CIBC MELLON

CHAPTER 3

In Search of New Value

RISE OF THE CONSOLIDATORS: CANADIAN ASSET OWNERS PURSUE SCALE AND OPPORTUNITY

CIBC MELLON

Foreward

Canada's pension plans enjoy a well-deserved global reputation for strong management and resilient performance, but they are not immune to shocks in the markets in which they operate. The COVID-19 pandemic has been testing pension plans and their asset managers, prompting significant volatility in financial markets and reshaping the global economy.

This is the backdrop against which we surveyed 50 of Canada's leading pension plans, seeking insights into how they have coped with the crisis, the challenges and opportunities that now lie ahead, and how they are positioning themselves accordingly.

Our first chapter explored how pension funds are adapting their investment strategies, while our second chapter explored how pension plans are expanding in-house capabilities while also becoming more strategic in their use of outsourcing.

In this third chapter, we explore how Canadian pension plans are seeking scale via consolidation, and in some cases transforming into asset managers who compete for external mandates. The ongoing evolution of Canadian pension plans as asset managers will bear close observation by industry participants and by global pension industry watchers – particularly given the significant disruption to markets in 2020 and into 2021.

Rise of the consolidators: asset owners as asset managers

72% of Canadian pension funds are **currently focused on consolidation options** that seek to offer greater certainty that the fund will be able to meet its liabilities.

50% of pension funds considering merging other funds' assets into the plan believe this will require them to **cope with greater scrutiny;** however, **economies of scale** and regulatory effectiveness offer significant potential benefits.

50% of pension funds **plan on implementing their consolidation plans over the next three to five years.**

Across markets, segments and business lines, for Canadian asset owners, asset managers, insurance companies, and indeed across many other industry verticals, the hunt for scale has been a key driver of stronger outcomes. For asset owners and asset managers alike, the collection and consolidation of larger asset pools is at the heart of driving scale.

Scale can enable efficiencies, stronger pricing power and the development of more specialist capabilities to achieve key organizational goals. Greater scale can confer the ability to amortize research, technology, operational efforts across a broader cost base. Others see scale as enabling greater access to desirable investment opportunities (or indeed, desirable investment talent). Consolidation can take many forms; while many in the industry are familiar with annuitization or risk transfer of assets and liabilities to a larger provider, Canadian organizations have also launched other structures to enable asset management consolidation.

Various government entities across Canada have established independent pension asset management entities designed to deliver professional and advanced asset management to underlying sponsors. Some private pension entities are competing with asset managers to manage outside capital on behalf of other plans, or even embarking on campaigns to merge in and take on the pension assets and liabilities of other plans. The use of an Outsourced Chief Investment Officer (OCIO) is another route to access scale and efficiency while maintaining control over overall strategy. Still other structures may yet emerge. In each case, the consolidators offer a compelling proposition to smaller plan sponsors, who see opportunities to simply their cost structures or even exit the business of pension management to refocus on their own core businesses.

The "Canadian pension model" has become known around the world[1] for delivering out-sized results for stakeholders built around key factors such as independent governance, joint sponsorship by employers and employees, greater portions of in-house asset management, significant investment in talent, a long time horizon, and most recently higher portions of investment into private market assets. Competition for outside assets may very well represent the next stage of evolution for Canada's innovative industry.

One consequence of COVID-19 is likely to be that many pension funds and their sponsors will take time to review their strategies, operations and investment strategies. For some, this may involve reducing risk appetites and lowering allocations to higher-risk asset classes – particularly for funds that already enjoy strong funding levels – but many will pursue other de-risking options or consider consolidation.

According to our survey, pension funds say there are a range of options already being considered if not actively implemented. The push to reduce uncertainty is nearly universal: 72 per cent say they are already reducing the uncertainties around their liabilities through some sort of risk transfer, with an additional 26 per cent considering doing so through some form or another. This may mean the purchase of an annuity or another type of third-party guarantee, shifting to an investment approach where assets are matched more closely to liabilities, joining forces with other organizations to manage assets or asset classes at scale, or – for some – seeking to take in and manage assets on behalf of other asset owners.

Other solutions being implemented include the use of pension or government entities (52%) and greater use of an Outsourced Chief Investment Officer (OCIO) in certain circumstances (48%). Almost a fifth (18%) say they are considering consolidation by incorporating or merging other pension assets, liabilities or operations into their plans. The same number say they are thinking about whether to begin managing assets on behalf of other pension plans.

Collaborative strategies can work well, according to the director of investments at one pension fund: "Investments together with external funds have helped us remain sustainable over the past few months. Since performance has been dropping to some extent, we have been intent on improving capabilities and managing pooled assets has allowed us to delay exits where required."

Alistair Almeida
Segment Lead
Asset Owners

"The ongoing evolution of Canadian pension plans as asset managers will no doubt bear close observation by industry participants and by global pension industry watchers - particularly given the significant disruption to markets in 2020 and into 2021."

Ash Tahbazian
Chief Client Officer

“Asset owners and asset managers alike face rising pressure from stakeholders, increasing market complexity and growing competition for opportunities. The pursuit of scale and its ability to support greater focus and expertise - whether by growing assets or by tapping into specialized providers - will likely continue to accelerate.”

72%
of pension plans and sponsors are currently undertaking consolidation or risk transfer options that seek to offer greater certainty that the plan will be able to meet its liabilities.

50%
of pension funds considering merging other funds' assets into the plan believe this will require them to cope with greater scrutiny; however, economies of scale and regulatory effectiveness offer significant potential benefits.

50%
of pension funds plan on implementing their consolidation plans over the next three to five years.

Darcie James Maxwell
Lead Architect, Client Data Solutions

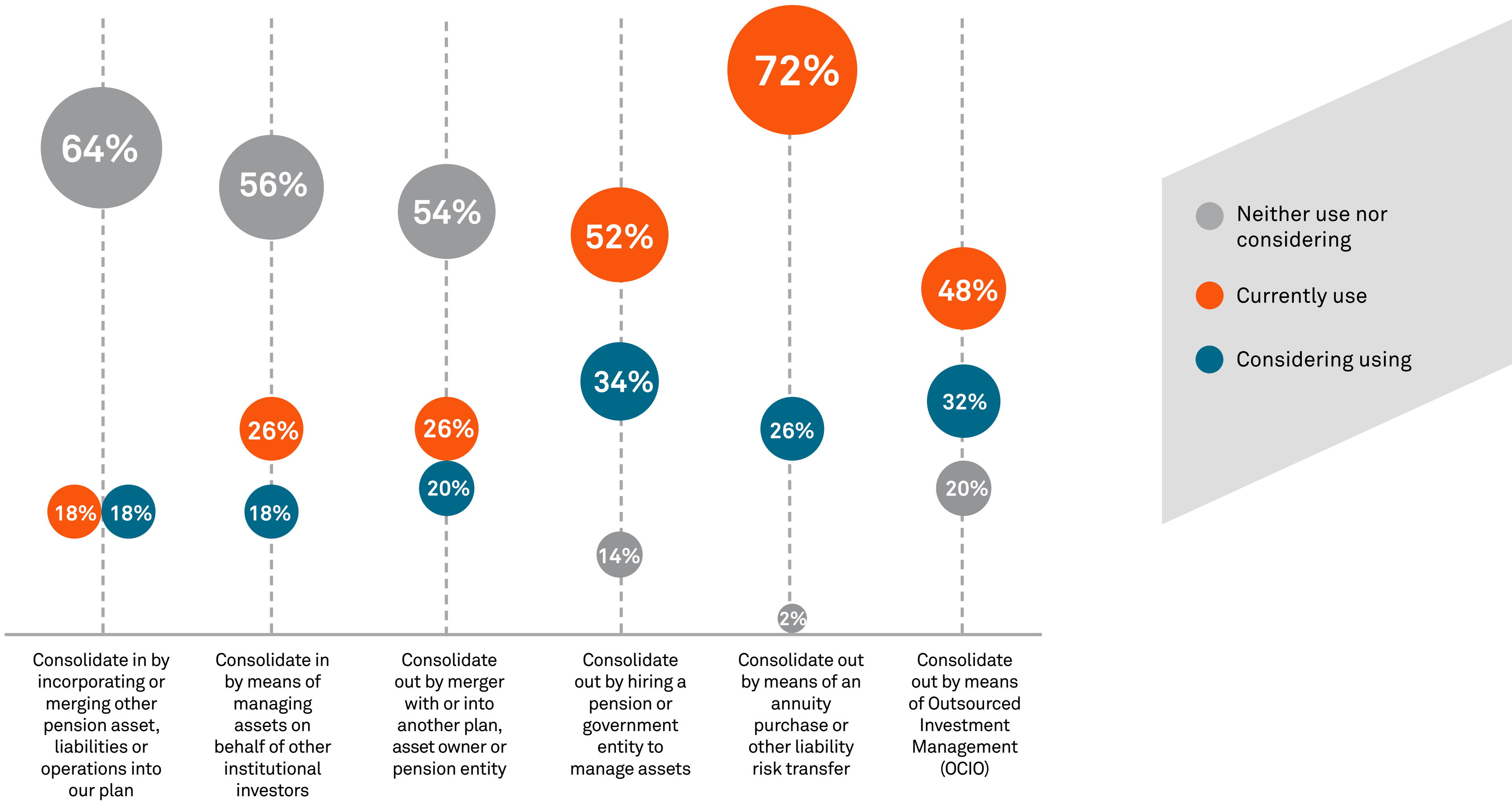
"As Canada's pension funds pursue innovative and sophisticated investment and organizational strategies, some are turning to advanced technology and data tools to streamline operations, access new market opportunities and gain competitive advantage. Target outcomes include greater agility, enhanced resiliency, and a desire to better future-proof technology operations against the emerging needs of tomorrow. Some players are looking to close gaps in technology investment and modernize legacy tools using established best practice, others seek to keep pace in the asset management technology arms race, and a few are looking to leapfrog global competitors and capture opportunity by breaking new ground.

Regardless of motivation or target stance, there is increasing recognition among Canadian pension funds that the status quo is insufficient to meet future needs."

The decision to consolidate, and if so, the selection of the model or models to employ, will not be a straightforward set of decisions. As with many other aspects of pension plan and asset management, one size does not fit all. While consolidation offers pension funds certain advantages, there will also be obstacles to overcome. Pension funds intend to take their time making such decisions and introducing any new approaches.

Just 4% anticipate completing such work within the next 12 months, though 40% are working to a timescale of between one and three years, with a further 50% expecting to take three to five years.

Do you use or are considering using the following approaches to consolidation?



Currently, 24% of pension funds report that they manage assets on behalf of external organizations, while a further 16% plan to do so in the future or are at least considering such a move. This portion may seem high, until one recognizes that the "Canadian model" of pension management has seen many pension plans move asset management and at times also plan member service delivery functions from government entities and employer plan sponsors out to separate entities reporting to independent Boards of Trustees and working in service of their employer / sponsor and plan member clients.

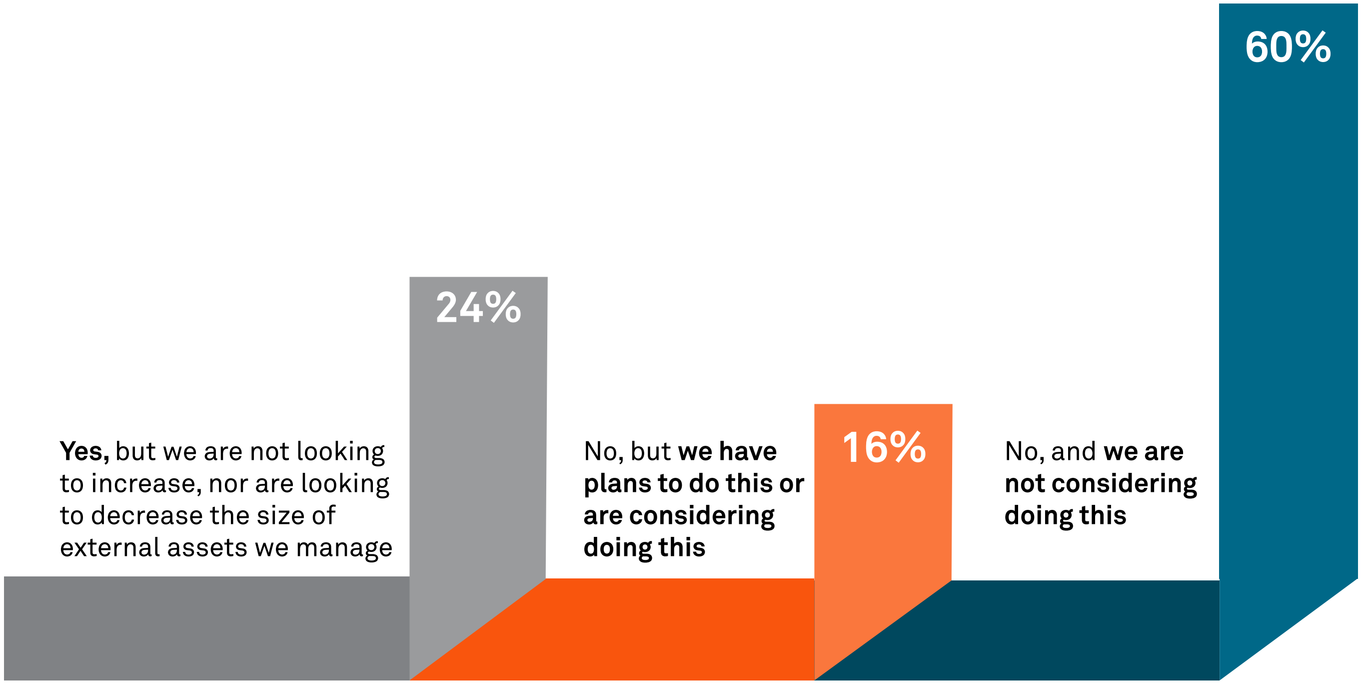
Funds that do manage assets in this way are most likely to do so on behalf of other pension plan members (cited by 92%), but third-party endowments and foundations (92%), charities (67%) and related organizational clients such as the corporate treasury function (67%) are also key - and for some, key prospects.

"

Scale confers considerable advantages on a pension organization. It enables more activities on both the investment and administrative side to be brought in house, reducing costs and improving long-term alignment of interests. Scale also enables organizations to make meaningful investments in technology, helping improve both pension administration and investment operations, that smaller organizations would not be able to make. Governance can also benefit from scale, because larger, more sophisticated funds often have an advantage in attracting board members and in ensuring their boards are well supported."

The Evolution of the Canadian Pension Model Practical Lessons for Building World-class Pension Organizations, World Bank Group Report

Does your organization manage assets from external pension funds?

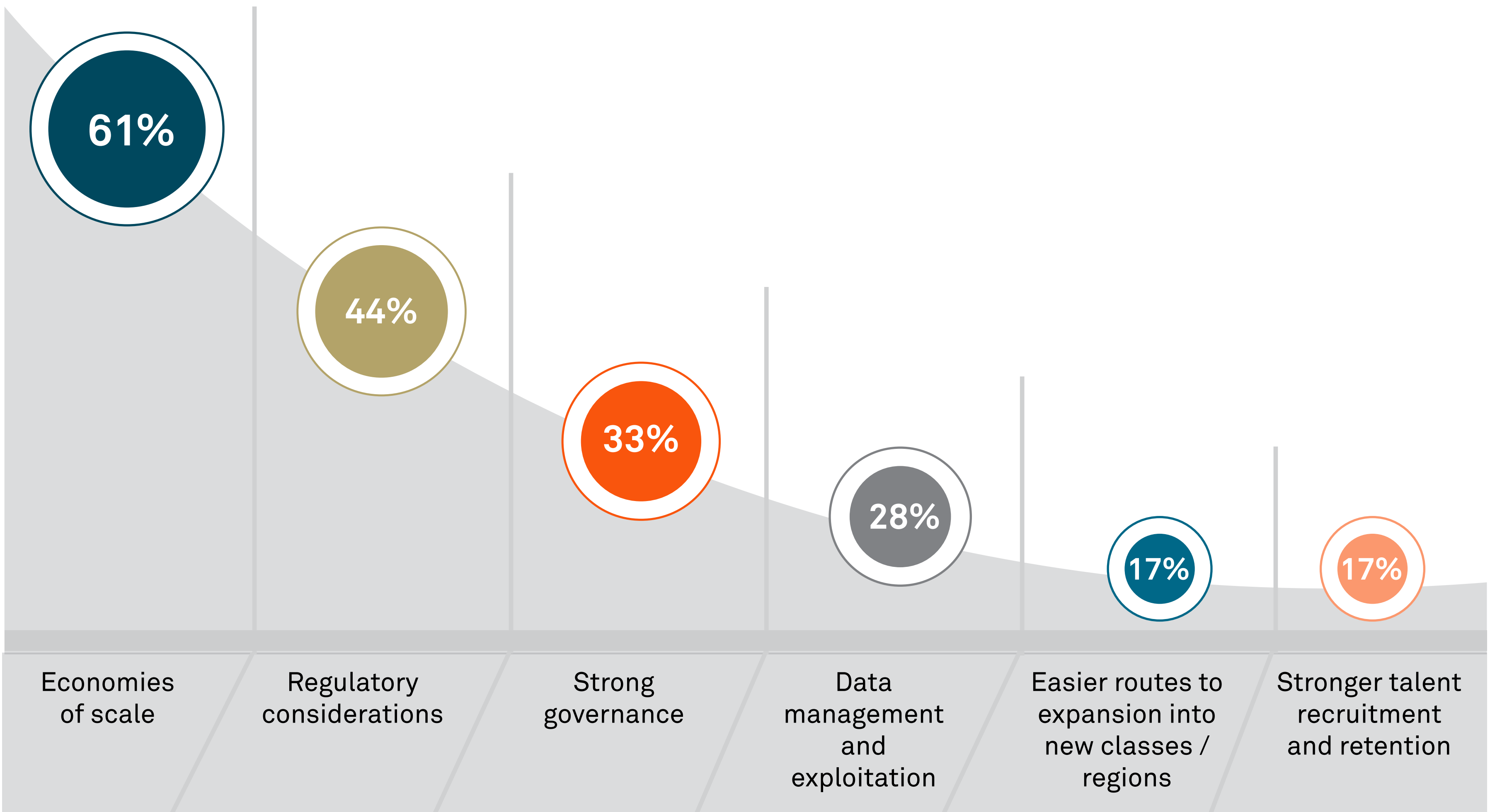


Consolidation brings benefits as well as concerns

Clearly, there are good reasons to consider consolidation options given the current market backdrop. Many analysts now expect moves such as mergers of pension plans or consolidation into larger multi-employer pension plans or pension asset management organizations to accelerate. Funds themselves realize the potential benefits of such mergers. More than half (61%) point to the possibility of securing economies of scale in a merged entity. Some 44% suggest that larger funds may also be able to manage their regulatory responsibilities more effectively.

There may also be scope to tackle some of the problems highlighted elsewhere in this research. For example, 28% of pension funds believe consolidation via a merger might be an opportunity to improve the way they make use of data. Some 17% think this could make it easier to plan expansion into new asset classes and regions.

What are the main drivers for plans considering consolidation via merger? (Select top two)



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DBplus was created to provide what employers and employees both want. Employers want predictable costs while attracting, retaining and de-stressing employees by providing a defined benefit pension plan. Employees want the same things: predictable contributions and a pension that will last their lifetime. Through DBplus, CAAT is making a modern defined benefit pensions available to more Canadian workplaces.

DBplus provides secure, predictable retirement income for life. CAAT’s low administration costs and not-for-profit structure provides employees a better return on their pension contributions and helps employers focus less on administration, and more on achieving their organizational goals.”

Derek Dobson
Chief Executive Officer,
CAAT Pension Plan

PODCAST

Scale, Expertise and Focus

United Way Greater Toronto joins the CAAT Pension Plan

Listen to United Way Greater Toronto Chief Operations and Financial Officer Michael Cheong, CAAT Pension Plan CEO Derek Dobson and CIBC Mellon's Ash Tahbazian discuss scale expertise and focus, including UWGT's decision to consolidate into the CAAT Pension Plan - as well as the power of scale, expertise and focus.

Michael Cheong
Chief Financial and Operating Officer,
United Way Greater Toronto

Derek W. Dobson
Chief Executive Officer,
CAAT Pension Plan

Ash Tahbazian
Chief Client Officer,
CIBC Mellon

Watch the video:
https://vimeo.com/cibcmellon/expertise

Listen to the podcast:
https://anchor.fm/cibcmellonperspectives/episodes/The-Power-of-Expertise--Scale-and-Focus-eqhua3

Consolidating into another pension entity: United Way Greater Toronto.

Michael Cheong
Chief Financial and Operating Officer,
United Way Greater Toronto

"Our intention has always been to continue providing a pension plan to our valued employees, but we found managing a pension plan took focus away from our core mission of tackling local poverty and unignorable issues linked to and impacted by poverty.

We were delighted to join the CAAT Pension Plan's DBplus plan at the end of 2020, which gave our employees access to a jointly-sponsored pension program run by those with expertise in pension and investment management.

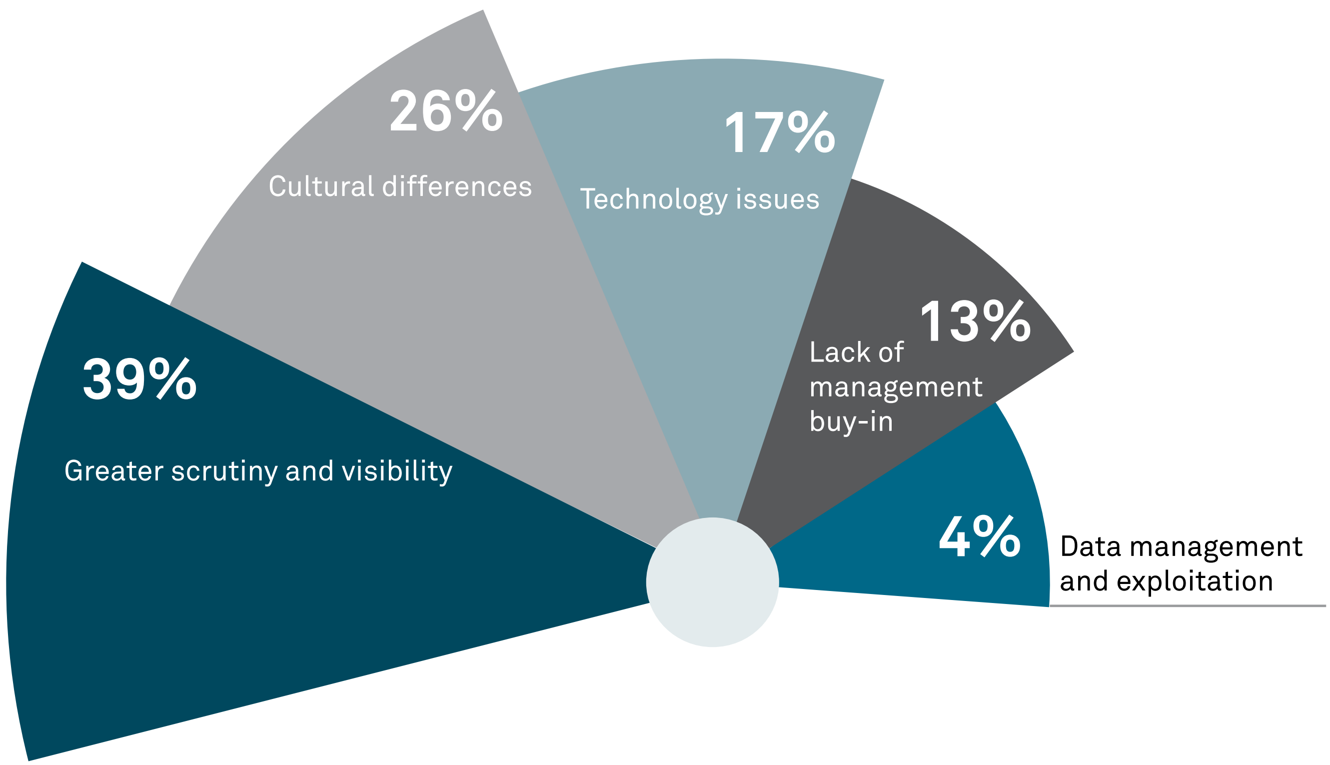
This merger allowed us to improve the pension plan we offer to our employees, helping ensure long-term, sustainable and secure retirement savings. An overwhelming majority - 99% - of members voted for the merger. The decision to join had many pros for our organization and employees. It was an easier and simpler plan to understand, with no member investment decisions to make. There were enhancements in areas like indexing, early retirement and survivor benefits. We were able to achieve more stable costs, reduce annual service costs, and stay aligned on the incorporation of ESG factors. We were also able to significantly reduce the governance and oversight requirements for our Board's Finance, Audit and Risk Committee."

Pension plan mergers present their own challenges, with hurdles to overcome even as plan stakeholders seek to deliver benefits to plan sponsors and members. Among those funds considering incorporating or merging other pension assets, liabilities or operations into their plan, 50% point to the need to cope with greater scrutiny and increased demands for visibility. Regulators and pension plan members will want to ensure that plan members' interests are protected.

There are the practical integration aspects of any merger: more than a quarter of pension funds (28%) point to technology issues, such as bringing legacy systems together which could jeopardize the route to economies of scale. Cultural differences are also an issue, highlighted by 11% of pension funds.

The same problems, moreover, confront pension funds considering incorporating or merging their assets into another pension fund or entity – as our findings show, pension plan mergers are challenging for both parties.

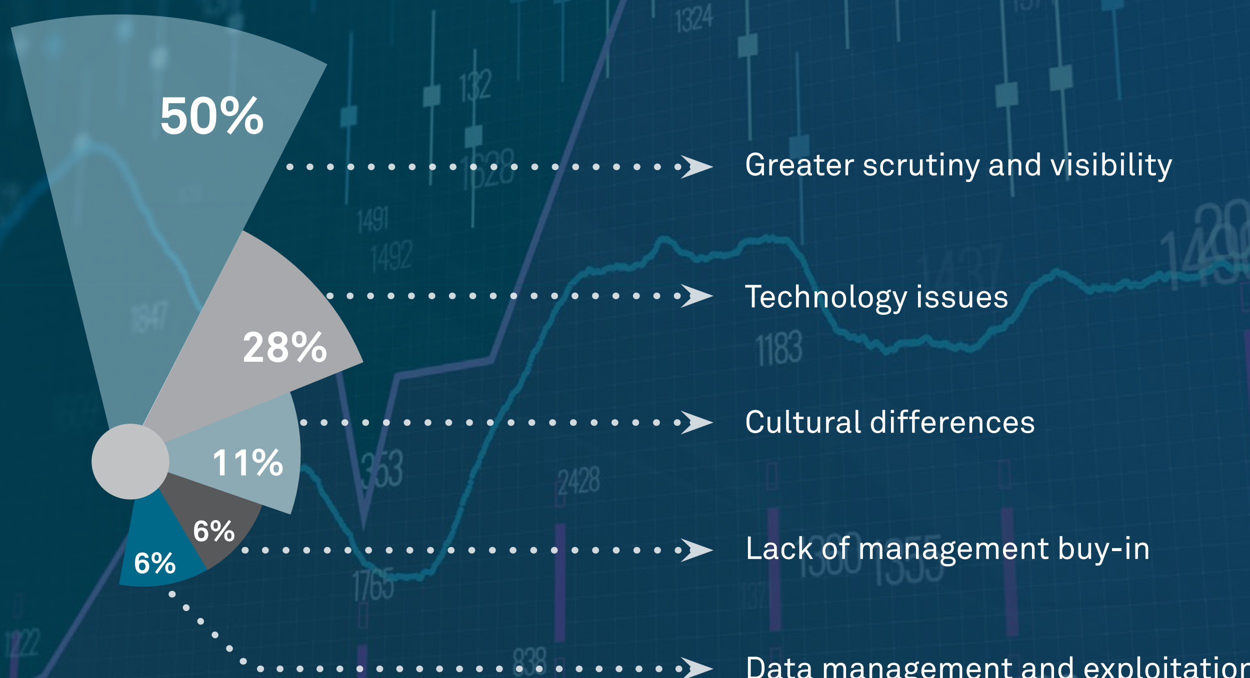
What do you consider to be the main challenge for consolidation via merger with or into another plan, asset owner or pension entity?



“In order to manage assets from external funds, we need more talent and technology capabilities; the governance, policies and legal terms will also need to be discussed before we move ahead to protect interests.”

Pension Fund Director of Investments

What do you consider to be the main challenge of incorporating or merging other pension assets, liabilities or operations into your plan?



Rise of the consolidators: new challenges face asset owners as they seek greater scale through consolidation.

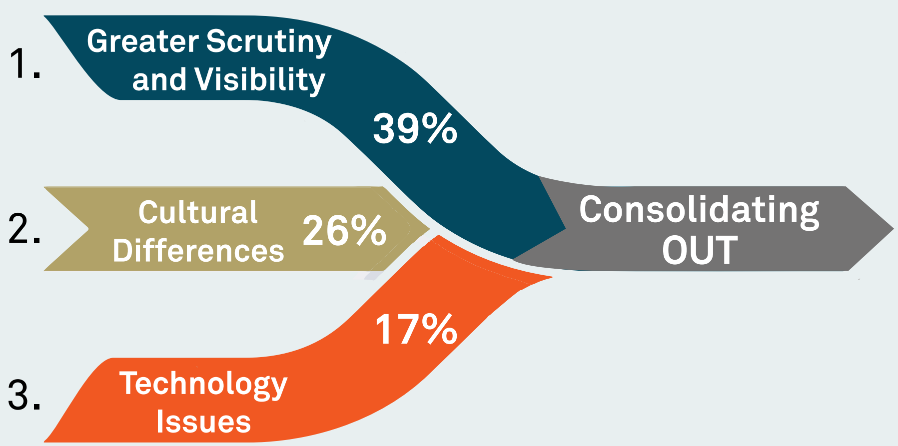
For asset owners seeking scale by moving investment, pension or operations activities out to a larger provider, and similarly for those looking to grow by consolidating in assets from outside pension entities, similar questions and challenges are in focus. Canadian pension plan sponsors take their fiduciary responsibilities seriously, and this is likely to colour their considerations of whether and how it makes sense to come together with other entities.

Greater scrutiny and visibility was top of mind across the board, along with concerns related to potential cultural differences between organizations as well as technology issues. Those looking to transfer responsibility, asset management or operations outside of their organization also expressed concern about cultural differences between organizations as well as the technology outlook.

Top three challenges:

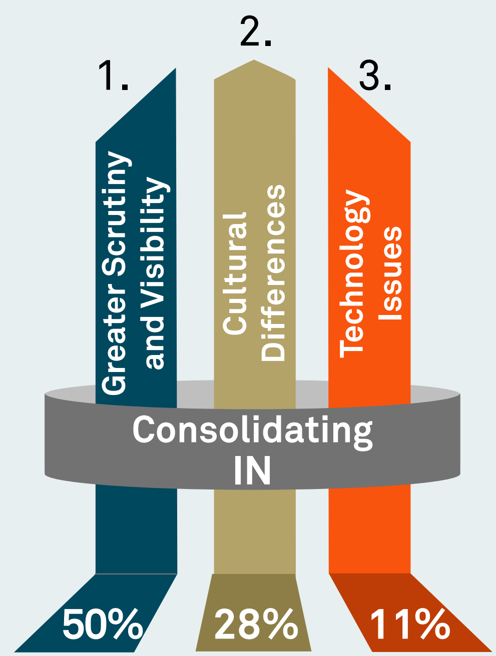
Consolidating OUT

Pension funds via merger into another entity



Consolidating IN

by merging outside assets, liabilities or operations into the plan



Areas for consideration

Potential focus areas as pension stakeholders consider their future operational stance

Governance	• How will consolidation impact our governance requirements? • What are our stakeholders' needs for transparency, oversight and compliance?
People and organization	• Do we have the necessary internal expertise to move or organization forward? • How will our talent needs evolve? • What is the right organizational design to set us up for the future?
Investments	• Do we have the scale and expertise to succeed? If not, how can we access it? • How are we evolving our asset allocation strategy? • What asset classes or strategies should we manage in-house? • Where will we rely on external managers?
Administration	• How do we deliver high quality service to plan members or stakeholders? • What is our technology strategy? • What is our data strategy?
Plan design and funding	• Is our organization appropriately aligned to its core mission? • How have our assumptions been confirmed or challenged by market turmoil in 2020? • How are we measuring, monitoring, mitigating and sharing risk?
Regulation and public policy	• How is our organization maintaining the trust of our stakeholders? • How are we navigating the regulatory and legislative environment? • How will we continue to operate at the highest standards?

“

Pension plan sponsors, pension asset managers, OCIO providers, insurers and other Canadian pension industry participants are leveraging their leading talent, advanced governance models, and investment expertise as they compete in a challenging market, seek to more efficiently access scale, and above all, work to deliver better results for their stakeholders.

Darlene Claes McKinnon
Executive Director,
Relationship Management

In addition to in-house expertise, many participants are engaging third-party experts for insights, advice, independent oversight and even hands-on participation in such aspects as governance, transformational project management, complex investment and operational strategies, and plan member services. We are seeing rising use of consultants and external advisors in areas beyond investment and pension design, as industry players work to act quickly but conscientiously in response to opportunities and risks.

For major organizational transformations, such as consolidation of assets or liabilities, thoughtful consideration is critical to successful outcomes, as the benefits and risks of consolidation must be carefully identified, measured and balanced. The need for support doesn't stop with the decision to change, either - we see a rising number of sustained engagements, with external advisors supporting smooth transitions as well as stronger sustained outcomes in complex multi-party relationships.”

Consolidation Implications: Questions worth exploring

Canadian Pension Plans have built a global reputation on a foundation of strong governance, sound leadership, advanced investment strategy, innovative organizational design and more. The emergence of Canadian pension consolidators and the move by some Canadian leaders to take on outside assets represents a new industry chapter that is likely to generate considerable discussion within and beyond Canada.

For pension plan sponsors seeking scale by engaging larger players to manage assets, take on liabilities or assume key operational functions, just as for organizations looking to grow by taking on mandates from smaller pensions, significant and thoughtful diligence will be required. As with any major organizational transition, robust review, collaborative engagement with stakeholders, and a sharp focus on governance are likely to help drive successful outcomes. "Structures, processes, and leadership that build and maintain trust among relevant pension stakeholders"including accounting for the needs of members, employers, unions, as well as government, regulatory and market stakeholders have been hallmarks of the "Canadian pension model."[2]

Many questions will arise as organizations contemplate new mandates – whether approaching them as counterparties, clients, colleagues, asset managers, service providers – establishing a shared framework will help both parties gain confidence around their shared concerns around scrutiny, visibility, technology and cultural alignment.

"Canadian pension plan sponsors take their fiduciary responsibilities seriously, and this is likely to colour their considerations of whether and how it makes sense to come together with other entities. From consolidation restructures, annuity buy-outs, innovative longevity risk mitigation strategies, and the strategic use of external asset managers to access scale, our clients continue to explore both old and new approaches to optimize their management of pension assets, liabilities and operating models."

Hilary Grimmett
Relationship Executive

Alistair Almeida
Segment Lead
Asset Owners

"For plans looking to transfer assets, liabilities or activities to another market participant, as well as for those looking to grow by merging in or managing assets on behalf of others, the top area of concern is greater scrutiny and visibility, followed by cultural differences and technology issues. To this end, pension funds on either side of the equation should consider how to address these concerns together - whether as prospective counter-parties, clients or colleagues. The Canadian pension model and indeed the Canadian market in general is known for its high focus on governance: it is no surprise that concern over scrutiny and visibility weighs heavily on participants."

Recap of Chapter 1 of our research: 10-minute Video Discussions

Investment strategy - what will life look like after Covid-19?

Our first chapter explores how pension funds are adapting their investment strategies based on the lessons learned through the pandemic. In this video, Ash Tahbazian, Megan Gentilesco and Alistair Almeida discuss challenges and opportunities, and explore how Canadian pension plans are evolving their allocations across asset classes and markets.

Recap of Chapter 2 of our research: 10-minute Video Discussions... (Cont'd)

In-house capabilities are on the rise, but outsourcing remains vital

Our second chapter explores how pension plans are expanding in-house capabilities while also becoming more strategic in their use of outsourcing. Considerations include alignment to organizational objectives, potential cost savings, opportunities to capture stronger returns, and a core strategic question on whether to invest into in-house or outsourced technology. In our chapter 2 video, Alistair Almeida connects with Darcie James Maxwell and Ian Fulton to explore these trends and questions.

Download all our chapters at **www.cibcmellon.com/insearchofnewvalue** or contact your relationship manager to discuss our findings.

More questions worth asking

A wide array of framing questions may help those on both sides of the consolidation equation assess the potential fit of any major transition.

<table>
<tr><th></th><th>Consolidating OUT to another pension management entity</th><th>Consolidating IN external assets, liabilities or operations from a pension plan or sponsor</th></tr>
<tr><td colspan="3">What are the benefits and risks of consolidation to our stakeholders?</td></tr>
<tr><td rowspan="2">Governance</td><td>• How will Trustees approach the strategy?
• What other stakeholders do we need to engage, and how – unions, employers, members, consultants?
• How will we provide confidence to stakeholders that transitioning key responsibilities to an outside organization is consistent with fiduciary, regulatory and member service obligations?
• What governance is needed over the outside operations – through the selection process and in terms of ongoing performance?
• What are the implications of consolidation to our investment policies and procedures?</td><td>• How will taking in outside assets or liabilities impact our organization’s governance and risk framework?
• How will we provide confidence to underlying clients and their plan members regarding sound governance?
• How will we sustain the confidence of the plans and members we serve?
• What are our responsibilities in terms of supporting governance over our organization by our new stakeholders?</td></tr>
<tr><td colspan="2">• How will consolidation change our governance and regulatory obligations?</td></tr>
<tr><td>People / Organization</td><td>• How will the change impact the organization’s people strategy?
• What are the implications of consolidation to in-house teams?
• What talent and organization should be retained in-house?
• What people or resources can we free up by transitioning out? Can we reallocate them to better achieve our goals?</td><td>• How will our talent needs change as we grow?
• How should we structure our organization to maximize success for stakeholders?
• What is our target client, stakeholder or member service model?
• What new skills, people or capabilities do we need as we expand our services to outside organizations?</td></tr>
<tr><td>Investments</td><td>• How does the current asset/liability mix align with the consolidator entity?
• What are the implications to our investment policies and procedures?
• Do we have strategic alignment (e.g. risk tolerance, stance on ESG)</td><td>• How will we continue to achieve the investment performance our stakeholders expect?
• What will be managed in-house?
• What will be outsourced?
• How will the organization continue to balance risk and liabilities?
• How should we adapt our investment and allocation strategy as we grow?</td></tr>
<tr><td>Administration</td><td>• What technology, administration functions, member services or other administrative activities must be retained?</td><td>• What is our long term technology and data strategy?
• How will the organization evolve its business functions over time (e.g. client service, marketing, member support, risk management)?</td></tr>
<tr><td rowspan="2">Plan Design and Funding</td><td>• How will consolidating out impact plan design or funding assumptions?
• What cost efficiencies can we achieve through consolidation?
• How will engaging an external provider change our liability, solvency or funding obligations?</td><td>• How will inbound assets, mandates, clients, liabilities or operations impact risk or funding?
• What new opportunities will open up as we gain scale? What new risks?
• How can we gain cost efficiencies as we scale up? How do we share those with our stakeholders?</td></tr>
<tr><td colspan="2">• Are the financial advantages of consolidation sufficient to justify the transition effort and costs?
• What are new obligations or impacts to current members/stakeholders could result from the changes?
• How will a new consolidation mandate benefit current stakeholders?
• How can we demonstrate that the transition serves the interests of our current stakeholders?</td></tr>
<tr><td>Regulation and Public Policy</td><td colspan="2">• What are the regulatory and policy implications of the change?
• How will members perceive the change?
• What current or emerging legislation from various government levels will impact our organization?
• Are there any additional considerations or consequences we need to consider?</td></tr>
</table>

Methodology

In 2020, CIBC Mellon's research provider interviewed senior executives, including directors of investment, CEOs and managing directors, from 50 pension funds headquartered in Canada to assess their asset management trends, including their response to the impact of COVID-19. The funds being managed were split evenly between those with AUM of C$600million -C$1.2 billion to those with AUM over C$1.2 billion. The average AUM of funds in the study was $C31 billion. Respondents were located across Canada; 26% of respondents were private plans, and 74% public.

Watch for Chapter 4 of our research, which explores the push to lower fees, the fallout from liquidity limitations, and the future outlook as Canada's innovative pension funds reposition themselves for the future.

To learn more, please visit www.cibcmellon.com or contact your Relationship Manager.

1 "World Bank Group. 2017. The Evolution of the Canadian Pension Model: Practical Lessons for Building World-Class Pension Organizations. World Bank, Washington, DC. © World Bank. **https://openknowledge.worldbank.org/handle/10986/28828 License: CC BY 3.0 IGO."**

2 The Evolution of the Canadian Pension Model : Practical Lessons for Building World-Class Pension Organizations : The evolution of the Canadian pension model : practical lessons for building world-class pension organizations (English). Washington, D.C. : World Bank Group. **http://documents.worldbank.org/curated/en/780721510639698502/The-evolution-of-the-Canadian-pension-model-practical-lessons-for-building-world-class-pension-organizations**

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