



# University of Toronto

(OFFICE OF THE VICE-PRESIDENT, BUSINESS AFFAIRS – FINANCIAL SERVICES DEPARTMENT)

TO: Business Board

SPONSOR: Sheila Brown  
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DATE: January 12, 2004 for January 19, 2004

AGENDA ITEM: 6

## ITEM IDENTIFICATION:

**Pension Strategy**

## JURISDICTIONAL INFORMATION:

The Business Board approves policies with respect to financial programs and transactions, and approves individual programs and transactions as required by those policies.

## PREVIOUS ACTION TAKEN:

In October 1997, Business Board approved the funding strategy for the registered University Pension Plan (RPP) and the unregistered Supplemental Retirement Arrangement (SRA).

## HIGHLIGHTS:

In 1997, the University had a registered pension plan in surplus, to which it was not permitted to make contributions, and had just established the SRA. The strategy that was adopted in 1997 was to utilize pension budget, established at 75% of employer current service cost, to fund the SRA unfunded liability over 5 years, and for other University purposes.

At July 1, 2003, the RPP was in deficit. The SRA, while also in deficit, had assets of \$91.2 million, exceeding the original funding commitment, and liabilities are moving back and forth between the SRA and RPP in accordance with the rate of increase in the Income Tax Act maximum pension over time. The RPP deficit requires payment of full current service pension contributions and special payments in respect of unfunded past service.

The proposed pension strategy going forward is to consider the RPP and SRA together, to put in place a funding mechanism that amortizes deficits in both plans over the 15 year period permitted under pension regulations and to do so using a smoothed approach that is both prudent and predictable. Here are the specific recommendations:

1. Employees make their regular annual contributions.
2. For the 2003-04 fiscal year, the University contributes \$26.8 million to the RPP and \$9.5 million to the SRA.

3. Beginning May 1, 2004, the University contributes 100% of the required employer current service cost for the RPP and SRA. This will require restoration of the operating budget pension budget to 100% of the RPP current service cost.
4. Beginning May 1, 2004, the SRA is put on the same basis as the RPP with respect to deficits. With the achievement of full funding of the original past service liability occurring at the time the SRA was established in 1997 and because a portion of the liabilities will move back and forth between the SRA and the RPP in accordance with the Income Tax Act maximum pension over time, future SRA deficits should now be treated like those of the RPP and funded over 15 years.
5. Beginning May 1, 2004, the University makes special payments of no less than \$26.4 million annually to deal with the RPP and SRA deficits by way of a smoothed budget allocation over about 15 years. This smoothed approach provides for higher payments than required in the earlier years, thus holding off any possible solvency issues and providing for predictability.
6. The OISE plan is a closed plan (no new members) and is still in a surplus position. It is unlikely that the university will have to make a current service cost contribution to this plan in the near future and therefore no budget is proposed for this.
7. Steadfastly make a special payment of no less than \$26.4 million annually in respect of the RPP and the SRA even if investment returns reduce plan deficits. By doing this, the University will be making provision for future periods of poor investment returns.
8. Continue to set these funds aside, regardless of Income Tax Act restrictions. If not permitted to make contributions to the RPP, reserves should be set aside outside the RPP.
9. Make provision for funding any future augmentations that might occur by setting aside the corresponding amount from pension surpluses existing at the time.

#### **FINANCIAL AND/OR PLANNING IMPLICATIONS:**

To implement this strategy, the University's operating budget allocation for pensions must rise from \$31.2 million for fiscal year 2003-04 to \$65.9 million for 2004-05, \$75.5 million for 2005-06, \$77.8 million in 2006-07, \$80.3 million in 2007-08, \$82.7 million in 2008-09 and \$85.0 million in 2009-10.

With these contributions and if the assumptions contained in the projections with respect to investment returns, participation, etc. would be achieved, the RPP deficit would increase to about \$236 million in 2004-05 and then gradually decline over time. The SRA deficit would remain approximately at current levels even though liabilities are projected to rise. There is considerable variability expected in these liabilities since they will be influenced by the rate of increase in the Income Tax Act maximum pension, which is pegged to the increase in the industrial wage starting in 2006.

The impact on the financial statements is expected to be an increase in pension expense on the income statement from \$39.7 million in 2002-03 to about \$90 million annually. Pension liability on the balance sheet is expected to rise to about \$131 million by 2007-08 and then begin to fall as the deficit is reduced over time.

#### **RECOMMENDATION:**

That the Business Board approves the funding strategy contained in the nine recommendations provided above.

January 12, 2004

To: Members of the Business Board

From: Sheila Brown, Acting Chief Financial Officer

Subject: **Pension Strategy - Funding of Pension Plans and Supplemental Retirement Arrangement**

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The purpose of this report is to recommend a strategy for funding the pension plans and supplemental retirement arrangement to ensure that the plans can continue to meet their obligations to provide pensions to current and future pensioners.

The University of Toronto has two registered pension plans and one unregistered plan. The University of Toronto Pension Plan ("RPP") is the main plan which covers most employees at the university. The University of Toronto (OISE) Pension Plan ("OISE") covers University of Toronto employees who were previously employees of OISE prior to June 30, 1996 and are either continuing employees of the University or retirees. The unregistered Supplemental Retirement Arrangement ("SRA") was established in 1997 and provides additional retirement income to compensate for the limitations prescribed under the Income Tax Act (Canada) on the amount of lifetime retirement benefits payable from the registered pension plans.

**Financial Status of Pension Plans at July 1, 2003:**

**University of Toronto Pension Plan:**

- Deficit based on market value of assets \$203.5 million
- Surplus based on actuarial value of assets \$2.2 million
- Solvency ratio excluding indexing 1.02

**Supplemental Retirement Arrangement:**

- Deficit at market value of assets \$17.4 million

**University of Toronto (OISE) Pension Plan:**

- Surplus based on market value of assets \$7.1 million
- Surplus based on actuarial value of assets \$18.0 million

**Current pension funding strategy:**

The current pension plan funding strategy was approved by the Business Board in 1997 and was imbedded in the University's long-range budget plan. This strategy recognized that the University was prohibited under the Income Tax Act from contributing to the University Pension Plan since the pension surplus at the time was greater than 10% of liabilities. This strategy established the supplemental retirement arrangement and provided for the funding of its past service cost over five years as a first priority for allocation of funds generated from the required employer contribution holiday. The resulting operating budget strategy provided for the ongoing base budget for the current service costs of the RPP to be maintained at its then current level, which amounted to 75% of the annual employer current service cost. The OISE current service cost base budget was eliminated since the interest on the OISE surplus each year was sufficient to cover the yearly current service cost obligations.

## **What has changed since 1997?**

The RPP has moved from a market surplus position to a market deficit position due to poor investment returns, pension enhancements and employer and employee contribution holidays. The SRA is no longer a new plan and enough funds have been set aside to cover the original SRA obligation of \$78.0 million. Some of the liability is transferring back and forth between the SRA and the RPP in accordance with the increase in the Income Tax Act maximum pension. The University and employees must contribute the full current service cost and the University will be required to make additional special payments to deal with the pension deficit. These factors require a revised pension strategy going forward.

## **Proposed pension strategy:**

The University's actuary, Hewitt Associates, has modeled a number of alternative strategies that have been considered. The proposed strategy is the one that best combines the need for financial prudence, maintenance of a solvency ratio greater than 1.0, and operating budget predictability. The proposed strategy incorporates the following recommendations:

1. Employees make their regular annual contributions.
2. For the 2003-04 fiscal year, the University contributes \$26.8 million to the RPP and \$9.5 million to the SRA.
3. Beginning May 1, 2004, the University contributes 100% of the required employer current service cost for the RPP and SRA. This will require restoration of the operating budget pension budget to 100% of the RPP current service cost.
4. Beginning May 1, 2004, the SRA is put on the same basis as the RPP with respect to deficits. With the achievement of full funding of the original past service liability occurring at the time the SRA was established in 1997 and because a portion of the liabilities will move back and forth between the SRA and the RPP in accordance with the Income Tax Act maximum pension over time, future SRA deficits should now be treated like those of the RPP and funded over 15 years.
5. Beginning May 1, 2004, the University makes special payments of no less than \$26.4 million annually to deal with the RPP and SRA deficits by way of a smoothed budget allocation over about 15 years. This smoothed approach provides for higher payments than required in the earlier years, thus holding off any possible solvency issues and providing for predictability.
6. The OISE plan is a closed plan (no new members) and is still in a surplus position. It is unlikely that the university will have to make a current service cost contribution to this plan in the near future and therefore no budget is proposed for this.
7. Steadfastly make a special payment of no less than \$26.4 million annually in respect of the RPP and the SRA even if investment returns reduce plan deficits. By doing this, the University will be making provision for future periods of poor investment returns.
8. Continue to set these funds aside, regardless of Income Tax Act restrictions. If not permitted to make contributions to the RPP, reserves should be set aside outside the RPP.

This strategy provides for prudent financial management of the pension plans combined with a level of predictability for the operating long-range budget plan.

## **Pension Projections Illustrating this Strategy:**

The graphs at the end of this paper illustrate the impact of the proposed strategy on the pension surplus (Graph # 1) and on the pension budget (Graph # 2). It is important to note that:

-the nominal investment return assumption used for both the RPP and the SRA is 7% for 2004 and thereafter. The models are therefore based on a 7% per annum average return over 15 years. It should be noted that 67% of the time, actual returns will fluctuate between minus 3% and plus 17%.

-The annual special payment has been determined by the actuary to be \$26.4 million representing approximately the amount that would be required to amortize the expected market value deficit as of July 1, 2004 in the combined RPP and the SRA over 15 years. The \$26.4 million annual payment will be allocated as follows, \$24.8 million in the RPP and \$1.6 million in the SRA.

-the proposed strategy, and thus these projections, includes the cost of pension augmentation from 75% of CPI to 100% of CPI for faculty and librarian retirees up to and including July 1, 2004, but not beyond July 1, 2004.

### **What about Possible Future Augmentations**

As noted above, the recent UTFa settlement provided for an augmentation to faculty and librarian pensioners benefits from 75% to 100% of inflation for 2003 and 2004. The cost of that augmentation is \$12 million for faculty and librarian retirees. The cost of this augmentation has been amortized over 15 years with the addition of \$1.4 million per annum to the annual special payment required. This does not however address the possibility of other future augmentations. Over the past years, augmentation has essentially represented a distribution of surplus. In the absence of a pension surplus, provision of further augmentation is very uncertain. However any augmentations that might be provided in future would have to be funded, either by contributions to the plan or from any future pension surpluses. The latter strategy makes the most sense given the rationale for making augmentations. Therefore, this gives rise to the following additional recommendation:

9. Make provision for funding any future augmentations that might occur by setting aside the corresponding amount from pension surpluses existing at the time.

To implement this strategy, the University's operating budget allocation for pensions must rise from \$31.2 million for fiscal year 2003-04 to \$65.9 million for 2004-05, \$75.5 million for 2005-06, \$77.8 million in 2006-07, \$80.3 million in 2007-08, \$82.7 million in 2008-09 and \$85.0 million in 2009-10.

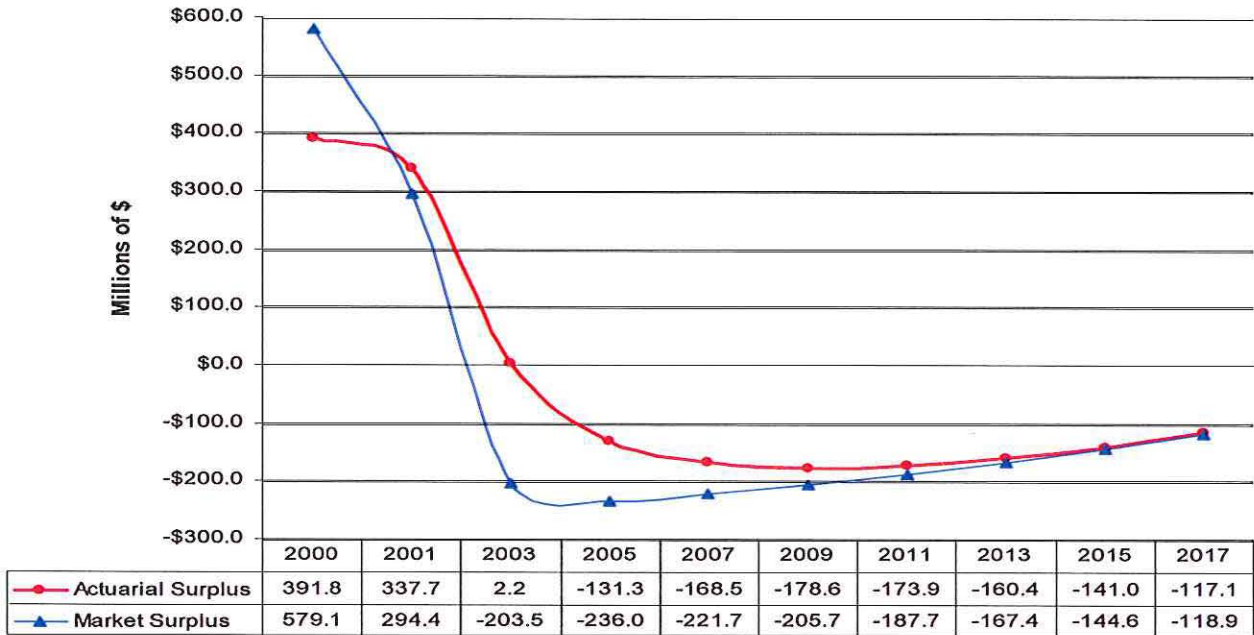
With these contributions and if the assumptions contained in the projections with respect to investment returns, participation, etc. would be achieved, the RPP deficit would increase to about \$236 million in 2004-05 and then gradually decline over time. The SRA deficit would remain approximately at current levels even though liabilities are projected to rise. There is considerable variability expected in these liabilities since they will be influenced by the rate of increase in the Income Tax Act maximum pension, which is pegged to the increase in the industrial wage starting in 2006.

The impact on the financial statements is expected to be an increase in pension expense on the income statement from \$39.7 million in 2002-03 to about \$90 million annually. Pension liability on the balance sheet is expected to rise to about \$131 million by 2007-08 and then begin to fall as the deficit is reduced over time.

### **Recommendation**

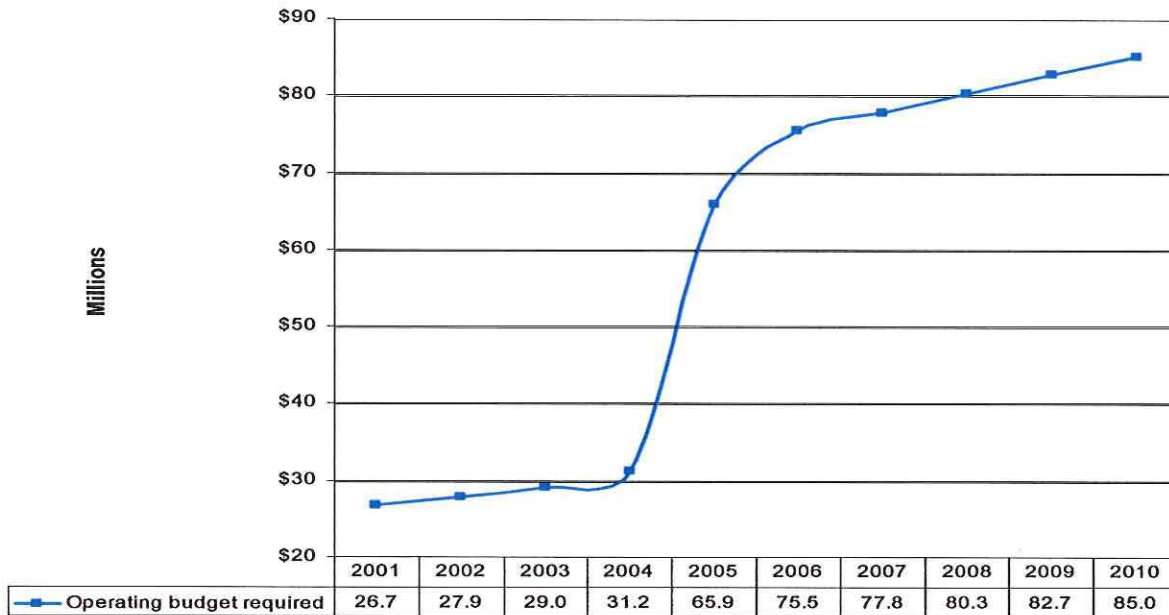
That the Business Board approves the funding strategy contained in the nine recommendations provided above.

**GRAPH #1**  
Registered Pension Plan Actuarial and Market Surplus



**Actuarial and market at July 1**

**GRAPH #2**  
Operating budget required



**As at April 30**

Period	Special Payments Built Into Operating Budget (millions)	Amounts Required For:					Total (millions)
		Special Payments to Pension Plans (millions)	EFIP Repayment <sup>1</sup> (millions)	SRA Pension Payments (millions)	PBGF Premium (millions)		
May 1, 2011 – June 30, 2011	\$ 9.5	\$ 2.5	\$ 1.5	\$ 0	\$ 0	\$ 4.0	
July 1, 2011 – April 30, 2012	\$ 47.7	\$ 37.6	\$ 7.4	\$ 0	\$ 5.0	\$ 50.0	
May 1, 2012 – June 30, 2012	\$ 12.9	\$ 7.5	\$ 1.5	\$ 0	\$ 0	\$ 9.0	
July 1, 2012 – April 30, 2013	\$ 64.3	\$ 55.5	\$ 7.4	\$ 0	\$ 5.0	\$ 67.9	
May 1, 2013 – June 30, 2013	\$ 14.5	\$ 11.1	\$ 1.5	\$ 0	\$ 0	\$ 12.6	
July 1, 2013 – April 30, 2014	\$ 72.7	\$ 55.5	\$ 7.4	\$ 0	\$ 5.0	\$ 67.9	
May 1, 2014 – June 30, 2014	\$ 15.4	\$ 11.1	\$ 1.5	\$ 0	\$ 0	\$ 12.6	
July 1, 2014 – April 30, 2015	\$ 76.8	\$ 55.5	\$ 10.0	\$ 8.3	\$ 5.0	\$ 78.8	
May 1, 2015 – June 30, 2015	\$ 16.2	\$ 11.1	\$ 2.0	\$ 1.7	\$ 0	\$ 14.8	
July 1, 2015 – April 30, 2016	\$ 81.0	\$ 63.3	\$ 10.0	\$ 8.3	\$ 5.0	\$ 86.6	
May 1, 2016 – June 30, 2016	\$ 16.2	\$ 12.7	\$ 2.0	\$ 1.7	\$ 0	\$ 16.4	

<div style="border: 1px dashed black; padding: 5px; display: inline-block;">Available \$411.0</div>		<div style="border: 1px dashed black; padding: 5px; display: inline-block;">Required \$404.2</div>
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<sup>1</sup> Includes principal and interest repayment of EFIP borrowing