MEMO

To: Board of Trustees

From: Hugh O'Reilly

Date: September 29, 2017

Re: Meeting with Government Sponsor

The purpose of this memo is to help prepare government-appointed trustees in advance of the meeting requested by Helen Angus, Deputy Minister, Treasury Board Secretariat.

Context

This meeting has likely been arranged against the backdrop of Deputy Angus having been briefed on OPTrust's 22-year history and desiring greater *line of sight* into the Plan. During this history, the Plan, including its investment performance and funded status, has performed well. However, for a good part of its initial 20 years, OPTrust has lacked a long-term strategic plan, has not maintained regular communication with the Government and has been the subject of several issue-based incidents. As a result, it has not been viewed as a sophisticated partner. While perceptions may take time to change, over the last 30 months, with the full support and encouragement of Trustees, OPTrust has implemented a focused strategy that is highlighted below.

Government ministers and officials routinely meet with their appointees to agencies, boards, commission and government business enterprises. Those appointees act in accordance with their legislated responsibilities and most often as an agent of Her Majesty. OPTrust is not a crown agency, (unlike OPB, but similar to IMCo). The duties of the Board of OPTrust are defined in the Trust Agreement establishing the Plan and applicable legislation, including the *Pension Benefits Act* (Ontario). Under the *Pension Benefits Act* (Ontario), the Board is subject to fiduciary duties which requires them to put the interests of the Plan members first before the interests of any other person and to always act in the interests of the Plan membership as a whole.

Both the Trust Agreement and the Sponsorship Agreement require the Trustees to meet with the Sponsors annually to "explain the annual report to them and answer any questions they may have about the Plan and the Fund." In recent years, this has been fulfilled through the annual performance briefing that management and the lead Trustee from each side arrange with the respective Sponsors. Outside of this meeting, management routinely meets with the Sponsors to ensure open lines of communication.

Each year all of OPTrust's Trustees are required to attest to compliance with the Board-approved Trustee Code of Conduct. In accordance with the principle that fiduciaries may not benefit from their position (codified in section 22(9) of the Pension Benefits Act), the Trustee Code of Conduct requires Trustees to declare a conflict where they have an actual conflict of interest or where there is an appearance of a conflict. The Code of Conduct also requires Trustees to be aware of situations where their fiduciary duty to OPTrust may conflict with their fiduciary duty to another person.

Background

Defined benefit pension plans face many challenges today. The overall concept, designed decades ago, evolved during a time when interest rates had hovered at eight or nine per cent. The idea that real interest rates would drop below one per cent and stay there for years was inconceivable. Also, the workforce consisted of a demographic that was swelling in size, thanks to the baby boom and a small retiree population. There were significantly more active workers than retirees. All of these factors have changed, creating challenges that are compounded by today's volatile markets and low interest rates.

These challenges have left the false impression with many, that all DB plans are unsustainable. Indeed, many defined benefit pension plans are having difficulty in coping with the existing environment. This is likely to be exasperated should Canada experience a prolonged recession. While challenges exist, OPTrust is managing the Plan with the long-term focus of keeping the pension promise sustainable. In fact, the Pension Asset Expert Advisory Panel Report that was commissioned by the Province of Ontario, released earlier in 2017, as a response to the Auditor General's ruling on the use of the OPSEU Pension Plan Surplus states:

> *The accounting asset arises in part because OTTP and OPSEUPP (OPTrust) are conservatively managed in order to protect the Plan's funded status in case of poor performance and to maintain contribution and benefit stability for members and employers regardless of economic conditions.*

OPTrust agrees with the Province's expert panel statement about the OPSEU Pension Plan. OPTrust manages the plan conservatively through a rigorous risk-based process. The primary tools we use to manage the Plan are the Funding Policy and the Investment Plan, which serve to document our long-term strategy. The strategy allows us to focus on the long term without having us fall victim to short-term market fluctuations. A "typical" recession is unlikely to require Sponsors to make any immediate decisions about the Plan's design that would affect contributions and benefits.

We are not resting on our laurels. We are of the view that we have a responsibility to members to continue to find ways to improve on the work we have already done. This sense of responsibility does not arise because the Plan is unsustainable in its current form but because we believe in the availability of additional risk management tools. As you are aware, OPTrust has been engaged in a discussion with its Sponsors since 2012 about the need to create a second schedule of benefits and attract new employers/members into the Plan.

The Plan does not need membership expansion in order to become sustainable — it already is. Plan expansion would help OPTrust spread investment risk over a larger cohort of members. It is not a lifeline to sustainability. Rather, it is another tool to help address the challenges outlined above.

The Measure That Matters

The 2016 Funded Status Report focused on "the Measure That Matters." You will recall that we changed the title of the annual report to focus on the single most important business metric that reflects our ability to deliver pensions today and protect them for tomorrow – the plan's funded status.

OPTrust is fully funded, though not all public plans nor all Jointly-Sponsored Pension Plans are fully-funded. Member contribution rates are among the lowest among our peers and they are stable. Benefits continue to be paid as they have been both promised and earned by members.

Conservative Discount Rate

In setting assumptions, actuaries use a myriad of variables to project the cash flow of a pension plan over the next hundred years. Then they use a discount rate to take the present value of those cash flows in today's dollars. That discount rate is the single most important assumption used by a plan — and it is sometimes the most abused. The higher the discount rate the lower the liability of the Plan. For OPTrust, a one per cent increase in the discount rate will decrease the liability by approximately 19 per cent.

The discount rate is set based on the expected return on assets invested by OPTrust, less any margins for adverse deviation. Generally, a higher discount rate as justified by the actuary reflects the higher investment risk taken by the plan's administrator. This has the affect of lowering the plan's liability but fails to acknowledge or account for the increased risk.

OPTrust has the second lowest discount rate (second only to the Ontario Teachers' Pension Plan — also mentioned in the Province's expert panel report) at 5.4 per cent as of December 31, 2016. Furthermore, we expect the discount rate to continue to decline for the December 31, 2017 filed actuarial valuation report. The reason for the continued drop in the discount rate is two-fold. The first is a reduction in the Plan's overall risk profile due to its investment strategy that reflects the Plan's obligations. The second is due to an increase in the margins for adverse deviation that are tantamount to a rainy-day fund that readies the Plan for the next recession or market downturn.

Member Driven Investing (MDI)

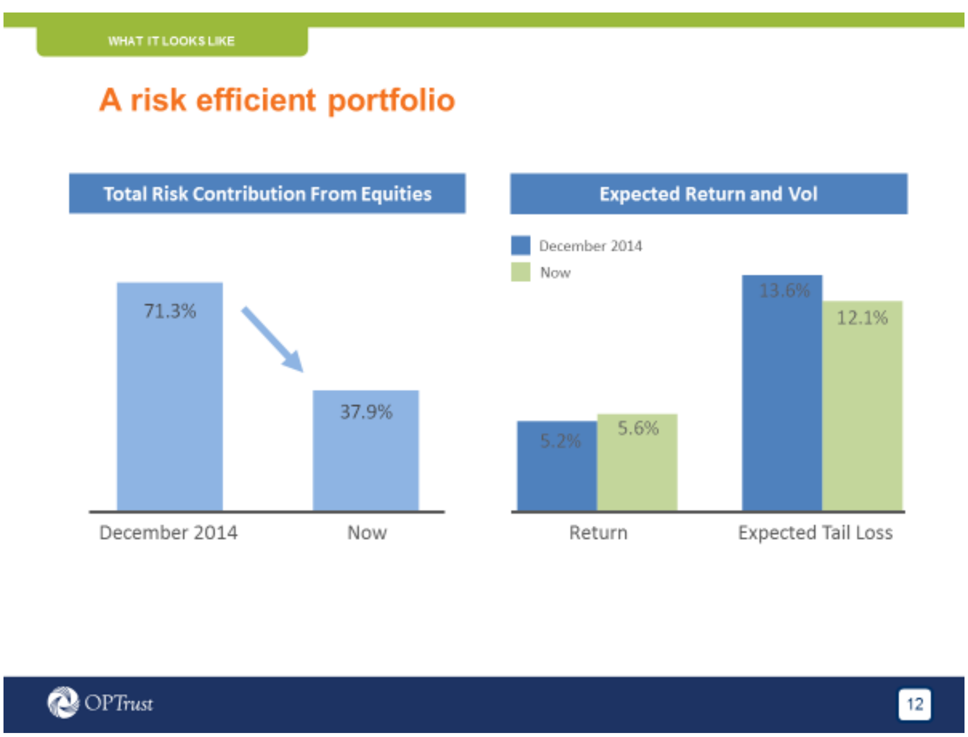
OPTrust has implemented its MDI strategy to ensure our investment portfolio and how we manage our plan needs, fully align with members' interests. The goal is to keep the Plan in balance at all times to protect its funded status and improve plan certainty. We use three performance metrics to measure our strategy and actions:

- Sustainability
- Risk efficiency
- Surplus preservation.

Performance and Cost

Generally speaking, an investment policy with higher expected investment return will carry greater risk. The MDI strategy along with the method of setting the discount rate allow OPTrust's investment team to take on less risk on our members' behalf because doing so helps the Plan remain sustainable at lower expected investment returns.

Over the past few years, OPTrust has greatly reduced the amount of risk carried in its investment portfolio. Risk is managed through the use of a conservative discount rate and by the strategic partnerships we make in the course of business.



Year-to-date, OPTrust's return, while not public, is 3.9 per cent and excludes OPTrust's alternative investments, which we expect to generate a higher return, driving up overall performance. For comparison, Ontario Teachers' Pension Plan released mid-year results at the end of June and announced an overall return of 3.8 per cent.

OPTrust's performance is generated at an overall cost of 35 basis points, 24 of which are related to investments. These figures mean our costs are 0.35 and 0.24 per cent of the overall value of the fund, almost identical to peer plans and exponentially lower than investment vehicles like mutual funds.

OPTrust has moved into the Top 10 Global pension funds for member service performance, as measured by the CEM benchmarking. Current membership satisfaction rating is nine out of 10, with 59 per cent being measured as perfect 10s.

Compensation

Over the 10-year period of 2007-2017, the Board of Trustees and OPTrust have engaged at least six different consulting firms that specialize in executive and senior management compensation structures. Firms such as Hay Consultants, Boston Consulting Group, Willis Towers Watson, Meridian, McLagan, and Hugessen Consulting have provided reviews, analysis and recommendations to both the Board and management on the architecture and emerging trends on compensation systems within the pension and financial industries.

Following a comprehensive review and redesign in 2015 of the short- and long-term incentive compensation programs, the Board agreed on a robust and market-comparable compensation philosophy and program redesign, launched January 1, 2016.

With an eye to ensuring the organization's compensation system is aligned with members' objectives while remaining leading edge in our industry to attract and retain high performing talent, the BOT has recently embarked on a RFP process to secure a new compensation advisor to the Board. The current compensation system, which was launched January 1, 2016, has not distributed payments under the Long-Term Incentive Plan (LTIP). The pragmatic view of the Board is to ensure the current compensation philosophy is reviewed and measured against market-competitive data through the expert opinion of its chosen consulting firm. The new compensation advisor will be brought forth during the October 4-5, 2017.

Public Policy Role

OPTrust has taken a more active role over the last 30 months in the public policy debate. It is important to emphasize that we became involved only in activities that support and meet OPTrust's policy goals and the interests of its members.

OPTrust was the first and one of the only pension plans publicly supportive of the Ontario Retirement Pension Plan (ORPP) proposal, and the subsequent proposal to expand CPP coverage.

Earlier this year, OPTrust authored a white paper on the accounting treatment of pension surpluses that exist in our plan as well as in the Ontario Teachers' Pension Plan. This is a contentious issue between the government and the Auditor General. OPTrust entered this debate because we believe strongly that the auditor's view undermines the risk that is shared by our sponsors and our members. While our reasoning differs from that of government, our position supported the government's overall position on the matter.

Finally, OPTrust routinely provides expert pension policy advice, both informally and formally, to the Ministry of Finance through policy consultations.

Thought Leadership

Throughout the last 12 months, OPTrust has grown its influence in our sector and community by starting conversations on several important topics. Examples include:

- Late last year, we held the International Summit that was attended by industry leaders from around the world.
- The white paper on climate change received a very high level of media attention and led to meetings with Canada's environment minister and the environmental commissioners of both Ontario and the EU – at their request.
- OPTrust has led the development a white paper on the Canadian pension plan model, to be published by the World Bank later this fall.
- In partnership with HOOPP, we are cohosting a policy symposium in November that will be attended by senior policy makers and regulators.

Membership Expansion: OPTrust Select

Membership expansion is not crucial to the sustainability of the Plan but it provides an additional tool to mitigate risk. Membership in the Plan is now below one to one active to inactive ratio as the Ontario Public Service evolves. The ability to expand the potential membership base would help address the maturity challenge. Absent any membership expansion, OPTrust is likely to reduce its overall risk exposure and continue on the trajectory of managing the Plan with added conservatism.

When OPTrust was formed, the Sponsors envisioned a Plan with multiple employers and multiple employee groups (e.g. GO Transit and the ATU, Ontario Housing Corporation and CUPE). Section 40 of the Sponsorship agreement acknowledges that the "Sponsors agree to discuss in good faith the future membership of the Plan...."

OPTrust Select is a modest defined benefit plan that is intended for workplaces in Ontario that do not have a comparable plan. Peer plans like OMERS, CAAT and HOOPP are similarly looking to expand their plans.

The Government of Ontario, through numerous budget and policy positions, has clearly stated its desire to expand public sector plans and provide greater retirement income security to Ontarians.