A McMaster Pension Plan Primer

Most of you have heard about the McMaster pension surplus and the pension holidays the University has been taking over the last decade. But how big are these items? This note is meant to bring to the whole community an understanding of the magnitudes involved. There are a number of aspects to our retirement program, but the foundation is the McMaster Registered Pension Plan and all the discussion below refers to that Plan. In addition the University pays some retirement benefits out of the Operating Budget; for the most part, ones that it is not allowed to pay out of the Plan. These include payments associated with the Window Early Retirement plan of the late 1980's, the Special Early Retirement plan of 1996-97, and payments to some individuals for pensions that exceed the maximum Revenue Canada allows to be paid out of a registered pension plan. The University tends to view these all as a package and lumps them together in talking about these issues. The Faculty Association generally talks about the Registered Plan separately and that is the focus here.

THE SURPLUS

First, let us consider the surplus. The surplus at any point in time is the difference between the value of the assets and the value of the future liabilities. Both values depend on the assumptions that are made. One can relatively easily attach a value to the financial assets at a point in time. However, the assets are not going to be liquidated at that point in time so really one must estimate what the assets would fetch if they were liquidated at some unspecified date. While there is some uncertainty here, the consensus is that it is small in comparison to the liability side of the ledger.

The liabilities of the Plan are necessarily amounts that are owed to Plan recipients in the future. How much must be paid out depends on length of life, not only of the pensioner but also of the spouse. It depends critically as well on individuals' final earnings and on how many individuals take early retirement. These future payments, uncertain as they are, must be converted to a value today and that involves further assumptions. In short, we don't really know ***precisely*** how much we will need to pay out nor even if we did, how much we would have to set aside in the current period to allow us to meet those liabilities.

Our Plan Actuary makes the necessary assumptions and calculates the values of assets, liabilities, and surplus (the difference between the two). One could write pages about the appropriateness of these assumptions. However, taking the Actuary's assumptions, the `on-going' surplus at July 1, 1996 is $160,603,000. It grew by approximately $55 million during the preceding 12 months although $27 million of this amount arose due to a one-time change (delay) in the federal government pension rules regarding indexing of the maximum pension that can be paid out of a registered pension plan. It is worth noting that because of the way in which the Plan Actuary values assets, the increases in the stock markets in the last year or two have not yet all been factored in. Thus, even if the stock market stopped growing, the assets and the surplus would continue to grow substantially over the next few years.

These values of surplus need to be put in context, of course. How big are they relative to the assets and liabilities of the Plan? If the surplus were only 5% of assets, a small swing in the stock market could wipe the surplus out in short order. One of the simplest ways to think of this is by considering the ratio of assets to liabilities in the Plan. As of July 1, 1996, our Plan had $1.31 of assets for every $1 of liabilities. In other words, more than a 30% premium. Moreover, because of the way assets are valued, some of the gains in the stock market in the last few years have yet to be factored into the calculation.

PENSION HOLIDAYS

Pension holidays can be defined in many ways and one of the problems in coming to a common understanding is the many different definitions. The way one defines a holiday may well relate to the purpose for which the measure is going to be used or the political point one is going to make. The way I will define it is no exception and bear this in mind.

Each year the Actuary for the Plan makes an assessment of how much money would need to be put into the Plan to cover the increased liabilities (future pensions) that have been earned that year. This amount is known as the Current Service Cost. If you subtract from the Current Service Cost the contributions of employees, what remains is the contribution that would be necessary by the employer to fund the liability increase in that year. In the absence of a surplus, this is what the employer would need to put into the Plan. I will use the term Pension Holiday in any year to mean the amount by which the University contributions (transfers into the Plan) fall short of meeting the Current Service Cost (less our contributions) in that year. Given this definition, the McMaster University Pension Holidays are as reproduced below.

McMASTER UNIVERSITY PENSION HOLIDAYS

YEAR	HOLIDAY
1987-88	$ 2,870,000
1988-89	$ 5,010,000
1989-90	$ 5,680,000
1990-91	$ 6,020,000
1991-92	$ 6,100,000
1992-93	$ 3,910,000
1993-94	$15,740,000
1994-95	$17,150,000
1995-96	$17,200,000
TOTAL	$79,690,000
TOTAL with interest	$113,450,000

Notes:

1) The source is the table on "reconciliation of results" from the Actuary's Report (W.M. Mercer) for each year.

2) The calculation for the "total with interest" uses the fund yield, based on book value including investment income and realized gains or losses.

How has the University taken these holidays? The University has been treating the surplus as a source of funds to pay part or, more recently, all of the employers' share.

Until the last 3 years in the table, the size of the holiday reflected a decision to use the surplus over about 15 years to reduce the University's contributions. The much larger holidays in the last 3 years arise because the University has been prevented, by Revenue Canada, from putting any additional funds into the Plan. Revenue Canada prevents employers from contributing to a plan that already has a huge surplus, although it allows employees to continue doing so. The University could, of course, have used the surplus to improve pensions, or to pay the employee premiums. It did not.

Do these holidays which reduce the surplus threaten the integrity of the Plan? In the early days of pension holidays, this was a key concern of employee groups. The surplus was much smaller and had only recently surfaced and many employees were concerned that this was a raid on funds that were needed in case the market collapsed or for pension improvements. Given the size of the surplus now, this argument is heard less frequently but there are still some who have concerns about it.

How have these holidays influenced McMaster's budget position? First, all of the holiday is not an Operating Budget saving. Suppose 3/4 of the liabilities in the pension plan created in any year are associated with the Operating Budget, while the remaining liabilities are associated with employment from research grants and contracts, ancillaries and the like. Then, roughly 3/4 of the amounts listed above can be thought of as additions to the Operating Budget that would not have been available, in the absence of pension holidays. The budget crisis of the last few years would have been immeasurably more difficult without the availability of the pension surplus (as universities without such surpluses have discovered).

So, where have the monies from the pension holiday gone? The University has used them to supplement the Operating Budget and to allow researchers (and other employers within the University system) to pay less than they otherwise would have had to in the fringe benefits line of their budget statements. The savings have accrued to Faculties and Departments and allowed them to function under the recent budget crisis. Would we have had to take more (Rae/Harris/George) unpaid days if the University did not have the pension surplus available? Quite possibly.

If all this money is available in the pension surplus, one might ask, why don't we use it to reduce both the employees' and employers' premiums? Wouldn't that be more equitable? This is a question those of us involved with pensions have heard over and over. Some other university pension plan agreements have clauses in them that, in fact, require any holidays to be shared. Ours does not. Some other administrations have negotiated pension holidays. Windsor, for example, recently signed an agreement to improve salaries by 5.4% over each of the next 3 years by cutting out the employees' pension premiums.

McMaster University has always insisted the surplus belongs to the University. The employee groups, as most of you will recall, took the University to court over this matter and sought to restrict the University from taking these holidays unilaterally. In the end, the court battle turned on the wording of a phrase in the Pension Plan that the courts ruled allows the employer to unilaterally take pension holidays. But is that right?

There are many different ways of viewing who should have rights to the surplus. I will lay out a few here but readily admit there are yet other ways of looking at the issue.

One view expressed by the administration from time to time is that the University is the residual payor. If there is a shortfall, the University must cover it. If there is a surplus, therefore, the University has a right to it.

Another view is that both employers and employees agreed to put money aside to fund an expected pension. The pensions we are going to earn are much lower than anticipated in the original formula and had we anticipated the slow growth in salaries in the 1980's and 1990's we would have realized far less needed to be set aside. From this perspective, we both have contributed to the surplus.

Another way of thinking of the issue is to note that much of the surplus is due to the excess or unanticipated earnings in the stock market. Both the employee and the employer contributed premiums which grew at higher rates than anticipated and both in this sense created the surplus and both have moral right to it.

Yet another view is that for a period in the 1980's the University, with great foresight, put more money into the Plan than was necessary according to the Current Service Cost Calculations (opinions differ on why this was the case, see below). Some of the surplus, it can be argued, is due to this foresight and provides the University with a moral claim to the surplus. The Faculty Association has argued at times that the excess contributions were in fact being put into the Plan to allow future pension improvements. More sceptical members have suggested that the University was not showing great foresight but was hiding funds so that it would appear salary increases were impossible. From that point of view, the excess contributions, in fact, represent our lost salaries and hence we as employees have a right to the surplus so created.

A complication to all of this (reinforced by the court decision) is that it seems pretty clear that if the Plan were ever wound-up, or terminated, the members of the Plan (the employees) would have the major claim on the surplus. Thus, we have the ironic situation that money we would likely own on wind-up, the courts allow to be depleted by the University now, so that on wind-up nothing (in the way of surplus) might be left. Isn't the law fun?

Before finishing this note, let me say a few words about the next instalment. I plan on writing next about the, so called, "DNR max" problem: the capping of the size of individual private pensions by the federal government. This makes pension improvement somewhat difficult within the current defined benefit plan. I will also include a discussion of the interests of the various groups which participate in our common Pension Plan and how our interests are not always aligned. Finally, discussions are beginning between the administration and employee groups about surplus (in particular to the use of the surplus to cover the bridging payments of the Special Early Retirement Program) and I will write about the future options that appear to be available. I am hoping that this last issue will be aided by discussion generated by this *Newsletter*. I encourage you to post your comments and concerns to g-mufagab, or to write to the *Newsletter* editor.

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(The views stated here are my own and do not reflect the official views of MUFA. I would like to thank, without implicating, the following individuals for helpful comments on an earlier draft: Sherm Cheung, Wayne Lewchuk, Daphne Maurer, and Doug Welland.)