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PENSION UPDATE

Tentative 2012 Valuation Agreement Reached

The Partners, the Ontario Teachers' Federation (OTF) and the Government of Ontario, have agreed on a proposal to eliminate the 2012 deficit and file a balanced valuation of the Ontario Teachers' Pension Plan (the Plan). The agreement is subject to final approval by the OTF Executive; the Executive will be seeking a recommendation from the OTF Board of Governors on February 6, 2013 to file on the basis outlined in this *Communiqué*. Until that happens, this agreement remains confidential to members of OTF.

Is OTF required to file a 2012 valuation?

The short answer is no. Because the Partners filed in 2011, the next mandated filing is not until 2014. Members will recall that, on several occasions, the Partners have made the decision to file in a non-mandatory year because they determined it was beneficial to members and the long-term sustainability of the Plan. That is where we find ourselves again in 2012.

The 2011 Report to Members (April, 2012) from the Ontario Teachers' Pension Plan Board (OTPP) announced that, despite the filing of a balanced valuation in 2011 and an 11.2% return on investments in 2011, the Plan was facing a further $9.6 billion funding deficit at January 1, 2012. This deficit arises primarily from two factors: increasing life expectancies and low interest rates.

In early February of 2012, when the Partners received the preliminary valuation results identifying a $9.6 billion deficit, they were also provided projections for 2013 and 2014. Given that the low interest rate environment is expected to continue, the projected deficits were much larger (potentially twice as large) and, if valuations were filed in those years, more significant Plan changes would be required in order to balance.

What factors into a decision to file?

In a typical year where a filing is being pursued, many factors are considered. Since a balanced filing is required when a deficit exists, the Partners consider their options—reduce benefits, increase contributions or some combination of both. Likewise, the Partners discuss the actuarial assumptions (factors which influence the cost of pensions) used by the OTPP. While the OTPP sets the assumptions that factor into the discount rate (interest rate) used to value the Plan's liabilities, if the Partners have questions or concerns, they discuss them with the OTPP.

As a result of an earlier valuation agreement, if the discount rate used is below a certain threshold, the Partners may trigger a process— the Hearing Officer Review—to have an independent party comment on the appropriateness of the discount rate. This is discussed in more detail below.

This was certainly not a typical year. These valuation discussions took place in a political and economic context which differed from that of other recent valuations. The timeline also changed mid-course. Normally, the deadline to file a 2012 valuation would have been September 30, 2012. During the period of these discussions, that deadline was extended twice: first to December 31, 2012 and then to February 28, 2013. The extensions were not exclusive to the Plan but apply to it as well as other plans.

What else was different about the context this time?
The 2012 Ontario Budget, released March 27, 2012, signalled the Government's intention to freeze its funding commitments to the large public sector pension plans in an effort to help reduce the Provincial deficit. The Jointly Sponsored Pension Plan (JSPP) consultations that followed proposed that Government contributions to JSPPs would be frozen at current levels for the next five years, and that pension funding deficits during that timeframe would have to be addressed through benefit reductions, rather than contribution rate increases. Agreements were reached, to this effect, with three JSPPs (HOOPP, OPTrust and CAAT), but not with the Plan.

Given the Government's stated position in its budget, and in the JSPP consultations, increasing contributions to offset any portion of the 2012 deficit was not possible. The only means by which the deficit for 2012 could be met were through changes to benefits and/or changes to actuarial assumptions.

What other factors affected the Plan's deficit?
During the course of these discussions, the $9.6 billion deficit went up and down as assumptions were modified.

The OTPP commissioned a study on longevity which provided data showing that the life expectancy of teachers had further improved since their last thorough analysis. While this is good news for Plan members, it increases the long-term liabilities of the Plan. Coupled with some other assumption changes, the projected deficit to be addressed for 2012 increased by $2.4 billion to approximately $12 billion.

The two-year wage freeze had a positive impact on liabilities, and the OTPP adjusted the salary estimates used to calculate the funded status of the Plan. The change compensated for the alteration in assumptions, including improved life expectancy. Thus, projected liabilities increased as a result of one factor, decreased as a result of the other, and the Partners were back where the discussion initially began—determining how to eliminate a $9.6 billion deficit.

How did the Hearing Officer Review impact the discussions?
The Partners triggered this process and all three parties (OTF, Government and OTPP) agreed on a Hearing Officer. Each party made submissions and representations. The final report of the Hearing Officer and the OTPP's response were released by the OTPP in August 2012.

The Hearing Officer's non-binding report acknowledged that the 2.85% (real) discount rate used by the OTPP was within a reasonable range, but at the low end, and that he could support a rate of 2.95%. He also recommended that the discount rate being used by the OTPP could be increased further (thereby reducing the deficit) if the Partners amended the Plan to include 100% conditional inflation protection (CIP). Lastly, he recommended that the process used for setting the discount rate should be a building block approach, where the OTPP estimates its long-term expected rate of return and then applies margins for adverse deviation (that reduce the rate accordingly), rather than a formulaic approach based on long-term bond yields.

The OTPP agreed to increase the discount rate by 10 basis points to 2.95%. Given the sensitivity of the Plan to the discount rate, the value of this change was approximately $3 billion. The OTPP agreed to further increase the discount rate if the Partners amended the Plan to include 100% CIP (because doing so permanently de-risks the Plan) thereby eliminating more of the deficit. These two modifications eliminated a significant share of the deficit but were not sufficient to completely close the gap.

How are CIP provisions different under this proposal?
In order to file a balanced valuation in 2008, the Partners introduced 50% CIP in the Plan for post 2009 service. This meant that service accrued before 2010 would continue to receive 100% indexing, but that service accruing after 2009 would only receive indexing of between 50% and 100% depending upon the Plan's funded status.

The proposed expansion of the current 50% CIP regime to 100% CIP for post 2013 service means that service accruing after 2013 would only receive

indexing of between 0% and 100% depending upon the Plan's funded status. This would result in inflation protection for Plan members as follows:

For Pension Credit Accrued	Level of Inflation Protection
Before 2010	100% indexing
From Jan. 1, 2010 to Dec. 31, 2013	50% to 100% indexing, based on Plan funding
After 2013	0% to 100% indexing, based on Plan funding

What else does this proposal include?

As part of the balanced valuation filing in 2011, the Partners already invoked CIP at the 60% level (for post 2009 service) for benefits payable since January 1, 2012. In order to balance the 2012 valuation, the Partners propose to invoke CIP at the 50% level (for post 2009 service) for benefits payable beginning January 1, 2014. The Partners would also invoke CIP at the 45% level (for post 2013 service) for benefits payable beginning January 1, 2015.

What impact will the new CIP provisions and "invoking" have on me?

Circumstances will vary depending on where you are in your career, but a few examples are **shown below** to assist you in understanding what the changes might mean for you.

Your pension will be indexed based on the level of CIP that is invoked after you retire, not while you continue to work.

It is also important to keep in mind that examples are often based on "worst-case scenarios". Models alone cannot predict the actions that might be taken collectively, by the Partners, to address future funding challenges. Individuals should make decisions about when to retire based on their personal circumstances, including financial needs.

NICOLE	% LEVEL/$ AMOUNT OF INDEXING		
	100%	100/60%	100/50/45%
Pension credit before 2010	$450	$450	$450
Pension credit between Jan. 1, 2010 & Dec. 31, 2013	$150	$90	$75
Pension credit after 2013	$400	$240	$180
Total Annual Pension Increase for Indexing	**$1000**	**$780**	**$705**

INFLATION PROTECTION EXAMPLES

Let's look at Nicole, and her colleagues Michael and Keisha. All of them expect to enjoy a full 26-year career, which is average for most teachers these days. By the end of 2013, Nicole will have completed 60% of her career. Michael will be closer to retirement, having completed 90% of his career, while Keisha will still have much of her career to enjoy, having only completed 25%.

For the sake of comparison, let's assume that each of them retires with an annual pension of $50,000 and that inflation is 2%. If their pensions were fully inflation protected (or indexed) at 100%, they could expect to receive an increase of $1,000 to their $50,000 annual pension. [see chart below for Nicole - column 1]

However, some of their pension credit (post 2009) is already subject to the current regime in which conditional inflation protection (CIP) applies, and for which the Partners have invoked at 60%. If CIP is still invoked at 60% when she retires, this would reduce the indexing that Nicole could expect to receive from $1,000 to $780 ($900 for Michael and $640 for Keisha). [Nicole - column 2]

With an expanded CIP regime (as proposed), where the Partners also invoke at 50% (for post 2009 service) and 45% (for post 2013 service), the indexing that Nicole could expect to receive, assuming these same CIP levels were still invoked when she retires, will decline a bit further from $780 to $705 ($870 for Michael and $513 for Keisha). [Nicole - column 3]

All of this assumes, of course, that Plan funding will remain as is, and that the current levels of CIP invoked by the Partners will not change. However, this will not likely be the case. If Plan funding gets worse, further CIP may have to be invoked. On the other hand, as Plan funding improves, there are mechanisms in place that could restore indexing that has been foregone.

The bottom line is that when Nicole and her colleagues retire, the indexing that they will receive will reflect the funding realities (good or bad) facing the Plan at that time. **Although their pensions will be subject to CIP, it is only the level of CIP that is invoked after they retire that matters. While they continue to teach, their pensions will accumulate, unaffected by the current level of CIP that has been invoked.**

What will these changes mean for Plan funding in future years?

Each year, the OTPP values the Plan's assets and liabilities. The OTPP will report its 2012 performance in April of 2013. The Partners are confident that the report will show positive performance. However, it is quite likely, despite positive results, that a deficit (smaller than 2012) will result again for 2013.

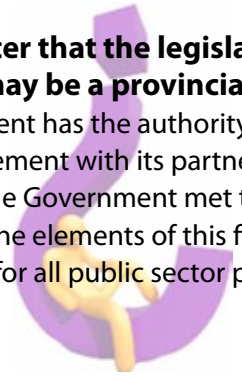
We continue to be in a low interest rate environment and pension plan liabilities are very sensitive to interest rates. All pension plans are experiencing this pressure, not just our Plan.

Each year, the Plan's gains and losses are allocated (or smoothed) over three years (previously over five years). Therefore, smoothing also impacts the bottom line, sometimes with a net gain to assets and sometimes with a net loss.

The actuarial assumptions and the method used in setting the discount rate are also very important. Along with the Partners' agreement to file in 2012, on the basis explained in this *Communiqué*, the Partners have also agreed to review the Funding Management Policy. The parties will be seeking the advice of an independent expert in completing this review.

Other factors affecting future valuations are life expectancy and the balance between the number of years (on average) spent working versus those on pension. These will continue to pose funding challenges for the Plan. Analysis of data by the Demographic Task Force over the past year shows that the average retirement age for teachers has crept up slightly, which has a positive impact on Plan funding. The Partners will continue to study the impact of these factors on Plan funding and proceed with their plan to conduct a survey of Plan members (likely Fall 2013) to explore preferences as to further benefit changes that may be necessary in future.

Does it matter that the legislature is prorogued or that there may be a provincial election soon?



The Government has the authority, as it always does, to enter into this agreement with its partner, the OTF. In reaching this agreement, the Government met the conditions stated in its budget, and the elements of this filing are consistent with expectations for all public sector pension plans through the JSPP process.

Teachers continue to have all the same protections under the *Pension Benefits Act*, The *Teachers' Pension Act* and the Partners' Agreement which they have enjoyed. No other Plan benefits have been amended. The only caveat is that, for the five-year period announced, the Government will not pay more into the Plan than its current level.

OTF continues to examine the possibility of a JSPP agreement and whether it would also be in the best interests of Plan members.

If this valuation is filed with the Financial Services Commission of Ontario (FSCO), the next mandatory filing will not be until 2015. This provides Plan members the assurance of stability in their benefits and contributions over that period.

Why not wait and file in 2014 when it is mandatory?

This is an option that the OTF Executive seriously considered. Given the estimated deficits of the Plan in both 2013 and 2014, however, the OTF Executive decided to pursue a 2012 filing. We believe it is in the best interests of Plan members.

How will the decision to file be finalized?

By legislation, it is the OTF Executive which has authority (and responsibility) to enter into agreement with the Government of Ontario to file valuations of the Plan. The OTF Executive is comprised of the Presidents, General Secretaries and Table Officers of the four Affiliates (AEFO, ETFO, OECTA and OSSTF), along with the OTF Secretary-Treasurer. It has been the practice of OTF to seek support from the OTF Board of Governors before signing the filing agreement. The OTF Board of Governors will make that decision on **February 6, 2013**. In the meantime, this all member communication is available to all OTF members, and each Affiliate will share this information within their membership through their own processes.

A *Communiqué* will be issued after February 6, 2013 confirming the decision of the Board. No information about this tentative proposal will be made public before that date.