Global Pension Fund Consolidation and Mergers

Consolidating and restructuring assets across multiple plans into a single entity with the aim of protecting value in a risk controlled and transparent manner

Limited Access

STATE STREET

This paper has been prepared as an overview of the factors for pension plans undertaking a consolidation or merger event.

Consolidation in the pension sector is a global trend that has been playing out across many countries. From our experience in helping asset owners around the world embark on mergers of funds, we know that laying out the right foundational steps and selecting the right partner(s) are paramount to a mergers' success. In this paper, we highlight some of the key factors to help ensure a smooth transition of assets and to future-proof a robust operating model and associated investment infrastructure.

"A consolidation of pension funds has a singular objective – to improve pension member outcomes. At State Street, we support our clients with a wide range of solutions designed to create an effective road-map for a merger event and contribute to a successful restructure."

DANIEL MORGAN

Global Head of Portfolio Solutions

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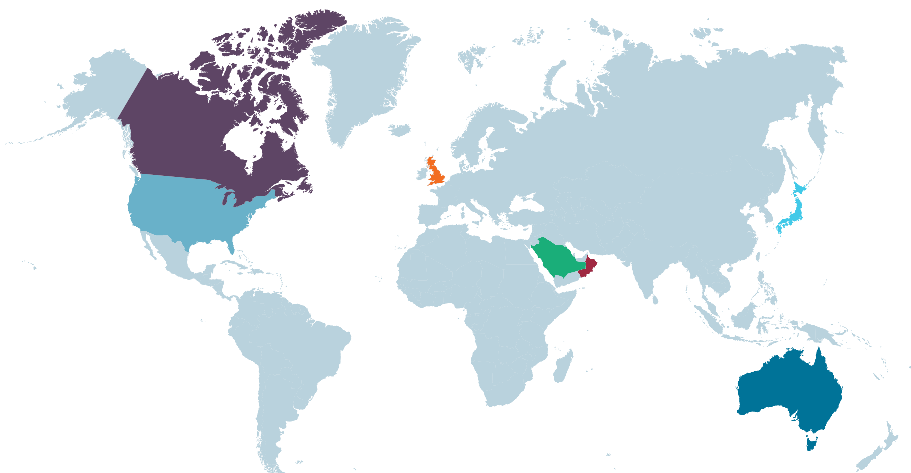
Executive Summary

Pension Fund Consolidation, a Global Trend

Figure 1: Examples of Pension Consolidation Around the Globe



Oman – Merger of up to 11 pension funds (Oman government plans pension fund merger – Arabian business)

United States - Recent state public pension consolidations and additional opportunities to consolidate across Public Pension Systems ("The consolidation of state-administered public pension systems in U.S. states" - Dec 2015, Journal of Public Budgeting, Matkin and Chen) along with corporate plans consolidating as a result of the M&A activity.

Japan – Japanese life insurers to merge corporate pension operations. Six of the largest life insurers planned to combine corporate pension assets in stages expected to complete by 2023 (Nikkei Asia)

Australia – Consolidation activity is predicted to result in only 10 super funds in Australia. 'The Rise of The Mega Fund' (noticeably since that publication mergers announced include Statewide and Hostplus, LUCRF and AustralianSuper, LGIA and Energy Super)

Saudi Arabia – New giant Saudi pension fund aims to crack world's top 10 ranks – (Bloomberg)

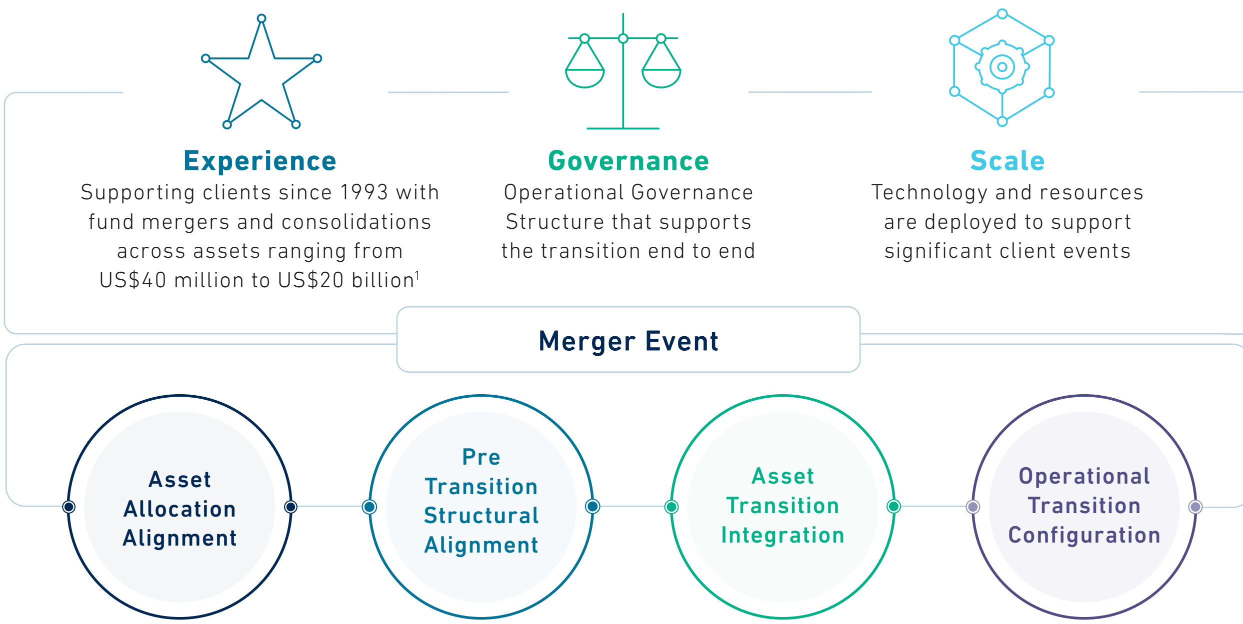
Canada – 72 percent of Canadian pension funds considering consolidation options: survey (Benefits Canada.com)

United Kingdom – United Kingdom weighs extending consolidation of pension sector to schemes of £5 billion – "Government unveils consultation to subject more plans to value-for-members tests" (Financial Times ft.com)

Lifecycle of a Consolidation Event

Below we outline some of the key high level structural and operational considerations associated with a merger event

Figure 2: Operational Lifecycle of a Merger Event



Asset Allocation Alignment

Investment Products/ Options

This is a critical phase in the planning process to assess the alignment of funds, investment products and options associated with funds merging and anticipate what it will look like once the funds have merged. With experience on mergers of various sizes, State Street's subject matter experts are well placed to assist in planning this important stage.

Pre Transition Structural Alignment

Third-party Providers

Ensuring that the various incumbents and third-party providers can facilitate a seamless integration and deliver service requirements on day one. Connectivity to third-party providers including member administrators, securities lending agent, data solutions and technology providers.

Technology Integration/ Data Solutions

Adopting a comprehensive data management solution that can integrate multiple data sources and ensure that investment and operations processes will continue seamlessly on day one of the transition.

Project Management

Establish a robust project management team with stakeholders from merging funds and relevant third party providers.

[1] Source: State Street Global Markets, as of January 2022

Asset Transition Integration

Portability of Assets

Unlisted assets often present with difficulties around the transfer of ownership title, specifically when dealing with overseas partners and managers.

Stamp Duty

Stamp duty may be payable on assets transferred through the merger process, so funds should consider what relief and exemptions are available and factor this into the timeline for transferring ownership titles.

Exposure Management

During a merger event, exposure management will be required when assets move or asset allocations and / or manager changes occur.

Operational Transition Configuration

Policy Alignment

Consideration and review of fund policies may help identify any misalignment and determine policy standards for the merged fund.

Accounting, Tax and Reporting Implications

Understanding the operational requirements of accounting and tax implications and issues identified prior to going live.

Transition Date

Determining a transition date is a critical element of the operational transition. There are custody, accounting, tax, performance and reporting implications to be considered to ensure optimal timing.

Member Equity

Member's position and rights must effectively be the same once transferred to the successor fund as they were prior.

Transition Management

A detailed understanding of the asset movements, portfolio exposures and optimal method of sequencing activities is required.

Considerations for Research and Portfolio Construction

Mergers and Asset Allocation

A merger event presents a multitude of risks and challenges, including key investment lifecycle considerations such as asset allocation and external manager allocation or evaluation.

At State Street Global Markets, we have partnered with renowned academics from Harvard Business School and MIT Sloan School of Management and have award-winning research capabilities that enable institutions to go beyond traditional approaches to help enhance performance, manage risk, and navigate the opportunities and challenges that may arise as market conditions change. Here are some insights we can bring from these partnerships:

From a strategic asset allocation perspective, investors have long relied on techniques such as mean-variance analysis and scenario analysis to help determine an optimal portfolio. To construct a portfolio asset allocation that can meet the funds' objectives and prove to be resilient to changing market conditions, portfolio construction techniques should jointly consider investor objectives and constraints to identify optimally diversified portfolios. These portfolios balance risk and return objectives effectively across regimes, requiring appropriate assumptions for asset class return, risk and correlation assumptions. These should be stress tested across a variety of economic and market environments and considered throughout the investment horizon (not just at its conclusion).

Asset correlations can be asymmetric as diversification can disappear when it is needed the most and are rarely stable through time or over different investment horizons. Our report on 'The Myth of Diversification Reconsidered' proposes that investors measure correlations conditional on the main portfolio growth asset and focus on diversification that is truly helpful when the growth engine falters and apply full-scale optimisation to construct portfolios that exploit correlation asymmetries to reduce risk.

We also document the profound divergence in correlations observed over high and low frequencies and introduce a portfolio construction framework that allows investors to build portfolios that jointly account for aversion to risk over different frequencies. The overall asset allocation process should also account for liquidity benefits and illiquidity costs of each asset class. These can be modelled quantitatively in units of return and risk, as shadow asset and liability allocations within the portfolio, enabling investors to account for the unique benefits and costs they can derive from liquidity, such as the ability to rebalance the portfolio, meet capital calls and take advantage of market timing skill.

Having successfully defined the strategic and dynamic asset allocation approach, manager allocations should subsequently be selected through a rigorous and objective assessment of manager quality, considering the quality of alpha, diversification benefits, factor exposures and performance across regimes. Downside protection strategies can also be developed to help hedge against portfolio losses, where a variety of hedging strategies can be considered through an in-depth analysis to assess the efficacy of various approaches. This includes tactical implementation of hedging strategies to gain downside protection while mitigating costs during periods of market stress.

With a demonstrable track record of innovation, State Street Associates has provided various bespoke advisory projects on behalf of our clients, developing customised solutions for investment challenges catering to pensions, central banks, sovereign wealth funds and investment managers, covering essential issues in investment management. Over the years, we have developed innovative portfolio construction and risk management tools, a suite of investor behaviour indicators, and an array of high-frequency economic indices helping our clients exceed their performance goals while managing risk effectively.

Planning a Merger Event

Risks And Challenges in a Merger Event

Pension funds need to consider the interaction of multiple factors when undertaking and planning a merger event. These considerations can include investment managers, asset allocation, target operating model, technology, platforms, data management, governance, internal management, people, culture, costs, timing, tax and impact to existing members or assets.

When planning a merger event, good strategy provides a solid foundation for implementation. However, vigilant management and execution of the plan is equally important. Factors such as vague or missed communications, lack of understanding of the timing of exposure shifts or stakeholder responsibilities, change of plans mid transition and lack of coverage can have adverse effects – which is why funds look to external providers such as State Street to help.

We manage merger transitions by leveraging our purpose built systems, experienced global team and provide clear accountability through transparent reporting.

As a restructure often involves many asset transfers and transactions in a short period of time, it is imperative that all stakeholders are aware of the expected volumes to ensure adequate resourcing is available. We provide dedicated resources to each merger event and offer a full pre-trade document for each component, containing detailed information including the estimated costs, liquidity analysis and risk profile of the event. Similarly, our clients dedicate internal contacts to ensure decisions can be made in a timely manner, keeping merger plans in line with expectations and on schedule.

Figure 3: Event Level Risks

Resources and Focus

- Lack of understanding from all stakeholders on the resources and time required to successfully restructure the assets

Planning and Activation

- Missing key detail in the planning and documentation stages
- Markets and accounts not being open – causing delays

Communication

- Poor communication amongst stakeholders can lead to uncoordinated activities, stakeholders not understanding key action dates or activities and incorrect exposure management

Decision Making

- Stakeholders that are unable or unavailable to make decisions
- Stakeholders who are not adaptable to event changes and the need to pivot from the original restructure plan

Foundations of a Successful Merger

Stakeholder Analysis. Extensive planning in collaboration with key stakeholders to understand the pre and post merger objectives and define roles, responsibilities and expected timeframes, are all crucial steps for building trust and ensuring clear communication to successfully complete a merger event.

Any merger event is an iterative process and consistent communication is crucial through the entire course of the event. Key milestones at this early stage include, understanding high level investment structures, executing legal documentation and establishing operational readiness.

Figure 4: Stakeholders and Roles

Funds in Scope

- Number of funds being integrated
- Which funds can integrate and when
- Listed versus unlisted assets
- Investment, operational and other key governance stakeholders

Role of Pension Fund

- Set objectives and timeframe expectations
- Approval of final transition plan and exposure shifts
- Authorisation of day-to-day decision making, to keep the event progressing
- Collective management of unlisted assets in conjuction with custodian

Service Provider at each Fund

- Custodian
- Managers (Investment/ Currency/Other)
- Administrators/ Unit Registry
- Asset consultant(s)

Role of Service Providers

- Ensure operational readiness, account opening and process transition activity
- Timely provision of target and/or legacy portfolios
- Processing of redemptions and applications
- Manager allocation, asset allocation and project management

Understanding The Investment Structure

In the early stages of a restructure, we explore and map existing portfolio exposures and understand how investments are held by the fund. It is important to know the split of listed versus unlisted assets and which assets are in pooled versus segregated mandates.

Once determined, the considerations for pooled investments versus segregated mandates will be different – as shown in the table below. These considerations need to be identified early and then factored into the event plan. Each stakeholder has a unique set of timeframes and requirements, which need to be acknowledged, assessed and integrated into the plan. Merger complexities often require restructuring over a number of stages, which can occur prior or post the target merger date. We identify the most efficient path to restructure the listed assets and present it to our clients.

An implementation plan cannot be finalised until there is a clear understanding of how funds are structured today, how they need to be structured in future and factors that may impact the ability to get to the future state in the desired timeframe.

Figure 5: Investment Structure Considerations

Pooled Funds

Understanding pooled investment structures

- Fund opening dates
- Special and scheduled distributions
- Settlement timeframes
- Custodian/unit registry
- Notice periods
- Currency for application/ redemption
- Ability to in-kind assets
- Application/redemption costs
- Non-transferability
- Change of beneficial ownership
- Tax considerations

Segregated Mandates

Understanding segregated mandate requirements

- Market openings
- Number of securities
- Cash weights and currency
- Hedging requirements
- Special instructions or limits
- Custody costs
- Corporate actions
- Trade freeze and termination periods

Considerations

Transition and general considerations

- Cost differences – in specie/cash
- Cost differences – cashflows
- Transferring emerging market positions
- How are unlisted assets being transitioned? (Client/ Custodian)

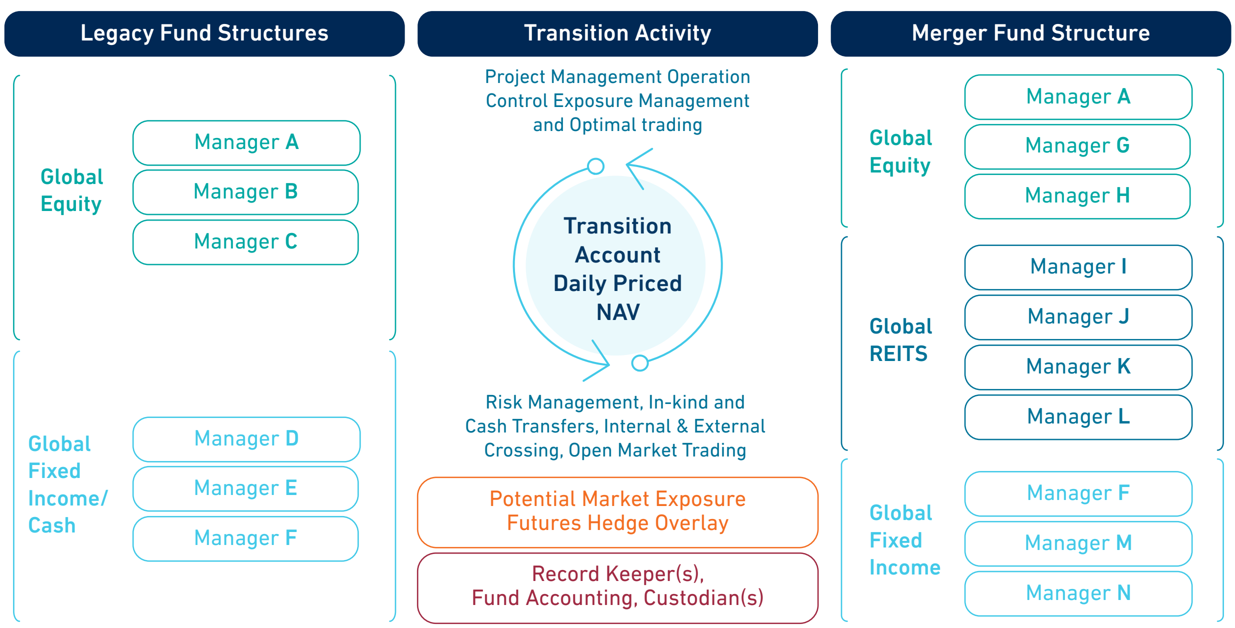
Formulating and Documenting a Merger Plan

Once we have collected the relevant information from stakeholders, we identify any scheduling restrictions such as custody, manager, fund or market specific requirements, that may impact the proposed time frame – we start to document a project plan that will provide a road map for merging the assets of each entity. A merger often involves many asset transfers and transactions in a short period of time.

It is imperative that all stakeholders are aware of the expected volumes to ensure adequate resourcing is available.

Below is a simplified merger workflow example – showing the types of activity our team coordinates as we move from the legacy fund structures to the target merged structure.

Figure 6: Example of a Simplified Merger Workflow



From the insights gathered from the stakeholder discovery sessions, we define a strategy, highlighting the considerations identified and how we intend to manage the risks specific to each merger event. The level of detail in the preliminary analysis is reflective of individual stakeholder constraints identified, and the information provided by the funds and their stakeholders in the discovery sessions.

Managing Costs in a Merger Event

Keeping costs under control is an important goal in preserving portfolio value for our clients. Our analysis incorporates a range of considerations, designed to help clients understand the costs associated with their restructure event. Our agency model and trading strategy provide an important source of cost savings to our clients. Transitioning of less liquid portfolios requires experience and the ability to access a wide range of liquidity sources – our multi-broker, agency model offers this.

At the pre-trade stage, to understand the best avenue for execution, we examine the liquidity profile of all stocks to be traded. We understand whether a position can be traded on market easily and for the less liquid names we devise a specific liquidity sourcing strategy.

We use a combination of market liquidity, broker indications of interest, investment manager liquidity, trader experience and transaction cost analysis to find the best liquidity channel for execution. In-specie transfers can be a key component to reduce restructure trading costs, as it increases the opportunity to capture in-kinds, and reduces trading activity. At the same time, it avoids spread costs going in and out of pooled investments. However, there are costs that can arise from in-specie transfers, such as stamp duty, taxes and custodian transaction costs. During our analysis, we consider these costs as they relate to each merger, providing our clients with a full comparison when considering in-specie versus a cash redemption or cash application approach.

We manage the risk and liquidity using trading strategies and liquidity venues to deliver efficient and cost-effective outcomes for our clients and their members.

Considerations we assess from external stakeholders can include some or all of the following

Manager Spread Costs	Preliminary analysis to determine spread costs for each manager if redemptions or applications are made as cash
Associated Custody Costs	Charges often apply to each security transferred in and out of the transition account, as well as purchases and sales
Taxes/Fees	Some markets apply stamp duty or other taxes if redemptions are made in-specie and there is a change of beneficial ownership
Futures Commissions	Estimated based on the expected contracts and values to be traded
Manager's Ability to Provide In-specie	Some managers may not be able to offer in-specie due to infrastructure constraints or dollar value falling below threshold levels

Case Study

Enabling Complex Asset Transfer in Super Fund Merger

About The Funds

- Two Australian superannuation funds undertaking a merger to improve member outcomes and economies of scale
- The larger, managing **A$9.5 billion in assets**, with roughly 40 percent allocated to unlisted assets (25 percent alternative assets) and 98,000 members
- The second, with **A$1.5 billion AUM***, holding roughly 85 percent unlisted alternative assets, and circa 25,000 members

Objective

- The **larger fund** was seeking to **grow its footprint** in its sector. Having established a strong alignment with the target fund's membership and asset allocation, the core aim was to transition the target's assets into its portfolio structure
- The **smaller fund** had identified that it was in members' best interests to merge with a larger fund, offering **improved products and services, economies of scale** and **operational efficiencies**

Challenge

- **Transition complexity**. Transitioning an unlisted, alternatives-heavy portfolio brings unique challenges. The transfer would bring issues related to stamp duty, pre-emptive rights, pricing cycle alignment, unit pricing structure, liquidation considerations and reporting needs
- **Operational demands**. Working with multiple parties, including overseas alternatives managers, to seamlessly integrate multiple data sources. Managing heightened reporting and pricing activity in the lead up to the transition date

Our Approach

- **Transfer planning.** Our project team supported the client for eight months leading up to the transition, helping to set project timelines and liaise with external fund managers in the United States and elsewhere. We worked with managers to obtain **out-of-cycle pricing** for alternative assets where needed, to help ensure member equity and to avoid significant swings in asset valuations where possible
- We worked with the client on **transition planning**, preparing the conversion of trust structures to mandates and advising on issues such as the transferability of stock in certain markets and stamp duty implications
- **Execution.** We worked with fund managers' international transfer agencies to deliver on reporting requirements. Daily unit pricing was conducted before and during transfer to ensure alignment — and we delivered additional reporting to provide robust oversight as the client's AUM* rose by circa 17 percent over a one-week period

The Result

- **Member outcomes.** Assets were transitioned into the successor fund with optimal efficiency, ensuring members retained maximum portfolio value
- **Operational excellence.** Data integration was managed to ensure day one investment and operations processes continued flawlessly. Successor fund gained access to additional custodial services such as enhanced performance and attribution analytics, look-through reporting and frequent tax reporting
- **Restructuring.** The successor fund had the opportunity to convert trust structures to mandates, helping to support its active investment strategy and broaden its manager selection

* Assets Under Management

**This and the proceeding case studies are based on a specific client experience within a specific time-frame; similar outcomes cannot be guaranteed. Certain details were treated in a summary fashion or were omitted for reasons such as client confidentiality.

Transitioning Private Market Assets

Engaging your Custodian for the Transfer of Private Assets

Below is a high level overview of the main steps to transfer private assets from the existing funds to the selected transition vehicle. It can be challenging to document a timeframe to complete these tasks as it may vary depending on the type of funds in scope and any restriction and / or specific legal requirements they may be tied to; however, this is where your custodian can accompany you and help liaise with managers and administrators to ensure a smooth transition of these private assets.

It is also worth highlighting that the provision of accounting services is not dependent on the name change to the transition vehicle being completed. In its capacity as a custodian, State Street's experience is that all investments can be captured in accounting while the process is being completed.

Private Asset Migration – Illustrative Example of Actions	Action Owner
Private Asset Name Change	
Document all non-custody investments and respective fund manager or administrators contact details	Custodian/Clients
Authority to communicate with custodian in relation to merger sent to fund managers or administrators	Clients
Direction to add custodian to distribution lists for statements sent to fund managers or administrators	Clients
Collate requirements for name change for all investments	Custodian
Collate all forms required to change client investment names	Custodian
Create tracking log and categorise all requirements or forms per investment	Custodian
Funds with NO Restriction on Name Change	
Complete forms and provide supporting documentation	Clients
Deliver forms to fund managers or administrators	Custodian
Track completion of name change with fund managers or administrators	Custodian
Funds with Restriction on Name Change	
Review requirements to effect name change	Custodian/Clients
Engage legal counsel or consultant as required	Clients
Complete forms and provide supporting documentation	Clients/Legal
Track completion of name change with fund managers or administrators	Custodian
Fund Accounting (not dependent on completion of name change)	
Review and document all statements received from fund managers or administrators	Custodian
Agree on fund structure, hand-offs, operating model	Custodian/Clients
Agree on load date	Custodian/Clients
Capture all positions in fund accounting system	Custodian
Deliver reconciliation of all positions once captured	Custodian

Factors to Consider When Choosing a Partner for a Merger Transition Event

Fund mergers are complex events that come with significant risks. These events are both operational and investment focused and as such requires a team that can combine effective operational project management experience, with execution capabilities that provides access to a broad range of liquidity. Consider the following before choosing a partner for a merger transition event:

- **Resourcing and team expertise**
- **Business model** – agency providers will be able to access a wider range of liquidity sources, which is critical for achieving best execution in a merger event
- **Level of transparency** provided around execution quality
- **Robust technology**

State Street's team is backed by experience in multi asset class restructures across mandates, pooled funds, custodians and ownership structures.

Why Partner with State Street?

State Street operates a global transition management platform and has been managing transition exercises for customers since 1979.

Our transition management services operate on an agency basis, which means we are able to source liquidity across a broad range of channels. It is imperative that a provider restructuring your assets has access to a range of cross asset class liquidity as well as deep expertise in integrating assets in a merger situation.

Our experience in both planning an event and communicating across multiple stakeholders over custody, registration, tax, asset allocation, risk management, exposure management and execution enables us to understand, document and successfully execute a restructure event.

State Streets' Long-standing Experience in Consolidating Pension Assets

US$188 billion
value of consolidated assets where State Street has managed mergers and whole of fund restructures[2]

28
Managers on average involved per restructure event[3]

Responsible for
more than 10%
of the world's assets[4]

Investments in leading order management, risk and execution technology

Insights from a global strategy team to design and test implementation paths and solutions

Market leading TCA[5]
To measure trading costs

A multi asset class, pure agency, specialist transition manager with a dedicated team of transition management professionals with vast experience restructuring assets and managing consolidation or merger events.

28 years
of transition management experience[3]

[2] Completed from 2008 to January 31, 2022 – Source State Street Global Markets

[3] As of June 30, 2022 – Source State Street Global Markets

[4] State Street and McKinsey Global Institute, Global Capital Markets, December 31, 2018*

*Updated in April 2020 per bespoke McKinsey report. This represents State Street's Q4 2018 AUC/A (US$31.6 trillion) as a proportion of total global financial assets (US$295 trillion).

[5] TCA: Total Cost Analysis

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