Guidance

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This Guidance Note provides OSFI's interpretation and expectations relating to the requirements for the investment option selected by the administrator of a member choice account plan[1] as the default investment option.

Subsections 8(4) and 8(4.1) of the *Pension Benefits Standards Act, 1985* (PBSA) impose a standard of care on pension plan administrators when administering the pension plan and the pension fund. Subsection 8(4.1) of the PBSA requires that the plan administrator invest the assets of the pension fund in a manner that a reasonable and prudent person would apply in respect of a portfolio of investments of a pension fund. This requirement is often referred to as the "prudent person rule". The PBSA also provides that, in carrying out its legislative responsibilities to administer the pension plan and fund, the plan administrator must use all relevant knowledge and skill that the administrator possesses or, by reason of the administrator's profession, business or calling ought to possess.[2]

The PBSA explicitly provides that, with respect to defined contribution accounts or additional voluntary contribution accounts in a defined benefit plan, a pension plan may permit members[3] to make investment choices from among investment options offered by the plan administrator.[4] When providing investment options, the administrator must offer investment options of varying degrees of risk and expected return that would allow a reasonable and prudent person to create a portfolio of investments that is well adapted to their retirement needs.[5] The PBSA also provides that if an administrator offers investment options that satisfy these requirements, and the member makes an investment choice from among these options, the administrator is deemed to have met its statutory duty regarding the investment of pension plan assets relating to these accounts.[6]

If a member does not make an investment choice from among the investment options offered by the administrator, the investment option selected by the administrator as the default investment option will apply to the account of that member. Given the requirements of section 8 of the PBSA, as noted above, the administrator must select a default investment option in accordance with the prudent person rule.

Selecting a suitable default investment option

A plan administrator could offer the same default investment option for all plan members or the default option could be structured to provide different investments for different members or classes of members. While it is not expected that the administrator's selection of a default option accommodate individual plan members' risk tolerances, it should, depending on the approach, take into account, either the general characteristics of the plan's membership as a whole, or the individual plan members who will be invested in the default option (by, for example, taking into account their age or expected retirement date). When selecting a default option, plan administrators should take into consideration the following:

- the age and/or risk profile of the pension plan membership[7]
- the general suitability of the default investment option as a vehicle for retirement savings purposes. The investment strategy and asset allocation of the default investment option should offer long term appreciation and capital preservation by investing in a diversified mix of fixed income and equity investments. As such, the default investment option should hold an appropriate balance between risk and return for the age and risk profile of the plan membership. A plan administrator who selects a default investment option that is made up of predominantly secure but low-yielding investments, such as guaranteed investment certificates (GICs), or money market funds, may not be meeting the requirement to provide a default investment option that is suitable for retirement savings purposes. While this type of default investment option is low-risk, it may not deliver sufficient investment returns over the long-run to allow members to accumulate enough funds from which they can generate an adequate retirement income.
- the costs associated with the investment option. Costs are an important consideration when selecting a default investment option, as they reduce investment returns, the size of accumulated account balances, and therefore the amount of retirement income which can be generated.

Two possible types of investment funds that a plan administrator could consider when selecting a default investment option include a balanced fund or a fund comprised of a portfolio of investments that takes into account a member's age, i.e. a target date fund.[8]

Characteristics of a balanced fund

A balanced fund is an investment fund that offers a mixture of safety, income and capital appreciation. In order to provide both income and capital appreciation while avoiding excessive risk, a balanced fund holds a combination of equity and fixed income investments. A balanced fund typically has a target allocation of between 40% and 60% of its assets to equities and the remainder to fixed income investments. A balanced fund does not materially change its allocation to equities and fixed income investments in response to market conditions. A balanced fund will instead be automatically rebalanced to maintain its target allocation to equities and fixed income.

The rate of return earned by a balanced fund is not guaranteed and investment returns will depend on the performance of the underlying securities held in the balanced fund. There may be periods of time during which a balanced fund has a negative rate of return.

Characteristics of a target date fund

A target date fund, like a balanced fund, invests in a mix of asset classes, including equities and fixed income. However, unlike a balanced fund, the asset allocation in a target date fund is typically tailored to the age or expected retirement date of the individual member, and the asset allocation of a target date fund will gradually adjust over time to reduce risk.

A target date fund includes a schedule or "glide path" according to which the target date fund's asset allocation is adjusted. The glide path reflects a typical investor's changing risk tolerance as they get closer to retirement, with adjustments made to the fund to limit risk over time by reducing the fund's sensitivity to capital market fluctuations. Implementing the glide path results in a gradual reduction in equity exposure and an increased allocation to fixed income investments. While glide paths differ between target date funds, all glide paths provide for more exposure to equities for younger investors and more exposure to fixed income for investors closer to retirement. A target date fund, however, does not take into account the individual risk tolerance of any particular investor or any

investor's individual circumstances, including whether the investor holds investments outside of the default fund.

As with a balanced fund, the rate of return earned by a target date fund is not guaranteed and investment returns will depend on the performance of the underlying securities held by the fund. There may be periods of time during which a target date fund has a negative rate of return.

Documenting the selection of the default investment option

While the administrator of a member choice account plan is not required by the *Pension Benefits Standards Regulations, 1985* (PBSR) to establish a statement of investment policies and procedures[9], the administrator has a fiduciary responsibility to ensure that the pension fund's assets are invested in a prudent manner.[10] An administrator should therefore establish, implement and adhere to policies and procedures that support its responsibilities with respect to investment options offered to members, including the default investment option. Administrators of pension plans that offer member choice accounts should document the process and the rationale for selecting the default investment option.

Communicating the default investment option

Plan administrators should pay particular attention to how the default investment option is described in communications to plan members. The description of the default investment option and its investment strategy should include

- its investment objective;
- the type of investment and the degree of risk associated with it;
- its top ten holdings by market value;
- its performance history;
- a statement that its past performance is not necessarily an indication of its future performance;
- the name and a description of the benchmark that best reflects the composition of the investment option;
- the cost associated with the investment option, expressed as a percentage or a fixed amount; and
- its target asset allocation.[11]

If the default investment option selected by the administrator is a target date fund, OSFI expects that an explanation of the target date fund and an illustration of the glide path be provided.

Reviewing the default investment option

The administrator should review the design, performance and continued suitability of the default investment option on an ongoing basis. A review is especially important when certain events occur that could reasonably be expected to have an impact on the appropriateness of the default investment option. Such events could include

- a change in the age and risk profile of the pension plan membership;
- consistent overperformance or underperformance of the underlying funds used in the investment strategy;
- a change to the cost of the default investment option;
- a change in the manager of the fund; or
- significant changes in financial markets or the economy.

1 The term “member choice account plan” means a pension plan that maintains separate member accounts in relation to which a member is permitted to make investment choices and includes plans that have a defined contribution provision and plans that maintain accounts for additional voluntary contributions.

2 Subsection 8(5) of the PBSA

3 For this Guidance Note, the term “member” includes a former member or any other individual who maintains a member choice account in the plan.

4 Subsection 8(4.2) of the PBSA.

5 Subsection 8(4.3) of the PBSA.

6 See subsection 8(4.4) of the PBSA

7 For the purposes of this Guidance Note, “pension plan membership” includes a former member or any other individual who maintains a member choice account in the plan

8 Target-date funds are also referred to as "lifecycle funds," "retirement funds" and "age-based funds".

9 Subsection 7.1(1) of the PBSR

10 Subsections 8(3) and 8(4) of the PBSA

11 Paragraph 7.3(1)(a) of the PBSA