



GUIDELINE No. 7

PENSION PLAN FUNDING POLICY GUIDELINE

November 15, 2011

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CONTEXT FOR THE GUIDELINE

This guideline is intended to provide guidance on the development and adoption of funding policies for pension plans that provide defined benefits.

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 defined benefit pension plans is to ensure that sufficient assets will be accumulated to deliver the promised benefits on an ongoing basis; and to protect pension benefits in situations that involve employer insolvency or bankruptcy.

Due to the emphasis on solvency funding under minimum funding requirements and the fact that the performance of plan assets may not be matched with the change in plan liabilities, funding rules can result in large annual fluctuations in funding requirements.

Funding decisions have a significant impact on pension plan sponsors and beneficiaries. These decisions impact the pace of funding, the security of members' benefits, and the ongoing viability of the plan itself. Therefore, they should not be made on an ad hoc basis. Practical financing considerations, including capital market movements, and other 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 and the sponsor.

These factors could include:

- benefit security
- stability and/or affordability of contributions
- the financial position of the sponsor and competing organizational demands for cash
- the demographic characteristics of the plan's beneficiaries (any person with an entitlement under the plan)
- the minimum funding requirements under applicable pension legislation
- the financial position of the pension plan
- the terms of the plan documents and any related agreement, such as a collective bargaining agreement, between the plan sponsor and plan beneficiaries
- *Income Tax Act* maximum limits applicable to pension plans
- legislative and plan provisions with respect to utilization of funding excess

A funding policy should support the decision making process and be consistent with the purpose and goals of the pension plan.

Role of the Plan Sponsor

While not a requirement under any current pension legislation, 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, 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 by the plan sponsor, such as ensuring that the investment policy is consistent with the funding policy and the required contributions are made. The responsibilities for the implementation of the funding policy should be understood by both plan sponsor and plan administrator.

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 investment policy 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 sponsor's funding objectives and methods for achieving them.

It is important to ensure that the two documents are consistent with each other, and changes may be required to either the investment policy 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 investment policy.

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.

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

Elements of a Funding Policy

When plan sponsors document their funding objectives, 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 constitute what CAPSA believes is best practice for issues that should be considered in establishing a funding policy. Ideally, a written funding policy would address the following issues as they relate to the plan.

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 investment policy, it would be reasonable to avoid duplication and refer to the investment policy 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.

2. Funding Objectives

The funding policy should indicate how the funding objectives integrate with the plan's investment policy, as well as the plan sponsor or plan objectives. These objectives can be stated as they relate, for instance, to benefit security, stability of contributions, and to contribution or benefit levels. The policy could also document circumstances in which funding in excess of the legislated minimum would be considered.

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 the extent to which the plan's assets are mismatched against its liabilities and the demographic characteristics of the plan beneficiaries. Due consideration should be given to how these risks may affect the security of beneficiaries' benefits.

4. Funding Volatility Factors and Management of Risk

The funding policy should document the structure of the plan's liabilities as it affects funding risk. It should describe the plan's tolerance for volatility in funding requirements. The policy should also take into account the characteristics of the plan's liabilities and the link of the plan's liabilities to the performance of the plan assets. The policy could include any scenario testing practices that are used as a tool to evaluate the effect of different hypothetical situations on the plan's funding position and requirements. Details on scenario testing practices could include the frequency, the timeline for projections and the specific risks that are being evaluated.

5. Funding Target Ranges

The funding policy should describe any funding targets, contribution target levels and established cost sharing arrangements (if they are relevant to the plan's structure). 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. The funding policy can also describe any mechanisms that would allow flexibility in funding and accommodate potential short term operational requirements.

6. Cost 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 between both parties.

7. 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 plan sponsor's policy on using funding excess for an ongoing entity, and if appropriate, could cover its use in the event of 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 that the plan sponsor wishes to keep before using the funding excess.

8. Actuarial Methods, Assumptions and Reporting

The plan sponsor can provide useful guidance to the plan actuary in selecting actuarial methods and assumptions that are appropriate for the plan sponsor's risk management approach. This guidance can include the going concern actuarial cost method, desired margins or provision for adverse deviations and acceptable asset valuation methods and ranges. The plan administrator would provide information on data, investments, historical experience, etc. to assist the actuary in developing these assumptions. This combined input would

normally be reflected in the actuary's selection of methods and assumptions – in particular, the margins for adverse deviations – provided they do not lead to assumptions that deviate from accepted actuarial practice.

The actuary's 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 tax statutes. As a result, the plan sponsor would need to make additional decisions on funding that could be guided by the plan's funding policy.

9. Frequency of Valuations

The plan sponsor may establish standards for the frequency of valuations, subject to any legislative requirements. These are useful for internal monitoring purposes and for the production of reports that are filed with regulators.

10. 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.

11. Communication Policy

Sharing funding information is strongly encouraged. The plan sponsor or plan administrator 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, it 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 Multi Employer Pension Plans (MEPPs)

Different funding considerations may apply to single employer pension plans, than to other types of pension plans such as multi employer pension plans (MEPPs). Some of these considerations may also apply to some extent to other types of pension plans that exhibit similar characteristics.

For MEPPs, benefit levels rather than contribution levels, will typically need to be adjusted to reflect the funding level of the plan. Although contribution levels are fixed, volatility in the plan's financial position can translate into fluctuating benefit levels.

In the case of a MEPP, the plan administrator would typically be responsible for the adoption of the funding policy. However, there may be situations where responsibilities are shared between different plan stakeholders, and the funding policy might be covered by more than

one document. In either case, the funding policy should clearly define the roles the plan sponsor and plan administrator have in its establishment and implementation.

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.

Although each of the elements listed in the previous section applies to all defined benefit pension plans, special considerations apply to MEPPs. The funding policy for a MEPP should describe the approach followed to set benefit levels and issues relating to the use of fixed contributions. These issues could include how the plan's financial position affects benefit levels and in what manner benefit levels may be adjusted. These plans should also document the respective decision making roles of trustees, employers and collective bargaining agents (as applicable). The issues of how to apply an even-handed treatment of beneficiaries, both the current and future generations, in different circumstances and the policy on benefit reductions or restructuring (when applicable), should also 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.