIP&P) and outline the elements that it must include.

I.2 Writing a SIP&P

The plan administrator is responsible for the SIP&P and should ensure that it adequately covers essential aspects of investment. In the case of an already established pension plan, investments in place must be considered, in order to establish whether they are in compliance with the SIP&P being prepared.

In preparing a SIP&P, the administrator of any pension plan should consider:

- the current investments in place;
- the rate of future contributions;
- the amount and structure of current and accruing liabilities;
- how these liabilities and the various investments being contemplated would respond to plausible economic events, that is the "what if" scenarios;

- the financial situation of the plan;
- the tolerance for risk;
- the maturity of the pension plan;
- the estimated cash flow requirements;
- the financial risks the plan sponsor may face with regard to funding the pension plan.

This will require technical information and perhaps expert advice. The person assigned the task of drafting the SIP&P should have wide expertise. A defined benefit plan's actuary has a good appreciation of the current and developing liabilities, but may not have as deep an understanding of the plan's investments. An investment manager may have great expertise in only a limited class of assets. Further, the investment manager may focus on the return and volatility of invested assets without considering the obligations that the fund must secure. The plan administrator should ensure that those contributing to the financial management of the pension plan have ample opportunity to comment on the SIP&P.

The plan administrator should ensure that the advice it follows is free of conflicts of interest. The plan administrator should keep in mind that an investment manager who writes the SIP&P for a plan does not have an incentive to constrain the investment manager's actions or set up effective performance appraisals. Likewise, someone recommending the purchase of financial products may overlook the need to disclose commissions to offset fees for service, thereby distorting the true pricing of products.

The SIP&P should document how the plan administrator will monitor, reward or replace investment managers and others serving the fund for performance results and compliance with the SIP&P.

I.3 Understanding the Plan's Obligations and Objectives

I.3.1 Defined Benefit Provisions

Membership and Benefits

To apply the *PBSA*'s standard of care for investment, the administrator of a plan must first understand the obligations of the plan.

The administrator of a plan with defined benefit provisions should consider factors such as:

- Whether pensions in payment are increased to keep pace with the cost of living. The increases may be promised explicitly in the plan text (indexation), or there may be an understanding among various parties that increases will be granted from time to time.
- Whether the pension formula adjusts to increases in salaries over time, or whether the plan administrator intends to grant increases to keep the formula current.

- How the obligations are distributed among the categories of members and former members. Within these categories, how obligations are distributed by age and time to retirement.

- Whether changes in employment levels or conditions are likely to change patterns of retirement.

- Whether there are important ancillary benefits contingent on full or partial termination.

- Whether any plan changes are anticipated (e.g., conversions, etc.).

Solvency Ratios

A pension plan with a solvency ratio near or below one demands very careful management of risk because the fund assets may be inadequate to secure promised benefits should the employer's contributions cease. To control risk, some plan administrators attempt to immunize the plan against changes in nominal interest rates. However, if the plan is not winding up, the plan's obligations may be affected by other factors, such as inflation, salary increases, continued accruals, and changing eligibility for early retirement, that cannot be addressed by an immunization strategy.

Plan administrators should be wary of increasing risk to earn their way out of a solvency problem, for example through acquiring high yield but illiquid or lower quality assets.

Plan Maturity

In a mature pension plan, the liability for accrued benefits is significantly larger than the cost of a one-year benefit accrual. If the liabilities exceed assets, the requirements for additional special payments prescribed to fund the deficiency will tend to overshadow the plan's normal annual cost. This presents a particular problem for negotiated contribution defined benefit plans where contributions often cannot be increased to meet the minimum standards for funding a deficiency. Furthermore, the perception that the accruing benefits are not commensurate with the contributions being made may encourage participating employers to leave the plan. Therefore, plan administrators of mature plans must be sensitive to a deteriorating financial position of the plan.

Where liabilities to pensioners are fixed and liabilities to older plan members less subject to change from salary inflation, plans may protect themselves against fluctuations in interest rates through purchase of annuities and cash flow or duration asset/liability matching. While the purchase of annuities permanently safeguards pensioners against changes in interest rates, plan administrators must be careful to ensure that the insurer is financially sound and the implicit rate of return is reasonable on a long term basis as the plan remains responsible for these liabilities.

I.3.2 Defined Contribution Provisions

In a plan with defined contribution ("money purchase") provisions, the pension plan may appear to discharge its investment obligations simply by paying out contributions accumulated in members' accounts along with investment returns, even though these may be low. However, the plan administrator of this type of plan provision should consider include:

- Needs and reasonable expectations of members who, for example, may focus more attention on the cash value of their accounts than on the pension income they can purchase.

- Mix of members. Younger members look for growth of their accounts while older members are more concerned with protecting their capital.

- Members' risk tolerance. Younger members may be more tolerant to risk than older members because they have more time to adjust financial strategies and recoup losses.

- Variation of risk tolerance and expectations among plan members of the same age. A strategy based on "average member" needs may be unsatisfactory for many individuals.

- Ability of plan members to choose investment options. Plan members may be given several investment options with differing risk and return expectations.

The ability of members to make an informed decision depends on their sophistication and on the range of options. Plan administrators should consider providing ongoing information and training to plan members and establishing limits on the risks plan members take. The plan administrator should understand that the responsibility for duty of care in investments is not automatically transferred to plan members in a money purchase plan.

Administrators of defined contribution plans should also address the following:

- The asset classes and investment styles (active vs. passive, growth vs. income, etc.) offered.

- The investment managers selected.

- The determination of standards of performance for investment managers.
- The monitoring of investment manager performance and the actions taken in response to unsatisfactory performance.

- The education of members and beneficiaries about plan provisions, retirement planning, and investment methods.

- The communication of information about investment options, investment performance, fees charged to member accounts and administrative support available to members.

- The monitoring of the following:

    - “Default” accounts for participants who have not indicated in investment option.

    - The participation rate (in plans where participation is optional) and the investment options selected by members. The purpose of such monitoring is to determine whether changes may be required in communication and education programs.

I.4 Understanding Risks

Assets are subject to many investment risks and, if not properly managed, this could lead to the erosion of the value of the pension fund.

Some of the key risks inherent in investments are:

Credit risk:	the risk that a counterparty will not pay an amount due as called for in the original agreement, and may eventually default on an obligation.
Mismatch risk:	the risk that a solvency deficiency will develop because an increase or decrease in the market value of the plan assets are not matched by a corresponding increase or decrease in the liabilities.
Currency risk:	the risk that the market value of a financial instrument will fluctuate due to changes in exchange rates.
Price risk:	the risk that the market value of an investment or of a financial instrument based on investments will fluctuate.
Interest rate risk:	the risk that the market value of a security will fluctuate due to changes in market interest rates.

Other risks include inflation risk, timing risk and political risk in emerging markets.

Credit risk is addressed in sections I.6.1 (Categories of Investments and Loans) and I.6.5 (Lending of Cash and Securities). However, plan administrators should consider the credit risk in any transaction that commits pension assets to, other than a benefit or an expense. Mismatch risk is addressed in section I.6.3 (Asset Mix and Rate of Return Expectations).

Like many other risks, credit risk can be controlled through diversification. It is also reduced through careful underwriting, holding collateral, and obtaining guarantees from third parties. SIP&P should identify credit risk where it is material and describe how it will be managed. If exposure to credit risk is long term, then the SIP&P should provide for regular credit review.

In addition, the cash flow needed to meet plan obligations puts pressure on the administrator to optimize the value of the assets, when they need to be realized. Matching of assets and obligations is therefore instrumental in maintaining the viability of the pension fund. However, matching may produce lower yields. The administrator must understand the financial risks and costs of either fully matching and/or not matching. For example, a mature plan with a closed membership and 90 per cent of the plan's liabilities attributable to retired members would not necessarily have 90 per cent of the funds assets invested in fixed income investments given the anticipated reduction in return which would result. Similarly, a start-up plan with no retired liabilities is unlikely to be fully invested in equities given the risks involved.

These risks are amplified in a volatile interest rate environment and evolving investment market. The plan administrator may use dynamic scenario testing to assess the pension fund's ability to withstand such volatile market conditions.

I.5 Measuring Risk

Measures of risk include the volatility of both the solvency ratio and required contributions. In addition to quantifying the level of benefit security, the solvency ratio is a measure of the "mismatch risk" described in section I.4, in that a plan in a surplus position can afford a greater degree of mismatch than one that is underfunded.

Investment literature focuses on a trade-off between risk and expected return, where risk is a measure of the volatility of return. A portfolio of assets whose value varies little from year to year is seen to have little risk. However, a defined benefit pension fund is established to secure liabilities that are sensitive to interest rates and other economic and demographic factors. A portfolio that is insensitive to these factors and gives a steady annual return will do a poor job of securing obligations to members and pensioners when a drop in interest rates drives up the cost of providing promised pensions. The deficits that can result may trigger the termination of the plan with a solvency deficiency unless the employer is willing and able to make special payments.

These risks apply to money purchase plans as well; however, the investment risks are borne almost entirely by plan members. Although solvency ratios do not apply to these plans, individual members can be subject to the "mismatch risk" described above; particularly members approaching retirement who plan to purchase an annuity with their account balance.

I.6 Prescribed Elements of a SIP&P

I.6.1 Categories of Investments and Loans

Within certain limits needed to protect the plan from arbitrary action in the decision-making investment process, the range of authorized investments and loans should:

- facilitate the building of an investment portfolio that can serve the needs of the plan efficiently;
- take into consideration potential changes in circumstances in the short term future;
- avoid the concentration in any one investment market.

A description of an authorized investment category should at least address:

- the quality of assets to be included in the category;
- the impact on the investment resulting from changes in equity markets, interest rates and inflation;
- the priority in claims to assets upon liquidation;
- cash flow characteristics.

Administrators should consider what should be done with an asset in the event it becomes downgraded to a quality below that stated in the investment policy.

The SIP&P should relate the use of derivatives to the objectives of the fund and the obligations of the pension plan. If the use of derivatives is authorized, the SIP&P should:

- list the acceptable derivatives instruments;
- state the proportion of asset portfolio that may be so allocated;
- indicate the purpose (hedging, index replication, etc.) for which they are to be used;
- identify which managers are authorized to use derivatives, and set trading limits;
- indicate where the products are to be obtained;
- describe how over-the-counter products are to be managed.

Plan administrators should understand how the use and risks of derivatives will be measured for their plan and document this understanding in their policies. Plan administrators should refer to OSFI's D*erivatives Best Practices Guideline for Federally Regulated Pension Plans* for further discussion on this topic.

I.6.2 Diversification of Investment Portfolio

A principle of portfolio theory is that investment risks can be reduced through diversification by asset types, industries and geographic regions. Diversification, however, has costs, including the effort of choosing investments, transaction fees, custody costs, costs of financial reporting, and potentially lower returns. Any increase in these costs can be justified by the reduction in risk.

The degree of diversification appropriate to a plan will depend on its size, the willingness of stakeholders to assume risk, and the investments' inherent risks. For most plans, prudence calls for greater diversity than what is prescribed by the requirements of sections 9 and 10 of Schedule III of the *PBSR*. For example, there is a five per cent parcel limit for real estate investments which addresses the risk of undue dependence on the fortunes of one asset. However, two similar properties on the same city block that are held by different owners normally rise and fall together in value. Therefore, the SIP&P need to address concentration in real estate by geographic sector and by type – residential, commercial or industrial.

On the other hand, the legislation does not require a pension plan to diversify its holdings of securities when a federal or provincial government issues or guarantees them (as recognized by sections 9(2), 9(3)(d) and 9(3)(e) of Schedule III). However, while credit risk is reduced, administrators must consider other risks (e.g., interest rate, liquidity, etc.) and whether the cash flow characteristics and return of these investments best suit the plan.

The benefits of diversification may be achieved at low cost by investing in an investment vehicle established to hold a diverse portfolio (e.g., a pooled fund). Plan administrators should be familiar with the investment policies of these vehicles since their policies effectively become sub-policies of the plan. They should also ensure that the vehicles are well managed and meet the requirements of Schedule III.

I.6.3 Asset Mix and Rate of Return Expectations

A SIP&P should specify:

- the expected rate of return of the portfolio;
- the expected volatility of that rate;
- the types of return expectations;
- over what time frame they are expected to be achieved;
- how they are going to be used to monitor the investment manager’s performance.

Examples of rate return expectations are:

- a real rate of return of x per cent over a period of years;
- a nominal rate of return;
- a rate of return over some benchmark portfolio.

Difference types of return expectations are used for difference purposes. Some are used to monitor the investment manager's performance; others are used to establish expectations for the fund based on the portfolio of investments chosen. The administrator should consider what actions are required, if any, if expectations are not met (for example, if the investment manager's performance falls below a certain level over a specified period of time).

A SIP&P should identify both the categories of authorized investments and the acceptable proportions for each category. This may be expressed as a range of possibilities, in recognition that changing economic conditions or views of the market may require a change in asset allocation.

The range of possible allocation should be sufficiently narrow so that:

- the intentions of the plan administrator are clear;
- the activities of investment managers can be controlled;
- third parties can assess the security of benefits.

The SIP&P should also specify an "asset allocation target" or "normal position."

The plan administrator should be satisfied that extreme allocations permitted under the SIP&P make sense under the economic conditions expected for the coming year and for the plan obligations currently in effect. The SIP&P should be reviewed at least annually and revised as necessary to reflect radical and long term changes in economic conditions or in the obligations of the plan.

Matching the cash flow characteristics or duration of assets and liabilities (asset/liability management) is an important tool for building and maintaining a portfolio suitable to the needs of the plan. However, this may produce lower yields and, therefore, higher costs in providing pension benefits under defined benefit provisions. Still, even in the absence of an asset/liability management strategy, knowing the degree of mismatch will help the plan administrator appreciate the risks to which the plan is exposed.

I.6.4 Liquidity of Investments

Pension plans make payments as specified by plan provisions and pension law. Their timing also depends on decisions by plan members or other beneficiaries. The investment policy should anticipate the plan's needs for cash in the coming year and address how these needs will be provided for so that:

- assets are not liquidated unexpectedly and potentially at unfavourable prices;
- the portfolio does not contain excessive amounts of cash or low yielding liquid assets.

I.6.5 Lending of Cash and Securities

An investment policy should address the lending of cash and securities, specifically:

- the circumstances in which this activity will be carried out;
- who is authorized to commit the plan to lending;
- maximum exposure in aggregate and by counterparty;
- required collateral;
- margin requirements.

The policy may vary by what is lent and the term of the loan. As with investment in securities, exposure to counterparty risk can be reduced by diversifying. Pension plans that engage in securities lending should follow OSFI's *Guideline on Securities Lending by Pension Plans*.

I.6.6 Retention or Delegation of Voting Rights Attached to Investments

Plan administrators should not ignore the value of voting rights acquired through plan investments. Shareholder votes are often most valuable when used in alliance with others. Failure to describe in the investment policy how these rights will be used leaves plan administrators open to charges of either negligence or arbitrary action, possibly in violation of the standard of care requirement. Investment policies should describe and require the use of voting rights, whether directly or through proxy.

If the power to vote proxies is delegated to investment managers, proxies should be bound by rules established in the investment policy. The administrator should receive a report showing how proxies were voted, and affirming compliance with the administrator’s proxy voting policy.

I.6.7 Valuation of Investments Not Regularly Traded at a Public Exchange

Investments must be valued for many purposes, including:

- to evaluate the performance of managers;
- to determine the security of benefits;
- to meet regulatory requirements;
- to determine a suitable rate of contributions to fund accrued and accruing benefits.

Investment policies of pension plans holding assets not regularly traded at public exchanges should state the basis for valuing these assets and the frequency of valuation. The basis for valuation will be established by generally accepted accounting principles or by law. Where market value is used, information can be obtained from public exchanges. The plan administrator should work with the professional to ensure that all necessary information is available.

I.6.8 Related Party Transactions

The *PBSR* generally prohibits related party transactions. However, the *PBSR* exempts related party transactions where they are not material to the pension plan. The investment policy should set a reasonable standard for materiality for these transactions. In addition to a limit per transaction, the investment policy should set a cumulative limit for repeated items.

The *PBSR* also exempts any related party transactions necessary for the operation of the pension plan and purchased at terms and conditions at least as favourable for the pension plan as otherwise available. This exemption permits the plan sponsor to provide services to their pension plans and to charge reasonable fees, when permitted by the plan text. Record-keeping, accommodation, administration and brokerage services are services where the close relationship between related parties could prove mutually beneficial and where it can be confirmed that the pension plan was getting reasonable or even favourable terms and conditions.

I.7 Duty of Plan Administrator to Identify and Manage Other Risks and Issues

To arrive at a prudent portfolio, the plan administrator should address the following risks and factors in addition to those specified in the *PBSR*..

I.7.1 Pledging and Borrowing of Assets

Administrators of plans that pledge or borrow assets should examine the risks of these activities and ensure these are addressed in the investment policy. Further, the plan administrator should ensure that any pledging or borrowing is permitted by the trust agreement.

Pledging assets is necessary for some activities that serve a pension plan well, such as engaging in futures contracts.

Borrowing may result in a pattern of cash flow more suitable to the needs of the plan and reduce its vulnerability to changes in interest rates; for example, it may allow a plan to meet its cash flow needs without loss from the hasty sale of assets.

I.7.2 Foreign Exposure

Foreign investment provides an opportunity for plan administrators to diversify plan assets thereby improving the plan's risk diversification and potential for increased returns. However, the levels of exposure to various foreign markets and how the plan achieves them will depend on many factors, perhaps the most important being the limit imposed by the *Income Tax Act*. Plan administrators using derivatives to extend foreign exposure should be aware that potential rulings from Revenue Canada could nullify the purpose of the derivatives and thereby put the fund at risk.

OSFI's main concern remains the suitability of investments to the objectives of the plan. Foreign investments may carry other risks:

- foreign regulatory and fiscal environments;
- availability and reliability of information about investments;
- more expensive transaction costs than in domestic markets;
- local political and market conditions;
- foreign currency fluctuations.

However, because currency variability may be greatly diminished or eliminated through foreign exchange futures, currency risk constitutes a risk that can be reduced to a manageable level, usually at a modest cost. Administrators considering the adoption of a currency hedging strategy should obtain the best advice on the subject and make and document a policy decision.

In this sense, foreign investments are just one more category of investments. However, because of vast differences in costs and availability of information, the investment policy should identify clearly how exposure to specific foreign investments should be managed.

I.7.3 Effects of Management Fees, Transaction Costs and Custodial Fees

The investment policy should specify the plan administrator's choice between active and passive management and the rationale for this choice. In deciding between active and passive management, administrators should examine performance over a suitable term and take into account all relevant costs. Returns may be unimpressive after considering their administrative costs. To assess performance, plan administrators may need to secure expert advice. They should ensure that the advisors are free of conflicts of interest.

I.7.4 Responsibilities and Compensation of Fund Managers and Professionals

Those involved in the investment process must have clearly defined roles and responsibilities. The investment policy should identify the tasks that need to be done and which officer or agent should perform them, together with appropriate authority for actions. Accountability both for action and inaction is important.

The assignment of responsibilities should include adequate checks and balances to protect the interests of the pension plan. Material transactions or shifts in allocation should be approved by the plan administrator or the party it has empowered to make these decisions, particularly if it involves underwriting or investment in illiquid assets. Where the custodian provides monitoring and reporting services to the administrator, the former should be provided with a copy of the investment policy and adequate supporting material so that they may question improper activities.

The assignment of responsibilities should protect the pension plan from conflicts of interest. In particular, the valuation of plan assets should be performed by people independent of the investment and lending function and should be sufficiently frequent to alert the plan administrator of significant losses or deviation from authorized activities.

All compensation should be consistent with investment policies and goals. Any system of rewards must not encourage deviation from the ethical behaviour or the mandate assigned to the investment manager.

I.7.5 Communication Between Administrator, Auditor, Actuary and Manager

Achievement of plan objectives requires communication and cooperation between all parties involved in setting and carrying out the investment policy. Copies must be sent to each portfolio manager and investment manager, as well as the plan actuary in the case of a defined benefit plan.

I.8 Monitoring and Reporting

At least annually, the SIP&P must be reviewed to ensure that it continues to meet the circumstances and objectives of the plan.

Procedures should be established to monitor investments and to assess the risk/return profile on a regular basis. There should be appropriate procedures for adjusting the portfolio where the administrator is not comfortable with the risk profile.

END

Appendix II

Investment Policies and Procedures Guideline

Prescribed Investment and Lending Limits for Pension Plans that Are Subject to the *PBSA*

Type of Assets 2	Limits/Restrictions	Exceptions	Reference [3]
Loans to or investments in: a) a single person; b) two or more associated persons; or c) two or more affiliated corporations	10 % of the total book value of the plan's assets.	Funds on deposit with a financial institution that are insured by CDIC, CompCorp, or similar provincial bodies; Segregated or mutual or pooled funds that meet the requirements of Schedule III; Unallocated general fund of a life insurance company operating in Canada; An investment corporation, real estate corporation, resource corporation; Securities of, or guaranteed by: the Government of Canada, a province or agency; Fund of MBSs guaranteed by the Government of Canada, a province or agency; Fund that replicates a widely recognized index.	Section 9
Real property and Canadian resource property: a) Parcel of real property; b)Total of Canadian resource properties c) Aggregate of all properties	a) 5% of book value of the plan's assets; b) 15% of book value of the plan's assets; c) 25% of book value of the plan's assets.		Section 10
Securities: To which are attached voting rights to elect directors of a corporation	30% of the corporation's securities issued with voting rights.	Real estate corporation; resource corporation and investment corporation.	Section 11
Related party: Loans to or securities of	Prohibited	Securities acquired at a public exchange. Investments not material to the pension plan.	Sections 16 and 17
Foreign investments	20% of book value of the plan's assets at date of purchase		*Income Tax Act*

1. This table serves as a quick reference. For a complete understanding of the permitted investments, refer to sections 6 and 7, and Schedule III of the *Pension Benefits Standards Regulations, 1985 (PBSR)*>

2. Exceptions: Investments made as a result of an arrangement within the meaning of subsection 192)1) of the *Canada Business Corporations Act*, for the reorganization or the liquidation of a corporation, and assets acquired through the realization of a security interest.

3. Reference is to Schedule III of the *PBSR*, except as indicated.

Appendix III

Investment Policies And Procedures Guideline

List of Other Investment Related Guidelines and Best Practices Papers Issued by OSFI

Guideline – Securities Lending – Pension Plans
(February 1992)

Guideline for Federally Regulated Pension Plans – Derivatives Best Practices
(May 12, 1997)

A copy of these guidelines may be obtained through the OSFI website at www.osfi-bsif.gc.ca or by calling (613) 990-7655.