Salary, Benefits and Pensions
Information Report #2

The UofT Pension Plan:

Is it competitive? Is it equitable?

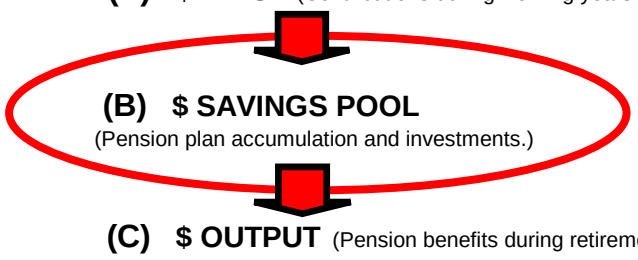
Most people, unfortunately, take little interest in their pension plan until they are about to retire. This is common but can be disastrous, as some of our retired colleagues have discovered. It is much too late to correct for past indifference when you retire. By then there is minimal leverage with the employer and by then financial investments no longer have the long time horizon necessary to compound assets.

The purpose of this report is to provide a brief perspective on the University of Toronto pension plan by asking two questions: Is the UofT pension plan competitive with peer academic institutions? Is the UofT pension plan equitable in its benefits to retired and to active faculty? The answer is, I believe, a clear "No" to both questions.

Successful recruitment by UofT of the best new faculty candidates requires that our pension plan be competitive. The following two pages illustrate how poorly our pension plan compares with pensions at US institutions. (Last year 45% of our new hires came from the US).

But first, a simplified sketch that may help in conceptualizing a pension plan and how defined benefit (DB) and defined contribution (DC) plans differ. The Appendix gives a more detailed explanation and provides examples.

Simplified Sketch of a Pension Plan



Defined Benefit (DB) plan

(A) $ Input is NOT defined, can vary. (Must be sufficient to provide for defined $ output in (C).)

(B) One COMMON $ savings pool. (No individual accounts.) Sponsor controls it.

(C) $ Output benefit IS defined by "plan formula". (Subject to tax law restrictions.)

Defined Contribution (DC) plan

(A) $ Input Contribution IS defined. (Subject to tax law restrictions.)

(B) INDIVIDUAL $ savings accounts. (Not one pooled account.) Individuals control them.

(C) $ Ouput benefit NOT defined, can vary. (Depends on $ input and on investments.)

Is the UofT pension plan competitive?

Among major universities in North America, the University of Toronto is anomalous in that it has a DB pension plan without the option of a DC pension plan. Why?

Every university in the United States (that I have looked at), large or small, distinguished or less so, has a DC pension plan. Some offer both a DC and a DB plan and give the individual faculty member a one-time choice between the two plans.

Canada is different. It has universities with DC plans, universities with DB plans and universities with hybrid (HB) plans. To illustrate: In Canada HB plans exist at Brock, at York, at Queens and at McGill. DC plans exist at UBC, and at Western. DB plans exist at UofT, at McMaster, and at Trent.

How do we go about comparing different types of pension plans? We can compare a DC plan with other DC plans by comparing the "$ Input" numbers (which are defined in a DC plan and assuming the range of investment vehicles offered are the same) and we can compare a DB plan with other DB plans by comparing the "$ Output" numbers (which are defined in DB plans via the plan formula). But comparing a DC plan with a DB plan is fraught with difficulty, unless one has access to the annual actuarial reports of a DB plan and can tabulate the actual dollars input into the DB plan. I have done this for the UofT plan and that is why it is the only DB plan in the comparison that follows.

"Pension $ input is proportional to pension $ output", when seen over time. This notion is important in what follows and its logic applies to any financial savings plan, including a pension plan. Minimal contributions into a pension plan during one's working years must necessarily result in correspondingly minimal pension plan benefits as output upon retirement.

The chart on the next page shows "pension $ input" as a percentage of faculty salary[1] for five Canadian Universities and for nineteen US universities. The choice of universities was to some extent determined by the availability of information on the web.

UofT is the only university of the 24 listed which has a DB plan and a DB plan only. The chart also shows how the total input contribution is shared between the member and the university. The amount of input varies, and so do the proportions that come from the employer and from the employee. *The average total input contribution is about 15% of salary, - with 10% from the university and the remaining 5% from the faculty member*. At some US universities (like Harvard, Princeton, Purdue, Utah), the DC pension plan is *fully* funded by the university.

The chart suggests that if UofT "normalized" its pension dollar input to that of peer institutions, pension benefits today could probably be twice what they are[2].

University of Toronto has the lowest standing. UofT's total pension input (averaged over the last 14 years) is about 6% of salary base[3], consisting of 3% from members, plus 1% from UofT into the regular pension plan and about 2% from UofT into the SRA[4] plan. The low input, of course, is due to the many contribution holidays.

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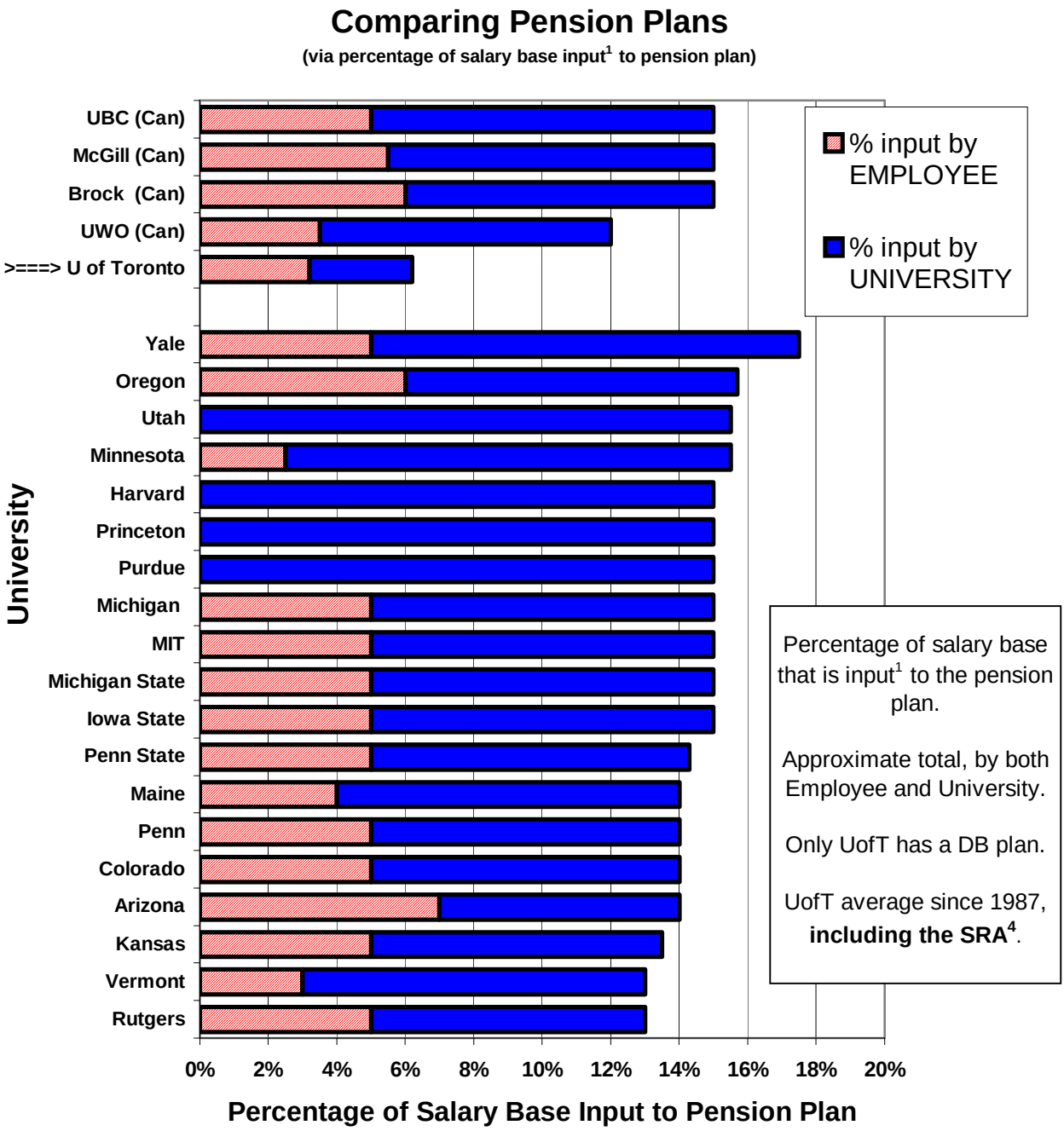
[1] The relative contribution numbers are approximate for some institutions since there may be multiple contribution steps in the pension input. In such cases the highest input is shown.

[2] "Of Little Benefit", George Luste, UofT Bulletin, April 12, 1999, Forum article. The article arrives at a similar conclusion by means of a more detailed and quantitative approach.

[3] Data presented by G. Luste to Business Board of Governing Council on June 21, 2001.

[4] SRA is the "Supplemental Retirement Arrangement" introduced in 1996 to provide pension benefits for salaries in excess of the salary cap (about $98,500) set by the federal tax legislation in 1976. The SRA is not governed by the Ontario "Pension Benefits Act".



In fact, the UofT standing is overstated in this chart and its real position is actually worse than shown. As of July 1, 2000 about 25% of UofT pension assets were in surplus. At present a surplus does not translate into “pension $ output”. (The “surplus” issue will be discussed in a future report.)

Is the UofT Pension Plan Equitable?

The UofT has a fiduciary responsibility for the welfare of the members in the pension plan. But a reduced pension benefit for the member means a reduced financial obligation, out of base budget, for the University. Thus the Administration has cause to minimize the pension payout benefits any way it can. The sketch on the first page illustrates that if less is paid out at retirement in a DB plan, then less is required as input by the university.

This may result in enrichment on the part of the pension plan sponsor. "Unjust enrichment" is the legal cause of a class action law suit recently initiated by four retired women faculty members (Ursula Franklin, Phyllis Grosskurth, Blanche Van Ginkel and Cicely Watson) against the UofT. Although this action bears on underpayment while they were employed, it also involves their diminished pensions. There are other retired faculty who have suggested similar possible legal action against the University as a result of "unfair" pension treatment.

Another factor that determines pension input (contributions by sponsor and or employee) are the actuarial assumptions. The University hires consultants who set the actuarial assumptions that determine the size of the pension "surplus" inside our DB plan. The existence of a surplus determines whether UofT can take a "contribution holiday". In the past 14 years the University of Toronto has taken a pension holiday every year save one and a half years (approximately). (To be fair, since 1996 they have set aside funds for the SRA.)

There are no corresponding conflict of interest issues in a DC pension plan. A DC pension plan is similar to an RRSP, as the account "belongs" to the plan member.

The following list is a sampling of some of the inequities of our DB pension plan. Space constraints do not allow for more than the briefest list and summary.

(1) Broken-year-service[5]. A break in continuity of service can have devastating consequences in our DB plan. UofT does not bridge non-consecutive years of employment service and unlike other DB plans, the UofT plan does not allow for purchase of missing years. This means that when you retire, you receive separate pension payments for each continuous segment of service. That is unfair.

To illustrate: former Dean of Dentistry, Gordon Nikiforuk, 78, was at Uof T initially for 14 years, until 1964, when he went on a temporary leave to UCLA. As planned, he returned to UofT in 1970 and retired in 1990. Today Professor Nikiforuk receives an annual pension of only $1,956 for his *first 14 years* of service at UofT.

(2) Part-time-service[5]. As in Professor Nikiforuk's case, part-time faculty who retired prior to July 1, 1996 receive an astonishingly small pension. They received no protection from inflation.

Professor Carol Brehaut, 69, who served UofT for 38 years, until 1994, today receives a total pension of about $22,000 from our DB plan. Professor Brehaut's part-time service pension benefit was not calculated by the same formula as was used for her full-time faculty colleagues.

(3) New-spouse[5]. If one marries or remarries after retiring, the new spouse has **no** survivor pension benefits at all in our DB plan should the plan member die first. In a DC plan, the new spouse is protected provided the member does not use his/her account to purchase an annuity prior to the remarriage. Among others, former Chief Librarian Bob Blackburn, 82, who retired in 1981, now lives with this anxiety.

[5] Not applicable or not an equity issue in a DC pension plan.

(4) Plan Changes[5]. Past changes in the DB pension plan formula at UofT have disadvantaged various plan members. A case in point is the "Retiring Cohort of 1989", for whom Professor Frank Hooper has long sought a just resolution, but without success.

(5) Retroactive benefits[5]. Pension plan improvements, pay equity adjustments, etc are usually made retroactive (out of the plan "surplus") for all service years for working people in the DB plan formula - but **not** for those already retired. Why should one group get retroactive benefits while others (the retirees) do not?

(6) Exceptions to (5) above. Not surprisingly, exceptions will be made if sufficient pressure is put on the University. In 1996, when the SRA was introduced, eleven senior professors who retired before July 1 (and were to be frozen out of this new benefit) threatened legal action. They were subsequently awarded the SRA benefit retroactively at a cost of $1.2 – million[6] to the University.

(7) Exit-salary vagaries[5]. Since our retirement pension is determined by the best three years of salary, everybody who retired in 1981 (like Bob Blackburn) received substantially less pension than everybody who retired in 1982, only one year later (after the 18% Burkett award). Similarly the 3-year-Social-Contract salary freeze reduced pensions - but did not affect those in DC plans as much. The pension surplus linkage to reduced across-the-board salary settlements (see UTFA Report #1, September 27, 2001) works greatly in favour of the University.

(8) Cross-subsidization[5]. Here is one example of many. Older retirees (like Blackburn and Nikiforuk) never had a "pension contribution holiday" during their many years of service. Yet the surplus, which their contributions helped create, is used to give "pension holidays" to current staff. Unfortunately, in a Defined Benefit plan there is no direct linkage between what a plan member contributes to the pension plan during a working career and what one receives in benefits upon retirement.

Defined Benefit versus Defined Contribution versus Hybrid

Which pension plan is best for you? That depends upon many factors. It depends upon your age, your career path, your retirement needs, your risk tolerance, your investment skills and probably a number of other factors. There is no one answer that applies universally to everybody.

In special cases, the answer is simpler. A young untenured or mobile faculty member should prefer a DC plan. But an older faculty member, within say 10 years of retirement, might prefer a DB plan.

In fact, one of the fundamental distinctions of a defined benefit plan is the way in which the contribution rate is determined on an average basis for the plan as a whole – regardless of how many years to retirement. Because each member is charged the average rate, when members are young they will be contributing more than the cost of their actual in-year service accrual. When members are older they will be contributing less than the cost of their in-year accrual. Throughout a continuous 35 year career with the same employer, the "overcontributions" and the "undercontributions" tend to balance out.

The Hybrid plan, as implemented by McGill and Brock and outlined in the appendix, warrants a close look. But one does not get "something for nothing". In a hybrid plan the DB component is usually a bit (10%?) less generous than in a pure DB plan. As well, the DC component may have more restrictions.

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[6] Business Board minutes for April 21, 1998, page 9 (Report Number 92).

In his April 23, 2001 letter to the University community, former Vice-President Finlayson concluded his defense of the UofT defined benefit pension plan with these words:

> " *… it is the University which bears all the risk. Whatever happens in the future, and it is not likely that the next ten years will replicate the last decade, the benefit defined for each of us by our Pension Plan is immutable. It is fully protected against market uncertainties and mostly protected against the ravages of inflation for your entire lifetime."*

These are grand words but we should never accept this line of argument. In a non-profit public institution such as a university, who in fact is the real "risk bearer"? At Ford they can tap shareholder dividends. In the government they can "borrow" against the next generation (by "printing" more money). But at UofT they can only reach into our salary pockets. We bear the risk.

Professor Finlayson's earlier words (23 January, 1987 UTFA Newsletter, when he was President of UTFA) are much more persuasive:

> ***"Employers "contributions" to pension plans are not ex gratia payments. They are employees' deferred salary. For this University's administration to reduce payments into the Pension Plan is to reduce staff members' total compensation just as surely as it would be were the University to withhold money from our salaries."***

Conclusion

Let me assure the reader that no imminent change in our pension scheme is being proposed here. The aim of this report is to inform you and to begin debate on possible changes. And as additional assurance, if changes were eventually to be proposed, I believe there will need to be a "grandfather" clause that would allow current plan members to maintain the status quo if they so wished.

In the weeks ahead, prior to the formal negotiations in the new year, UTFA will be discussing pension matters with the Administration. Discussions are not the same as negotiations. Our aim will be to exchange views and to seek common ground.

But let me repeat from my last Report:

> "We believe profoundly that equitable and peer-competitive compensation is important for the well-being of our institution."

Please feel free to contact me if you have any questions or comments.

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Appendix

Ontario has 18 universities. Seven have DB plans (most notably UofT and McMaster), seven have HB plans (Brock, Queens and York), and four have DC plans (Western and Lakehead).

Both UBC and McGill are highlighted as examples below because they are seen as "peer institutions" to UofT in Canada. Perhaps UBC, with a pure DC pension plan, most closely resembles the average US university.

In a ***defined contribution (DC)*** plan[8], the amount of contribution is defined and known in advance, but the amount of pension isn't. The amount of pension you receive depends on the size of your "pension accounts" at retirement, your age and market conditions when you convert these savings into a retirement income. Depending on the long-term investment results you achieve, your defined contribution pension could be significantly higher than the pension you earn under a comparable defined benefit plan… or significantly lower, for that matter. In a pure DC pension plan this market risk rests with the plan member.

Ontario's pension legislation was changed last year to permit locked-in retirement savings to be transferred to a "Locked-in Retirement Income Fund" (LRIF). An LRIF operates much like a Life Income Fund, with minimum and maximum withdrawals prescribed for each year, but does not require the holder to purchase an annuity at any time so it can continue for as long as the retiree (and surviving spouse) live.

In a ***defined benefit (DB)*** plan, you receive a pension based on a defined formula (usually tied to service and pay). You do not have an individual "pension account" because your pension is based on the formula. It is your employer's (the plan "sponsor's") responsibility to ensure that contributions and investment earnings are sufficient to provide your future pension. While the formula is defined and predictable (unless it changes during one's career), the "value" of the eventual "defined benefit" resulting from it is much less well defined - since our exit salary relative to inflation is not "defined" while we are still years away from retirement.

A ***hybrid (HB)*** plan combines one or more characteristics or design features from traditional defined benefit, traditional defined contribution, or the newer innovative designs. There is a myriad of hybrid plan design possibilities. Two examples are given below.

Example - I **McGill University (Montreal)** **[hybrid DC / DB plan]**

The McGill Pension Plan is a *hybrid* plan[8]. First, it is a defined contribution plan. You and the University each contribute a certain amount to the plan every month. You choose how you wish to invest these contributions from a range of investment options provided through the plan. When the time comes to retire, you use your pension account balances to "buy" a pension.

But to protect against the investment risks inherent in a straight defined contribution plan, the McGill Pension Plan includes a ***defined benefit minimum***. If your minimum pension, using the defined benefit formula, is *higher* than the pension you can buy with the value of your pension accounts (based on the default investment option), you receive the minimum pension instead. Conversely, if your pension accounts flourish as a result of strong market performance, you get the full value of your defined contribution pension.

You automatically earn the right to the minimum pension if you are at least age 55 or have been a member of the McGill Pension Plan for two or more years when your employment. If this is the case, when you "settle" your pension accounts, the value of the minimum pension you have earned using the defined benefit formula is compared to the total value that you would have

[8] Some of the explanatory text comes from the McGill Pension Plan brochure of Nov, 2000 (pre Quebec Bill 102). I am grateful to Ms. Christine Halse for providing a copy.

accumulated in your *Employee and University Contribution Accounts* if you had always invested 100% in the Balanced Account. *If your defined benefit minimum pension is worth more*, the University will contribute an extra amount to your pension accounts to make up the difference. This extra amount represents the value of the "supplementary pension".

Over the last 10 years less than 1% of retiring McGill Pension Plan members have required a supplement to bring their pensions up to the minimum. However, this statistic could look different in the event of a prolonged market decline.

Example - II **Brock University (St Catherines)** **[hybrid DC / DB plan]**

The Brock Pension Plan is basically two plans in one. The minimum amount that an individual will receive is called the Minimum Guarantee Pension (technically called the Defined Benefit Plan). Of more relevance to most individuals in recent years is what is called the Money Purchase Pension (or the Defined Contribution Plan). The Minimum Guarantee Plan acts as a sort of insurance guaranteeing the minimum amount that an individual will receive. It is based on the years of service at Brock, and average salary for your best five years, multiplied by a factor of .017 (1.7% of salary). The University is the guarantor of the Minimum Guarantee Plan and must provide sufficient funds to meet its liabilities.

The Money Purchase Plan is a contributory plan. The amount paid out depends on the amount paid in and the performances of the stock and bond markets. The contribution rates are: (a) above YMPE[8]**, 9% by University plus 6% by employee** and (b) below YMPE, 7.4% by University and 4.4% by employee

At retirement, members have a number of options for their future sources of income. One of the choices is a variable annuity plan in the Brock Pension Plan. A variable annuity is not available at UofT.

Example - III **University of British Columbia** **[straight DC plan]**

The University of British Columbia Faculty Pension Plan is a defined contribution (money purchase) pension plan. Both plan members and the University make contributions to the member's account, which, together with earnings, are used ultimately to provide benefits at retirement, at termination of the member's employment or upon the death of the member. The contribution rates are: (a) above YMPE**, 10% by University plus 5% by employee** and (b). below YMPE 8.2% by University and 3.2% by employee. There is also a Supplemental Arrangement if you are a member of the UBC Faculty Pension Plan, similar to the UofT SRA. Membership is automatic when your contributions and the University's contributions to the Pension Plan exceed the maximum annual amount allowed under the *Income Tax Act*.

Example - IV **University of Minnesota** **[straight DC plan]**

Participation is mandatory in the University of Minnesota Faculty Retirement Plan. The contribution rate is **13% by the University plus 2.5% by the faculty** member. Federal tax law limits combined employee and employer contributions to $30,000 per calendar year or $24,800 annually (in US dollars) if employed on or after July 1, 1996. *An additional benefit is that there is no mandatory retirement at age 65 at any US university.*

[8] YMPE or "Year's Maximum Pensionable Earnings" on your income tax return. In 2001 it is $38,300. It is supposed to be approximately equal to the average industrial wage in Canada.