UTFA Information Report

University of Toronto Faculty Association November 17, 2008

Information Report #9[1] – part II

Inconvenient Truths

about the

U of T Pension Plan: the missing contributions

Academic Year to July 1	Did the UofT Administration contribute its share of the annual pension plan service cost?	What is today's cumulative value of the missing UofT contributions?
1987	Partial contribution	$ 16 million
1988	No pension contribution	$ 42 million
1989	No pension contribution	$ 80 million
1990	No pension contribution	$ 113 million
1991	No pension contribution	$ 154 million
1992	Partial contribution	$ 182 million
1993	Partial contribution	$ 232 million
1994	No pension contribution	$ 279 million
1995	No pension contribution	$ 358 million
1996	No pension contribution	$ 438 million
1997	No pension contribution	$ 569 million
1998	No pension contribution	$ 687 million
1999	No pension contribution	$ 733 million
2000	No pension contribution	$ 895 million
2001	No pension contribution	$ 883 million
2002	No pension contribution	$ 898 million
2003	No pension contribution	$ 938 million
2004	Partial contribution	$ 1,089 million
2005	Extra contribution	$ 1,194 million
2006	Extra contribution	$ 1,258 million
2007	Extra contribution	$ 1,493 million

For nearly two decades, from 1987 to 2004, the Administration of the University of Toronto made very few pension contributions towards the retirement benefits of its faculty and staff.

This astounding and salient fact could have dire consequences in the years ahead and merits a full understanding by all with a stake in the pension plan. The Administration has in effect deferred a substantial obligation. In doing so I believe they have borrowed from the future. This should be of particular concern to younger faculty.

How is this repeated failure to make pension contributions possible? Do the *Pension Benefits Act (Ontario)* and FSCO[2] provide adequate oversight of pension funding? The short answer is: no, the oversight is inadequate.[3]

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[1] This Information Report, Parts I and II as well as the Appendix to Part II, are posted on the new UTFA website, http://www.utfa.org . Part I highlighted the official July 1, 2007 UofT pension plan *wind-up deficit* of about $513 million. This large wind-up deficit is not surprising given the above table and the history of missing contributions, often referred to as *contribution holidays*, taken by the Administration.

[2] Financial Services Commission of Ontario (FSCO), see http://www.fsco.gov.on.ca/english/pensions/

[3] To illustrate: FSCO permits indexation benefits to be "excluded" for the purposes of solvency funding. It permits exclusion it does not mandate exclusion. This is an estimated $700 million liability in our plan. (*Wind-up* includes pension indexation in the pension formula, *solvency* may not.)

What does '*annual pension service cost*' mean?

Pensions are deferred compensation. Salary income is set aside during our working years to provide pension income during our retirement years. UofT faculty and staff are expected to contribute about 5% of their salary income and the University is expected to contribute an additional 10%. In other words, if the faculty/staff contribute $1.00, the Administration is expected to contribute about $2.00. This is the expected ratio. The actual experience was that from 1987 to 2003 for every $1.00 faculty/staff put in, the Administration put in $0.39.

UofT has a defined benefit (DB)[4] plan for all faculty and staff. There are no individual accounts; rather, upon retirement, a pension formula determines your individual pension benefit level. The Governing Council of the University of Toronto is both Sponsor and Administrator of the plan, a position of unilateral authority. Thus, Governing Council assumes final responsibility for the *pension promise*.

The service cost. The *annual pension service cost* is an important pension concept. Each year the pension plan actuary (Hewitt Associates) evaluates the total present value of pension benefits to be earned by all faculty and staff for the coming year. This is called the *current service cost*.

To illustrate, on July 1, 2002 the total current service cost was $59.6 million.[5] The faculty/staff share of this cost was $22.3 million, payable via a payroll deduction. The University's expected contribution was the remaining $37.3 million.

While the employees made their contribution, the Administration of the University made no contribution at all. How could the Administration get away with this? Because the plan was deemed to have a notional $194 million going-concern actuarial surplus[6] as of July 1, 2002, the Administration simply allocated a portion of this notional actuarial surplus in the plan to meet its $37.3 million service cost obligation for that year, instead of putting new money into the plan. This means that while the Administration *budgeted* for its share of the annual pension service cost, in fact, it spent the money elsewhere.

What is today's total dollar value of all the missing pension contributions?

The right hand column in the table on page 1 shows the cumulative value of all the missing pension contributions by the University from 1987 to 2007. On July 1, 2007 it totaled $1,493 million ($1.5 billion). This total has two distinct components: first, the missing contributions that were not made because the Administration took contribution holidays, and second, the time value (i.e. investment returns foregone[7]) of the missing contributions.

For 14 of the 17 years from 1987 to 2003, there were no contributions whatsoever from the Administration. Significantly, the contribution holidays were taken during years when the market provided unprecedented positive returns. This represents a major lost opportunity of increased investment return to the pension plan members.

It must be acknowledged that faculty and staff had contribution holidays for about 4.5 years over this period. These were negotiated[8] as part of a formal compensation settlements. The value of those missing contributions

[4] Defined benefit pension plan – for a definition and introduction see http://en.wikipedia.org/wiki/Pension

[5] The $59.6 million service cost is 13.7% of the participant salary base of $434.6 million in 2002.

[6] If the pension plan *surplus* exceeds 10% of the accrued going-concern liability, section 147.2 of the Income Tax Act requires that the excess pension plan surplus must be used to reduce the employer's (not the employees') remaining current service cost. But as has been noted the employer sets the interest rate assumption that can help create the *surplus*.

[7] The calculations in the table on page 1 are based on the actual annual pension plan investment returns. One must include the time value of money in calculating today's value of the missing pension contributions.

[8] In formal Salary, Benefit, and Pension negotiations. Regrettably, the unfortunate Administration pension holidays engendered the unfortunate "me too" request by faculty and staff.

pales in comparison to the bonanza enjoyed by the University, but it is not insignificant; it has a present value of $196 million. Together the total value of all missing pension contributions is $1,689 million[9] as of July 1, 2007, or about $320,000[10] for each active faculty/librarian member contributing to the plan.

This missing $1.7 billion total would have increased the current market value of our pension plan assets (now about $3 billion) by more than 50%. If there had been **no** pension contribution holidays during the past 21 years, this very substantial sum would have been available to cover the current wind-up deficit, to make substantial improvements to our defined benefit formula going forward, to improve the indexation of pensions for current retirees, to increase the $150,000 cap on the Supplemental Retirement Arrangement (SRA) , etc. It was not until 2004, long after the missing contributions had 'left the barn', and a market downturn resulted in a notional going-concern deficit, that the Administration established a reserve pension fund for future going-concern surpluses. It is unfortunate that this policy was not established in 1987.

Remember, these numbers are as of July 1, 2007 and so predate any recent financial turmoil. The problem we are describing is a long standing one.

How could the pension plan be in surplus from 1987 to 2004 if little or no new contributions were added?

There are two major factors to the explanation.

Factor #1 is rather transparent. The uniquely robust equity market between 1987 and 2000 generated unprecedented returns. (However what the market gives in excess returns in one time period it can also take away in another time period – as is evident in today's market.)

Factor #2 is really more significant but hidden. The plan sponsor/administrator and actuary increased the interest rate assumptions in the going-concern liability calculation. This numeric change reduced the notional going-concern liability and so increased the surplus (defined as the difference between assets and liability). This is essential to the understanding of how so many holidays were allowed.

The rough rule of thumb applied by actuaries is that a 1% increase (decrease) in assumed interest rates translates into a decrease (increase) of about 20% in the going-concern liability. The UofT actuarial assumption for the real[11] interest rate has been changed four times since 1987: from 2.25% to 2.5% (1987), then to 3.0% (1991), then to 3.5% (1997) and finally to 4.0% (1999) where it sits today. If actuaries assume that future interest rates will be high, far less money will appear to be needed today to fulfill the future pension promises to active and retired members. A similar 1.75% *decrease* in assumed interest rates would result in about a 35% *increase* in the going concern liability. Such a decrease would have significantly reduced the plan's actuarial surplus, and resulted in considerably less room for contribution holidays. Obviously The contribution holidays were the result of overly optimistic real rate assumptions by the plan administrator; they were not a free lunch from a generous equity market.

If our plan's actuaries applied their 1986 assumption today, namely 2.25%, our plan's going-concern liability would increase by about $760 million[12] and thus produce a very sizable notional going-concern deficit today. **In other words, if the actuaries had not increased the assumed interest rates over the years, most of the ensuing contribution holidays would not have been possible and the plan would not be in the predicament**

[9] Detailed tables of these numbers are provided via tables in an Appendix to this report. This Appendix is posted on the web at www.utfa.org .

[10] About 52% of the total annual service relates to the 2,736 faculty, and 52% of $1,689 million is $878.3 million.

[11] Real return, above inflation, as opposed to nominal interest rate which includes inflation. The current real return on the Government of Canada Real Return Bonds (RRB) is about 2.5% . See http://www.bankofcanada.ca/en/rates/bonds.html at the bottom of the page. It was below 2% until recently.

[12] Page 41 of University of Toronto Pension Plans, Annual Financial Report, for the year ended June 30, 2007, on the web at http://www.finance.utoronto.ca/Assets/reports/pension/2007.pdf

it is today. Overly optimistic assumptions by the employer's actuary will reduce the employer's immediate liability but are not in the best long-term interest of plan members. Legendary investor Warren Buffett addresses the problem of the employer's actuary and their actuarial assumptions as follows:

> *"The actuaries who have roles in this game know nothing special about future investment returns. What they do know, however, is that their clients desire rates that are high. And a happy client is a continuing client.….. Unfortunately, the subject of pension assumptions, critically important though it is, almost never comes up in corporate board meetings. (I myself have been on 19 boards, and I've never heard a serious discussion of this subject.).*[13]

In summary, since 1986 the UofT Administration took advantage of more and more optimistic actuarial assumptions, which in turn created a notional going-concern pension surplus. This increased notional surplus then invoked the income tax rule disallowing further contributions. Because the Administration controlled the assumptions I would argue that it is disingenuous of them to now claim that they had no choice but to take those contribution holidays from 1987 to 2004.

Conclusions:

Unfortunately, the intrinsic nature of defined benefit (DB) pension plans, such as ours at UofT, allows the plan 'to rob Peter to pay Paul' – unless Peter is fully informed and participates in the decision. Who is Peter and who is Paul? In our report Peter represents all the pension plan members and Paul is the plan sponsor/administrator or Governing Council. Peter may also represent one group within the DB plan and Paul another group within the same DB plan – but that is another pension topic for another day.

There is a related governance issue. Management guru Peter Drucker has written: "[*Pension plans] must be free from any suspicion of conflict of interest. They must be set up to serve their beneficiaries and no one else.*" [14]

Unfortunately, the current administration of the UofT pension plan has a real conflict of interest issue. The Business Board of Governing Council, which has responsibility for the financial oversight of the University of Toronto budget, also has oversight of the pension plan for the faculty and staff. This is the classic 'two-hat problem'.

UTFA has proposed the creation of a new, independent Board of Trustees to administer the $2 billion UofT DB pension plan for faculty, with equal representation from both plan members and Governing Council.

In the two information reports that follow I will discuss the following topics:

- investment issues and investment oversight, and
- pension governance.

I welcome any and all comments.

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[13] Warren Buffett, Dec. 10, 2001 issue of Fortune (vol 144, issue 12) see http://money.cnn.com/magazines/fortune/fortune_archive/2001/12/10/314691/

[14] Drucker, Peter. "The Unseen Revolution: How Pension Fund Socialism Came to America," 1976, p. 86.