Pension Plan Primer

The Sequel

I promised to write again about pension issues and here I deliver another installment. Since last writing, salary negotiations have overtaken us and have changed the direction I had planned for this article. You will have heard by now that MUFA has negotiated a two-year contract which includes a 50% pension holiday for the next two years. We learned during the course of our negotiations that the surplus had grown so large that it would now be possible for employees to take a pension holiday of about half their contributions without having any impact on the Operating Budget. Consequently, we decided to include this holiday as part of our negotiation demands and in the end it became part of our agreement for the next two years. This does not put an end to the need to discuss long-term changes in the Plan, but gives us two years of a contribution holiday while we continue to discuss other alternatives.

Representatives of the employee groups continue to meet with the Administration to discuss the bridging payments and long-term pension plan improvements. One way to think of these two different issues is that if we are going to reach agreement on the bridging payments, we should make every effort to do so soon. We could make current monthly bridging payments from the Plan, but we could not reimburse the Operating Budget for payments already made. Every month that passes reduces the benefit possible to the Operating Budget. This argues for looking at changes that are simple and can be done quickly. Long-term Plan improvements have a different time horizon and do not need to be completed so quickly. Thus, more complicated changes to the Plan can be entertained.

Before beginning to discuss possible changes to the Plan, I would like to make clear, which I perhaps did not in my earlier article, that I believe that McMaster has a very good Pension Plan in most respects. Discussions about change are about improving an already decent Plan. That said, of most concern to faculty is the limit the Federal Government (Revenue Canada, formerly Department of National Revenue) puts on the size of the pension that can be paid from a registered pension plan. The limit at present is $1722 of pension per year of service. That is, for 20 years of service, the pension paid out of the McMaster Plan can be no larger than $34,440 per year and for 30 years, no larger than $51,660. Our pension benefit formula is based on a calculation of 1.4% (of the best 4 years salary) per year of service up to the Canada Pension Plan maximum (approximately $36,000) and 2.0% per year of service beyond that amount. If one should retire with a salary (best 4 years) of, say, $100,000 and 30 years of service, the calculation within the pension plan would yield a pension of approximately $53,520 (1.4% of 36,000 plus 2.0% of 64,000). Since this is in excess of the maximum pension (often called the DNR maximum þ for Department of National Revenue) this size pension could not be paid out of any registered pension plan. In fact, any salary (final four years) over approximately $96,000 would not attract any additional pension. We will refer to this maximum income that can attract a pension as the DNR maximum income.

The faculty salary profile is now such that many Professors reaching normal retirement age will bump into this ceiling. Moreover, the Federal government has announced that the ceiling will be frozen at its current level until the year 2006. By that time, with any reasonable scale increases (or even unreasonable ones) a large majority of faculty will run into the ceiling. The Pension Plan will no longer serve faculty the way it once did. Contrast this situation with that of staff, who typically will not run into this pension cap. A decade ago when the cap was far higher in real terms (it has not been adjusted for inflation for many years now) both faculty and staff could look forward to pensions which, when combined with the Canada Pension Plan (CPP), would yield about 2% of final earnings per year of service. Staff still look forward to this, many faculty now look forward to less.

It is worth noting here as an aside that clinical faculty members, whose pensions are based on income which include clinical earnings and which are thus usually much higher than non-clinical faculty incomes, had to face this problem some years ago. The University and the Pension Trust Committee recognized the problem in a number of ways, most recently by allowing clinical faculty to `opt-out' of the McMaster Salaried Pension Plan.

It is important to understand this DNR maximum pension issue because it is crucial to the assessment (from the faculty viewpoint) of any scheme to improve our Pension Plan. Suppose, for example, we were to propose increasing the percentage of final average earnings we earn per year of service. The 2% earned on salaries over the CPP ceiling is already at the maximum allowed by Federal legislation so we might consider raising the 1.4% which attaches to the first $36,000 of earnings to, say 1.6%. This would, of course, do absolutely nothing in terms of pension for someone already at the DNR maximum income (or someone who would, in any event, meet it before retirement). For someone well below the DNR maximum, and below even the CPP ceiling of $36,000, it would yield an additional 0.2% per year of service. For example, for an individual with 25 years of service it would yield an increment to pension of an additional 5% of final earnings. For someone with final earnings above the CPP cap, (but still below the DNR maximum) the increase would be 5% for that part of pension below $36,000 and zero for that part above $36,000. At final average earnings of $80,000 for example, the improvement would be 2.25% (5x36/80).

For those above the DNR maximum salary there is no improvement possible in pension, though there is a slight benefit from the contribution side. It is minor, however, in comparison to the pension improvement for those with lower incomes. Since the University does not collect pension contributions on earnings that are above the DNR maximum income, and since the DNR maximum income would fall, the individual's pension contributions would fall slightly. The scheme proposed above would cause the DNR maximum income to fall from about $96,000 to $93,000 with a corresponding $150 per year saving in premiums.

What can we conclude from this example and discussion? First, improving the pension multiple on earnings below the CPP ceiling is not very attractive to faculty and will become less attractive to faculty as time passes and more faculty bump into the DNR maximum income ceiling. Moreover, the same analysis is likely to apply to any other change in benefits that lowers the DNR maximum income. Second, MUSA members are unlikely to share the concern about the DNR maximum income, since at the moment most of their members do not anticipate bumping into this ceiling. It should not be surprising that staff are in favour of increasing the 1.4% to some higher number, while faculty (and clinical faculty) are not. Third, if we do nothing, faculty pensions will become a progressively smaller percentage of final earnings as more and more faculty go over the DNR maximum income. Fourth, extending the analysis a bit, it can be argued that a substantial amount of the surplus has arisen because of individuals bumping into this DNR maximum income ceiling. This requires some further elaboration.

You may recall that in my last installment, I mentioned that last year there was a one-time adjustment of $27 million to the surplus that arose because of the delay in indexing the DNR maximum pension. The Federal government had frozen the maximum some years earlier but had indicated that indexing would begin again in 1996. A year or so ago the government had a change of mind and indicated instead that the ceiling would be frozen for another decade. The actuary made revised calculations of the value of future pensions and found them to be about $27 million lower than in previous estimates. So the extra $27 million surplus, in fact, represents $27 million that will not be paid to individuals who exceed the DNR maximum income. By no means all of the surplus arises from this source. Other reasons that have been put forward for the size of the surplus include: incomes have grown less rapidly than assumed in the actuarial calculations so the liabilities of the Plan are smaller than anticipated; the stock market investments of the Plan have done better than anticipated so the assets are larger; and there was a period during the 1980's during which individuals (mostly clinical faculty) with incomes in excess of the DNR maximum were contributing on full incomes even though they could receive pensions only on incomes up to the DNR maximum income.

The discussion above regarding increasing the pension benefit and its differential impact, leads naturally to the question: are there improvements to our Pension Plan that would lead to an improved situation for all members of the Plan? This is a question we have been addressing in meetings between employee groups and the Administration that I mentioned in my last pension article. The meetings/discussions arose out of the Directions II document in which the Administration expressed an interest in providing relief for the Operating Budget by paying the bridging payments for the Special Early Retirement Scheme out of the pension surplus. Employee groups agreed to pursue such discussions with the understanding that agreement to pay these bridging payments would need to include some additional benefit for Plan members. A second stimulus for these discussions is the magnitude of the surplus I wrote about in the last installment. It is now so large that improvements are possible that will have no impact on the Operating Budget. The discussions have been more broad ranging than just the bridging payment issue and have involved discussions of longer term directions for the Plan.

Before going into more detail about options for consideration, it is worth noting the different groups one must keep in mind because of their different interests. Obviously, there are the faculty, the clinical faculty, the staff, and the exempt staff employee groups. The main differences in these groups is in final earnings as has already been discussed. However, there are also retired faculty (already receiving pensions) who can argue they have some claim to the surplus (moral, if not legal). In addition, it is important to realize that when it comes to pay-outs from the Plan, there are two distinct groups that we might want to keep in mind. There are future retirees who will draw pensions from the Plan, and there are individuals who leave McMaster and receive a Termination Benefit from the Pension Plan. Finally, an important consideration as well is intergenerational equity. Does any proposed change improve the lot of those about to retire at the expense of those many years away from retirement (or *vice versa*)?

The Termination Benefit is one of the less well known features of the Plan and deserves a word of explanation here. The Termination Benefit is the cash value take in lieu of a pension when a member leaves the Plan. It is calculated as the larger of: twice the member's contributions (plus interest earned) and the commuted value of the pension (basically, the present value of pension with corrections for life expectancy). Once an individual has met the Rule of 80, the commuted value is generally the larger of the two numbers, but prior to that age the contributions based calculation is generally better. From the perspective of Plan changes, improvements in the pension received will improve the commuted value calculation, but not the contribution based calculation. Improvements in pensions will do nothing, therefore, for short- service Plan members (not yet eligible for Rule of 80). As a consequence, if one is considering making improvements to the pension benefits received, to be fair also to short-service terminations, one might want to consider at the same time making improvements to the contribution based calculation in the Termination Benefit (for example, by improving the interest rate used to calculate the cash value).

In seeking improvements that might benefit pension recipients, the most obvious improvement is to increase the percentage one gets of final earnings per year of service, but this is not attractive to many faculty as I have already explained. Similarly, reducing to 36 months from the current 48 months, the time period over which we calculate final average earnings, also fails to improve the lot of anyone who will bump into the DNR maximum income ceiling. The same conclusion as in the earlier example applies. It will be beneficial to groups with lower final average earnings but not to most faculty. There will, of course, be some faculty for whom this change would be beneficial and we could support the improvement in the context of a package of changes which also provided improvements for higher income faculty.

According to my understanding of the presentation by the Plan Actuary, there are a few possibilities for improvement on the benefit side that might be considered beneficial to all who retire. The first is a change in the Normal Form of the Pension. Currently the Normal Form of the Pension is a guarantee of payments for 5 years with 50% survivor benefits for married members. Ignoring cost considerations for the moment, we could change the Normal Form of the survivor benefit to a maximum of 2/3 of the member's pension (from the current 50%) and increase the guarantee for single pensioners up to 10 or even 15 years. One would probably want to consider these changes in tandem since one of the changes benefits married members and one benefits single members. Second, we could consider a form of permanent bridge. A bridge is a payment to early retirees that continues until the Canada Pension Plan payments begin (say, at age 65) and is intended to smooth out the retirement income stream. A bridge scheme would, of course, only benefit early retirees (it cannot be paid out of the Plan after age 65). There are both lifetime limits and annual limits on the amounts which can be paid. Since we currently have no bridge benefit for early retirees, we have considerable room for improvement here.

The fact that our discussions regarding improvements stem from the possible payment of the bridge for the Special Early Retirement Plan, is a strong argument for a permanent bridge. This Plan (if we agree) and the earlier `Window' plan would both draw on the pension surplus to make special payments to a few individuals who just happened to be at the right age at the right time. Some argue that this is unfair to those who are the `wrong' age and everyone should have an opportunity of enhanced early retirement. The Rule of 80 does provide this feature to some extent. A bridge benefit could substantially improve the options.

The third possibility for improvement lies in the indexing provisions for pensions. This option has the additional benefit of potentially increasing the benefits of current retirees. Currently our pensions are indexed by the lesser of: a) the inflation rate, and b) the book value rate of return on the fixed income portion of the fund in excess of 4.5%. In addition there is a two-year catch-up feature so that if full indexing for inflation does not occur in any one year, one can have delayed indexing if in the next two years the rate of return less 4.5% is in excess of the inflation rate. The delayed indexing feature is only a recent addition in last year's agreement. Even without it, our Plan has been essentially fully indexed for inflation for most of the last two decades. The last time we fell short of full indexing was more than 15 years ago. Nevertheless, there is always the concern that we might fall short again and it would be possible to further improve the indexing features. This could be done either by increasing the length of time for catch-up, by looking at a different interest rate differential, or by actually guaranteeing full CPI indexing. None of these indexing improvements would effect the DNR maximum income and would provide a potential benefit for all.

The other place one can look for improvements to the Plan is on the contributions side of the pension calculation. We all pay contributions as a proportion of income (3.5% up to the CPP income ceiling of approximately $36,000 and 5% on income thereafter). A contribution holiday benefits all Plan members at the time they make contributions. It is an extremely simple adjustment to make and it is this feature that led us to the consideration of a 50% member contribution holiday in our recently negotiated agreement. A contribution holiday alone does, however, cause a reduction in the termination benefit since it is now calculated as a multiple of past contributions (plus interest). For this reason we agreed in our negotiations to seek a change to the Pension Plan text that will allow the Termination Benefit to be calculated based on `normal contributions' as opposed to member contributions. In this way, both retirees and those taking the termination option can benefit. While these changes benefit all Plan members, they fail to improve our pensions. For those with lower incomes, and correspondingly lower pensions, the extra funds could, of course, be invested for retirement in an RRSP. For faculty members, many will have no RRSP room in any event, so this opportunity is unavailable. Nor is any additional RRSP room created by a contribution holiday since in a defined benefit plan such as ours, the Pension Adjustment which determines RRSP room is calculated based on the defined benefit (and its growth in any particular year).

Where does all this leave us? A few simple changes are available to choose from that could offer benefits to all or almost all. Changes to the normal form of benefit helps everyone who takes a retirement pension; changes to create a permanent bridge help everyone who takes early retirement; changes to the way interest on the contributions is calculated for the termination benefit helps those who take this benefit; a change to a 36 month period for calculating average earnings would help those below the DNR maximum income taking retirement; and, finally, more complete indexing helps those currently retired as well as anyone who eventually takes a pension. All of these seem to be excellent opportunities to explore.

To make more major permanent changes to the Plan will, no doubt require long and complex negotiations. For individuals who expect to retire with earnings below the DNR maximum income, one of the most attractive options may be to improve the 1.4% per year of service earned on incomes below the CPP ceiling. For those who expect to exceed the DNR pension ceiling, however, this is not an attractive option and could use up the surplus without providing them any benefit. The most attractive option for this group would seem to be to find a way to supplement pensions on incomes over the DNR maximum income level. This would require that supplementary payments be made outside the Plan; for example, from the Operating Budget or from another fund. Some other institutions, such as UBC, I understand, have established such funds. Such a plan could be considered here as well. To fund such pensions out of the surplus would be complicated and probably would require agreement by all parties to take money from the surplus fund to establish a supplementary fund outside the Plan. However, if those with incomes below the DNR maximum are to benefit by an increase in the percent earned as a pension (on income below the CPP ceiling) from 1.4% to something higher, agreement should not be impossible.

As if these options are not enough, there is also an alternative possibility of moving our Plan towards a defined contribution plan. In such plans, individual pensions are tied to individual contributions. The limits on the size of pension that can be paid appear to be less binding and this seems to be a major attraction. The committee representing the Administration and all the employee groups discussing pensions has just begun to hear about this alternative. If we move further in this direction, I will see that additional information on this alternative is published in this *Newsletter*.

The choices available are many and it will take some time to understand all the implications of moving in one direction or another. I, or my successor in these discussions, will keep you informed.

Les Robb