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SHARING THE RISK



DELEGATED DC INVESTMENT SOLUTIONS ARE COMING TO CANADA

Delegating responsibility for key investment decisions to an external provider has been an emerging trend for defined benefit (DB) plan sponsors for some time – especially in the United States and the U.K.

More recently, this trend has expanded to include the defined contribution (DC) market, and has made its way to Canada. While it's not a service that every DC pension plan may seek or need, plan sponsors who are thinking of shifting some governance responsibilities should explore such arrangements with their eyes wide open to the pros and cons.

Delegated DC investment solutions defined

While many DC plan sponsors work with consultants or investment advisors to design an investment lineup appropriate for their employees, the fiduciary responsibility still rests with the plan sponsor. Under a delegated arrangement, that fiduciary responsibility is shared by engaging a third-party to manage the investment lineup with the third party being given the freedom to act on a scale which can go up to a purely discretionary basis.

Life's brighter under the sun



The plan sponsor still retains ultimate responsibility for the plan, with a duty to prudently select and oversee the third-party, and put a process in place to ensure that all actions taken are solely in the best interest of plan members. But the sharing or delegation of risk comes from the third party taking on part or all of the responsibility for investment implementation, monitoring, and related governance functions.

The adoption of delegated solutions was driven in large part by two periods of significant market decline, namely the technology market crash at the turn of the century and the financial market crisis of 2008. The negative impact of each of these events on pension plans had management looking at ‘outsourcing the Chief Investment Officer’ function (OCIO) through a discretionary investment management arrangement.



The outsourcing trend has now gained traction in the DC market, especially in the U.S. and U.K. as providers expand their service offerings to meet the unique demands of DC plans. In the U.S., plan sponsors are increasingly relying on legislative protections, such as those found in Section 3 (38) of the Employee Retirement Income Security Act of 1974 (ERISA).

ERISA defines Section 3(38) investment managers as fiduciaries with full discretionary authority over plan investments and making plan investment decisions. And under **Section 405(d)**, *the plan sponsor and/or trustees of the plan are not liable for acts or omissions of the 3(38) investment manager, and are under no obligation to invest or otherwise manage any asset of the plan which is subject to the management of that investment manager.*

It’s this level of protection that has made DC investment delegation services appealing to many U.S. plan sponsors. U.S.-based companies with operations in Canada should note that these protections are not available in Canada. Currently, the closest arrangement to full fiduciary outsourcing in Canada is the PRPP/VRSP regime, although the plan sponsor still has responsibility for selecting the service provider.

WHY DELEGATE?

While there is no comparable legislation in Canada to ERISA 3(38), we expect the trend to delegate will continue to grow in this country as plan sponsors seek to outsource responsibilities for a variety of reasons. These include:



MARKET COMPLEXITY:

DC plans are growing in size and number. The investment option universe has also expanded, with more sophisticated investment options and new alternative and specialized asset classes previously found only in DB plans. The delegation of investment responsibilities allows, depending on the plan, a greater, more expert focus on governance and oversight and an expanded opportunity set for investment options, leveraging the service provider’s knowledge and expertise.

CHALLENGING MARKET CONDITIONS:

Interest rates – and yields on traditional fixed income investments – remain low, with increased equity market volatility. While investment performance is just one of many contributors to retirement readiness, plan sponsors may feel greater exposure to claims from current or former plan members relating to retirement savings adequacy and seek to shift this responsibility to a third party.

LACK OF RESOURCES:

DC plan management takes internal resources, time and a level of expertise needed to make the right decisions. The delegation of some responsibilities can free up time and resources to focus on their core business.

GREATER FLEXIBILITY IN TIMING:

Most pension committees meet only a few times a year, with decision-making typically limited to those times. While fast decision-making may not be required often in a DC plan context, the delegation of investment decision-making can provide greater flexibility in terms of the timing of investment changes, as decisions can be made and acted on almost immediately.

Many DC plans have already transferred a number of responsibilities to their service provider, such as plan member education and communication. A next step for some is the transferring of investment decision and monitoring. While there may be additional plan costs to compensate for the additional risk taken on by the third-party provider, there may be internal cost savings in terms of both time and staffing. In addition, some costs could be offset by savings realized from economies of scale that providers may offer.

However, Capital Accumulation Plan (CAP) guidelines as well as pension and common law still require plan sponsors to monitor all third-party service providers, so time and effort is still required to ensure the service provider is adhering to CAP guidelines and all legal requirements. Methods of benchmarking or comparing service providers may also be required to satisfy this monitoring requirement, as is ensuring your provider does not have any conflict of interest in the decisions being delegated.



WHEN DOES DELEGATION NOT MAKE SENSE?

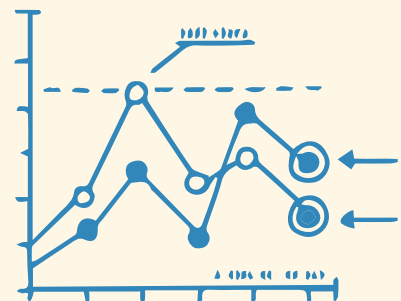
- You're satisfied with your organization's current ability to manage this function internally
- You already receive adequate support from advisors, consultants and recordkeepers
- You want customization of the investment selection process to mirror your organization's beliefs and philosophy related to a retirement savings program
- You believe that other plan design factors – such as plan member contribution rates, company required and matching contributions, mandatory or voluntary membership – play a more critical role in determining retirement savings success, and that there is little added value to outsourcing investment decision-making.

The white-label fund solution

In many delegated DC investment solution situations, a **white-label fund approach** is taken, with funds “named” according to their asset class or objective instead of a specific fund company. In many cases, the third-party delegate employs a “fund-of-fund” approach, which uses multiple complementary investment strategies (and managers) combined into a single, easy-to-understand option for plan members. The plan sponsor is delegating key decisions such as active versus passive approaches, strategic versus tactical, default fund selection and the selection of managers to the fund. Plan sponsors who do delegate will want to ensure that their provider makes decisions that are consistent with their own retirement savings beliefs.

The white-label fund structure lets the **third-party monitor the underlying investment managers of funds**, and make any changes needed to managers or their mandates. These changes have no impact on the investment choices of plan members, who will continue to be invested in the same funds, even if there are changes to the underlying investment managers.

One of the key trade-offs with this approach is the potential loss of brand recognition in relation to fund providers. With a brand name fund, plan members can find unbiased information about the fund from other sources. When a fund is white labelled, they lose this ability and may feel less certain about how the fund is managed. For this reason, greater plan member investment education may be needed.



Defining the services to be delegated

Delegated DC investment solutions can be customized arrangements, and plan sponsors may choose to retain some responsibility for certain aspects of plan decision-making. For example, the plan sponsor will most likely still dictate the overall plan objectives, and may establish investment objectives or parameters as well.

In most situations, the third-party service provider is hired to help with three main tasks: implementation, monitoring, and governance/reporting:

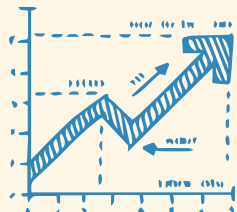
IMPLEMENTATION:

Includes investment manager and fund option selection, development of all documentation (such as the statement of investment policy) and all audit and regulatory filings.



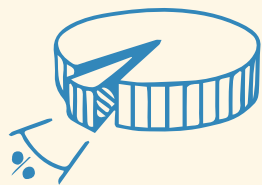
MONITORING:

Includes measuring the plan's continued alignment with plan goals and objectives (such as participation levels, engagement, retirement readiness, and income adequacy), ensuring manager fees remain competitive through benchmarking, and evaluating risk metrics and manager performance.



GOVERNANCE AND REPORTING:

Includes developing a structure for reporting that aligns with the sponsor's oversight role, reporting to and updating the pension committee on industry trends and events.



More to come

The delegated DC investment solution industry is just emerging in Canada, and there are a number of factors that plan sponsors will need to weigh in considering this option. This includes the need to develop a new governance structure for the plan, and documentation that outlines a clear delegation of responsibilities – from plan design, to plan member education, to the measurement of plan competitiveness and income replacement adequacy.

There are a couple of types of providers expected to introduce offerings in the near future. These include:

- **Consulting firms**, who currently provide advice and services to DC plan providers;
- **Insurance companies**, such as Sun Life, who currently act as DC plan recordkeepers and provide an investment platform.

“At this early stage, a delegated DC investment solution may not be a fit for every Canadian DC plan, but it's a trend worth noting as plans in other jurisdictions seek out this service to share their risks, access outside expertise, and redirect resources to place a greater focus on their core businesses.”