For the first time in its history, the Combination Pension Plan of which you are a member is being forced to re-evaluate the long term sustainability of current contribution rates and benefits. This document is a follow-up to the brief bulletin sent to all members on 14th October 2010, and is intended to provide more detailed background to the situation and to prepare the ground for further consultation with members, including member meetings and ultimately a questionnaire on your views of the options.

Three points need immediate emphasis. Firstly, there is no threat to current pensions. The concern is long-term and with sustainability over that long-term. Secondly, this present document is intended to provide a plain language, explanation of the situation. The binding legal documents, the Trust Agreement and Schedule A to the Trust Agreement which govern the University of Victoria Combination Pension Plan, should be consulted by those wishing more precision. Thirdly, although by law the Trustees and the University must have different emphasis in their priorities, both are working together with actuarial advice to address the problem.

Sincerely,

Dr. Keith R. Dixon
Chair, Board of Pension Trustees

Member Forums

The issues described in this bulletin and possible courses of action will be discussed at member consultation forums. Members are strongly urged to make an effort to attend a forum. They are scheduled for:
- Tuesday, Jan 18, 2011 at 4:30 pm, Bob Wright Centre, B150
- Wednesday, Jan 19, 2011 at 12 noon, Cinecenta

As space is limited we ask that you pre-register at http://web.uvic.ca/vpfin/financialplanning/pension/forumreg.php. If these sessions are filled, others will be planned.
tended to fund any supplements required to meet the DB minimum mentioned above, and as such remain part of the plan and are not allocated to individual members.

When starting a pension, a member has to make a choice, staying on the left side of Figure 1 with some options where the member retains control of the assets, or moving to the right side of Figure 1 by purchasing a 3½% variable annuity within the Plan. The DB minimum is attached only to this annuity and will be explained in a little more detail below.

Let us first dispose of the left side of Figure 1 (dashed boxes). Members who choose this route give up the DB minimum feature of the plan, perhaps because they consider their CCA large enough to provide a better pension than the DB minimum, perhaps because they prefer to retain control of the assets, or because of other personal preferences such as flexibility of annual withdrawals. Many members in the recent past have decided to use the funds in a structure which the Canada Revenue Agency calls a “Variable Benefit” (essentially a Life Income Fund). They may also decide to give up the assets by buying a 5% annuity (which does not carry the DB minimum) within the plan or some external annuity, but these options are another story and not part of this discussion. The important point for our purposes is that any option selected from the left side of Figure 1 essentially converts the member’s entitlements to pure DC and he or she is no longer affected by the DB minimum or its sustainability.

Members who decide when starting a pension to take advantage of the DB minimum, are required to use their CCA assets to purchase an internal variable 3½% annuity, thereby moving to the right side of Figure 1. This annuity then provides regular pension payments...
similar to an external annuity but with two unusual features. First, the pension is adjusted annually depending on investment performance of the plan (relative to the 3½% assumed in the annuity calculation), and also adjusted for the mortality experience of the annuitant pool. Second, should the annuity payments fall below the member’s DB minimum then a supplement is provided from the assets of the DRBA. The DB minimum is indexed for inflation, a very important point in the present discussion and explained in more detail below.

Calculation of the DB minimum at normal retirement (age 65) is based on the member’s average salary for the highest consecutive five years of their employment at the University. This average salary is then multiplied by the accrual rate (1.3% up to the average YMPE and 2.0% above) times the member’s years of service to obtain the annual DB minimum. After the pension has commenced, the DB minimum is indexed annually based on changes in the Canadian Consumer Price Index to a maximum of 3% per year.

Interaction of the three factors (market performance, mortality experience, and indexing of the DB minimum) means that the need for supplementing a member’s pension to the DB minimum can vary considerably over time, with supplements paid in some years but not in others. Figure 2 is a graph which illustrates these fluctuations, excluding mortality, for one hypothetical case history. The member is assumed to have a DB minimum pension of $1500 per month shown unindexed by the horizontal line composed of long dashes and a starting internal variable annuity of $1200 per month. The steadily rising line of short dashes shows this DB minimum indexed for inflation at 2% per year over 25 years. The fluctuating dotted line represents the variable annuity under a set of randomly generated market returns which, over the 25 years, average to the 6.5% annual return assumed in our valuation, less the underlying assumed 3½% annuity return. If the dotted line falls below the short-dashed line at any time then a supplement is paid from the DRBA to restore the pension to the DB minimum (short-dashed line). In Figure 2 this condition occurs from year zero to about year 4 and again for a few years centred about year 10. If the dotted line is above the short-dashed line, then no supplements are paid. Historically, it has been the case that longer pension time frames led to less need for supplements and similarly members with many years of service were less likely to require supplements.
The Sustainability Problem

Referring back to Figure 1, there is no problem with sustainability of the left side of the flow chart – the account balances are whatever the market determines and there are no pre-set targets! However, on the right side, it is essential that the contributions to and investment returns on the DRBA ultimately balance the liabilities generated by DB minimum supplements payable to members who choose the 3½% variable annuity. Valuations of the plan are legally required every three years and a valuation of the state of the plan as of 31st December 2009 was recently completed by our actuaries, Mercer (Canada) Ltd. A valuation report has been filed with FICOM (the pension regulator in B.C.) which meets the regulatory standards but does not address the long term sustainability of the plan. Section 5.04 of Schedule A to the pension trust agreement requires the actuary, at each valuation date, to assess whether contributions are required beyond the current 1% of salaries to “maintain the Defined Retirement Benefit Account on a sound actuarial basis.” Mercer advise that if the 1% contribution is maintained, then based on the valuation assumptions the DRBA assets will not be sufficient to support the liabilities and the Plan will not be sustainable. Further, if action is not taken, the situation may deteriorate even further. After reviewing all of the evidence, the Trustees and the University are strongly in agreement with the need for action within a short timeframe, not in some future valuation period.

The Choice

There are only two fundamental ways to solve the sustainability problem described above: increase contributions or decrease benefits! There is also, of course, the possibility of some combination of these two solutions.

The Increased Contribution Solution

The actuaries advise us that, if there are no changes in benefits, then annual contributions to the DRBA should be 5.05% of salary, rather than the current 1%. This will appear to be a staggeringly large increase! However, it is essential to remember that the DRBA, approximately $60 million, is leveraged by the market performance of the much larger CCA, approximately $350 million excluding voluntary and variable benefit accounts. The situation is similar to others involving leverage. For example, if you purchased a house with a 75% mortgage and property markets fell 20% then your investment would have a net value only one-fifth of its original. The big difference of course is that most leverage situations involve borrowed funds, which is emphatically not the case for the pension plan! In any event, the recent market turmoil has taken a large toll on the standing of the DRBA. The liabilities have also been strongly impacted by low interest rates and by the increasing longevity of people in general and University people in particular. All of these factors increase the present value of future liabilities. The plan trust documents provide a formula for meeting increased contribution costs in which the University pays 2/3 and the member 1/3. Thus the impact of increasing the DRBA contribution from 1% to 5.05% would be extra costs of 1.35% of salary for the member and 2.7% for the University. This is a significant issue for the University since for current salaries, they would have to find more than $3 million extra per year. Figure 3 shows the effect on members at various salary points. It is very important to note that there would be no change in total contributions to member’s CCAs: i.e. the left side (dashed boxes) of our flow chart in Figure 1 would be unaffected.

There is, of course, always the future possibility that market conditions may improve enough to enable a reduction in contributions in the future. However, at this point in time, these numbers are what is required to “balance the books” by the increased contribution route.

### Figure 3: Salary Impact of Contribution Increase

<table>
<thead>
<tr>
<th>Annual Salary</th>
<th>Additional Contributions Per Year</th>
<th>Additional Contributions Per Pay</th>
</tr>
</thead>
<tbody>
<tr>
<td>$50 - $60,000</td>
<td>$675 - $810</td>
<td>$28.13 - $33.75</td>
</tr>
<tr>
<td>$60 - $70,000</td>
<td>$810 - $945</td>
<td>$33.75 - $39.38</td>
</tr>
<tr>
<td>$70 - $80,000</td>
<td>$945 - $1,080</td>
<td>$39.38 - $45.00</td>
</tr>
<tr>
<td>$80 - $90,000</td>
<td>$1,080 - $1,215</td>
<td>$45.00 - $50.63</td>
</tr>
<tr>
<td>$90 - $100,000</td>
<td>$1,215 - $1,350</td>
<td>$50.63 - $56.25</td>
</tr>
</tbody>
</table>

*NOTE: These additional contributions would not change a member’s defined contribution entitlement.*
The Reduced Benefits Solution(s)

The alternative solution of a reduction in benefits is naturally more complex, since there are many possibilities, each affecting different groups of members to varying degrees. Mercer was asked to study the magnitude of changes required to maintain the current contribution levels to the DRBA at 1% under various scenarios. A complete description of this exercise would take many pages, but some of the main options are summarized below:

1. **Eliminate DB minimum for all future employees.** This option would eventually solve the problem, but would take many years to do so. It would not solve the current problem, still requiring additional contributions from current employees.

2. **Eliminate DB minimum for all future service.** This option would affect both current and future employees. In this scenario the plan has sufficient current assets to meet the DB minimum obligations already earned by existing members. Future service would not add to those obligations, effectively changing the future plan to a pure DC model. The 1% of salary which currently goes to the DRBA could be diverted to member's CCAs. However, although this solution would eliminate the funding problem, it would represent a fundamental change to the entire structure of the plan and would be very difficult, if not impossible, to reverse if future market conditions improve.

3. **Change the DB minimum formula,** by reducing the accrual rate, so that the sustainable cost remains at 1%. This option could be structured in various ways, some affecting only future employees and some affecting current employees in various age groups. However, in all cases the required reductions in accrual rates turn out to be very large, in the 20-30% range if this is the only option considered.

4. **Eliminate inflation indexing of the DB minimum for members who have not yet commenced their pensions.** This option does not entirely reduce the cost to 1%, but it does come close at 1.41%, leaving members (0.14%) and the University (0.28%) with only small extra costs. This option also has the advantage of being the most easily reversed if future conditions improve. Indexing could be permanently or temporarily restored if future valuations allow. The effect of this option is most easily understood by again referring to Figure 2. The DB minimum would be un-indexed (long-dashed line) and only in years where the short-dashed line falls below the un-indexed line would supplements be paid. However the DB minimum would still provide insurance in the event of extreme market events (larger than those contemplated by Figure 2).

5. **Combinations of options** could be considered but would likely prove administratively complex.

Assessing the Options

When considering the available options, members will need to assess their individual situations to determine which course of action would serve them best. Most likely, this assessment will depend on a member’s risk tolerance since the choice could be viewed as essentially a decision to purchase insurance by maintaining the benefit, or to take the risk of reducing the benefit. Risk tolerance is, of course, largely a personal characteristic, but could be influenced by factors such as whether the plan is your primary or sole source of family retirement income, the relative age of your spouse, and his or her financial independence.

The assessment should also include the related issue of how likely you are to utilize the DB minimum. For example:

a. Your CCA assets may be sufficient to provide a pension larger than the DB minimum, making any changes to the DB minimum largely irrelevant.

b. Historically, members who left employment prior to the earliest pensionable age (55) were less likely to be eligible for a defined benefit supplement than members who continued to normal retirement.

c. Historically, longer service members have been less likely than shorter service members to be eligible for a defined benefit supplement.

d. Do you wish to retain control of your assets and their disposition to your heirs? This is only possible if you choose the left side of Figure 1.
Next Steps

This bulletin will be followed by member forums to present and discuss the issues and choices. Information on these forums is on page 1 and you are strongly urged to make every effort to attend one of the sessions. If the initially planned two sessions are insufficient then others will be planned.

Following the forums, the Trustees and the University will seek member feedback via a member survey or questionnaire. The results of the forums and survey(s) will be used as one of the main inputs to determine the final approach and recommendations to the Board of Governors. If the decision is to change contribution rates, then the target date for the change will be April 1, 2011. If a benefit change is preferred, then further work and discussion will be undertaken before plan changes are recommended to the Board of Governors.

Finally, the Trustees and the University reiterate their commitment to working together to resolve the problem, and their confidence that an acceptable solution can be found.

This publication is based on relevant plan documents. If there is a discrepancy between this publication and the plan documents, the plan documents apply.

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