

ONTARIO TEACHERS' PENSION PLAN

UPDATE

You would have to be marooned on a desert island not to be aware of the turmoil in the financial world these days. Rumours rule and nervous markets respond. It is hard to see where it all might end; and to top it off, the Ontario Teachers' Pension Plan (OTPP) has announced changes to the way in which inflation protection is calculated.

OTPP members can certainly be forgiven for feeling a bit queasy about changes to their future cost of living adjustments (COLA), but a little information might help to ease the stress.

In fact, the changes are not related to any current market downturn. Pension plans are long term investors, so today's problems, while troublesome in the short term, are more like a chance to do

some bargain shopping. Why would the partners, the Ontario Government and OTF change the benefit structure? What does the change mean for the average CPCO member?

Filing Valuations, Actuarial Assumptions and other Imponderables

By law at least once every three years, pension plans must file valuations with the Financial Services Commission of Ontario. The purpose is simple – to find out if plans have sufficient funding to cover pension obligations through the next 60 or 70 years. Should a valuation show a shortfall, pension law requires the plan's sponsors to balance the books prior to filing.

When the 2005 valuation showed a significant shortfall of \$19.4 billion, everyone pitched in. The OTPP Board used slightly more optimistic expectations for plan returns and the partners imposed

a contribution rate surcharge of 3.1 per cent in three stages beginning in 2007, amortizing the remaining shortfall over 15 years. As of January 1, 2009 you will contribute 10.4 per cent of your earnings up to the maximum for CPP contributions (\$44,900 in 2008) and 12 per cent on the rest.

The 2005 deal also included an expert panel to review the actuarial underpinnings and a Pollara survey of 2,880 members to test their willingness to see future contribution rate or benefit changes.

What is in the Toolbox?

Resolving OTPP funding shortfalls depends on three main tools. Control of the toolbox is shared between the OTPP Board and the partners:

1. *Actuarial assumptions (the OTPP Board)* In valuing the OTPP the actuary makes a series of assumptions on everything from how long members will live to what the rate of inflation will be over the next 60 years. The assumptions are really guesses – extremely well researched and informed guesses, but guesses nonetheless.
2. *Contribution rates (the partners)* Both members and the government contribute equally to the OTPP. Increases to contribution rates are possible, but at some level, using contribution rates alone to solve a deficiency would drive the rates to unsustainable levels. The current cap is 15 per cent.
3. *Benefits (the partners)* Members are entitled to a variety of pension benefits. Among them are the basic accrual rate (2% per year of credit), the formula (2% X years of credit X average of your "best five"), the 85 factor and inflation protection.

Preliminary figures for the mandatory 2008 valuation showed a new shortfall of \$12.7 billion. How could that be? The contribution rate increase had already taken care of the first shortfall. The two villains in the piece were mortality and low interest rates. Each comes with a story of its own.

Mortality

We have all heard the anecdotes. *Ah! Poor old Principal Fred! He retired at the end of June, took two steps into the playground and pitched face down never to rise again. It is like that for all of us. The stress shortens our lives.*

Nothing could be less true. We asked Mary Hardy, a University of Waterloo demographer, to look at OTPP mortality. She discovered that not only do teachers outlive the standard mortality tables; they do it in spectacular fashion. Teachers, she found, live on average three years longer than even the strengthened tables being used by the OTPP suggested. It is great news for members, but it means the partners and the OTPP administration must fund pensions for a longer period. The price tag for that extra time is a whopping \$5.5 billion.

Interest rates

Generally, low interest rates are a good thing. Mortgages and credit cards cost less but we do not do as well in savings account. Through our working years, cashflows are generally outgoing anyway. It is a different story for pension plans.

Think of an average principal, Sally, about to retire. The OTPP knows some facts about Sally: her age; her years of credit; her “best 5”; and so on. It can also make some shrewd guesses about other factors, for example, her life expectancy. At 57 she can expect to live to 90. Let’s give her a 30-year career, an average “best 5” of \$100,000 and 33 years of expected retirement. Her starting pension will be \$60,000. At a 2 per cent average inflation, the centre of the Bank of Canada’s target, by her 33rd year, her pension will be \$113,072. She will have drawn \$2.8 million worth of pension payments.

The OTPP does not have to set aside the whole amount to fund a pension. The unused portion each year will continue to earn as Sally lives out her retirement. Discounted into today’s dollars, at 3 per cent, the OTPP would need about \$1.1 million to fund her pension, but at 2 per cent it would need \$1.5 million to fund the same pension. The low interest rate on valuation day added a lot to the shortfall. Thus, talks on the 2008 filing began with a \$12.7 billion problem.

Discount Rate

The interest rate at which a present value must grow to reach a specified value over a specified period.

Had the Partners resolved the 2008 shortfall using contribution rates, members would have paid an additional surcharge of nearly 5 per cent of gross earnings for the next 15 years – from the 12 per cent end rate we will see on January 1 to 16.9 per cent. Put into perspective, on the \$100,000 salary I used above, that is \$75,000 in additional pension contributions. Moreover, this new surcharge would have pushed contributions far beyond the 15 per cent cap set by the 2005 deal, so the partners had to look at alternatives.

Of the possibilities – raising the 85 factor to 90, decreasing the 2 per cent accrual rate or making some part of inflation protection conditional – the survey mentioned above clearly showed that members preferred the latter, so the partners took that advice, adopting conditional indexing for service after 2009.

Conditional Indexing 101

Beginning January 1, 2010 the pension you earn between then and the day you retire will come under *conditional indexation*. The term means different things in different plans, but for the OTPP it will work like this:

- The cost of living increase is calculated by taking the average total CPI for Canada (not seasonally adjusted) for 12 months ending in September and dividing it by the average from the previous 12 months. For 2008 the increase will be 2.5 per cent. You will find the CPI numbers on the Bank of Canada website at <http://www.bankofcanada.ca/en/cpi.html>.
- On pension you have earned up to January 1, 2010, you will receive 100 per cent inflation protection under the old familiar rules.
- For pension you earn between January 1, 2010 and your retirement, you will be guaranteed 50 per cent of the CPI adjustment.
- The other 50 per cent will be discretionary in the hands of the partners; but the partners and the administration will continue to fund the OTPP with the expectation of paying 100 per cent COLA every year.

The change has no effect until after you retire, and even then, only if the partners must use it.

The partners intend to pay 100 per cent COLA going forward and to deal with any modest shortfalls through adjusting contribution rates; but, if the OTPP is under intense pressure, they now have a new tool in the toolbox.

Effect on members

The partners will make their decision as each valuation rolls up. You will not see a change in your cost of living adjustments unless the partners have to open their toolbox. If they must resort to conditional indexation, how much will you have at risk?

Let's use a constant \$60,000 pension and 2 per cent inflation to demonstrate the risk. With a 100 per cent guarantee, that 2 per cent would be \$1,200. The following chart shows three principals with three different ratios of before and after January 2010 time.

Assume inflation running at 2%	Sally with: <ul style="list-style-type: none"> • 28 yrs before • 2 yrs after • \$60,000 base pension 	Tom with: <ul style="list-style-type: none"> • 15 yrs before • 15 yrs after • \$60,000 base pension 	Andrea with: <ul style="list-style-type: none"> • 0 yrs before • 30 yrs after • \$60,000 base pension
Guaranteed Pre-Jan. 2010 portion	\$56,000 x 2% = \$1,120	\$30,000 x 2% = \$600	\$0
Guaranteed Post-Jan. 2010 portion	$\frac{\$4,000}{2} \times 2\% = \40	$\frac{\$30,000}{2} \times 2\% = \300	$\frac{\$60,000}{2} \times 2\% = \600
Conditional Post-Jan. 2010 portion	$\frac{\$4,000}{2} \times 2\% = \40	$\frac{\$30,000}{2} \times 2\% = \300	$\frac{\$60,000}{2} \times 2\% = \600

Sharing risk

By 2040 all members will be guaranteed 50 per cent COLA plus as much of the remainder as the health of the OTPP will allow. That is a guarantee of at least half of the change. The government shares the risk and will pay an equivalent amount in special payments, if it is ever necessary to reduce a COLA payment.

Before this change, the entire risk from shortfalls rested on active members. The partners chose this particular benefit because it will eventually provide equal sharing of plan risk among all members, active and retired, and the province. Moreover, it costs no one anything until it must be invoked.



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