FUNDING YOUR PENSION

Top Webcast Q&As

HERE ARE THE MOST COMMON Q&AS FROM THE FUNDING YOUR PENSION WEBCASTS HELD APRIL 17 AND 20, 2010.

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Q: WHAT WILL HAPPEN TO MEMBERS' PENSIONS IN LIGHT OF THE PROJECTED FUNDING SHORTFALL?

A: First off, nothing needs to happen now. However, if a shortfall persists, the Ontario Teachers' Federation (OTF) and Ontario government must take steps to eliminate it before the next funding valuation is filed with the provincial pension regulator. The next valuation must be filed in 2012, but the OTF and government could choose to file earlier.

To address a funding shortfall, OTF and the government can:

- increase contribution rates; or
- invoke conditional inflation protection for pension credit earned after 2009; or
- change benefits members will earn in future years; or
- use a combination of these options.

Current Ontario legislation protects the value of pension benefits that working and retired members have already earned.

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Q: HOW WILL THE FUNDING SHORTFALL AFFECT MEMBERS WHO WILL BE RETIRING SOON?

A: It won't affect their basic pensions. Teachers' pensions are defined by a formula based on years of service and average earnings. Basic pensions do not depend on the size of the pension fund or the funding status of the plan when a member retires. This means it's unnecessary to delay or advance retirement plans because of the shortfall or concerns about possible future benefit changes.

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Q: WILL TEACHERS BE GIVEN ADVANCE NOTICE OF ANY CHANGE TO THE 85 FACTOR, CONTRIBUTION RATES OR OTHER BENEFITS?

A: No decisions have been made to change pension benefits or contribution rates as of now. If such action is required down the road, teachers will be given plenty of notice of any change. Teachers who qualify to retire under the 85 factor will not lose that opportunity.

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Q: HOW CAN WE HAVE A SHORTFALL WHEN THE PLAN IS MAKING LOTS OF MONEY?

A: There are two sides to the pension balance sheet: assets and liabilities. Liabilities are the projected cost of future pensions.

A shortfall will arise if projected pension costs grow faster than projected plan assets. This is what happened in 2009. Pension plan investments returned 13% and generated $10.9 billion in income. Yet, the plan is projecting a $17.1 billion shortfall as at January 2010.

Declines in real – or after-inflation-- interest rates caused a $15 billion increase in pension costs. Plus the plan is still recognizing investment losses from 2008 due to smoothing.

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Q: WHY IS THERE A FUNDING SHORTFALL?

A: Pension costs have been growing faster than plan assets for several years. There are a few reasons for that. Last year, declining real interest rates were the number one factor. The real interest rate is the interest rate after taking inflation into account. The pension plan uses real interest rates to estimate the amount of money required now to fund pensions in the future. Real interest rates declined to 1.5% at the end of 2009 from 2.1% at the start of the year. The decline added an estimated $15 billion to projected pension costs.

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ASSETS REQUIRED FOR A TYPICAL $40,000 PENSION

Real Interest Rates	Amount Required[1]
5.0%	$585,000
4.0%	$660,000
3.0%	$745,000
2.0%	$855,000
1.0%	$995,000

[1] For retirement at age 58

Look at the chart. You can see how interest rates affect pension costs. If interest rates are at 1%, we need to set aside almost $1 million to secure a $40,000 annual pension. At 5%, we need only about $585,000.

Another reason for the current shortfall is the effect of "smoothing" or spreading out investment gains or losses over five years. Smoothing is a common pension plan practice that evens out short-term fluctuations in investment returns. The pension plan will recognize about $5 billion in 2008 losses every year until 2012.

6 **Q: PLEASE EXPLAIN HOW LOW REAL INTEREST RATES LEAD TO UNDERFUNDING OF THE PENSION PLAN.**

A: Interest rates are used to estimate the cost of paying future pensions to current members.

When interest rates drop, pension costs rise. To understand this concept, imagine you are saving for a down payment for a house or car by a specific date. If your savings earn less each year because interest rates are low, you will need to put aside more money to reach your goal on time.

It's the same with pensions. When real interest rates drop, the plan needs to set aside more money to reach its goal.

7 **Q: WHAT STRATEGIES WILL BE TAKEN TO ADDRESS THE SHORTFALL?**

A: A Sustainability Working Group is looking at ways to keep the pension plan affordable and secure for future generations. This group includes representatives from the OTF, government and pension plan management. The group will set out a plan this summer and it's premature to say what the plan will include.

There are a few levers OTF and government can use to address the shortfall: they can raise contribution rates, invoke conditional inflation protection for credit earned after 2009, reduce other future benefits, or adopt some combination of these measures.

8 **Q: WILL THE PENSION PLAN BE THERE FOR MEMBERS?**

A: Yes, members can expect to receive a pension when they qualify to retire. The fund has more than $96 billion in assets, which is enough to pay pensions for many years. But pension plans must look ahead more than 70 years. That's how long the pension plan needs to be funded to pay benefits to all current members and their survivors. And current law protects the value of pension benefits already earned by members. However, it is possible that the benefits members receive when they retire will not be exactly the same benefits that pensioners receive today.

Why? Well, in the same way that your mortgage rate or insurance premium changes depending on circumstances, the pension plan also has to adjust to demographic and economic realities. The sponsors (the OTF and the Ontario government) can change contribution rates and future benefits when required, and they have done so in the past.

About a decade ago, benefits were enhanced using surplus funds. Subsequently, contributions were raised to address funding shortfalls. So periodic adjustments are made to both contributions and benefits when required, but the pension plan continues to be there.

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Q: WHO DECIDES WHETHER TO CHANGE PENSION BENEFITS OR CONTRIBUTIONS?

A: The two plan sponsors, the OTF and Ontario government, decide how to resolve funding shortfalls. They are responsible for defining contribution rates and benefit levels.

The OTF represents members and the Ontario government represents employers.

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Q: WHY IS OUR RATE OF RETURN ASSUMPTION DIFFERENT FROM OTHER NORTH AMERICAN PENSION PLANS?

A: The rate of return assumption estimates how much the plan's investments will earn over time.

There is no single assumption that is universally used by pension plans. Each plan has its own assumptions that reflect its investments, risk tolerance and other unique factors.

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Q: WHO DECIDES WHAT THE RATE OF RETURN ASSUMPTION IS?

A: The pension plan's board members are responsible for determining the rate of return assumption. They draw on advice from external actuaries and the pension plan's internal team of experts.

Before the board decides on the assumption, there is extensive consultation with the plan sponsors and their external actuaries. The consultation may also include an independent review.

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Q: COULD A SMALL INCREASE IN THE RATE OF RETURN ASSUMPTION ELIMINATE THE SHORTFALL? AND, IF SO, WHY ISN'T THIS DONE?

A: The board could assume a higher rate of return to avoid funding shortfalls today; however, if the plan earns less than expected over time that would result in an even larger problem in the future. Conversely, if it earns more, today's teachers and the government contribute more than needed. The board has to consider all factors in deciding what's prudent and appropriate.

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Q: HOW CAN WE HAVE SUCH A LARGE FUNDING SHORTFALL WHEN A FUNDING VALUATION FILED LAST SEPTEMBER SHOWED THAT ASSETS AND LIABILITIES WERE IN BALANCE?

A: Funding valuations are conducted annually, using assumptions as of Jan. 1 of any given year. The Jan. 1, 2009, funding valuation was filed with the pension regulator in September. It showed that the fund had enough assets to meet its projected future pension obligations.

The preliminary 2010 funding shortfall is based on assumptions as at Jan. 1, 2010, by which time the long-term real interest rate had declined to 1.5% from 2.1% a year earlier.

The pension plan is very sensitive to changes in the real interest rate (the rate after inflation). A quarter per cent change in the real rate can cause liabilities to increase or decrease by about $7 billion.

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ONTARIO TEACHERS' PENSION PLAN

aefo Association des enseignantes et des enseignants franco-ontariens

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