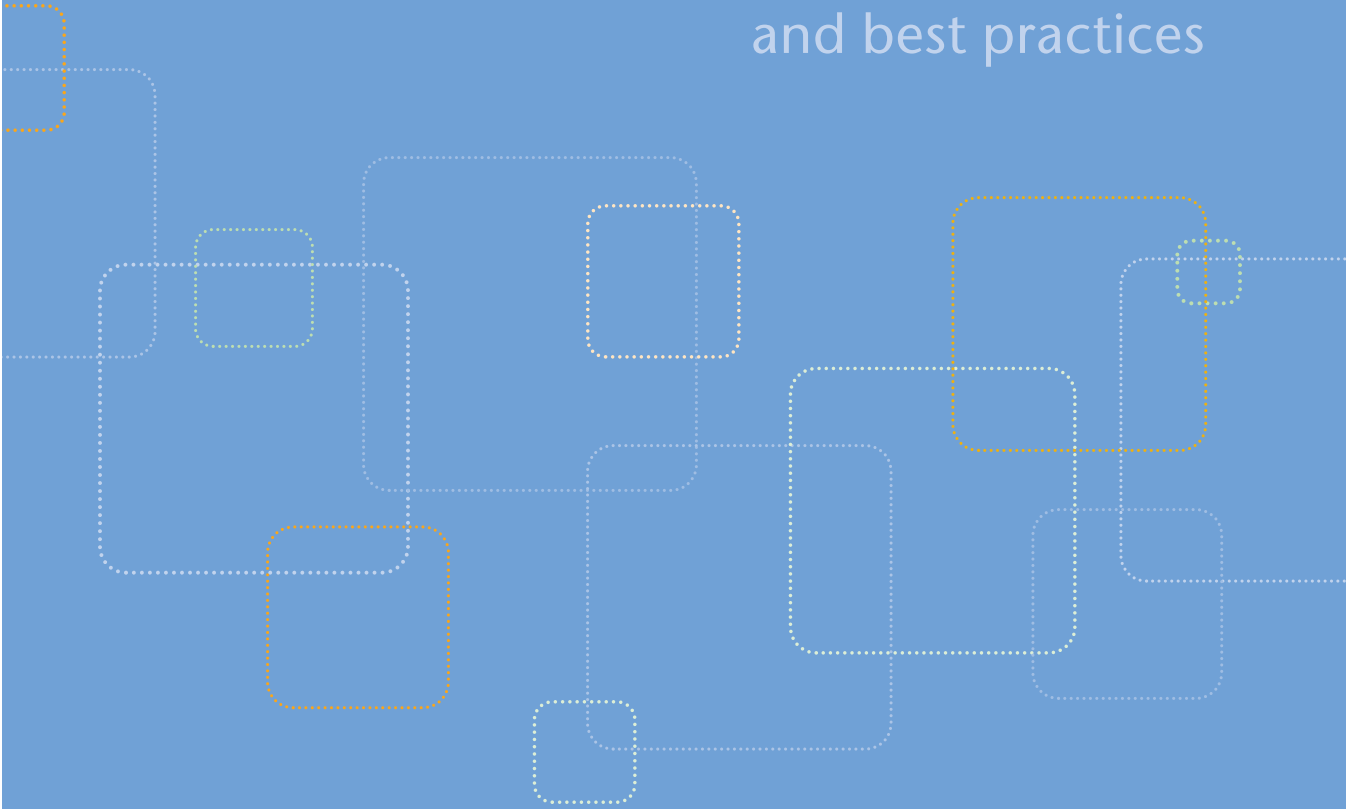


OMERS Submission to the Ontario Expert Commission on Pensions

# Closing the Gap

between pension regulation

and best practices



October 2007

**OMERS**  
Plan for the Future

**OMERS** primary responsibility is to ensure a strong and stable pension plan for employees in Ontario's municipal sector. We provide first-in-class investment management and superior pension services to plan members and employers.



### **OMERS** by the numbers

**\$48<sup>+</sup>** billion

#### **Net Investment Assets**

Invested in public markets, private equity, infrastructure and real estate

**906**

#### **Employers**

Includes municipalities, school boards, libraries, police and fire departments, children's aid societies and other local agencies throughout Ontario

**372,000**

#### **Members**

Includes active members, retirees and survivors. The largest concentration of active members is in the 40 to 49 age range

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The world of pensions is changing

## We must evolve to keep pace

OMERS welcomes the opportunity to contribute to the review of the pension system by the Ontario Expert Commission on Pensions.

This submission represents the views of two statutory corporations: the OMERS Administration Corporation responsible for investments, plan administration and services to plan participants; and the OMERS Sponsors Corporation responsible for plan design, benefits and contribution rates. Employers and plan members are represented equally on the boards of both corporations.

OMERS is:

- A public sector multi-employer defined benefit plan
- A large and complex plan with a highly diversified membership
- A jointly-sponsored plan with a tradition of employer/member governance
- A large pension fund investor pursuing a global investment mandate.

It has been more than 20 years since the *Pension Benefits Act* underwent meaningful change. A great deal has transpired during the intervening two decades.

Ontarians are aging. The ratio of pension plan contributors to beneficiaries is shrinking. Ontarians are living longer, increasing lifetime pension payments. A few defined benefit plans are near maturity and others, including OMERS, will reach maturity in the next 10 years or so when the outflow of benefit payments equals the aggregate inflow of contributions and investment returns. Changing demographics have forced pension funds to seek higher returns and make hard investment choices in matching assets with long-term liabilities. So have prolonged low long-term interest rates that have driven up liability costs, and concerns about over-exposure to volatile public equity markets. As a result, pension fund investing has diversified in terms of investment strategies and assets owned. Investing has also become global in scope to earn potentially higher returns outside Canada.

Industry leaders, including OMERS, have developed often-complicated investment structures to comply with legal requirements, to mitigate risks, and to ensure effective asset ownership. The goal is always

### Recommendations

**1** Amend the *Pension Benefits Act* to consist of the fundamental principles applicable to all pension plans in Ontario.

**WHY?** A principle-based approach to legislation is more flexible and enables regulations to evolve in step with industry best practices.

**2** Exempt jointly-sponsored plans from the quantitative restrictions on pension fund investing.

**WHY?** Rules are outdated and impose complexities and costs that ultimately reduce investment returns.

**“At OMERS, our commitment is to optimize investment returns without incurring undue risks, thereby delivering pension benefits at affordable cost to our current and future retirees.”**

Michael Nobrega  
President and CEO

the same – to guarantee the retirement income of plan members at a reasonable cost. Structures and strategies have also evolved in response to regulatory obstacles.

Regulations have not kept pace with Canadian and global trends in pension fund investing. Having recently experienced a three-year examination by the Financial Services Commission of Ontario, it has become clear to OMERS that rules and regulatory perceptions are out-of-step with investment practices and governance standards that have evolved in recent years.

It is time to close the gap between pension regulation and best practices in the industry.

With that in mind, we recommend that:

- Pension law should clearly respect the broad fiduciary powers of pension plan administrators and adopt a more flexible principles-based approach rather than a rigid rules-based approach. This does not mean a weakening of the *Pension Benefits Act*. The fundamental pension rights of members must be clearly spelled out and protected by legislation, as they are now.

- The quantitative constraints on pension fund investing contained in the Federal Investment Rules be removed from the *Pension Benefits Act* for jointly-sponsored pension plans.
- Regulatory relief from the Federal Investment Rules be introduced immediately on an interim basis while governments study and amend legislation.
- Jointly-sponsored public sector pension plans be exempt from the solvency funding requirement because government sponsors do not go bankrupt.
- The relationship with the regulator move to a co-operative model that involves advice, guidance and consultation on regulatory and policy issues.

Our submission provides an overview of the OMERS model and its advantages, a summary of the OMERS experience in pension and investment management and a case for a new regulatory relationship.

At the request of the Commission, we have also identified four technical issues and made appropriate recommendations. These are discussed in Appendix I: Technical Issues.

### 3 Exempt jointly-sponsored plans from the solvency funding requirement.

**WHY?** Contribution rates and taxes will not need to increase to fund a wind-up scenario with negligible probability.

### 4 Enhance the regulatory relationship by moving to a more co-operative model and providing the regulator with additional tools and resources.

**WHY?** A consultative approach will result in more proactive oversight and enable plan administrators to act with greater certainty to the benefit of their members.

## The advantages of a multi-employer defined benefit plan

### Strength in numbers

OMERS is perhaps Canada’s leading example of a successful multi-employer defined benefit plan. It was cited recently by the Governor of the Bank of Canada as a plan that effectively pools risks among a number of plan sponsors.<sup>1</sup> As such, OMERS could be a practical template for private and public sector employers to maintain their defined benefit plans.

OMERS has a major presence in Ontario. The pension plan was formed in 1963 to create efficiencies for employers in sharing the administrative and investment costs of providing pension benefits to workers employed by municipal governments and other local agencies. We began in 1963 with 160 employers and 8,000 active members. By the end of 2006, we had 906 employers, 237,000 active members, and more than 100,000 retirees. Beneficiaries receive \$1.7 billion annually in retirement, survivor and disability pensions.

To the outsider, OMERS is a complex plan. Yet the model answers many issues raised by the Commission about the benefits of pooling pension funding to achieve affordability for members and sponsors.

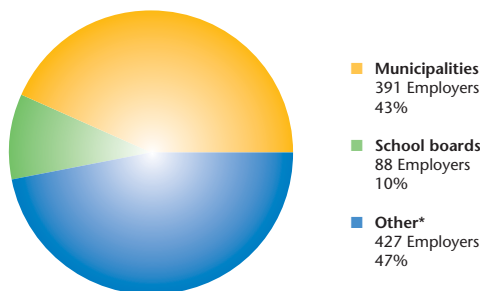
#### The employer perspective

The size of employers participating in OMERS varies enormously from cities, towns and villages to school boards, local hydros, libraries and children’s aid societies. Our largest employer is the City of Toronto with 24,000 active plan members. However, 500 employers (55% of the total) have fewer than 50 employees.

Smaller employers cannot afford on their own the professionalism and technology in plan administration achieved by a multi-employer plan. In the past decade, OMERS has invested \$77 million in developing and maintaining highly sophisticated technologies to enhance plan administration and deliver administrative and reporting efficiencies to employers, thus relieving pressure on the local tax base. Investments in plan administration, coupled with extensive staff training in customer service, have produced excellent member services. Plan members consistently give OMERS a service satisfaction rating exceeding 90%. Our annual plan administration costs of \$109 per member are at the low end of large- and medium-sized plans, based on 2005 survey data. We deliver quality services at reasonable costs and rank as one of the most modern and efficient plan administrators in Canada.

#### OMERS employers

906 Employers



\* INCLUDES POLICE, ELECTRICAL UTILITIES, CHILDREN’S AID SOCIETIES, LIBRARY BOARDS, AND HEALTH UNITS

<sup>1</sup> David Dodge, Governor of the Bank of Canada, in remarks to Conference Board of Canada’s 2007 Pension Summit: *Striking the Right Balance*, Toronto, Ontario, May 10, 2007.

**“Municipalities in Ontario pooled together to form OMERS, and we should examine ways to construct similar pension arrangements for private sector employers.”**

David Dodge  
Governor of the Bank of Canada

One outcome of our multi-employer model is that small employers can compete in the labour market when a decent pension can be a deciding factor in recruiting professional, skilled and unskilled workers. The pension factor will be increasingly important as labour markets tighten with the aging of the workforce, and could be a competitive advantage for Ontario to attract skilled workers.

#### **The employee perspective**

The OMERS model allows a wide cross-section of unions and employee associations to participate in a common plan. Many defined benefit plans have a reasonably homogeneous plan membership either because the members are in one occupation or have a single employer. OMERS is an example of a dynamic plan where the commonality among members is that they work for many governments and agencies, mostly at the local level in Ontario. There are more than 40 umbrella groups representing unions and employee associations and hundreds of locals representing workers in the OMERS plan. About 80% of members are in unions or employee associations and 20% are not, including managers and elected officials.

An outcome of our model is that workers can move freely to other OMERS employers with no change in pension entitlements. As well, we have over 25 transfer agreements providing for portability of service, some dating back to the 1970s, with Canadian public sector and private sector pension plans. OMERS was also a founding signatory in 1991 to a multi-plan portability agreement with other major Ontario plans. Portability facilitates labour market mobility and the ability to carry pension benefits to a new employer is a key issue for our members.

#### **The retiree perspective**

The multi-employer model delivers many benefits to former employees; they retire knowing their pensions are secure for the rest of their lives and they will not be affected by swings in investment markets. They treasure the inflation protection that sustains the purchasing power of their retirement dollars. And they are reassured by the quality of our instant-response client services in answering any questions they may have.

#### **Cost-efficient investments**

Our investment practices are liability driven. We invest employer and member contributions, and the income received from investments, to meet or exceed the Plan's funding requirement as determined by the present value of all current and future pension entitlements. We have achieved exceptional returns since 2003 as our shift to alternative asset classes has begun to pay off. The measure of our success, however, is not just high investment returns, but ensuring that we have the right long-term assets to match liabilities. Liabilities guide our investment strategies in terms of how much risk we are prepared to assume to achieve acceptable investment returns.

OMERS began in 1963 with \$5 million in assets, virtually all non-marketable Ontario debentures. Today, we administer close to \$50 billion in net investment assets on a global basis. Our success is based, like a few other large funds, on the extensive use of in-house investment professionals, minimizing fees paid to external fund managers. Our assets include public and private equity, infrastructure,

real estate, fixed income securities, derivative contracts and hedge funds. All asset classes require specialized investment and management skills to optimize performance. Asset classes such as real estate, infrastructure and private equity require large, long-term individual capital commitments to make worthwhile deals happen. Often they are of a size beyond the reach of small pension funds (even on a co-invest basis) because these funds cannot afford to incur the risks involved in proportion to their total assets and liabilities.

Size matters. The pooling of pension funding can (and must) lead to the creation of a large investment organization with the critical mass of professional expertise, technological tools and risk management controls to enhance the prospects of appropriate investment returns. This, too, is an expensive undertaking. Our investment in technological systems to support our expanding investment activities has exceeded \$20 million over the past decade.

The size and diversity of our portfolios attract investment professionals who would otherwise seek careers in private sector investment firms. In a highly competitive marketplace, we have designed performance-based incentives that attract and retain the talents the Plan requires to ensure cost-effective success.

All this underscores that we rely on investment income to pay about 70% of long-term pension liabilities, with only 30% supported by employer and employee contributions. The reliance on investment income is expected to increase as the Plan matures in the next decade or so.

### Enjoying economies of scale

The Commission has expressed concerns about how best to achieve efficiencies for employers and employees in defined benefit plans. The OMERS model illustrates economies of scale in plan administration and pension fund investing, and in attracting talented professionals on both sides of the business.

Our experience supports the Commission's notion of encouraging the consolidation of smaller pension plans, either with compatible large partners, or by pooling their resources with similar-sized funds. As a multi-employer plan, OMERS is well positioned to assume the administrative and investment responsibilities of other plans. We currently provide third-party management services to some other plans, such as Ryerson University and Transit Windsor. Under the *OMERS Act, 2006*, OMERS has the authority to administer additional pension plans or pension funds on a third-party basis.

The Commission has raised questions about whether single-employer plans should be encouraged to form, or join existing multi-employer plans. This could be a complex, time-consuming and costly process. We anticipate that such a development would involve heavy initial costs on the administrative side in adjusting systems and working through amendments to governing legislation, although cost efficiencies should emerge over time. The greater advantage for a fund like OMERS would be the ability to assume responsibility at very low cost for invested assets and achieve the asset diversification, risk management, enhanced returns and economies of scale that smaller funds lack. We could readily accommodate funds with assets of \$10 billion or less without significantly altering our investment costs. The Commission should consider the benefits of amending the *Pension Benefits Act* and other relevant legislation to provide greater flexibility for pension plans to grow.



OMERS relies on investment income to pay about 70% of long-term pension liabilities, with only 30% supported by employer and member contributions.

### Size in the global context

It should be emphasized that while OMERS is a large fund in Ontario, it is a small fund in the global context. Twenty years ago most Canadian pension funds focused on domestic passive investing. At that time, the consolidation of pension plans made less sense because investment opportunities in Canada were limited and pension funds were obliged to invest virtually all of their assets in Canada. A few large funds created by consolidation would have dominated the domestic market. Today, the marketplace is global. Pension funds have latitude in diversifying investment risks and improving investment returns by acquiring assets in other nations.

The largest 100 pension funds in the world include five from Canada. OMERS ranks 46<sup>th</sup>.<sup>2</sup> This is a humbling contrast to our status as the second-largest Ontario pension fund. The pension world is dominated by U.S. funds with strong representation from European funds and the rapid emergence of pension and state-managed investment funds in Asia and the oil-rich Middle East. The Abu Dhabi Investment Authority, for example, manages \$875 billion (U.S.) of assets, more than triple the size of CalPERS, North America's largest pension fund.<sup>3</sup> This is the world in which we must compete for investment opportunities – not just against pension funds, but also large mutual funds, other private pools of capital and increasingly state-sponsored investment corporations

in the developing world. All are scouring the world for reliable, long-term, risk-adjusted returns to meet their fiduciary responsibilities to those they serve.

### Summary

It is in the best interests of Ontarians that their pension plan administrators have cost-efficient, pooled access to technological systems and professional skills, based on scale efficiencies, to secure their retirement benefits. The ability to earn acceptable levels of returns is becoming increasingly difficult, leaving smaller funds and their members particularly vulnerable. The multi-employer model is an attractive solution in reforming the pension system. Its main advantages are:

- Costs and risks are pooled across multiple employers
- Larger investment funds lead to better investment opportunities, higher returns, cost-efficiency and ability to attract top professional talent
- Efficient and professional pension plan administration produces high-quality member services
- The multi-employer plan can serve a highly diverse membership in terms of occupations and income levels.

<sup>2</sup> P&I/WW 300 [Pensions & Investments/Watson Wyatt Worldwide 300], *Pensions & Investments*, September 3, 2007.

<sup>3</sup> Morgan Stanley data quoted in *Wall Street Journal*, September 21, 2007, p. A1.

## The advantages of a jointly-sponsored governance model

### Sharing responsibility

**Another aspect of the OMERS template is joint governance in which members and employers share responsibility for decision-making and the obligation to fund the plan. It gives employers and members an equal voice at the boardroom table in accepting responsibility for the Plan's success.**

OMERS employers and members have had this responsibility since 1968. It is the prototype of the representative governance model and should not be confused with “lay” boards as some critics have done. In representing employer, member and retiree groups, board members bring multi-faceted expertise to the board table. Successive generations of directors have provided oversight of executives and managers, who have delivered strong results in pension plan services and pension fund investing. Most important, successive boards have represented the best interests of *all* plan members.

#### The OMERS experience

Under the oversight of these directors, OMERS has been an active investor in public equity and debt markets since 1974 – longer than virtually any other public sector plan. OMERS entered the commercial real estate market three decades ago. OMERS pioneered Canadian pension fund investing in infrastructure in 1999. OMERS has many years of success as a private equity investor. OMERS was an early mover into

innovative investment products, such as derivative contracts and hedge funds. And OMERS has developed first-rate, member-sensitive pension plan services over the past decade. All this has occurred under the watchful eyes of those who represent employer and member groups.

Governance is an evolutionary process. Over the years, we have adopted policies, processes and procedures that have kept pace with our entry into new asset classes and the utilization of more complex investment structures. For example, we have incorporated such modern governance standards as an on-site compliance office and an internal audit department. Today, we require board members to earn university accreditation as directors. We continue to review governance enhancements with a current major review being conducted by external experts.

#### Accepting full responsibility

Recently, OMERS was granted its independence from the Ontario government. The new independent governance model is detailed in the *Ontario Municipal Employees Retirement System Act, 2006 (OMERS Act)* and strengthens our well-embedded joint-governance tradition. OMERS has always been *jointly funded* by employers and plan members. It has been *jointly governed* since 1968. The province was the official sponsor until 2006, when the *OMERS Act* was passed, but did not actually contribute funds to the Plan. With this legislation, OMERS became a *jointly-sponsored plan*, in which employers and members are directly responsible for the major decisions about the pension



plan. Through the OMERS Administration Corporation, employers and members continue to share responsibility for plan administration and investment management. Through the OMERS Sponsors Corporation, employer and member representatives are now responsible for plan design and decisions on contribution rates and benefits.

The significance for other plan sponsors is that the joint-sponsor model makes employers and members directly responsible for the major decisions about the pension plan and pension fund as they both share funding surpluses or deficiencies.

Joint-sponsorship should also ensure full disclosure, transparency and accountability by the plan administrator to the sponsors, as well as plan members. OMERS has practiced full disclosure for many years through a detailed annual report available to all plan members and other interested parties.

Jointly-sponsored pension plans have a major presence in Ontario. In 2004, the five largest jointly-sponsored plans represented about one-third of the members of all pension plans registered in the province.<sup>4</sup> These plans are established by statute, trust or collective agreement. The provincial government recently amended the *Pension Benefits Act* to recognize jointly-sponsored pension plans as a distinct class with special regulations regarding funding and other matters.

### A solution that works

The result of the jointly-sponsored governance model is a balance between employers' and members' rights and responsibilities. This model shifts the focus from how employer and member interests differ to how the two groups work toward the common goal of financially sound funding. The complexity of the representative model should not be seen as an obstacle, but rather as a workable solution, as the OMERS experience has demonstrated since 1968.

### Summary

The many advantages of the joint sponsorship model include:

- Balance between employer and member interests
- Ensuring that employers and members understand the financial impact of benefit design decisions and the role of contributions in plan design
- Sharing funding shortfalls and surpluses, which leads to better decision-making by all participants
- Improving governance oversight of plan administration as well as pension fund investing and related risks.

<sup>4</sup> Ontario Ministry of Finance, *The Funding of Jointly-Sponsored Defined Benefit Pension Plans*, 2005, p. 4.

## How we secure the retirement years of plan members

# Coping with changing demographics

### Changing demographics are putting pressure on defined benefit pension plans to secure the retirement years of their members.

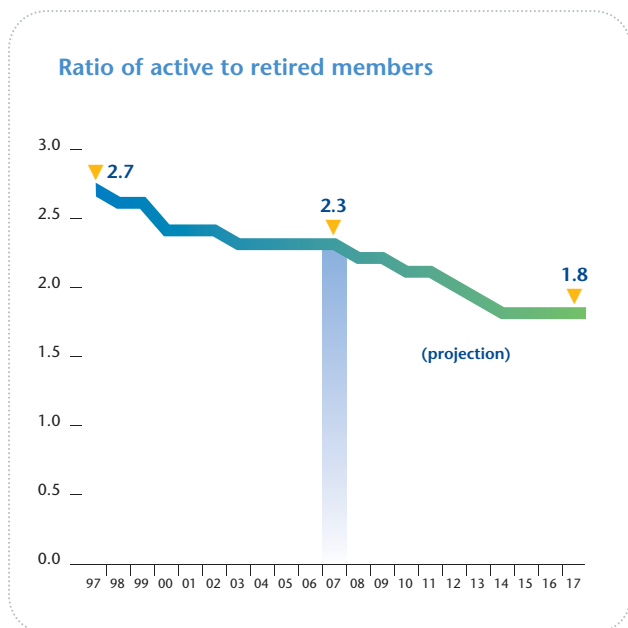
First, the ratio of contributors to beneficiaries is shifting. In OMERS case, active plan membership has expanded steadily over the past 10 years – from 186,000 in 1997 to 237,000 at the end of 2006, a 27% increase. Our retired membership, including family survivors, has grown even faster from 69,000 in 1997 to 101,000 at the end of 2006, a 46% increase. OMERS still attracts more new members (18,000 in 2006) than leave (12,000) although the gap is narrowing as the Plan matures. Over the next two decades, however, over half the membership will retire.

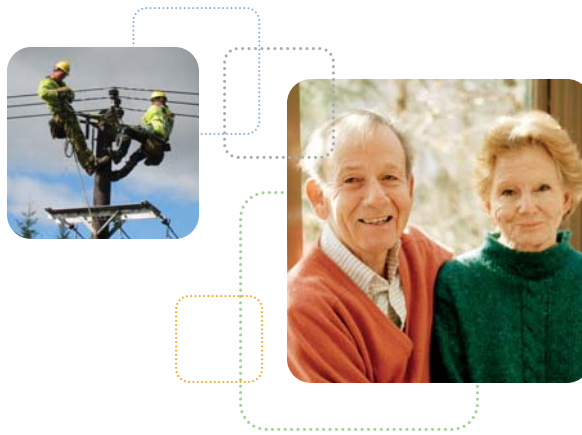
Second, the Ontario population is aging. The average age of an OMERS active member has risen by 1.43 years since 1998 to 45 years in 2006. It is expected to increase by another two years to 47 in

the coming 10 years despite the retirement of the large cohort of baby boomers. Part of the explanation is the trend to hiring new employees at older ages than was traditionally the case. With labour markets tightening, it may well be that much older workers will be hired back (and want to work) after their first retirement.

Contributions for current service costs for active members will continue to rise as the average age of an active member increases. This poses challenges in determining the right balance between contributions and benefits. It raises concerns about inter-generational equity. There is a risk that contributions could become more volatile as the payroll base of contributing members shrinks relative to the size of total liabilities. Gains and losses will be spread over a smaller payroll base.

Third, Ontarians are living longer in retirement. At OMERS, women comprise 54% of plan members today compared with 50% in 1997. If they retire at 65 they can expect to live until 86. Men at 65 have a life expectancy of 83. About 20% of retirees are aged 51 to 60 and can expect to draw retirement benefits for another 25 to 35 years. About 40% of retirees are 60 to 70 and a similar proportion is over 70. Currently, 901 members are aged 90 plus and 22 are over 100 years old. As people live longer, there is an increased cost to the pension plan.





In our view, large defined benefit plans cope well with these types of demographic changes. They generate the level of investment returns necessary to compensate for diminishing contributions relative to benefit payments; they guarantee retirement income for as long as members live; they pool group longevity risks over a large membership base; and they can afford benefit enhancements that respond to member needs. (By contrast, defined contribution plans generate substantially lower investment returns partly due to fees and expenses, leave members anxious about what their pension benefits will be when they retire, and offer less robust benefits.)

#### **A 10-year window to plan maturity**

OMERS has reached a turning point in its maturity. Benefit payments in 2006 were equal to incoming contributions, and are expected to continue to grow more rapidly than contributions during the next 10 years. Investments will continue to provide substantial support for the growing benefit payments; however assets and liabilities will grow more slowly than has been the case in the past.

In preparation for the day when OMERS is a mature plan, we continue to shift an increasing portion of assets into alternative investments. They are expected to generate strong, predictable returns with less volatility than publicly-traded stocks and bonds. They are also a good hedge against inflation. They generate substantial cash flows to pay current pension benefits and help to compensate for the impact of lower interest rates on liability costs.

Still, despite these efforts, managing the volatility of contribution rates will remain a challenge. Because equity investments are a large proportion of the total fund, shifts in market performance cause swings in the financial position of the plan that are significant in absolute dollar terms. Consequently, mature plans are susceptible to large surpluses or large deficits.

#### **Core objective**

Our primary purpose is to secure the pension entitlements of the men and women who work in a wide variety of occupations at the local level throughout Ontario.

The Commission's background paper notes there are two million pension plan members in Ontario. OMERS represents 12% of them – and 35% of those in the public sector. OMERS plan membership is greater than the population of Windsor or Kitchener and about the same as Vaughan. The number of people who receive benefits from OMERS exceeds the population of Ajax, Pickering, Niagara Falls, Peterborough or Newmarket and is close in size to Kingston, Guelph or Thunder Bay.

In 2006, OMERS paid about \$1.7 billion in pension benefits. The current average pension for new retirees is \$21,000 a year, though the range is large and reflects the wage levels and years of service of individual members. In the next 10 years, we project that payments will double to \$3.6 billion as the number of those receiving pensions grows from 100,000 to 130,000.

**A good deal for plan members**

The formula for an OMERS pension is 2% of the average of a member’s “best five” years of earnings, integrated with the Canada Pension Plan, for each year of service.

The value of an OMERS pension is fully protected against inflation to a maximum of 6% annually, with any balance carried forward to subsequent years. OMERS introduced partial inflation protection on an ad hoc basis in 1971 at 10% of the Consumer Price Index (CPI). It was guaranteed at 70% of the CPI in 1992 and 100% in 1999, up to 6%. This feature is greatly valued by members. OMERS also pays excellent survivor and disability benefits.

Retirement income is enriched by Canada Pension Plan and Old Age Security benefits. The following table shows that retiring members with a full career’s participation in the OMERS plan can expect between 70% and 85% of their pre-retirement income to come from these three sources.

All in all, this is a good deal for plan members. The contributions for 2007 for a member earning \$45,000 are \$2,965 a year for normal retirement age 65, and \$3,591 for normal retirement age 60 (most police and firefighters). Member contributions are matched by the employer. Members receive extraordinary value for the contributions made.

This is further illustrated by the simple example of an OMERS member we’ll call Pat, who retires at 60 with 32 years of service. Suppose Pat’s “best five” years of earnings average \$48,000.<sup>6</sup> Over the past 32 years, Pat contributed \$59,000 to the OMERS pension plan, matched by employer contributions. Pat lives until age 84, with a spouse who lives a further five years. The total pension benefits paid to Pat and spouse are \$934,000, and include Pat’s bridge benefit from age 60 to 65, annually adjusted inflation protection, and survivor benefits paid to Pat’s spouse.

For \$59,000 in payroll contributions, (\$118,000 including the employer’s contributions), Pat (and spouse) will have received \$934,000. This is a decent pension by any measure. Even when the amounts are

**Retirement income as a percentage of pre-retirement earnings**

(based on 35 years service)

Pre-retirement earnings	\$ 35,000	\$ 45,000	\$ 65,000	\$ 85,000
OMERS pension <sup>5</sup>	\$ 15,170	\$ 19,645	\$ 32,730	\$ 45,815
CPP pension	\$ 8,178	\$ 10,365	\$ 10,365	\$ 10,365
OAS pension	\$ 5,603	\$ 5,603	\$ 5,603	\$ 5,603
Retirement income at 65	\$ 28,951	\$ 35,613	\$ 48,698	\$ 61,783
Replacement ratio	83%	79%	75%	73%

<sup>5</sup> Pension based on “best five years” of average earnings.



inflation-adjusted to reflect real dollars, contributions are \$83,000 for each of Pat and the employer, and benefit payments to Pat (and spouse) total \$665,000. The example also illustrates the burden placed on investment performance to provide a very substantial portion of every benefit dollar to retirees.

#### The role of RRSPs

Many Canadians enrich their retirement income beyond a workplace pension, the CPP and OAS by contributing to a registered retirement savings plan (RRSP). While only one-third of Canadians contribute annually, 68% have RRSPs according to a recent poll.<sup>7</sup> Based on anecdotal feedback from education seminars, we suspect the proportion of OMERS members contributing to an RRSP is lower, principally because they do not have the discretionary income. However, in a 2005 survey, 57% of our active members have told us that they would like OMERS to offer an RRSP. The idea has strong support among retirees (46%) as well as employers (42%).

#### Should defined benefit plans be permitted to offer RRSP services?

In the context of the Commission's mandate, encouraging Ontarians to save for their retirement makes eminent sense. This begs the question as to whether large defined benefit plans could or should offer their members RRSP services. This issue requires further analysis and consultation with members and sponsors. However, if a defined benefit plan were to offer RRSP services, these services should be in

addition to, and in no way compromise, the security and scope of defined benefit entitlements. Rather, RRSP services would be separate and apart from the defined benefit plan.

#### Defined benefit plans work

Defined benefit plans like OMERS benefit large segments of the population and secure their income and quality of life in retirement in many ways. To summarize:

- Retirees have predictable retirement income
- Benefits are fully protected against inflation
- Pension benefits, and thus retirees, are insulated from market risks
- Retirees have a high replacement ratio of pre-retirement income
- Member longevity risks are pooled
- Benefits can be expanded and enriched over time when surplus occurs
- Administrative costs can be minimized.

Although defined benefit plans are facing challenges due to demographic pressures, these challenges can be managed with the right plan design, governance structure and regulatory support.

<sup>6</sup> Nominal dollar amounts used throughout this example.

<sup>7</sup> Ipsos News Centre, *RBC RRSP poll [16<sup>th</sup> annual survey] shows retirement planning can pay off*, December 18, 2006.

## The role of pension funds in Ontario's economic prosperity

### Collateral benefits

OMERS invests the pension fund exclusively to secure the retirement income of its members. We do not invest to achieve other public policies. Nor should we. Financially securing the retirement years of a large population of Ontarians is a noble objective in its own right. Nonetheless, the way we invest produces collateral benefits to society and creates economic prosperity. By virtue of its size and investment activity, OMERS is a critical driver of the provincial and national economies.

#### Investing in Canada

OMERS investments have a home-country bias. Approximately 61% of the total fund is invested in Canada, with 31% in Ontario. We have operated in recent years under a global mandate to reduce exposure to the Canadian market, which represents less than 3% of global market capitalization. The shift in allocating capital ensures that members benefit

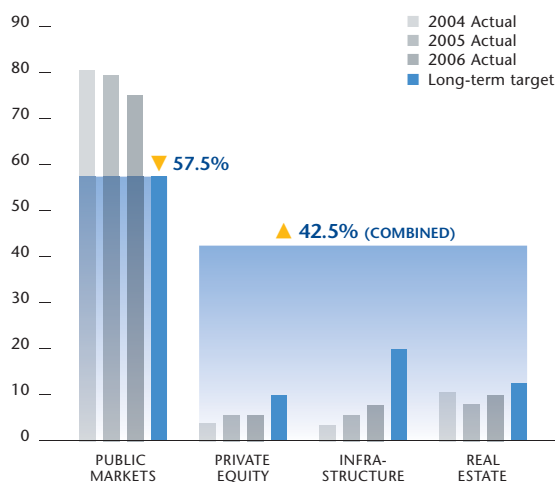
from greater diversification, potentially higher returns from foreign assets and reduced over-exposure to the small Canadian market in the global context.

#### Competitive global markets

Global markets have become more integrated and more competitive. The days of corporate monopolies and oligopolies are disappearing. Free trade, globalization and deregulation of favoured industries have lowered entry barriers. Many thousands of innovative entrepreneurial firms have emerged, forcing large corporations to be more responsive to consumers and investors. Advances in technology (most of which did not exist when the *Pension Benefits Act* was last substantively amended) make it easy for investors and companies to conduct business, share information and move capital quickly to best advantage. Pension funds have contributed to this competitiveness by providing equity and debt capital to growth companies on a global basis, including developing economies.

#### Long-term investment strategy

Shifting asset mix to alternative assets



#### Market liquidity

Pension funds increase the liquidity of financial markets by investing in equities, long-term corporate bonds and securitized debt. Companies have greater capital access to expand their operations and undertake development projects. Increased liquidity reduces capital costs, further facilitating productive capital formation.

Large defined benefit pension plans have helped to deepen and diversify capital markets by investing in alternative assets, such as real estate, infrastructure and private equity, as well as derivative contracts and hedge funds.



### Market efficiency

With their enormous buying power and portfolio management skills, large pension funds contribute to market efficiency through active investing. They ensure efficient pricing of securities and risks and more efficient capital allocation.

### Cost-competitive investing

A recent study examined the performance of the Canadian equity component of defined benefit pension funds compared with mutual funds with domestic equity mandates. The study found defined benefit plans provided a much better return.<sup>8</sup> The Canadian equity components of defined benefit pension funds had an average annual return (net of management fees) of 1.2% higher than the market benchmark between 1996 and 2004. Canadian equity mutual funds earned 2.6% below the benchmark. A Canadian worker with no defined benefit pension coverage who invested in mutual funds would under-perform a defined benefit pension plan member by 3.8% a year.

### Corporate governance

Pension funds boost economic growth by demanding improved corporate governance from companies in which they invest. Better governance leads to better management, corporate efficiencies and financial success. Investors have greater insight into the risks and potential performance of companies, leading to both corporate and market efficiencies.<sup>9</sup>

OMERS is an industry leader in persuading companies to focus on shareholder value, link management compensation to performance, and act with economic, ethical, environmental and social responsibility. In addition to reaping value gains for our plan members, these initiatives help to drive economic growth and prosperity.

### OMERS private equity experience

Pension funds can help smaller firms to grow and prosper. Our goal as a private equity investor is to create shareholder value for plan members. When we restructure companies, the strategy is to strengthen competitiveness on a larger operating platform that ultimately results in new and more secure jobs.

OMERS Capital Partners manages a \$3 billion private equity portfolio involving more than 40 relationships with external private equity firms and 24 direct investments. Investing as a limited partner in private equity pools managed by external firms has enabled our team to climb the learning curve and acquire the market knowledge and skill sets to make direct equity investments that give us greater control and much enhanced returns. Undertaking direct private equity investments is difficult for small and single-employer plans that lack substantial financial resources and staff expertise.

<sup>8</sup> Keith Ambachtsheer and Rob Bauer, "Losing ground: Do Canadian mutual funds produce fair value for their customers?", *Canadian Investment Review*, Spring 2007, p. 9.

<sup>9</sup> The positive and significant impact of pension assets on a variety of econometric specifications are discussed in detail by E. Philip Davis and Yu-Wei Hu in, *Is There a Link between Pension-fund Assets and Economic Growth – A Cross-Country Study*, Brunel University and National Institute of Economics and Social Research, June 2005.

Our investment professionals sit on the boards of private companies to ensure effective governance oversight of corporate management in implementing growth strategies that enhance shareholder value. Our investments cover a wide range of firms, mostly in North America but increasingly in Europe.

Examples are:

- Affinia Group Holdings, a North American-based global aftermarket automotive parts manufacturer
- Constellation Software, a Toronto firm that invests in companies providing software solutions to public and private transportation, public housing, manufacturing, utilities and the justice system
- NXP, a Dutch semi-conductor manufacturer
- Cookie Jar Group, that develops, produces, markets and distributes high-quality, non-violent programming and supplemental education products to children, families and educators worldwide
- MAAX, a Quebec-based bathtub and cabinet door manufacturer
- TeraGo Networks, a Canadian provider of wireless broadband data communications to businesses and other organizations

- Trident Exploration, a Calgary company involved in the discovery and commercial development of natural gas in coal
- Warner Chilcott, a U.S. specialty pharmaceutical company focused on women's health care and dermatology
- Marketwire, a leading distributor of media content.

#### Investing in essential infrastructure

Infrastructure assets are vital to the efficiency, comfort and competitiveness of a well-functioning modern society. These assets are either owned by government or by a company in a government-regulated industry. Today governments recognize that the private sector, including pension funds and other institutional investors, can deliver public policy through infrastructure ownership efficiently and at high quality to the benefit of taxpayers.

OMERS is the Canadian pension fund pioneer in infrastructure ownership. We own over \$5 billion of equity interests in some 30 infrastructure assets managed by Borealis Infrastructure Management Inc. We have leadership experience in Canada, the United States and the United Kingdom and are pursuing opportunities in North America, South America, Europe, the Middle East and Asia.

**Large defined benefit pension plans have helped to deepen and diversify capital markets by investing in alternative assets, such as real estate, infrastructure and private equity, as well as derivative contracts and hedge funds.**



The expertise of our Borealis team embraces financial engineering, regulatory compliance, tax structuring and operational knowledge – all supported by legal, tax, finance, accounting and financial reporting professionals. Individual investments, which can exceed \$1 billion, are structured in unincorporated entities or partnerships, as shares in private companies, and as interests in trusts, convertible debentures and similar types of debt instruments.

Prominent infrastructure assets in which we have substantial equity include:

- Associated British Ports, the U.K.'s largest ports company that handles 25% (by weight) of Britain's maritime traffic
- The Detroit River Rail Tunnel, which moves over \$130 billion of goods annually through the busiest trade corridor linking Canada and the U.S.
- The Confederation Bridge between Prince Edward Island and New Brunswick
- Bruce Power, whose CANDU nuclear reactors generate 20% of Ontario's base-load electricity capacity
- Enersource Corporation, one of the top five electrical distribution utilities in North America that serves 175,000 customers in the City of Mississauga
- Enwave Energy Corporation, a pioneer in heating and cooling large urban buildings in downtown Toronto in an environmentally positive manner
- Scotia Gas Networks that delivers gas to 5.6 million customers in Scotland and the south of England
- The 2,700-kilometre Express Pipeline System that delivers conventional and synthetic crude oil from Alberta to refineries in six U.S. states
- MDS Diagnostic Services, Canada's largest operator of diagnostic laboratories
- Ciel Satellite Group, a Canadian satellite operator that will offer voice, data and broadcast coverage in North America starting in late 2008.

Our success in the infrastructure asset class highlights the advantages of a pension fund having its own dedicated company with a specialized professional team motivated by performance-based incentives. Capitalization and talent recruitment are barriers for small single-employer plans in cost-effectively finding, evaluating and closing deals and managing the assets to earn exceptional returns.



**A major real estate presence**

Few funds (OMERS, Ontario Teachers’ Pension Plan, CPP Investment Board and the Caisse de dépôt et placement du Québec being notable ones) have the resources to acquire the economies of scale and professional expertise essential to success in the high-end real estate asset class. The most effective entry point is to acquire a large and successful real estate firm as the platform for diversification and sustained growth.

OMERS is represented in this asset class by Oxford Properties, a company with a long history as a property owner and manager. OMERS also has its own history in real estate dating back to the 1970s. After the acquisition of Oxford in 2001, we consolidated our three real estate companies (Oxford, OMERS Realty Corporation and the former Hammerson Canada) under the Oxford brand.

Through Oxford, OMERS owns an \$8.5 billion portfolio of high-quality office buildings, shopping centres, hotels, industrial buildings and multi-residential properties. The portfolio includes interests in numerous notable high-quality assets such as the Royal Bank Plaza and Metro Centre office buildings and Yorkdale Shopping Centre in Toronto, Canterra Tower in Calgary, the Banff Springs and Chateau Lake Louise in Alberta and the Watermark Place development project in London, England.

In 2006, Oxford generated net investment income exceeding \$1 billion.

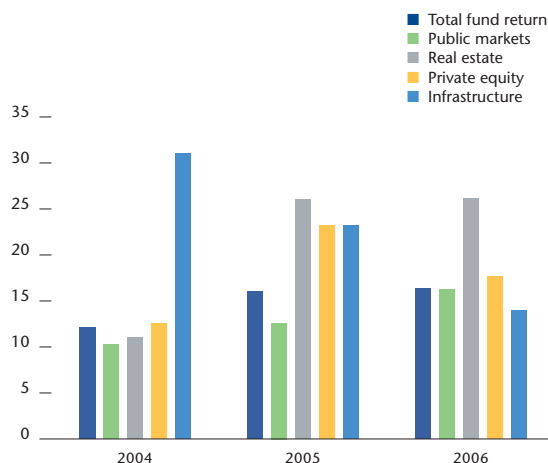
**The impact of alternative asset investing**

On a combined basis, our alternative asset classes (private equity, real estate and infrastructure) generated more than \$1.7 billion in net investment income in 2006 – equivalent to all current contributions, or all current benefit payments.

The success of our private equity, infrastructure and real estate operations underscores the importance of encouraging small single-employer funds to consolidate, or join an established multi-employer defined benefit plan. Investment operations of this scale are otherwise beyond their reach, to the detriment of their plan members.

Size and specialized investment talents in alternative asset classes attract other large pools of capital (pension funds, mutual funds, investment and merchant banks, investment firms, and major corporations) as co-investors in making deals happen and subsequently sharing the risks and rewards.

**OMERS public market performance**  
Versus alternative assets (%)



## The need for principle-based rules and removal of regulatory constraints

### Building in flexibility

It has been 20 years since meaningful changes were made to the *Pension Benefits Act*. Amending legislation is clearly a difficult process. The Act has failed to keep up with the substantial changes that have occurred over the years in pension plan administration, governance and investment practices among the large and leading defined benefit pension plans. The practices of large defined benefit plans in turn reflect the dynamics of a marketplace that operates on an increasingly global basis. As a result, gaps inevitably emerge between legislative intent at one point in time and industry best practices.

Ontario's pension law should, therefore, be flexible so that legislative change evolves more naturally over time in step with best industry practices. This can be achieved by shifting as much as possible to a principles-based approach from the current excessive use of rules. In making such a change, it is essential that legislation fully preserve the pension rights of plan members.

#### Recommendation 1

**That the *Pension Benefits Act* be amended to consist of the fundamental principles applicable to all pension plans in Ontario, such as the fiduciary duties and obligations of plan administrators, a “prudent person” test for investment of pension funds, a broad purpose clause, the powers of the regulator, wind-up provisions, offence provisions and adequate minimum standards for plan design (eligibility for membership, vesting and locking in, portability and transfer options, and member communication).**

#### Investment rules impede returns

The pools of capital held by Canada's pension funds are critical to the security of the population's retirement income and to a growing economy. Unfortunately, the efficient allocation of pension fund capital is constrained and distorted by arcane rules that do not reflect the current investment environment.

Pension funds are required to invest to the standard of a “prudent person.” OMERS and other large pension funds have effective governance structures, investment policies and risk management systems to ensure that all investment activity is conducted prudently. Quantitative constraints impose complexities and costs that can undermine investment performance to the detriment of employers and members. The plans that confront these rules most often are large pension funds that actively manage investments in-house. This is an area where differential rules make sense.

The Federal Investment Regulations, outlined in Schedule III of the *Pension Benefits Standards Act, 1985 (Canada)* regulations, include a series of quantitative restrictions. Ontario adopted these regulations in the *Pension Benefits Act* in 2001 as a result of an initiative to harmonize pension fund investment regulation across Canada (two provinces still have not done so).

Quantitative Rules in the Federal Investment Regulations

30% Rule

- Restricts pension plans to holding no more than 30% of the shares eligible to elect the board of a corporation
- Defined resource corporations, real estate corporations and investment corporations exempt from the 30% rule subject to undertakings and specific requirements

Concerns

- Presumes that pension funds are passive investors, a strategy that is no longer effective in producing the returns needed to safeguard the pension promise
- Impedes a plan administrator’s ability to protect its interests when investing in more than 30% of the equity, an issue that arises with illiquid assets
- May dissuade pension funds from investing in venture capital or infrastructure projects
- Impedes commercial and risk management practices
- Necessitates complex and costly structures to ensure compliance
- Puts pension funds at a disadvantage relative to less-constrained investors when competing for investment opportunities at home and abroad
- Limitation does not exist in other OECD countries<sup>10</sup>

5%, 15%, 25% Rules

- Restricts pension plans to holding not more than 5% of the book value of the fund’s total assets in any single parcel of real estate or Canadian resource property, 15% of the book value of the fund’s total assets in Canadian resource properties, and 25% of the book value of the fund’s total assets in the aggregate of real estate and Canadian resource properties

Concerns

- Presumes that real estate and Canadian resource assets pose greater risk than other types of assets
- Not a comprehensive yardstick for determining if an investment portfolio is adequately diversified
- Administrators look at market values, not book values, when assessing diversification risk
- Various terms are not defined, creating confusion and interpretation difficulties
- Creates a disincentive to investing in Canadian resources as opposed to foreign resources
- Redundant in the context of the “prudent person rule”

10% Rule

- Restricts pension plans to investing no more than 10% of the book value of the pension fund in any one entity

Concerns

- Book value is not an adequate measure as administrators look at market values to determine diversification risk
- Not a comprehensive yardstick for determining if an investment portfolio is adequately diversified
- Diversity restriction is common in OECD countries, but U.S. and U.K. laws set only a general requirement for diversification
- Redundant in the context of the “prudent person rule”

<sup>10</sup> Table 3, Column 5 – Ownership Concentration Limits, *Survey of Investment Regulations of Pension Funds*, OECD, 2007, p. 18-27.

**Our regulatory framework lags behind other advanced economies who have moved to oversight based on a prudent approach. The current rules unfairly punish those we serve – an aging population that expects and deserves secure retirement income.**

### Rules cause complexity and costs

A result of excessive regulation is that pension funds must construct elaborate financial, legal and organizational structures to bring their investments into compliance and achieve an appropriate level of influence over their assets. There is no prudential “value-add” from these structures. In many cases, investments that would benefit the pension fund’s members and employers are lost due to the structural barriers. Potential co-investors are often dissuaded by the complexity, and instead elect to find an investment partner outside Canada.

In the absence of these quantitative constraints, pension funds would still be safeguarded by the fiduciary standard and duty of care, the requirement for a detailed Statement of Investment Policies and Procedures, conflict-of-interest provisions, and oversight by the provincial regulator.

Our returns would undoubtedly be higher if they were not eroded by unnecessarily quantitative regulations that no longer have value. It is time to modernize pension fund investment regulations by eliminating unnecessary quantitative restrictions and adopting a more flexible and adaptable principles-based approach to regulation generally. Our regulatory framework lags behind other advanced economies (the U.S., Britain, Australia and the Netherlands are

a few examples) who have moved to oversight based on a prudent approach. The current rules unfairly punish those we serve – an aging population that expects and deserves secure retirement income. We strongly recommend that the quantitative constraints contained in the Federal Investment Rules be removed from the *Pension Benefits Act* for large defined benefit pension plans. So important is this regulatory relief that we further recommend that a moratorium be introduced immediately for large plans via regulation under the *Pension Benefits Act*, with a sunset clause if desired, while governments study this issue further.

## Recommendation 2

**That the *Pension Benefits Act* exempt public sector jointly-sponsored pension plans from the quantitative restrictions in Schedule III of the *Pension Benefits Standards Act (Canada)* regulations.**



### The solvency issue

The *Pension Benefits Act* requires administrators to file a solvency valuation whenever a going concern valuation is filed (at least once every three years). While a going concern valuation has a long-term outlook, a solvency valuation assumes that the pension plan will be terminated and wound up as at the date of the valuation.

A solvency valuation relies on one critical assumption: the long-term rate of interest that will determine the cost of annuity purchases. As interest rates have declined in recent years, annuity rates and solvency liabilities have increased dramatically.

Solvency valuations will continue to adversely affect funding viability. In our case, a one percent decline in real interest rates would create a solvency deficiency. Because a solvency deficiency must be paid over five years, significant contribution rate volatility could occur. We attempt to control contribution rate volatility by:

- Timing the filing of valuations within the three-year statutory periods
- Increasing investment returns by changing our asset mix targets to increase investments in alternative asset classes
- Smoothing investment performance and interest rates in the solvency valuation

- Creating a contingency reserve of 5% before addressing surplus
- Removing from the solvency valuation the value of post-retirement indexing.

The purpose of a solvency valuation is to safeguard the pension benefits of members if the plan is wound up. This makes sense in the private sector where there is a risk of employer bankruptcy. It makes no sense in the public sector where the likelihood of plan wind-up with a government sponsor is negligible.

Governments have begun to recognize that the solvency valuation is not in the interest of the longer-term health of the pension system. The federal government recently enabled federally-registered pension plans to extend the solvency funding payment period from five years to 10 years. Various jurisdictions including Alberta, New Brunswick, Nova Scotia and Quebec have suspended solvency funding requirements for municipalities and universities, and Ontario has amended the rules for certain multi-employer pension plans (though not for OMERS) to exclude new solvency deficiencies in setting contributions based on actuarial valuations with effective dates between September 1, 2007 and August 31, 2010.

**The purpose of a solvency valuation is to safeguard the pension benefits of members if the plan is wound up. This makes sense in the private sector where there is a risk of employer bankruptcy. It makes no sense in the public sector where the likelihood of plan wind-up with a government sponsor is negligible.**

OMERS is seeking an exemption of its Primary Plan from the solvency funding requirements. It is a durable plan, a fact recognized in OMERS exemption from the *Pension Benefits Act's* Pension Benefit Guarantee Fund provisions. The Supplemental Plan being introduced for police, firefighters and paramedics was exempted earlier in 2007.

A legislated exemption would alleviate the potential burden of additional contributions caused by a solvency deficiency on OMERS stakeholders, and, ultimately, taxpayers. These additional contributions often serve to increase a plan surplus once markets rebound or interest rates rise.

#### **Solvency funding and jointly-sponsored plans**

The efficacy of the solvency valuation is further reduced for jointly-sponsored plans, where the negative consequences far outweigh any potential benefit. The jointly-sponsored pension plan rules in the *Pension Benefits Act* Regulation specifically contemplate the possibility of benefit reductions on wind-up of a jointly-sponsored pension plan. The theory behind these rules is that employers and members should decide jointly the level of funding appropriate in light of plan liabilities and other relevant factors, and the consequences if such funding proves insufficient to fund accrued benefits in the event of a wind-up.

Solvency funding is inappropriate for governance structures, such as those of jointly-sponsored pension plans, where members have equal input into decisions around funding, investment, benefit design and plan wind-up rules. Sponsors should have the ability to design a plan in which employers and members decide to share in the benefits of lower contribution rates or more generous benefits on the understanding that benefits will be reduced in the event of wind-up in an insolvency situation.

The issue is more complicated for privately-funded, single-employer pension plans, where, as noted, the risk of insolvency is real and members require regulatory protection. Even so, there are calls for reform to reduce the financial burden and coverage-deterrent effects of solvency funding requirements.<sup>11</sup>

### **Recommendation 3**

**That the *Pension Benefits Act* exempt public sector jointly-sponsored pension plans from the solvency funding requirements.**

<sup>11</sup>In *Current Pension Issues and Trends*, 2005, Murray Gold suggests a comprehensive pension insurance scheme. In *Back from the Brink: Securing the Future of Defined Benefit Pension Plans*, 2005, the ACPM argues for the increased use of letters of credit to secure solvency deficiency funding obligations.

## Enhancing the regulatory relationship

### Clarity and ongoing dialogue

**OMERS recently experienced a three-year examination by the Financial Services Commission of Ontario (FSCO). The regulator examined governance and investment practices between 1997 and 2004 and made recommendations on how practices could be improved. FSCO's findings are attached as Appendix II. Most recommendations were implemented in the years prior to FSCO issuing its report.**

The examination deepened our awareness of the gap that has opened up between a regulatory regime created in 1986 and the practices of large pension funds like OMERS in an era of complex and sophisticated investing.

#### Complexity and obstacles

Part of the regulatory challenge is understanding the complexity of investment structures and investment strategies adopted by pension funds to address foreign and domestic tax issues, to ensure compliance with the Federal Investment Regulations as adopted under the *Pension Benefits Act*, to achieve strong investment returns, and to safeguard members' interests.

A major obstacle is the regulatory emphasis on quantitative rules that determine how much can be invested in certain assets and asset classes. A perennial example is the 30% rule that restricts pension funds to holding no more than 30% of the votes in electing corporate boards even though their equity ownership of a company may exceed 30%. Controls like this, with no clear purpose, undermine pension fund profitability and unnecessarily complicate investment planning. The 30% restriction is particularly difficult where we take full or majority ownership of companies

with the goal of strengthening their governance and financial performance to create value for plan members, with the collateral benefit of their long-term success contributing to broader economic prosperity.

#### Relevance of financial performance

The *Pension Benefits Act* does not clearly define prudence. Regulators tend to focus solely on the processes and procedures of governance conduct. This, however, ignores the relevance of financial performance as a component in the test of prudence under Section 22 of the *Pension Benefits Act*. Processes and procedures are important. But prudence should also require a pension fund to properly balance the risks and rewards of each investment to achieve positive financial outcomes. After all, the core purpose is financial – to secure the retirement benefits of members.

#### Respect for plan administrators

Regulations should clearly respect the broad powers of delegation that plan administrators have in exercising their fiduciary duty and determining best governance practices. Regulations are outdated and inflexible on this issue because they have failed to keep pace with changes in pension fund governance and investment preferences.

There is a built-in tension between regulations and pension fund practices in deciding who should judge the acceptability of investment and governance practices. The courts have consistently held that it is not the function of a court or a regulator to determine which decision the court or regulator would have made. Instead, they must defer to the judgment of the plan administrator in exercising its discretion to make reasonable decisions in good faith after considering the relevant factors that show these decisions are not unreasonable.

**Industry consultation, and respect for the discretion of administrators in managing their affairs, would improve the tone of the regulatory relationship to the benefit of all participants.**

#### **Liability protection in service contracts**

Finally, there is room for disagreement about the liability and indemnification provisions in contracts with service providers and agents. A regulator might argue that such provisions undermine the standard of care applicable to agents under the *Pension Benefits Act*. In some areas, it would be difficult – if not impossible – to retain reputable service providers without including such provisions in contracts.

#### **The need for clarity**

Our dialogue with FSCO officials underscores that regulators and the regulated would benefit from greater clarity on how the law should be applied to pension administration and investment management.

FSCO is not as proactive as it could be in advising, guiding and consulting with the industry. Instead, it responds to events. If the regulator had the authority and resources to proactively provide guidance and direction through comprehensive policy statements and industry consultation, plan administrators could act with greater certainty to the benefit of their members. We believe that FSCO should have the staff resources to provide policy advice on industry matters within government.

Industry consultation, and respect for the discretion of administrators in managing their affairs, would improve the tone of the regulatory relationship to the benefit of all participants. This does not involve a bold step. The Ontario Securities Commission uses policy statements and proposed rules to provide guidance to the securities industry, as does the Office of the Superintendent of Financial Institutions with

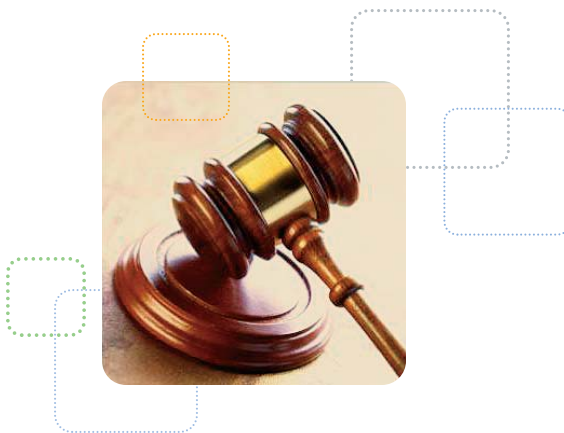
the federally-regulated pension industry. Both utilize a public consultation process to solicit input from affected parties before implementing new policies or rules.

FSCO has used the consultative process from time to time (risk-based monitoring being an example). We urge the Commission to recommend the ongoing use of such a consultative approach.

#### **Authority to issue binding rulings**

As part of a co-operative regulatory relationship, it would be useful if the regulator were empowered to issue binding rulings in advance of a pension plan following a proposed course of action. The mechanism is straightforward. A pension plan administrator would prepare a submission for the regulator's review. Following discussion, the regulator would make a ruling. The administrator could then proceed with comfort and certainty. Uncertainty increases the costs, resulting in foregone opportunities to improve performance.

Canada Revenue Agency is an example of a regulator with authority to issue binding rulings that assure the applicant that the regulator will not challenge the approved interpretation provided the subsequent actions accord with the circumstances presented to the regulator. (The Canada Revenue Agency website provides extensive information on the process, including fees and timelines.)



In short, there is real benefit in being able to talk to the regulator, explain the circumstances, and get a definitive ruling. However, the regulator must have sufficient resources to ensure its rulings are made in an informed, timely manner. In our view, rulings should be issued in less than six months; otherwise, administrators should be allowed to proceed with their plan of action on the assumption that the regulator has no significant objection.

#### Tribunal could be enhanced

While the Financial Services Tribunal has expertise in pension matters, access to the Tribunal is restricted to very limited circumstances relating to appeals from the Superintendent's orders. Often issues do not go to the Tribunal, but are commenced immediately in the courts. If the Tribunal is provided with a broader jurisdiction and scope of authority, and then is provided with appropriate deference to recognize its expertise, it will enhance the quality of decision-making relating to pension matters.

The example of the role of an arbitrator as set out in the *Arbitration Act, 1991* is illustrative. The Act allows the parties to an arbitration to agree in advance that an arbitrator has exclusive jurisdiction to consider an issue, and provides the flexibility to limit any review of the decision of an arbitrator to matters of errors of law only. This type of exclusivity, with a limitation on the scope of appeal or reviews that could be taken from the decisions, could be provided to FSCO by statute, similar to the exclusivity that a tribunal such as the Ontario Labour Relations

Board has. Courts might be more reluctant to interfere in the decision-making process of a tribunal that has such exclusivity and demonstrated expertise. (In the case of the Financial Services Tribunal, we believe its membership should be drawn from a broad range of stakeholder groups.) Certainty is provided to parties, who know that they must take their disputes to that tribunal, not to the courts, and that recourse from the decision of the tribunal is limited.

#### Recommendation 4

**That (i) the *Financial Services Commission Act* and the *Pension Benefits Act* be amended to provide for rule-making authority for FSCO on pension matters, enhance the jurisdiction of the Tribunal with respect to pension matters, and provide it with an appropriate exclusivity to protect its jurisdiction; and (ii) the pension office within FSCO be provided with appropriate resources by supplementing the current industry levies with additional powers to charge pension funds an appropriate and fair fee for the services that the regulator is providing.**

## Four ideas to close the gap

### OMERS recommends

- ...1 That the *Pension Benefits Act* be amended to consist of the fundamental principles applicable to all pension plans in Ontario, such as the fiduciary duties and obligations of plan administrators, a “prudent person” test for investment of pension funds, a broad purpose clause, the powers of the regulator, wind-up provisions, offence provisions and adequate minimum standards for plan design (eligibility for membership, vesting and locking in, portability and transfer options, and member communication).

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- ...2 That the *Pension Benefits Act* exempt public sector jointly-sponsored pension plans from the quantitative restrictions in Schedule III of the *Pension Benefits Standards Act (Canada)* regulations.

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- ...3 That the *Pension Benefits Act* exempt public sector jointly-sponsored pension plans from the solvency funding requirements.

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- ...4 That (i) the *Financial Services Commission Act* and the *Pension Benefits Act* be amended to provide for rule-making authority for FSCO on pension matters, enhance the jurisdiction of the Tribunal with respect to pension matters, and provide it with an appropriate exclusivity to protect its jurisdiction; and (ii) the pension office within FSCO be provided with appropriate resources by supplementing the current industry levies with additional powers to charge pension funds an appropriate and fair fee for the services that the regulator is providing.

**(a) Asset transfers/divestments****Issue**

The ongoing rights of members should be protected in the event of a material change in the identity or structure of a sponsoring employer.

The *Pension Benefits Act* offers protection to plan members who must join a successor employer's pension plan as a result of a material change in the identity or structure of a sponsoring employer. Essentially, it requires service and plan membership to be continuous for the purpose of determining entitlements and eligibility for membership under each plan. In theory, it is possible to transfer the affected member's entitlements to the new plan. Practically speaking, however, there is an inability under the *Pension Benefits Act* for a member who is affected by a divestment to transfer his/her assets from the exporting pension plan to the importing plan since the regulator requires that the importing plan replicate the exporting plan's past service pension provisions. Subsections 80(5) (sales and other divestments) and 81(5) (other transfers and plan mergers) address the treatment of an individual's pension in circumstances where there has been a material change in the identity or structure of a sponsoring employer and the individual becomes a member of a new pension plan.

**Discussion/Analysis**

With the increase in government divestment activity over the last decade, administrators and members of affected public sector pension plans have become concerned and frustrated about the negative impact of current FSCO policy on their ability to negotiate and consent to group inter-plan asset transfers. FSCO policy, which purports to preclude such transfers in all circumstances other than where the importing plan holds and delivers transferred pension credits by replicating the exporting plan's past service pension provisions, creates administrative and other problems which effectively prohibit employers from agreeing to inter-plan transfers and thereby preclude the consolidation of an affected member's pension service and credits under the new employer's pension plan. In most cases, the resulting dual membership results in affected members receiving smaller pensions in aggregate at retirement than if the asset transfer were permitted and the pension consolidated in the new employer's plan.<sup>12</sup>

Many public sector employees are affected by this issue and many have been waiting a number of years for plan administrators, the regulator and/or the provincial government to address it.

The provincial government has recognized and responded to these concerns, with limited effect, by amending the *Police Services Act* to permit the administrators of the Public Service Pension Plan and OMERS to enter into one or more asset transfer agreements in respect of eligible police force employees whose employment has been transferred between a municipal police force and the Ontario Provincial Police. This step is to be commended, but more remains to be done to address this issue facing the major Ontario public sector pension plans.

**Recommendation**

OMERS recommends that the regulations under the *Pension Benefits Act* be amended to permit the Superintendent to consent to a pension asset transfer between pension plans under subsections 80(5) and 81(5) of the *Pension Benefits Act* provided that: (i) affected members are provided with full disclosure; (ii) members and/or bargaining agents have the right to opt out of group asset transfers; and (iii) the value of benefits transferred on behalf of affected members is at least equal to the value of benefits under the exporting plan, calculated using consistent and appropriate actuarial assumptions, in accordance with a report prepared by an actuary.

<sup>12</sup>Under the proposed recommendation, members would be fully informed about values with and without a transfer, and would have the option to opt out of a transfer if it was less favourable to the individual member.

## (b) Division of pensions on marriage breakdown

### Issue

The existing statutory framework governing division of pensions on marriage breakdown provides insufficient guidance for members, former spouses, family lawyers and the courts, and more often than not gives rise to domestic contracts and court orders that are difficult or impossible for plan administrators to administer. Reform in this area is desperately needed and long overdue.<sup>13</sup>

### Discussion/Analysis

A pension is, in many cases, the most valuable asset owned by a spouse upon marriage breakdown. Often the pension alone will result in the member owing a significant equalization payment to the former spouse. If the member has insufficient assets outside the pension plan to satisfy the equalization obligation, the only resort under the current statutory scheme is an “if and when” arrangement, in which upon the member’s retirement, the parties elect to divide the member’s pension at source. These give rise to a myriad of administrative difficulties for pension plan administrators, and impose uncertainty and financial/legal risks on members, former spouses and their legal advisers.

Many of the orders and agreements filed with OMERS are deficient. OMERS must often enter into protracted correspondence with members or members’ counsel regarding specific wording of orders and agreements. In some cases OMERS is asked to comment prospectively; in others, OMERS is forced to use best efforts to decipher completed documents that have already been executed/issued and filed. Increasingly, OMERS is forced to incur legal costs to obtain advice about how to minimize the risk in administering deficient or incorrect orders or agreements.

The divisions agreed upon by the parties often oblige OMERS to perform ongoing year-to-year calculations that do not form part of the plan’s normal benefits administration system. For example, provisions commonly require OMERS to track split pension payments up to a set limit and subject to an interest component, after which payments resume in full to the member.

In addition to the problems of flawed orders and agreements, and the burden of interpreting and administering a variety of orders and arrangements, another significant problem with the division of pensions on marriage breakdown is the lack of clarity in the law with respect to members or former members who divorce and then remarry or enter into a subsequent common-law relationship. These circumstances often give rise to uncertainty and confusion as to how the member’s pension and any survivor benefits will be treated upon the member’s death.

<sup>13</sup>In early 2006, the Ministry of the Attorney-General and the Ministry of Finance solicited and received industry submissions addressing amendments required to the *PBA* and the *Family Law Act* to improve this area of pension law.

<sup>14</sup>[2001] 2 S.C.R. 413.

A final issue that should be addressed as part of reform of pension division laws in the context of family law entitlements is the issue, commonly referred to as “double dipping,” where the same pension is used first as a capital asset to satisfy a claim for equalization, and then later as the source of an income stream to satisfy a claim for support. The Supreme Court of Canada’s decision in *Boston v. Boston*<sup>14</sup> imposed a general prohibition on double dipping, but recognized that double recovery may still be possible under certain circumstances, thereby leading to a continued degree of uncertainty in this area of the law.

### Recommendation

In its March 2006 submission to the Ministries of Finance and the Attorney-General on this issue, OMERS recommended that:

1. A new statutory scheme should be created (by means of amendments to both the *Pension Benefits Act* and the *Family Law Act* (the “FLA”) to permit pensions to be valued and divided with finality and certainty at the time of relationship breakdown. Under this scheme (referred to as the “immediate settlement approach” or “ISA”), the former spouse would receive an immediate settlement from the member’s accrued pension, which would be transferred to a locked-in retirement account existing or established for the former spouse. The ISA/transfer approach would apply to all Ontario-registered plans (defined benefit and defined contribution plans).
2. The valuation rules for family law purposes (i.e., determining the value of the pension asset on the valuation date) and pension law purposes (i.e., determining the amount of the member’s pension that can be assigned under the *Pension Benefits Act*) should be the same and should be clearly prescribed by regulation. OMERS recommends that value be calculated using the commuted value basis prescribed under the regulations in the *Pension Benefits Act*. These rules should be consistent with existing valuation rules used by plan administrators for other purposes, so that plan administrators can value pensions with certainty using their existing calculators and systems. This would decrease the administrative burden and cost for administrators (and by extension, other plan members) while at the same time decreasing costs and increasing certainty and predictability for members and their spouses.
3. If parties choose to settle equalization claims by accessing the member’s pension asset, the application to the plan administrator to value and divide the member’s pension should be on a prescribed form. This would ensure certainty and predictability of result, and also ensure that the parties’ intentions are carried out without the increased administrative, legal and litigation costs currently associated with ambiguously or poorly-drafted domestic contracts and court orders.

**(c) Change *Pension Benefits Act* to support phased-in retirement****Issue**

The federal government's 2007 budget introduced measures designed to encourage older workers to stay working longer. First, the budget proposed to increase the maturation age limit under registered retirement savings plans and registered pension plans to 71 years of age, from the current 69 years of age, effective for the 2007 and subsequent taxation years. A bill implementing this change was passed by the House of Commons on June 13, 2007.

Second, the budget proposed amending the *Income Tax Regulations* to permit an employer to simultaneously pay a partial pension to an employee and provide further pension benefit accruals to the employee, thereby allowing the employee to continue working after he/she has qualified for a pension. This change will come into effect beginning in 2008. Although the federal government has circulated draft language for review, the legislation to implement the proposed phased-in retirement measures is still under development and will be introduced at a later time.

**Discussion/Analysis**

Under proposed amendments to the *Income Tax Regulations*, employers will be allowed to provide employees who are at least 55 years old and otherwise eligible to receive an unreduced pension, up to 60% of their accrued pension while continuing to work past normal retirement age. These employees will be able to continue to accrue credited service and credit for contributory earnings for active service in accordance with the terms of the pension plan, regardless of whether they continue to work full- or part-time. The option would not impose an early retirement reduction and the 60% limit would be based on the amount of pension benefits employees would receive if they were fully retired.

Sponsors of Ontario-registered pension plans that meet the requirements proposed in the 2007 federal budget, need to consider how the proposed changes could be used to support a workforce management program, including which employees should be eligible, and what percentage of full pension up to the maximum 60% permitted should be made available to eligible employees. Assuming employers wish to take advantage of the proposed changes to the *Income Tax Regulations*, consideration must also be given to what plan amendments are required to permit phased-in retirement and how payments of phased-in pensions should be recalculated as additional benefits and increases in pensionable earnings accrue during the phased-in period.

**Recommendation**

OMERS recommends the *Pension Benefits Act* should be reviewed and amended as required to permit sponsors of Ontario-registered pension plans to make the plan amendments required to permit employers and members to take advantage of appropriate models of phased-in retirement.

## (d) Remove administrative barriers to flexible plan design

### Issue

Ontario pension law and policy should actively encourage innovation in pension plan design.

Any comprehensive review of current pension benefits legislation should recognize the growing demand for legislative and regulatory flexibility to permit innovations in pension plan design. The *Pension Benefits Act* is currently designed for the most part to regulate single-benefit, single-employer defined benefit pension plans. Recent changes to recognize the unique requirements of jointly-sponsored plans have been welcome but piecemeal.

Traditionally, OMERS provided a limited amount of benefit flexibility, within a single OMERS pension plan, on an employer group basis, through its Supplementary Benefit program, pursuant to section 26 of the (now repealed) *OMERS Regulation*. The use of Supplementary Benefits to provide benefit flexibility was curtailed as the result of a 2003 ruling by the Canada Revenue Agency. The Canada Revenue Agency took the position that no contributions could be made to fund past service for Supplementary Benefits if the OMERS plan as a whole was in a surplus position, and that no contributions could be made to fund future service for Supplementary Benefits if the OMERS plan as a whole was in an excess surplus position.

Despite the Canada Revenue Agency's ruling and the problems it created for the Supplementary Benefit program, OMERS stakeholders continued to press for flexibility in pension benefits. OMERS investigated a number of different options, and ultimately concluded that the establishment of one or more supplemental pension plans, as defined in the *Income Tax Act*, would be the best option for providing benefit flexibility to OMERS members and employers. Supplemental pension plans are separately-registered pension plans that provide benefits that supplement the benefits offered in the primary pension plan.

The *OMERS Act, 2006* was passed containing express authority for the establishment of OMERS supplemental pension plans and, specifically, requiring the establishment of the first such plan (for police, firefighters and paramedics) by July 1, 2008. The OMERS Administration Corporation is required by the Act to establish the OMERS Supplemental Pension Plan for Police, Firefighters and Paramedics. The documents creating and supporting the Supplemental Plan were filed with regulators on May 25, 2007. The Supplemental Plan is available for participation effective July 1, 2008.

During the drafting of the Supplemental Plan, it became evident that the *Pension Benefits Act*, as currently enacted, imposes a number of requirements that create complexity and duplication in the administration of the Supplemental Plan. If the *Pension Benefits Act* is not amended to provide flexibility and simplify the requirements for multi-plan systems such as OMERS, this duplication and complexity will only increase with the creation of each additional OMERS Supplemental Pension Plan.

### Discussion/Analysis

The *Pension Benefits Act* as currently enacted contemplates a single plan per member model. It imposes all minimum standard and administrative requirements at the plan level, rather than at the member level.

For example, for an OMERS member who belongs to the OMERS Primary Pension Plan and one or more Supplemental Pension Plans, the following rights/options would have to be offered independently for membership in each plan, despite the fact that the benefits under the Supplemental Plan membership are intended to supplement or increase the member's Primary Plan benefits: options on termination of employment; waiver of joint and survivor benefit; spousal elections on pre-retirement death of a member; beneficiary designations.<sup>15</sup>

### Recommendation

OMERS recommends that the *Pension Benefits Act* be reviewed and amended as required, to permit multi-plan systems such as OMERS to administer multiple plans on a per member basis, rather than on a per-plan basis.

<sup>15</sup>It is arguable that benefits that can be characterized as "ancillary benefits" do not have to be offered separately for each plan membership.

## Report on the Pension Plan Examination of the Ontario Municipal Employees Retirement System – July 2007

### Requirements

The Report sets out requirements that must be met for the purposes of bringing the Plan and Fund into compliance with the *Pension Benefits Act*. They are:

- *Delegation of Responsibilities*: FSCO requires that all delegations be readily available in a standard form for inspection by those eligible under the *Pension Benefits Act*.
- *Nominal and Immaterial Threshold in Related Party Transactions*: FSCO requires that OMERS review the criteria set out in its Statement of Investment Policies and Procedures (SIP&P) to be used to establish whether a related party transaction is nominal or immaterial to the Plan, having regard to all factors set out in the *Pension Benefits Act*, which includes the Federal Investment Regulations (FIR).

### Recommendations

The Report makes recommendations that, in FSCO's opinion, will assist in ensuring that the Plan and Fund are administered in accordance with the requirements of the *Pension Benefits Act* in the future. They are:

- *Due Diligence*: FSCO recommends that due diligence, as it relates to the *Pension Benefits Act*, be documented and maintained in each investment file and that the documentation support any conclusions and positions arising out of such due diligence.  
  
FSCO recommends that the documentation be sufficient to facilitate independent confirmation of due diligence with respect to the application of the relevant legislation.
- *Provision of Information to OMERS Staff*: FSCO recommends that OMERS document and maintain in each investment file, information sufficient for OMERS staff to be able to monitor the Plan and the Fund for compliance with the requirements of the *Pension Benefits Act*.

- *Monitoring of Board Policies*: FSCO recommends that OMERS review its monitoring mechanism to ensure that its internal policies are followed.
- *Updating the Statement of Investment Policies and Procedures (SIP&P)*: FSCO recommends that OMERS establish guidelines and update the SIP&P before undertaking a new category of investment.

FSCO also recommends that OMERS consider including in the mandate of the legislative compliance officer the responsibility for monitoring the SIP&P, to ensure that it is updated as necessary.

- *Delegation of Responsibilities*: FSCO recommends that OMERS review the delegation processes to ensure that the processes provide for clear written documentation of the responsibilities being delegated.
- *Service Providers as Agents*: FSCO recommends that OMERS establish and implement procedures determining whether a service provider is an agent for the purposes of the *Pension Benefits Act*.  
  
FSCO recommends that OMERS advise service providers, determined to be agents, of their status as agents.

<sup>16</sup>Page 3 and 4 of report.



