FTR Now

Public Sector Pension Fund Pooled Asset Management

Date: November 27, 2012

The 2012 Ontario Budget announced the Government's intention to study the advantages of pooled asset management for Ontario's approximately 100 public sector and broader public sector pension funds. Mr. William Morneau was appointed to lead the study and his report, *Facilitating Pooled Asset Management for Ontario's Public – Sector Institutions* (the "Report") was released by the Ontario Ministry of Finance on November 16, 2012. That Ministry has invited comments on the recommendations contained in the Report.

This *FTR Now* summarizes the key recommendations contained in the Report and identifies some legal issues requiring further consideration.

SUMMARY

The chief advantages of pooled asset management for public sector and broader public sector pension funds identified in the Report are:

- reduced investment management costs due to economies of scale;
- access to alternative investment classes (real estate, infrastructure, and private equity) at reasonable investment management and related costs;
- enhanced risk management processes; and
- the potential for improved investment returns over the long-term.

The Report recommends the Ontario Government pass legislation to create a new arm's-length pooled asset manager, the Ontario Investment Management Corporation (the "Corporation"), to manage the assets of most public sector and broader public sector defined benefit and hybrid pension funds. Administrators of covered plans would be required to invest their pension funds in a family of unitized pooled funds created by the Corporation for at least seven years. It also recommends that the same compulsory use of the Corporation's pooled funds would apply to the Workplace Safety and Insurance Board's investment funds, the Agricorp Production Insurance fund, and the Ontario Nuclear Funds. The Report further recommends that other asset pools such as supplementary pension plan funds, university or hospital endowment funds, and, eventually, member-directed defined contribution pension plan assets, could be invested in the Corporation's pooled funds on a voluntary basis.

Successful implementation of pooled asset management is projected to result in annual savings of between $75 to $100 million provided that at least $50 billion of assets come under common management.

RECOMMENDATIONS

The Ontario Budget announcement focussed on smaller public sector pension plans (assets of less than $1 billion). However, the Report finds that combining the assets of all of these smaller pension funds would not realize sufficient economies of scale. Therefore, the Report recommends that the asset pooling initiative be mandatory for the vast majority of public sector and broader public sector defined benefit and hybrid pension plans, excluding only the three largest plans: Ontario Teachers' Pension Plan, OMERS, and Healthcare of Ontario Pension Plan. Some possible exceptions are highlighted by the Report for further consideration by the Ontario Government.

Administrators of each pension plan would retain the responsibility to make asset allocation decisions from within the Corporation's pooled fund options in order to ensure that pension fund assets are invested in a manner consistent with the liability profile of the pension plan. For at least a seven-year period, administrators would be required to invest the assets of their pension funds within the pooled funds offered and managed by the Corporation. After the seven-year period, continued investment through the Corporation would be optional. Investment management costs would be guaranteed not to increase for the first three years for the pension funds that are subject to pooling, provided the same asset allocation is retained.

Cost savings are projected to be derived from lower investment management and service-provider fees per dollar of assets under management by way of lowering external management fees, using in-house investment management expertise, or adopting more passive investment management strategies.

The Report indicates that a significant majority of pension plan administrators believe they currently have an under-allocation to alternative asset classes due to the associated costs. Asset pooling is expected to increase access to alternative asset classes on a cost-effective basis to allow for risk diversification.

The Report includes a transition plan. Within six months of the enabling legislation becoming law, the Corporation would have developed its investment policies, governance and procurement policies, and risk management framework. The transition plan calls for assets being transferred in kind and for the continued use of existing investment managers (whether internal or external) in the near term in order to minimize market disruption and provide employment transition for internal management teams where appropriate. The transition plan calls for full operation by January 1, 2018.

COMPULSORY PARTICIPATION

The Report advises that all public sector and broader public sector defined benefit and hybrid pension funds with assets under $40 billion should be required to participate in the pooling initiative. The vast majority of Ontario's broader public sector pension plans fall under this $40 billion threshold. The Report does list a number of possible exceptions from compulsory participation for the Government's consideration. Funds identified as possible exceptions include sufficiently large jointly sponsored plans (i.e. the Ontario Public Service Employees Union Pension Plan, the Colleges of Applied Arts and Technology Pension Plan and the Toronto Transit Commission Pension Fund Society), and, if it were to be created, an electricity sector jointly sponsored pension plan. The Report recommends that if the Government permits the exception of certain plans from mandatory participation, the administrator of those pension funds should still be permitted to voluntarily access the services and the pooled funds made available by the Corporation especially for alternative asset classes.

VOLUNTARY PARTICIPATION

The Report recommends that, notwithstanding the different taxation issues associated with hospital and university endowment funds and supplemental pension arrangement funds, the Corporation should be prepared to accept assets from these entities from its inception. The basis for this recommendation is that endowment funds and supplemental pension funds may otherwise face higher incremental investment management costs as they are often co-managed with pension fund assets.

Defined contribution pension plans with member-directed investment choice would only become eligible to invest in the Corporation's pooled funds when the unique implementation features relating to such plans could otherwise be managed. No estimated time frame for management of defined contribution pension plans is contained in the Report.

ALTERNATIVES CONSIDERED

The Report rejects the suggestion of establishing new sector-based investment management entities (e.g. university or electricity sector) for the reasons that the combined assets within each sector is insufficient to achieve the lowest possible investment costs, access to alternative asset classes would continue to be restricted, and there would be duplication of operational costs.

The Report also rejects requiring the governing bodies of one or more of the Teachers' Pension Plan, OMERS or HOOPP to become the public sector pooled asset manager in favour of establishing the Corporation. However, the Report recommends the Government allow for administrators to be permitted to enter into agreements to place their pension fund assets under the investment management of one of these entities as an alternative to using the Corporation if the agreement is signed prior to the establishment of the Corporation. For example, the Report anticipates that pre-OMERS municipal sector pension plans might choose to enter into agreements to have the OMERS Administration Corporation invest their pension fund assets, or smaller hospital plans might enter into agreements with the HOOPP trustees for investment purposes. Any administrator considering this alternative will be required to take action in the near term given that the Report recommends the Corporation be established as early as January 1, 2014.

STRUCTURE AND GOVERNANCE OF THE CORPORATION

The Report recommends the Corporation should operate at arm's-length from the Ontario Government and be led by an independent Board of Directors whose duty is to act in the best interests of its clients. It sets out how the Board should be constituted, including the recommendation that all appointees have investment expertise and that a set number of director positions be reserved for appointment by the pension plan sponsors and labour groups representing beneficiaries of plans whose pension fund assets are invested by the Corporation.

The Report recommends that the Ontario Government finance the start-up cost of the Corporation by way of a loan. The start-up cost is expected to be as much as $50 million. The Report finds that the Corporation will require qualified leadership and investment management talent, and the compensation of these individuals should be comparable to external benchmarks rather than traditional public sector compensation ranges.

KEY LEGAL CONSIDERATIONS

The Report contains only a short discussion of the legal issues associated with requiring a pension fund administrator to use the Corporation's pooled fund offerings to build an investment portfolio for the pension fund. It recommends that enabling legislation be passed to relieve administrators from fiduciary liability associated with any legislated transfer of investment management responsibility to the Corporation. Liability issues associated with use of the Corporation's pooled funds and the investment monitoring requirements of administrators during the seven-year compulsory participation period or thereafter are not explicitly addressed in the Report. Other questions include how the interplay between investment performance and employer and/or member contribution rates or cost of living indexation for retirees will be addressed and what role, if any, there may be for stakeholder participation in the oversight of the Corporation's activities.

The premise of the Report is that administrators will retain asset allocation decision-making authority and responsibility. However, the Report also recommends the Corporation should develop investment advisory expertise to assist administrators with this function. From a legal perspective, the question of whether advice on asset allocation from the investment manager itself is prudent also arises.

CONCLUSION

The Report provides the hope of improved asset management and risk management through the pooled funds designed and managed by the Corporation but raises a number of key considerations for sponsors and administrators of pension plans in Ontario's public sector. The Ministry of Finance has invited feedback on the Report from public sector institutions and other stakeholders.

If you have any questions about the Report's contents or its impact on your organization, or are interested in providing feedback on the Report, a member of Hicks Morley's Pension and Benefits Practice Group would be pleased to assist.