

Frequently Asked Questions about the Sustainability of the University of Toronto Pension Plan

(February 17, 2011)

[Helpful Definitions can be found at the end of the document](#)

1. What is the problem?

There are two problems.

The first problem is that, by the usual definitions, the pension plan has a deficit of approximately \$1B. The University of Toronto operates a defined benefit plan with firm commitments to retired employees. Thus, it is possible to project these future commitments or liabilities against the anticipated value of current assets. While the projections vary sharply depending on the assumptions that are applied to any calculations, there is clearly a major shortfall using standard assumptions.

It is theoretically possible to make up any persisting shortfalls by drawing on the operating budget at some later date. However, this is not a prudent approach. To ensure that future commitments to pensioners can be met, Ontario law stipulates that a healthy pension fund should ideally be more or less self-sufficient, i.e. the plan should itself generate enough revenue to meet the needs of pensioners, current and future. That is simply not the case in our plan or most other defined benefit plans in Ontario. Thus, the University will have to make substantial special payments into the pension plan over the next several years.

The second problem has to do with ensuring the long term sustainability of the pension plan. As members of the pension plan we are not contributing an amount that is commensurate with the value of the benefit we will receive. If this mismatch is not corrected, then even if the deficit is temporarily cleared by special payments, it is almost inevitable that it will recur. Only by increasing employee contributions to a level more commensurate with our benefits can we ensure that our plan is sustainable into the future. And not surprisingly, the Government of Ontario has been insistent that there is little point in

remedying past shortfalls unless pension plans also take steps to prevent their recurrence.

2. Why did the President of the Faculty Association say that the Pension Plan deficit is \$2B?

As noted, the size of the projected deficit can vary sharply with assumptions made about assets and liabilities. The President of UTFA takes the view that deficits should be calculated based on a very low investment return assumption, like that used when the organization is going out of business or being “wound-up”. In his recent paper, Professor Luste references a real (i.e. above inflation) investment return of 1.5%, leading him to project a deficit of \$2B.

The University uses a methodology that is entirely consistent with the expectations and requirements of the provincial and federal pension regulators, resulting in a deficit of about \$1B.

We would add that the wind-up solvency test for pension plans is one that has repeatedly been criticized as not appropriate for public institutions. It was designed for private corporations that can go out of business in the near or medium term. Plan assets should therefore be sufficient to ensure that pensions are covered, given the harsh reality of bankruptcy proceedings in the private sector. A second's reflection will show that such a scenario is nonsensical in our context. The University has operated for 183 years. We have sister institutions that are more than 800 years old. This "great good place" will be here and thriving hundreds of years hence.

3. Is the University over-estimating the returns we can expect from the investment of the pension funds?

No one has perfect foreknowledge of investment returns, but we think our assumptions are reasonable. When we compare our real investment return assumption of 4.0% to the real return assumption used by other large pension funds, we find that other funds most commonly fall within the range of 3.75% to 4.25%. Thus, we are in the middle of the currently accepted range, and our approach is consistent with the methodology and

investment practices of other large pension plans.

We also emphasize that actuarial assumptions are long-term assumptions that are expected to endure through a variety of economic cycles. We review these assumptions annually and make fine adjustments to them periodically to reflect long-term changes in economic trends.

For example, prior to 1987, the University used a 2.25% real rate of return, but the dramatic upturn in financial markets and interest rates over the ensuing 20 years led to revisions upwards in the return assumptions. Had the University continued to use a 2.25% assumption, it is very clear that critics would have accused the institution of hiding a massive pension surplus behind conservative assumptions so as to prevent benefit improvements for its employees. Indeed, there was very widespread revision of the return assumptions in pension plans at that time, and many other university plans made benefit improvements. In 2007, notwithstanding two years of excellent returns in the financial markets, the University prudently lowered the nominal interest rate from 7% to 6.5% -- the level at which it remains.

4. Why does the President of UTFA say the real rate of return should be 1.5% for these calculations?

We don't know. Were that benchmark accepted, it is hard to find a pension plan in North America that would not be massively insolvent. But we do acknowledge that optimism about financial markets has taken a serious knock. For example, a 2001 UTFA newsletter featured an analysis by Professor Luste promoting a Defined Contribution plan based on a 5.3% real rate of return. Even in 2007, when the University revised its rate of return downward (see above), Professor Luste suggested the Administration was creating an "apparent deficit". Like Professor Luste, we are more cautious about the financial climate in the near term, although we believe a target not far from 4% is reasonable over the longer term.

5. Didn't UTFA's pension consultant say the University's return assumption was "very aggressive"?

Professor Luste has indeed reported that an actuarial consultant, Mr Stephen Eadie, characterized the University's projected 4.0% real rate of return is "very aggressive". In fairness to Mr Eadie, we have not read his full report to UTFA and he, too, may have changed his mind in recent years. However, we note that in late 2007, Mr Eadie chaired the Ontario Chamber of Commerce pension task force that made a submission to the Arthurs Commission (the body charged with creating a new pension framework for Ontario). Mr Eadie and the Chamber recommended that the minimum funding requirements should be tied to a "normalized interest rate" that would be 6.5%. For all intents and purposes, that is the same rate we continue to use for the University of Toronto's pension plan projections.

In further support of the University's projected real rate of return, the actual investment return in the pension plan over the lengthy 21-year period from July 1, 1989 through June 30, 2010 was a 4.1% real return net of all fees and expenses. That period includes the highly negative investment return years of 2008 and 2009. Skeptics may claim that this window excludes the market collapse of October 1987. In fact, the markets rebounded quickly from that 'correction' and starting the clock in 1987 makes no difference to these results.

Nonetheless, as noted, we are constantly re-evaluating these projections and assumptions.

6. How did the deficit get so large?

Multiple factors led us to where we are today. Some of those factors reflect assumptions and decisions made 15 to 20 years ago, and some go even further back.

For example, during times of significant surplus both the university and members took contribution holidays, even as a significant portion of the surplus was used to enhance pension benefits. Surplus funds were also used to offset budget cuts during the mid 1990s – a strategy encouraged by the Government of Ontario. The result was that the funds flowing into the plan were diminished, and existing funds in the plan were depleted by some short- and medium-term commitments, even as some indefinite increases in entitlements were initiated that have contributed

to current sustainability challenges in the pension plan. This ‘double-whammy’ – no funds in, more funds out - had a huge impact on the pension fund.

We emphasize that the relevant decisions throughout that period involved governors, administrators, and UTFA and union representatives, over many years. It is unfair to look back and second-guess all those individuals with the easy wisdom of hindsight. And such an exercise is arguably unhelpful today except to remind us of the rationale for the contemporary consensus on better policies and best practices.

A further factor in the deficit was the world-wide economic downturns that occurred in 2008. The University of Toronto Asset Management Corporation [UTAM] did badly relative to its peers in that period. A major restructuring of UTAM governance has since taken place along with significant shifts in the way that the pension assets and endowed funds are managed.

Last, while the financial markets have rebounded, interest rates have remained at historically low levels – a factor that sharply increases the calculated deficit in our pension plan. On the other side of the ledger, as a society we are living longer and collecting our pensions for longer – good news for all of us, but another factor that increases the challenges of placing the pension plan on a sustainable long-term footing.

7. The University and the plan members took contribution holidays for several years. Why didn't the University place those contributions into a pension reserve for times like these?

Between 1987 and 2004, with financial markets buoyant, there was indeed a significant surplus in the pension plan. However, some \$500M was used to enhance retiree and active member pension benefits.

For many of those years the surplus in our pension plan was at a high enough level that under the terms of the Income Tax Act, the University

was prohibited from making contributions. In other years, the University chose to take holidays given the funded status of the plan. The funds freed up by contribution holidays were used by the Administration for a number of purposes, including:

- Providing funding for the Supplemental Retirement Arrangement (SRA);
- Matching donations for student scholarships and over 170 endowed chairs; and
- Satisfying the requirements of the Social Contract.

Employees also received pension contribution holidays over a number of years.

Suffice it to say that none of our unions or associations suggested that these amounts – whether for enhanced benefits, the SRA, the Social Contract offset, or contribution holidays for employees -- should be placed into a special reserve fund!

8. What are the options for addressing the deficit?

There are only two ways to increase the assets in a plan – obtain higher investment returns or add funds to the plan.

While we would obviously like higher investment returns, the likelihood of that occurring in the near future is not high. As noted above, we have set the target investment return at 4% above inflation over a ten year horizon. For the past twenty years, this has been a reasonable return target. However, financial markets are not expected to generate high returns in the near future, and it may be hard to achieve even the specified target. Hence, dealing with the problem through investment returns is not a reasonable prospect for the short and medium term.

Enhanced payments and contributions are therefore the most important tactic for both resolving the deficit and putting the plan on a sustainable long-term footing.

At present, the University's ongoing contributions are 11.2% of the relevant salary base. This amounted to \$78.3M in 2010. In addition, since 2004, the University has set aside an extra \$27M per year for the pension plan.

It is clear that additional payments will be required from the University but the University has limited capacity to do so without cuts to the operating budget that would adversely affect our collective academic mission. A variety of strategies must therefore be devised to generate additional payments. For example, we can transfer a pension reserve we maintain into the plan. We can consider transferring some or all of the Supplemental Retirement Arrangement (SRA) assets that are on hand. We can take advantage of our credit ratings to borrow funds. We can issue letters of credit. And we can sell or lease some of our real assets that are not critical to the operations of the University.

9. What is the administration planning to do about the deficit?

We are examining all of the options listed above. Our analyses to date indicate that we will require a combination of options to fund the plan. At the January 31st, 2011 meeting of Business Board, members discussed the strategies outlined in the University's recent report (<http://www.governingcouncil.utoronto.ca/AssetFactory.aspx?did=7486>) and voted to approve a proposal to initiate a process of borrowing up to \$150M as an initial step. An early payment into the pension plan has positive downstream effects, both as regards the generation of returns and meeting regulatory requirements. Discussions will continue with the Business Board and the Pension Committee.

10. If the deficit can be addressed, why are there concerns about the long term sustainability of the U of T pension plan?

First, this is not a concern unique to U of T. It applies to many defined benefit [DB] pension plans within the broad public sector. In the view of pension experts as well as the Ontario Government, employee contributions in many of those plans are simply too low in relation to the benefit being earned. Employees at U of T currently contribute 5.3% of salary; the University then pays the balance of the annual cost

to earn the specified level of retirement benefits – a sum that is currently 11.2% of the relevant salary base. This ratio of slightly more than 1:2 has been in place for many years. The Government believes that a more appropriate ratio is 1:1. For example, contributions into the Ontario Teachers Plan are 11% each for employees and the employers. The same is true for contributions into the Ontario Colleges plan.

The University agrees that employee contributions should be increased in order to ensure the long-term sustainability of our plan, and this will be the focus of negotiations with our Unions and Associations in the immediate future. Our perception is that, from the Government's standpoint, this is also a matter of fairness – those who gain from the excellent benefits under our plan should pay more for that benefit. Otherwise, it will be future generations of students (and the citizens of this province who are the tax payers) who will be paying disproportionately through University operating budgets.

11. What is the role of the Ontario Government?

To repeat: The U of T is not the only university in Ontario facing this problem. Indeed, all university DB plans have significant deficits as do DB plans elsewhere in Canada and the U.S.

This has led the Government of Ontario to adopt a new regulatory framework for pension plans. Boiling the Government's position down to essentials, universities are expected to make special payments into their DB pension plans to reduce current deficits. As well a number of universities will also be required to negotiate increases in employee contributions, thereby aligning those contributions more fully with the value of the earned pension benefit. (Alternatively, the Government would expect future benefits to be reduced to achieve that alignment).

If this happens in ways that meet the regulator's requirements, then universities will have a decade to pay off the cumulative shortfalls in their pension plans. Over that decade, it is very likely that interest rates will rise, leading to sharp reductions in the total solvency payments required. As well, there will be a positive cumulative effect from special payments by universities, increased employee contributions, and

ongoing investment returns. This ‘positive mortgage’ situation will steadily move pension plans to a more sustainable footing.

If, however, we do not make these special payments and achieve contribution increases that satisfy the regulator, the University will be required to repay any shortfall over the course of 5 years – amounting to as much as \$200M per year. This would lead to dramatic cuts to the operating budget.

We elaborate below for those interested in more detail.

In Ontario, all DB plans are required to establish funding models to ensure that if the organization were to cease operations, there would be sufficient assets in the plan to cover all pension obligations of current and future retirees. This is referred to as the solvency test. Under the regular rules, solvency deficits have to be funded over very short periods (typically 5 years). The province has recently indicated it will introduce regulations for the university sector with respect to addressing solvency deficits that will include criteria for making solvency payments over a longer time period.

The regulations will set out a two stage approach. The timing of the stages is tied to the date that the University files its formal actuarial valuation with the provincial regulator. The effective date of that valuation is July 1, 2011.

To enter stage 1, the University must submit a plan to the Ministry of Finance demonstrating how it will address the pension plan sustainability issue. If the government approves our plan, then there will be a solvency funding exemption for the three-year period from July 1, 2011, subject to certain minimum tests. In particular, the government still expects the University to begin reducing the deficit and putting the plan on a stronger footing as a ‘going concern’. Our plans to date should address this going-concern test.

During the three-year period, the University is expected to address the issue of contributions in relation to benefit levels with faculty and staff covered by the pension plan. If by the end of the three-year period, sufficient progress has been made, as defined by metrics the

government will develop and apply, then the solvency deficit at that time can be funded over 10 years instead of the regular five years.

To repeat: There are huge advantages to moving through this regulatory framework and achieving so-called 'solvency relief' i.e. relief from the accelerated payments required under current legislation. It strikes us as massively in our collective self-interest for the University's faculty and staff to agree with the administration on rational and fair strategies that enable us to surmount these regulatory hurdles.

12. Why should the employees pay more? We didn't cause the deficit problem.

Employees are **not** being asked to fund the deficit. Consistent with the Government of Ontario's regulatory requirements, they are being asked to increase their contributions to a level that is more commensurate with the value of the pension they will receive when they retire. As noted, the government has made it clear that if we do not make progress in increasing the employee contributions, bringing the ratio of Employee to Employer contributions closer to 1:1, we will be forced to make accelerated deficit payments that will have a significant adverse effect on all faculty and staff, as well as our students.

We want to acknowledge that everyone will also be affected by the need to direct additional resources into short-term payments that will reduce the cumulative deficit. Each Division of the University has already been working on a plan to support special payments scaled to its numbers of faculty and staff. Every academic and administrative leader with whom we have consulted is aiming to minimize job losses, while sustaining the core academic mission and student services.

While we do not under-estimate this challenge, the deficit reduction strategy that has been outlined has been under consideration for many months. It is designed specifically to ensure that the impact on the operating budget is mitigated. The contrast between this scenario and the alternative – an accelerated payment scenario approaching \$200M per year -- is stark.

13. What is the SRA?

The SRA (Supplemental Retirement Arrangement) was negotiated with UTFa in 1996 in order to restore pensions for plan members who had salaries in excess of the government maximum for a registered pension plan. At that time the maximum salary was approximately \$98,500. The government limit had remained in place without any increase for 20 years. UTFa and the University agreed that by 2001, the salary cap would increase to \$150,000.

Over the past few years, the income level that could be covered in the registered pension plan has been increased under the Income Tax Act and is expected to be at \$150,000 by 2013-14. Assuming the cap on pensionable earning remains at \$150,000, as of 2013-14 the SRA will no longer be required for new retirees. With pension payments under the SRA no longer growing, we should consider whether some or all of the SRA assets should be transferred to the Pension Plan. This is a matter that will be reviewed with UTFa.

In the event some or all of the SRA assets are transferred, the pension payments currently being made from the SRA will be honoured but funded from other sources of revenue (approximately \$10M per year for the next several years but then slowly falling to zero – a sum that has been factored into our plans as outlined to Business Board.

14.If additional debt is required, what will happen to our credit ratings? Won't this increase our cost of borrowing? Doesn't more debt increase costs in the operating fund?

It is possible that our credit ratings might be reduced if the rating agencies decide that increased indebtedness shifts our credit-worthiness. However, we have been very open and transparent in discussing our financial situation with the rating agencies. They were fully aware of the size of the deficit in arriving at this year's positive ratings, and they also are aware of the range of options and resources available to us to deal with the problem.

Adding more debt does require an increase in debt service costs, which are paid from the operating fund. Again, these costs are factored into all the projections presented to Business Board.

15. What kind of university assets could we sell or lease? Will that generate enough money?

We are examining the possible sale or lease of some land and buildings that are not critical for the current operations of the University, and that we believe will not be needed for future growth. The returns will be modest but could be very helpful. We do intend to be cautious about this option. The University is a very long-term institution, and we are well aware that the University has occasionally sold (or given away!) land only to regret it thirty or forty years later.

16. Wouldn't an increase in interest rates solve the problem?

It would not solve the problem but it would certainly help. A sustained 2% increase in long-term interest rates would cut the solvency deficit in half. Obviously, the chances that we shall benefit from an increase in interest rates are much greater if the University meets the government's regulatory requirements and has a longer time period in which to manage down the deficit in the pension plan.

17. Given its recent history, how can we trust UTAM to manage these funds wisely?

First, there has been substantial turn-over in the management team at UTAM. The new team has made meaningful changes in the way it manages the University's endowed funds and the pension assets of our faculty and staff. Particular attention is being paid to issues of risk, liquidity, and transparency, as well as containing fees charged by fund managers. As well, rather than adding permanent staff, UTAM is using external experts on a time-limited basis to address some of the residual complexity in its mix of assets.

Second, while UTAM is still a subsidiary corporation, its board is no longer comprised primarily of external appointees. Nor does the board advise on broad investment strategy. Instead, a new blue-ribbon Investment Advisory Committee has been working closely with UTAM

and with the President and Vice President – Business Affairs. Its members have substantial experience in major pension and trust funds, and are fully aware of the history that led to the formation of the Committee. To ensure a fresh start, there is no overlap between the membership of that committee and the previous external directors of UTAM. The Committee not only works with the CEO of UTAM, but also meets at length in camera to facilitate a critical perspective on current and future investment strategies.

Last, an additional layer of input from faculty and staff will be created with the new Pension Committee, described below.

18. What is the impact of the end of mandatory retirement? If people work longer, don't they pay longer? And receive a pension for a shorter time?

Since the elimination of mandatory retirement, the valuation that is prepared for the pension plans has been taking into account that faculty members in particular will likely continue to work longer. While members are starting their pensions later, they are also living longer, so the pension payment period is not decreasing.

19. Has anyone tried lobbying the government for more money?

U of T has been actively engaged in advocacy with government on a number of pension and financial fronts. We were a member of the working group on pensions, coordinated through the Council of Ontario Universities [COU], that examined many alternatives for the pension problems across the sector. This was a significant effort that had an impact on the solvency funding relief that has been announced (and for which we are awaiting the final regulations.)

We have also consistently pressed governments for increases in our per-student grants to cover inflation in the higher education sector. Last, we actively advocate for support for student aid and student scholarships, better coverage of research costs, and new capital funding.

20. Shouldn't the University offer a defined contribution plan?

This option has been discussed many times in the past. A defined contribution plan transfers the market risk to the member. When investment markets are delivering great returns, these plans are seen as very attractive. But when markets crash, as they did recently, members may find that they are not able to retire because their losses are too great. The University is, however, fully prepared to discuss a change to a defined contribution plan if our Unions and Faculty Association so wish.

21. Will our pension benefits be reduced?

First of all, benefits for persons who are already retired will be sustained. That is a firm commitment. As well, benefits for existing employees cannot be unilaterally reduced. Future benefit reductions could be negotiated with the various bargaining units as a way of reducing future costs, and may be advocated by some employees as an alternative to increasing contributions. We note that such steps have recently been adopted by the University of California system. However, in the short term, we expect the focus will be on paying for the benefits we already enjoy.

22. What role does the new pension committee have in this issue?

The new pension committee will be involved in reviewing the plans for pension sustainability, and will have the responsibility for approving the financial statements. They are also accountable for approving the return targets and risk tolerance for the investment of the plan assets, as well as the investment strategy and asset allocation. Clearly, they will have an interest in reviewing the funding strategy outlined above. The Business Board will also have a continuing role to play, as it is accountable for the financial health of the University.

23. Will my pension be paid?

Again, YES! There is no reason to worry about the payment of your pension. The pension you have earned will be there for you. This is a temporary problem, which may take some years to fix, but the

University is a long horizon organization, and, with constructive and creative thinking in all quarters, we will definitely resolve this issue.

HELPFUL DEFINITIONS

Going Concern Deficit – the going concern valuation assumes that the pension plan continues to operate for the foreseeable future. A going concern deficit is the difference between 1) the plan liabilities calculated using actuarial assumptions that provide for continued operation of the plan, and 2) the market value of assets as at the valuation date. A going concern deficit may be amortized and eliminated over a fifteen-year period.

Solvency Deficit – the solvency valuation assumes that the plan will be wound up as at the valuation date. A solvency deficit is the difference between 1) the plan liabilities calculated using actuarial assumptions that provide for plan wind-up plus wind-up costs, and 2) the market value of assets as at the valuation date. The actuarial assumptions that must be used for this valuation are prescribed by legislation and actuarial standards. Solvency deficits must be amortized and eliminated over a five-year period.

Hypothetical Wind-up Deficit – the hypothetical wind-up valuation also assumes that the plan will be wound up at the valuation date, and that annuities will be purchased for plan members, at levels that provide for the 75% indexation benefit in the plan. A hypothetical wind-up deficit is the difference between 1) plan liabilities calculated using wind-up actuarial assumptions making provision for indexation, plus plan wind-up costs, and 2) the market value of assets as at the valuation date.

Current service contributions - Contributions made by members and by the University to fund pension benefits earned in the current year are known as current service costs. The member share of those contributions is determined by formula, with the employer contribution representing the difference between the total current service contribution required (actuarially determined) and the portion paid by members.

Special payments - Contributions in respect of pension deficits attributed to benefits earned in prior years are past service contributions and are normally referred to as special payments.