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**SUSTAINABLE SOLUTIONS FOR  
ONTARIO'S PENSION INDUSTRY**

**Keynote Address**

**by**

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**to the**

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From Crisis to Sustainability"**

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It is an honor to be the keynote speaker before such a distinguished audience of pension industry specialists.

I wish this were a more cheerful period for pension fund investors. As we all look for better days ... I am reminded of an expression used by motivational speakers.

You have heard this many times. The Chinese symbol for “crisis” can mean danger or opportunity.

Unfortunately, there is no such meaning in this symbol ... though it gets repeated time and again because it sounds credible.

Failing to check what is true or false ... what is credible ... is one of the reasons we have a global credit crisis.

If we are to find sustainable solutions for the pension industry ... we must understand why things went wrong.

It's fashionable to blame our problems on the capitalist market economy. But that does not excuse any of us ... as fiduciaries ... from responsible due diligence in understanding the origin and evolution of the crisis.

The global credit crisis was initially created by political decisions in the United States that distorted risk in that housing market.

Historically, borrowers got a mortgage loan only if they could provide evidence of a reliable income and sound credit - and then made an equity investment in their home.

That began to change after 1994. President Clinton called for a dramatic effort to increase homeownership so that ... as he put it ... minority families, young families and low-income families could partake of the American Dream.

Politicians argued that requiring proof of income, employment, creditworthiness and a down payment were discriminatory. As agents of government policy, Fannie

Mae and Freddie Mac pressured lenders to extend credit to anyone who wanted to buy a home.

When it came the Republicans turn to govern ... President Bush argued that the gap between those with homes and those without (and I quote) “signals that something might be wrong in the land of plenty. And we need to do something about it.”

Over a decade or so, America did do something about it. It threw risk management out the window.

The result was extraordinary. Home ownership exploded. Documentation was abandoned. No income, no job, no assets? No problem.

Between 1998 and 2007, seven million high-risk borrowers bought homes with sub-prime loans. This represented 20 per cent of all mortgage loans.

Sub-prime loans were sent to Wall Street ... securitized and sold to investors around the world. By 2007, sub-prime loans

were a US\$1.5 trillion global market for investors seeking high returns with little or no concern for risk.

Rating agencies misplaced the credit and the default risk of unqualified borrowers with models that treated these securities like investment-grade corporate bonds.

If U.S. administrations had pursued their agenda of home ownership by putting high-risk loans on their own books ... the crisis would not have happened. Here's the irony. The U.S. government has now begun to do exactly that.

None of this excuses fiduciaries ... that is, institutional investors and their agents ... who lost other people's money because they chose not to do proper risk due diligence.

Let me share with you what OMERS does.

We actively manage all our fixed income securities. Active management means understanding risk to make sure our plan members are properly compensated for it.

Our six-member credit management and derivatives team approves all products before they can be traded. Sometimes the team has candid confrontations with portfolio managers mesmerized by investment returns.

Here's what happened as the credit bubble grew. Our team looked at the structure of CDOs. They looked at the history ... or lack of it. They looked at what these CDOs owned by way of collateral ... and often found nothing tangible.

Our credit team struggled to understand what OMERS was being asked to buy. They tried to assess how these CDOs would hold up if markets changed. They were concerned about the lack of transparency offered by people promoting these products.

They examined forms of credit enhancement ... quality of reporting ... and liquidity lines. Our credit team looked at the yields being offered for the risk involved.

In the case of Canada's asset backed commercial paper products, they found a contract provision that non-liquidity

support will only be given in the event of a major market disruption. But there was no legal definition of “major market disruption”. The contracts protected issuers like banks, not investors.

There was nothing brilliant in this analysis. Our people were simply doing their day-to-day jobs ... driven by the covenant we have with plan members to invest prudently.

That meant investing in what we understand and can explain. We were not impressed when sellers argued that other pension funds were buying these assets – so why wouldn't OMERS?

We take a *qualitative* approach to risk ... and do not rely on *quantitative* computer models that are only as good as the assumptions they incorporate.

We know that fear and greed drive markets. Quantitative models do not measure such emotional factors. Neither can regulation. Quantitative models do not measure human judgment. Nor can regulation.

By being skeptical, doing our homework and saying no, we avoided losses.

As we all work to sustain our pension system ... I stress that informed judgments about risk is one of the most important duties pension funds owe their plan members.

To achieve sustainability, pension funds must have robust governance ... investment ... risk management ... internal audit ... and timely reporting policies and procedures – and implement them ruthlessly.

This extensive oversight and risk management calls for significant professional resources. That means pension funds need critical mass ... so that they can afford to hire professionals with the requisite skills ... and actively manage the assets entrusted to them.

Critical mass matters because we all operate in a global marketplace. Earning acceptable risk-adjusted returns requires deep experience and expertise to deal with complex

products ... complex regulatory and tax regimes ... and yes, political interference in markets.

Our pension funds need much larger capital bases. Only two ... the CPP Investment Board and Ontario Teachers ... rank among the top 20 in the world.

OMERS ... while a large pension fund at 44 billion dollars... is way back in 46<sup>th</sup> place on the global list.

OMERS cannot compete against the global giants as a small player. Nor can other plans. The Ontario industry is highly fragmented with many thousands of small plans.

We are pleased that commissions on pension reform in British Columbia, Alberta, Ontario and Nova Scotia recognize the value of size.

The Ontario Expert Commission on Pensions led by Harry Arthurs recommended that small defined benefit and defined contribution plans be encouraged to consolidate into larger plans and (as he put it) “associate with super-plans.”

Professor Arthurs is here today. We thank you for your thoughtful recommendations. With government action, your recommendations will help the pension industry to gain sustainability.

We need some form of consolidation in both the public and private sectors because our pension funds are simply too small.

Many people are surprised that our big banks and insurance companies, for example, typically have their own pension funds with assets of only \$3 billion to \$6 billion. Universities are even smaller at \$1 billion or less. Thousands of pension funds have assets less than \$100 million ... that's millions not billions ... and as small as two or three million dollars.

These funds cannot afford to deliver the quality and depth of governance, investment skills and risk management expertise their members need and deserve.

Prof. Arthurs pointed out in his commission report that small and medium-sized funds lack the infrastructure, resources, expertise or inclination to undertake broadly based portfolio diversification on their own account.

They tend to purchase standard financial products and pay hefty fees for less favourable returns.

Prof. Arthurs concluded that (and I quote): “Plan size may be a greater determinant of a member’s pension than plan design. Large plans will generally perform better than small ones.”

Consolidation will also help large funds. As Prof. Arthurs added, without new members and new cash flow, the investment expertise of large mature plans will be underutilized and difficult to sustain.

The time has arrived for bold legislative leadership to create globally competitive critical mass in our pension industry.

This is not a revolutionary idea. British Columbia and Alberta have both aggregated pension fund capital in their public sectors to above \$70 billion.

We are seeing movement by the Ontario government in the direction of consolidation. The recent introduction of legislation to allow Ontario Teachers ... a plan it co-sponsors ... to administer public sector pension plans and pension funds is evidence of that.

But that should be only a first step.

The next step is for Ontario to mandate through legislation the consolidation of private and public sector pension funds into super-funds comparable in size to Teachers.

OMERS must be one of the super-funds. OMERS has to date done the heavy lifting among pension plans in the area of infrastructure investing in the Province of Ontario.

We were first to invest in green technology. We have led the renaissance in the nuclear industry in this province that will benefit other parts of the Canada.

We have invested in the “bricks and mortar” of our health-care infrastructure.

We are currently invested at the Windsor / Detroit border crossing where one of the largest infrastructure programs must take place in order to protect hundreds of thousands of jobs.

OMERS has paid its dues and will continue to invest in the Province of Ontario and the rest of Canada.

What distinguishes OMERS from most pension plans is that we have direct management expertise in ALL asset classes.

We have consistently achieved industry-leading results.

And we have the resources, policies and capacity to manage other funds.

OMERS is also a perfect model of a multi-employer and jointly governed organization.

Why am I calling on the Ontario government to mandate consolidation? The truth is that every sizeable pension organization believes that it should be the consolidator. None of us is going to consolidate willingly with anyone else ... no matter how compelling the arguments.

It is however in the best interest of all of us to get together and work with government to find a solution.

Under the super-fund model, we could all do much more together for our plan members *and* maintain our independent relationships with stakeholders ... administer our own plans ... and control benefits and contribution rates for our members.

The creation of super-funds should appeal to smaller funds. To facilitate their interest, governments could create sector-specific retirement wealth funds.

One retirement wealth fund for public sector pension funds ... another for not-for-profit organizations ... a third for private sector corporations ... a fourth for universities.

But even then these aggregated sector funds will still be too small in the global arena and would be best managed by a super-fund.

There is much to commend a move to super-funds. We all face a dark period of unfunded liabilities ... grave market uncertainties ... and a long road back to recovery. It's time to free ourselves from the entrenched positions of a fragmented industry that hinder rather than help our common search for sustainability.

The situation is onerous for companies faced with shoring up their pension fund and trying to survive. The role of companies is first and foremost to make profits. That requires quite different skill sets... and a quite different focus... from managing pension assets and liabilities.

An important advantage of a super-fund – and the key to sustainability for all of us -- is to actively manage pension assets. The days of passive investing ... of leaving investment decisions to fee-motivated outsiders ... must come to an end.

Super-funds can help smaller plans to achieve sustainability by striking a better balance between volatile public market investments and more stable private market investments.

OMERS currently invests close to 40 per cent of the total fund in private markets. Our long-term target is 45 per cent.

Why are we so out of line with other funds? Investing heavily in real estate and infrastructure has enabled OMERS to earn more stable returns and weather the crises of 2008 in reasonably good shape. These assets have produced annual returns exceeding 18 per cent over the past five years, including positive numbers last year.

Part of the reason for our sustainability is ownership of a full-service real estate asset management company with a

50-year history ... and an infrastructure asset management company with a 10-year history.

Oxford is managed by career real estate professionals ... and Borealis by career financial and investment specialists. Expertise matters. The management at both companies participates with other OMERS investment and corporate executives in all investment decisions so that we remain true to prudent investing.

By joining with OMERS in creating a super-fund ... other funds will have access to the expertise at Borealis and Oxford that none of them can afford to replicate.

The creation of super-funds should also make it easier for the Province of Ontario to introduce legislation to advance pension coverage for the 65 per cent of Ontario workers without such coverage.

We believe that joining a provincial plan should be mandatory for all employers and workers not currently covered.

The opportunity to invest the contributions of this provincial plan would be attractive to super-funds ... and would avoid the heavy costs of starting a new pension organization.

To conclude, bold and courageous political leadership is required to bring long-term stability to pension fund investing.

We are all going through the most difficult markets in our careers. No one knows when credit will flow freely again ... when economic recovery will take a firm hold ... when equity markets will recoup last year's huge losses ... when pension funding deficiencies will disappear. In the meantime, employers and workers fear major increases in contribution rates as actuarial valuations are filed.

This is the right time to bring about major change in the pension system so that we have the capital size... the shared professional expertise, the governance rigor and risk management disciplines to better handle future crises.

Leveraging the talents in major pension funds will help the entire industry to generate the level of long-term sustainable returns that our workers deserve and expect so that they can retire with financial dignity.

Thank you.