ACPM Submission to The Pension Investment Advisor to the Province of Ontario

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ACPM/ACARR

The Association of Canadian Pension Management

L'Association canadienne des administrateurs de régimes de retraite

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FOREWORD

The Association of Canadian Pension Management (ACPM)

The Association of Canadian Pension Management (ACPM) is the informed voice of Canadian pension plan sponsors, administrators and their allied service providers. Established in 1976, the ACPM advocates for an effective and sustainable Canadian retirement income system through a non-profit organization supported by a growing membership and a team of volunteer experts. Our members are drawn from all aspects of the industry from one side of this country to the other. We represent over 400 pension plans consisting of more than 3 million plan members, with total assets under management in excess of $330 billion.

The ACPM promotes its vision for the development of a world leading retirement income system in Canada by championing the following Guiding Principles:

- Clarity in legislation, regulations and retirement income arrangements;
- Balanced consideration of other stakeholders' interests; and
- Excellence in governance and administration

The ACPM regularly advocates and participates in public dialogue on pension issues.

Introductory Comments

The Association of Canadian Pension Management welcomes the opportunity to provide comments to the Pension Investment Advisor to the Ontario government (the "Advisor") on the proposed investment consolidation of broader public sector ("BPS") pension plans.

The ACPM supports the 2012 Ontario Budget goals of making BPS pension plans more affordable for taxpayers and more sustainable for plan members. In general, the ACPM also supports the concept of pooling the investment of smaller BPS pension plans in such a way as to make pension investment management more efficient and improve returns. Even small incremental improvements in net investment returns compounded over the long term make a significant contribution to the funding of a pension plan.

As part of this effort, the government should also turn its attention to the value that plan beneficiaries can expect as a result of investment consolidation and what risks are reasonable to take in order to achieve the desired results. Moreover, the discussion of consolidated investment should not take place in isolation; it should also take into account the discussion of equally important issues such as plan design, risk tolerance and management, appropriate governance, and member communication and education, all of which are part of the pension plan value and efficiency equation.

Overview

Below we answer the specific questions posed by the Advisor; however, we begin with some contextual comments.

In addition to government, many pension plan commentators and thought leaders are advocating for larger capital pools on the grounds of investment efficiency. While a simple "bigger is better" message may allow the concept of asset consolidation to gain traction, ACPM would strongly support careful consideration of other key issues such as plan governance, plan design and risk and liability management, as part of the decision making process.

While there are advantages to pension fund size where access to sophisticated investments can be achieved at a reasonable cost and risk, the ACPM experience makes it clear that fund size alone should not define the appropriate investment consolidation model. While the fund size should be large enough to achieve economies of scale, it is even more important that the model created provides sufficient investment choices, or put another way, asset mix flexibility for individual participating plans so that plan administrators can appropriately match their plans' assets to their plans' liabilities. Without proper matching of assets and liabilities, the advantages of size can be negated.

The advantages of mid-sized funds should also be recognized. For instance, mid-size funds are large enough to take advantage of smaller/mid-market investment opportunities that may be overlooked by larger players, including in private markets, either directly or via pooled investing.

Moreover, pooling investments and administrative functions alone will not necessarily result in efficiencies and deliver pension benefits at a lower overall cost. In fact, many small and mid-size plans have stronger funding ratios and governance structures than much larger funds. Improving the sustainability and health of pension plans overall should be the goal and a one-size-fits-all model is unlikely to be the solution in this regard.

The foregoing considerations underlie our responses to the questions posed by the Advisor. Our responses to these questions follow below. Please note that in many cases, the answers to the questions overlap (as the issues are related).

ACPM Responses to the Questions Posed by the Advisor

Question 1: What is the appropriate mechanism(s) for pooling the investments of BPS pension plans?

While there are various possible models for asset/investment consolidation of BPS pension plans, the two most straight forward possibilities are: (1) consolidation of investment management through an existing broader public sector pension plan; and (2) the creation of a new investment management entity for the investment of BPS pension plan assets. We understand that these are the two primary options under consideration by the Advisor and have focused our responses accordingly.

Both of these models could achieve the stated objective of pooling the investment of BPS pension plans as a way to make pension investment management more efficient. However, each model has different advantages/disadvantages that may make it more (or less) attractive to different BPS pension plans.

We believe that a not-for-profit statutory corporation operating as an independent investment management entity (the "**Investment Manager**") to which participating BPS pension plans would

outsource most aspects of their investment management needs is a preferred option for many Ontario BPS pension plans because it readily allows for more precise calibration of the size of the asset pool under management, the most customization related to the governance structure and the most potential for flexibility (related to both participation and asset mix allocation) for BPS pension plans. In order to be effective, we believe such an entity would need to have the following qualities:

1. To deliver the desired benefits related to efficiency and investment returns, the Investment Manager must provide high-quality, professional asset management through a top level investment management team overseen by a qualified board of directors who would be appointed based on a variety of needs and skills criteria. In order to attract and retain such a team, the organization must create a culture that is performance-driven and strongly motivated. It must also be prepared to pay competitive compensation (albeit consistent with its mandate to reduce costs), as similarly positioned investment management organizations and jointly sponsored pension plans have all done (e.g. OMERS, OTPP, PSPIB, CPPIB, AIMCo and bcIMC). This, in turn, will mean that the organization cannot be subject to compensation limits imposed on government agencies;

2. To foster confidence in the Investment Manager and promote good governance practices, the organization should be independent from government and from any one participating BPS pension plans—that is not to say that the government and participating BPS pension plans should not have input into the governance (as discussed in question 3 below)—and should operate on a cost-recovery, not-for-profit basis;

3. To allow participating BPS pension plans to best fulfil their fiduciary duties and address particularized circumstances (as discussed in question 4 and 5 below), the Investment Manager must offer a wide range of investment choices, and allow participating BPS plans to retain flexibility over asset mix decisions. In order to promote such flexibility, investment options offered by the Investment Manager should be unitized or otherwise amenable to being held in differing proportions by various pension plans;

4. To ensure efficiency of the investment structure as a whole, the government should undertake a thorough review of the pension investment restrictions, tax and securities issues associated with any model to ensure that the investment model preserves maximum efficiency.

Two currently operating examples of the type of model discussed above are AIMCo and bcIMC. Both are expert professional investment management agencies that provide flexibility as to asset mix for participating pension plans and other public sector clients. Also, bcIMC allows for voluntary participation, has a high degree of independence from the government and, while it provides representation to its participating pension plan clients on its board, is independent from any single client. We would encourage the government to consider the experience of both of these organizations in coming up with a model for Ontario.

<u>Question 2:</u> Should participation in the model be voluntary or mandatory?

It is important to recognize that the monies under management by most pension plan administrators are not "government monies", but comprise both employer and employee contributions (and investment returns thereon) intended to secure the pension promise. Administrators are required to manage such monies with a view to fulfilling their duties to pension plan members as a whole to ensure the pension promise is met.

We believe that the overlay of fiduciary duties to which pension plan administrators are subject leads to the conclusion that a voluntary model of participation is to be preferred. A voluntary model would allow pension plan administrators to assess the adequacy of the model for their particular pension plan and place their plan's assets with the Investment Manager where there is a strong business case to do so. That is not to say that pension administrators cannot be offered incentives to make the choice more attractive—including, for example, payment of transition costs, exemptions from certain pension investment rules, etc. However, plan administrators should preferably have a choice both to enter and exit the model, within appropriate parameters. We understand that part of the success of the bcIMC model, for example, was the high degree of involvement by plan sponsors/administrators in the creation of the bcIMC model.

Making the model voluntary also eliminates some of the risks associated with having a "captive" client base, which could otherwise tend to create complacency within the organization of the Investment Manager.

We note that, if participation is mandatory, careful consideration should be given to the complex transition issues (valuation, penalties, tax and contractual terms) related to moving assets/monies into a new investment management entity. Plans should not be forced to liquidate assets where this would be imprudent or would subject them to penalties or losses. Moreover, in a mandatory model (as in a voluntary one), plans should retain flexibility over asset mix decisions (or to retain a portion of their fund in cash or highly liquid investments) to ensure they have sufficient liquidity to meet pension payroll and expense needs.

Finally, if the model is mandatory, the government should expressly recognize that this involves an override of existing fiduciary duties on the part of pension plan administrators and should ensure administrators are expressly exempt from liability in this regard (e.g., by providing a statutory "safe harbour" from liability). Any such limitation of liability should not exempt plan sponsors from continuing to fund deficits in their plans.

***<u>Question 3:</u>* What is the appropriate governance model to ensure effective leadership and representative decision-making?**

The governance model for any investment management organization should balance the need for expertise in pension investment management, which will be important to the credibility of the organization, and the desirability of stakeholder input in the selection of the directors of the investment management organization. While there was a divergence of opinion among our members regarding the extent to which the entire board needed expertise in investment management, members did agree that the model should provide for needs and skills criteria as well as involvement by stakeholders in the board selection process. Stakeholder input provides the checks and balances needed in such a model, particularly if all pension investment functions are to be outsourced, and increases the level of understanding and inter-organizational integration, which will be essential if the model is to work effectively.

In the ACPM's view, stakeholders (both the government and participating BPS pension plan administrators/sponsors) should be involved in the selection of a board of directors, but should be required to apply needs and skills criteria to their selections. No one stakeholder should control the board appointment process. Nor should stakeholders have input into the selection of the organization's management. Those decisions, as well as decisions related to compensation, should be left to the board.

In general, in designing the Investment Manager, careful attention should be paid to defining and delineating the roles, responsibilities and authorities of the Investment Manager, plan administrators,

plan sponsors and the government to ensure that no gaps result as a result of outsourcing the investment function.

<u>Question 4:</u> How can the model meet plan-specific investment needs in a manner that is consistent with the fiduciary responsibilities of plan administrators?

As stated above, the Investment Manager should establish and manage unitized (or otherwise pooled) investment vehicles – much in the way that AIMCo and bcIMC do – for the investment of pension plan assets. The availability of several pooled vehicles representing different asset classes would give pension plan administrators the flexibility to set the appropriate asset mix for their plan to ensure that each plan's investments are appropriately matched to their liabilities, risk tolerance and liquidity needs. In the ACPM's view, this flexibility is critical to the success of such a model.

The investment management approach and available asset categories should, ideally:

1. Allow for tactical shifts if deemed appropriate by plan administrators;
2. Permit a variety of investment styles (e.g. passive, active, value, growth or core investment);
3. Allow for country or market biases in investment (e.g. developed, emerging, frontier);
4. Allow for liability driven investing and hedge fund strategies;
5. Allow for currency hedging;
6. Accommodate controlled use of leverage;
7. Permit plan administrators determine the desired duration of investments;
8. Accommodate differing risk tolerances;
9. Allow for the desired diversification;
10. Allow for Statement of Investment Policies and Procedures conditions (such as quality and environmental, social and governance ("ESG") factors) to be taken into account;
11. Respond to liquidity needs; and
12. Allow for immunization or tailored solutions to certain risks (e.g. longevity, salary escalation, inflation)

BPS pension plan administrators should remain responsible for reviewing and revising their statements of investment policies and procedures and therein setting the appropriate asset mix for their plans, based on available investment pools. Doing so will allow each plan administrator to continue to define their plan's risk level and investment beliefs through asset mix, asset category, asset quality, investment style, and volatility tolerance decisions. The Investment Manager should have the discretion to implement the investment policy set by the administrator through investments in the asset pools it establishes and manages. It will be critical for the Investment Manager to have the applicable skills and expertise in order to carry out the investment policies set by plan administrators, which is why it is so important for the organization to retain a high quality investment management team and to motivate the team appropriately to ensure that it does not become complacent.

As is the case with outsourcing to commercial third party investment managers, BPS pension plan administrators should remain responsible for the oversight of the Investment Manager and should receive regular reports from the organization on investment performance. As noted above, it will be important for the model to be voluntary and for BPS pension plans to retain the ability to withdraw their assets from management by the Investment Manager, in accordance with commercially appropriate limits, in order to be able to fulfil their fiduciary duties to plan members. It may also be necessary to provide for circumstances in which less than 100% of the assets of a participating pension plan will be invested by the Investment Manager in order to meet plan-specific requirements (e.g. liquidity).

As noted elsewhere, an appropriate transition period should be provided so that plan administrators can deal with asset transition issues in a way that does not disadvantage their plan members.

***Question 5:* How can the model be implemented? What is the appropriate transition period for implementation? How should transition costs be allocated?**

The complexity of this undertaking cannot be overstated. Structuring considerations include such legal issues as compliance with (or exemptions from) pension investment rules and securities rules; ensuring tax favourable treatment for pooled investments; and ensuring that the logistical and commercial aspects related to asset pooling are appropriately taken into account—e.g. how will the model incorporate leverage? on what basis will hedging and derivatives strategies be undertaken? how will existing assets be transitioned to the new model (e.g. in kind, going forward only, only liquid assets)? will transition of assets trigger any valuation issues for plans? what are appropriate time limits on entry and exit into and out individual asset pools and into and from the model as a whole?

As such, we would encourage the government not to rush implementation. Careful planning and an appropriately timed, possibly sequenced, approach will be key to ensuring an appropriate model and an orderly transition. During the transition period, issues related to employee retention at participating pension plans and appropriate on-going investment management prior to transition will have to be managed. In addition, consideration should be given to the use of external managers in the initial stages while the organization builds up sufficient investment talent to undertake direct investment. Given the transition costs, and the possibility that external management may need to be relied upon to some extent, the realization of cost savings/increased investment returns should be viewed as medium term, rather than a short term, goal.

It is likely that a transition of 3-5 years would be required for the Investment Manager to become fully operational, and perhaps longer to have a fully developed in-house investment team for some asset classes. In this regard, the approach used in other provinces to set up an investment management organization (e.g. Alberta and BC) could serve as a case study to determine appropriate timing, though we caution that both AIMCo and bcIMC were created out of existing government departments that fulfilled the same role as the current investment management organizations and therefore may have had less complicated transition issues than the Ontario BPS pension plans, whose assets are not under common management.

In order to ensure efficiency and fairness, the costs of start up and transition should be borne in the first instance by the province and then allocated back to the participating plans based on a sliding scale related to asset size. This model is similar to how the market prices investment services today.

The government should also give consideration to developing a cost structure that would allow pension plan administrators to assess the benefits to their particular pension plan of participation in the new model.

<u>Question 6:</u> What role should pension plan design, asset allocation models and the size of plan play in determining participation?

A model that is flexible as to asset mix will provide the broadest basis for participation by BPS pension plan. Models that provide no flexibility in that regard may not be appropriate for all BPS pension plans and may need to be limited based on plan design or asset mix. However, if the model is voluntary and provides a sufficient range of investment choices to pension plan administrators, there need not be any constraint on the type of defined benefit BPS pension plan that could participate. (However, see our comments regarding defined contribution plans at question 7 below.) Any mandatory model, particularly if it provides little flexibility, on the other hand, should give careful consideration to the types of plans for which it would be appropriate.

In our view, plans that have already achieved a sufficient size to take advantage of economies of scale related to investment management would not be prime candidates for consolidation. In fact, a fund size that is too large may create diseconomies of scale. We also note that, with greater fund size, come greater systemic risks. That is, investment losses in any one model will be spread across a larger asset base and, as such, may have a greater impact than losses to any one particular plan do today, thereby exposing Ontario tax payers to greater risk. "Mega-fund" size could also lead to more competition for a limited number of opportunities in the large fund space and missed opportunities in the middle market. For all of the foregoing reasons, we would encourage the government to consider optimal fund size in its design of the model.

<u>Question 7:</u> Are there any obstacles to the inclusion of defined contribution pension plans in the model?

We are of the view that including defined contribution ("DC")) pension plans would add additional complexity to the model, particularly where investment is member directed.

Where the investment of the assets of DC plans is directed by a plan administrator, the applicable fiduciary and investment considerations are not entirely dissimilar to those for defined benefit ("DB") pension plans and the model should not be closed to such plans, if it can meet their investment needs. However, opening participation to plans where investment is member-directed (as is the case with the majority of DC plans) may introduce unanticipated complexities into the model, particularly in the early stages.

The implications of including defined contribution arrangements—such as limits on entry and exit by individuals into specific pools offered by the Investment Manager; additional disclosure requirements; liquidity needs; valuation frequency; and the availability of investments appropriate to individual retirement planning—should be carefully considered. Given the additional complexities involved, we would suggest that the government consider delaying the decision to open the model to DC pension plans until the Investment Manager has sufficient experience with the transition of DB plans to inform the decision as to whether DC plans should be included and under what conditions.

<u>Question</u> 8: Should the model include other BPS Investment Funds?

In our submission, the initial focus of the Investment Manager should be primarily on BPS pension plans. However, provided that the appropriate governance is in place and flexibility is maintained as to asset mix, investment by other BPS investment funds could be included in the model. In considering investment by other funds, the government should also take into consideration whether any negative tax consequences would result from including such funds in the structure.