Savings and the single employer

SEPPs could suffer under proposed CAPSA guidelines.

FIELD NOTES

BY DOUG ANDREWS

In January 2004, the Canadian Association of Pension Supervisory Authorities (CAPSA) issued the *Proposed Regulatory Principles for a Model Pension Law* (Model Law Principles). Plan sponsors, administrators and supervisory authorities who deal with multi-jurisdictional pension plans have called for greater uniformity of pension legislation and regulation; we therefore commend CAPSA for responding with the Model Law Principles.

One of the proposals is that, except in the case of simplified pension plans and small plans, the legal administrator should be a pension committee with at least two members designated by the plan membership. This proposal could have significant funding and investment implications for pension plans, particularly those sponsored by a single employer (SEPPs) that have not been established through collective bargaining.

The proposal is based on Quebec's Supplemental Pension Plans Act (Quebec act). CAPSA believes that the pension committee model achieves the dual objectives of protecting members' rights and benefits and increasing the transparency of pension plan administration. In many pension plans outside Quebec, the employer is both the sponsor and the administrator. As the CAPSA report observes, "When the employer wears both hats, confusion may result that can undermine the credibility of the plan in the minds of members."

POTENTIAL IMPACT ON FUNDING AND INVESTMENT POLICY

Currently, funding and investment policy decisions are responsibilities of a pension plan's administrator. If the administrator of a SEPP is a pension committee instead of the employer, what impact will this have on funding and investment decisions for defined benefit (DB) pension plans?

A growing body of literature suggests that many DB investment policies mismatch assets and liabilities and that pension promises are debts the plan owes to the members. As such, to reduce the potential for volatility in the funded position of the plan, the plan's liabilities should be matched at least approximately with fixed income-type assets. Yet, in most pension plans, only 35% to 50% of assets are allocated to fixed income.

As a fiduciary, a committee member must act in the best interests of the pension plan's members and beneficiaries. Consequently, they would wish to see funding and investment policies that provide maximum security for the promised benefits. Funding volatility is undesirable, particularly if there is a possibility of insolvent plan termination. This reasoning implies that committee members will prefer conservative funding and investment policies.

Before accepting this conclusion, we must consider the pension framework in greater detail. Multi-employer pension plans (MEPPs) are administered by a board of trustees, with member representatives. This approach embodies the concepts behind the pension committee proposal. Nevertheless, many of these plans have non-conservative funding policies, and equity and fixed income asset allocations that do not closely match the liabilities. Why have the members of these plans' administrative committees not adopted more conservative policies?

WHAT IS THE NATURE OF THE PENSION DEAL?

The answer is that the pension deal for the majority of MEPPs reflects the interests of all employers and employees alike, and recognizes that there is an expected trade-off between levels of security and levels of benefit.

In most of these plans, both contributions and benefits are predetermined by prior costings and collective bargaining. The main lever the trustees have to pull in their job of delivering the target benefit is the investment

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policy. They may prefer a more aggressive investment policy to the alternatives of reducing benefits or requesting contribution increases. Moreover, contributions and investment income must support the benefits of different generations of plan members (e.g., retirees on fixed pensions who desire inflation adjustments, members about to retire who desire benefit security, and active members who desire increased benefits to keep pace with rising wages, costs and inflation). These tensions in MEPPs tend to keep funding and investment policies from being overly conservative.

Similar considerations do not exist in SEPPs. In most such situations, the employer establishes the plan voluntarily and expects to retain control over its cost through funding and investment policies. Some employers are averse to conservative funding because of competing demands for cash flow or the risk that surplus buildup will revert to members. Most pension plans have a greater allocation to equities than to fixed income because of the widely held belief that equities will deliver higher returns, thereby resulting in lower overall pension costs.

THE QUEBEC EXPERIENCE

With the pension committee model, the concern is that committee members—acting as fiduciaries—will adopt conservative funding and investment policies, thereby increasing costs to the employer. Yet in Quebec, the requirement that a pension committee be the administrator of a SEPP has been in place for more than a decade, and there is no evidence to suggest that such plans follow more conservative policies. Why not?

Both the Quebec act and the Model Law Principles require that the plan members designate two members to the pension committee. However, neither the Quebec act nor the Model Law Principles limit the number of pension committee members or require the number of plan member representatives to equal the number of employer-appointed representatives. In Quebec, members appointed by the employer usually dominate the pension committee of a SEPP.

WHY IT MAY BE DIFFERENT IN THE FUTURE

There are at least two reasons why past practices may change. First, governance models are constantly changing: if there has been confusion regarding an employer filling the roles of both sponsor and administrator, the same confusion would remain in a plan administered by a pension committee dominated by employer-appointed members. This is especially true if such members allow employer cost considerations to influence their choice of funding and investment policies at the expense of member benefit security.

Second, the legal environment is changing in Quebec and across the country. In Quebec, there is a preliminary statement of claim in a pending class-action case, commonly referred to as Jeffrey Mines, which alleges, among other things, that pension committee members acted improperly in adopting and maintaining an investment policy which permitted a significant portion of the funds to be invested in equities during a time when equity investment produced unfavourable returns. With the potential for legal action, committee members will likely take their fiduciary responsibilities more seriously when determining funding and investment policies, even if the committee members have been appointed by the employer.

A SUGGESTED SOLUTION

Employers establish DB SEPPs voluntarily, and funding and investment policies are key means of controlling their costs. As noted above, it may not be in an employer's interest for a pension committee to control funding and investment policies under the SEPP. Such lack of control may form a disincentive for the employer to adopt or continue such a plan. Consequently, it would be advisable for CAPSA to consider placing funding and investment policy outside the jurisdiction of the pension committee in the final version of its Model Law Principles. ■