

**DISCUSSION PAPER
PROPOSED CHANGES
QUEEN'S PENSION PLAN**

Pension Committee

March, 2005

INTRODUCTION

The University has maintained the current form of pension plan since 1969, with modest enhancements made when circumstances permitted. Based on feedback from Plan members, we believe the Plan is valued highly by a large percentage of our employees and retirees.

The Pension Committee administers the Pension Plan on behalf of the University. As part of its responsibilities, the Pension Committee monitors the Plan to ensure that it continues to meet the needs of Plan members while not placing an unreasonable financial burden on the University. In assessing the continued viability of the Plan, the Pension Committee considers many factors including the expected returns from the capital markets, the longevity of Queen's retirees, and the adequacy of government benefits.

While the Pension Plan was in a surplus position for many years, the most recent actuarial valuation has shown that the Plan's liabilities now exceed its assets by almost \$11 million. The reasons for this weakening of the Plan's financial condition are set out in Section I-8 of this paper.

The actuaries project that this deficit could grow to \$24 million or more by August 31, 2006 and to higher amounts beyond that date unless corrective measures are taken. This change in circumstances led the Pension Committee to undertake a thorough review of the factors contributing to the emerging deficit, and to examine a range of options to address the problem.

For this purpose, a Subcommittee of the Pension Committee was established in December, 2003. The Subcommittee held numerous meetings with our actuaries from Mercer during 2004 and early 2005. At these meetings, the Subcommittee examined in detail a number of possible changes to the Plan's provisions aimed at restoring the financial health of the Pension Plan as soon as reasonably possible.

The purpose of this paper is to give members of the Plan sufficient background to comment on the six changes that the Pension Committee plans to recommend. The Chair of the Pension Committee and the Director, Pensions have already had a number of meetings with the executives of the Faculty Association (QUFA), the Staff Association (QUSA), CUPE Locals 229, 254 and 1302, and with the Retirees' Association (RAQ), and received interim responses from all of these groups. We will also be holding two "town hall" information meetings for the membership at large in the second week of April. The dates are:

Monday, April 11	12:00 – 1:30 p.m.
Wednesday, April 13	5:15 – 6:45 p.m.

Both meetings will be held in **Dupuis Auditorium**.

If the Plan changes are approved at the meeting of the Board of Trustees on May 6, 2005 such changes could become effective September 1, 2005.

Plan members are encouraged to contact members of the Pension Committee should they have questions or concerns resulting from their review of this Discussion Paper.

Members of the Pension Committee

Board of Trustees	Mr. James Angus* Mr. Gordon Hall** Ms. Kathy Thompson*
Ex-Officio	Mr. Andrew Simpson, Vice-Principal (Operations & Finance) Mr. Bill Forbes, Director, Pensions & Insurance & Director, Investment Services
Active Plan Members	Dr. Bill Cannon***, School of Business Dr. James MacKinnon, Economics Ms. Linda McCauley, Health, Counselling & Disability Services Mrs. Bonnie Cuddon, Stauffer Library
Retirees	Mrs. Jessie V. Deslauriers Mr. John Gordon

* Nominees – Board of Trustees

** Board member and Vice-Chair of Pension Committee

*** Chair of Pension Committee

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I. THE CURRENT PLAN

To explain the proposed changes, we need first to describe briefly how the Queen's Pension Plan currently operates. The pension at retirement is determined as the larger of two calculated pensions: the "Money Purchase Pension" and the "Minimum Guarantee Pension", as explained in the next four sections below.

I-1 Money Purchase Pension

Each Plan member contributes 4.5% of salary up to the Canada Pension Plan ceiling (called the YMPE and equal to \$41,100 in 2005) and 6% of salary above the YMPE. The University contributes 6.0% of salary up to the YMPE and 7.0% of salary above the YMPE. These contributions go into each member's Money Purchase Account, along with an additional contribution by the University of 1.5% of member plus University contributions as determined above. This extra contribution began in January 1992, and creates a special reserve so that the Plan can guarantee non-reduction of pensions after retirement. (This concept is explained further in I-4.) The money in each member's Money Purchase account earns interest according to the investment results of the Fund. At retirement, the Pensions Office uses "annuity factors" (explained in the next section) to determine the "Money Purchase Pension" payable from each member's Money Purchase Account.

Money Purchase contributions in 2005 at various salary levels are shown in the following table:

<u>Salary</u>	<u>Contributions by Plan Members</u>	<u>Contributions by the University</u>
\$40,000	\$1,800	\$2,463
\$60,000	\$2,984	\$3,891
\$80,000	\$4,184	\$5,330

I-2 Annuity Factors

Annuity factors are used to convert Money Purchase account balances at retirement into pensions. An annuity factor is simply the lump sum cost of providing a pension of \$1 per year starting at the retirement age and ending on death. The factors at each age are dependent on a number of items, including:

- the retirement age;
- the interest rate assumption (6% under the Queen's Pension Plan);
- the mortality table (used to determine the expected payout period); and
- the type of pension chosen (guarantee period, single or joint life, etc).

For example, the current annuity factor under the normal form of pension (life with a 10-year guarantee) is 11.599 at age 65. If a Plan member retires at that age with a Money Purchase balance of \$300,000, then the Money Purchase Pension is \$25,864 per year ($\$300,000/11.599$).

If an annuity is purchased from an insurance company, the annuity factors will vary from year to year depending on the interest rates at the time of purchase; once the payments start, the amount does not change. In contrast, Queen's uses the rate of 6% to establish initial pensions and then gives pensioner increases according to the "excess interest" earned – that is, the amount by which investment returns averaged over a four-year period exceed 6%. The concept is described more fully in Section I-4.

I-3 Minimum Guarantee Pension

For each member at retirement, a Minimum Guarantee Pension is also calculated, using the formula:

[1.40% * of the member’s Final Average Earnings up to the Average YMPE, plus 1.80% of Final Average Earnings above the Average YMPE] multiplied by the member’s years of credited service in the Pension Plan.

*1.35% for service up to August 31, 1997

“Final Average Earnings” means the average earnings over the 48-month period which produces the highest average, and “Average YMPE” means the average of the YMPE over the same period. The Minimum Guarantee Pension is subject to a Canada Revenue Agency (“CRA”) maximum, which is currently \$2,000 per year for each year of credited service.

To illustrate how the formula operates, consider the following example:

Retirement Date	August 31, 2005
Final Average Earnings	\$ 55,000
Average YMPE	\$ 39,917
Years of Credited Service	30
Total accumulation in Money Purchase Account	\$300,000
Annuity factor at age 65	11.599

The Minimum Guarantee Pension would be calculated as follows:

- (1) Pension for each year of service up to August 31, 1997 =
 $1.35\% \times \$39,917 + 1.8\% \times (\$55,000 - \$39,917) = \810.37
- (2) Pension for each year of service subsequent to August 31, 1997 =
 $1.4\% \times \$39,917 + 1.8\% \times (\$55,000 - \$39,917) = \830.33
- (3) Minimum Guarantee Pension =
 $\$810.37 \times 22 + \$830.33 \times 8 = \$24,471$ per year

The member’s Money Purchase Pension (see I-2 on previous page) = \$25,864 per year

In this case, the Plan member would receive the Money Purchase Pension, as it is higher than the Minimum Guarantee Pension.

To be able to promise the Minimum Guarantee Pension, the Queen’s Pension Plan maintains a Minimum Guarantee Fund, which is entirely created by University contributions and investment earnings on these contributions. The University contributes to the Minimum Guarantee Fund based on the recommendations of the Plan’s actuary.

I-4 Queen’s Pension At Retirement and Post-Retirement Increases

At retirement, each member’s Money Purchase Pension is compared with his/her Minimum Guarantee Pension, and the Plan member receives the greater of the two pensions. If the Minimum Guarantee Pension is greater, in effect some money is taken from the Minimum Guarantee Fund to supplement the member’s Money Purchase Account to bring the pension up to the higher level.

Retired members of the Plan receive contractual pension enhancements based on the annual “excess interest” calculation.

Money Purchase account balances are converted to pensions at retirement using annuity factors which assume a long-term return on 6% per year. Excess interest is calculated each year based on a four-year moving average of the net rate of return on the fund in excess of 6%. If the four-year average return exceeds 6%, pensions in payment are increased by the excess. If the four-year average is below 6%, pensions are not reduced, but rather maintained at their previously-established levels.

From 1981 until 2002, the four-year average of the Plan's investment returns exceeded 6%. For the last two years, however, the four-year average has been below 6% – i.e., the excess interest has been negative. Nevertheless, pensions have not been reduced during this period. The Plan holds a reserve called the Reserve for Non-Reduction (“RNR”) to allow it to pay unreduced pensions until better investment returns raise members' “true” pensions to the level that will once again warrant future pension increases.

I-5 How Has The Plan Worked?

When the Plan was established, it was envisioned that most Plan members would retire under the Money Purchase provisions, due to good investment returns during their working careers. The Minimum Guarantee provisions were designed to provide a “floor of protection” in case investment returns were not as strong as anticipated. Also, the Minimum Guarantee would provide some protection for employees who had shorter-than-average working careers within the Plan.

Since the Plan also “self-insures” pensions at retirement, the annuity factors used at any point in time have been determined based on “best estimates” as to the mortality experience of the Plan's future retirees, at that date.

As we examined what has transpired since 1969, we observed a number of trends:

- Approximately 50% of the pension fund liabilities now relate to retirees; this figure was under 30% ten years ago.
- Our pensioners have enjoyed increasing longevity. Studies have led to the use of mortality tables reflecting Queen's retiree experience which provide for higher longevity than used by almost all other pension plans in Canada.
- While investment returns over the 20-year period ending August 31, 2000 have averaged over 12.5% per year, returns in the next two Plan years were negative. Numerous considerations, including the relatively low interest rates (Government of Canada bonds are currently yielding under 5%) and the low inflation of recent years, suggest that investment returns will be lower in future years - perhaps averaging only 7% to 8%.
- Lower investment returns in future could increase the costs of the non-reduction guarantee for retirees' pensions.
- As a consequence of the second and third bullet points, we now expect that many more Plan members will receive Minimum Guarantee Pensions at retirement than had previously been projected.

I-6 Actuarial Valuation Results

The Pension Committee has a regular “actuarial valuation” of the pension plan completed by our actuaries (Mercer Human Resource Consulting) every two or three years. In November 2004, Mercer completed an actuarial valuation as of February 29, 2004.

The actuary takes the market value of the Plan assets at that date (in millions) \$1,111.0
Mercer then determines the amount of money in:

- the Pensioner’s Fund – i.e., the amount held to provide pensions for those already retired; 529.0
- Money Purchase accounts for active members and deferred members of the Plan (“deferreds” are people who have left Queen’s but are not yet taking their pensions); 536.1
- Additional Voluntary Contribution Accounts: 30.9

The amount of money left over is the market value of the Minimum Guarantee Fund: \$15.0

Since market value results are subject to fluctuation over time, the actuary uses a slightly different approach to “smooth” the calculated value of Fund assets. This is called the “actuarial value” of assets.

The February 29, 2004 actuarial value of the Minimum Guarantee Fund is: \$14.1

Against these assets are liabilities of \$24.8 million, including

- the Reserve for Non-Reduction 6.8
- the Liability for Minimum Guarantee past service benefits 18.0

Since the assets are insufficient to provide for these obligations, we now have an **unfunded liability of \$10.7 million.**

As part of the valuation, the actuary also calculates the “Current Service Cost”. This is the annual amount of money the University should be contributing to the Minimum Guarantee Fund to pay for the Minimum Guarantee benefits which Plan members are earning during the present year. At February 29, 2004, the Current Service Cost for the Minimum Guarantee Pension was determined to be \$1,172,000 annually, which is approximately 1.21% of Plan members’ payroll.

I-7 Impact of Unfunded Liability

Under current pension legislation, the unfunded liability (deficit) of \$10.7 million must be paid off by the University over a period not to exceed fifteen years from the valuation date.

Consequently, the University’s total annual pension contributions have now risen to 8.24% of pensionable payroll, comprised of:

Money Purchase Contributions	6.46%
Minimum Guarantee Contributions	1.21%
Special Payments to pay off deficit	0.57%

It should be noted that the University’s pension costs have risen sharply from the level of 6.04% prior to the most recent valuation date. This means annual pension costs are now \$3 million higher than previously.

I-8 Comments on the Plan’s Financial Condition

While the Plan had a surplus (assets exceeded liabilities) for many years, the Pension Committee was not surprised to see a deterioration in the financial condition of the Plan at February 29, 2004. The Pension Committee was cognizant of the following developments:

- We had observed fewer deaths than expected among our pensioners, even though our mortality tables are very conservative.

- Since investment returns were relatively weak during the inter-valuation period, the latest projections from the actuaries indicate that more Plan members will retire under the Minimum Guarantee provisions of the Plan; this increases Minimum Guarantee liabilities.
- Salaries for those Plan members who will retire under the Minimum Guarantee formula have increased at a rate which is higher than had been anticipated.

Beyond reflecting these developments, the Pension Committee decided that the valuation report at February 29, 2004 should incorporate two changes recommended by the actuaries. These changes are as follows:

1. Mercer's study of the mortality experience of Queen's pensioners from 1999 to date strongly suggests that a further strengthening of the mortality table is appropriate. The suggested change in mortality rates would add about \$20 million to the Plan's liabilities. The Pension Committee has approved the mortality change, but it will be phased-in over three years. The adjustment to the tables for the first installment of the phase-in increases the Plan's actuarial liability at February 29, 2004 by \$7.7 million.

2. Section I-4 of this paper describes how post-retirement increases are granted using "excess interest". This section also highlights a very important feature of the Plan – pensions in payment are never reduced and a reserve for non-reduction (RNR) is held so that unreduced pensions can be paid.

Until recently, the RNR was set at an amount equal to 1.5% of the pensioners' liabilities. Because of the change in economic conditions resulting in lower investment-return expectations, Mercer believes that this reserve may prove to be insufficient, and now recommends that the RNR be increased to 2.5% of the pensioners' liabilities. This increases the Plan's liabilities by another \$6.6 million.

If no changes are made to the Plan, the actuaries project that the financial condition of the Plan will continue to weaken. Their projections reveal that, by August 31, 2006, the Plan's unfunded liability is likely to increase to \$24 million or more, even if the Plan experiences strong investment returns for Plan years 2005 and 2006. This increase is primarily attributable to the two further adjustments to mortality referred to in 1. above.

Initially, the Pension Committee examined whether changes to the Plan's investment policies – particularly those designed to moderate the year-to-year fluctuation in investment returns – could be used to address the growing risk exposure of the Plan. Committee members recognized, however, that such investment policy adjustments – although possibly necessary in future years if changes to the Plan's contribution levels and benefit provisions are not made – would, in all likelihood, stunt the future long-run growth rate in active-Plan-member Money Purchase balances and reduce the future extent of any pension increases for retirees.

Based on this realization and the developments described above, the Pension Committee concluded that it would be preferable to make amendments to the Plan's provisions as the means to restore the financial health of the Plan. Recognizing that the current "hybrid plan" – a combination of money purchase and defined benefit features – is highly valued by Plan members, the changes proposed in the next section of this paper are designed to restore the financial health of the Plan while maintaining its basic structure which has served members so well over the years.

II. PROPOSED PLAN CHANGES

II-1 General Comments

The proposed changes are the result of an intensive, year-long review conducted by the Pension Subcommittee. This Subcommittee was established in December, 2003, and its members are:

Bill Cannon*	Finance Professor, School of Business
Bill Forbes*	Director, Pensions & Insurance and Director, Investment Services
Gordon Hall*	Board Member and Chair of Audit Committee
Glenda Kaye	Director, Financial Analysis & Budget
James MacKinnon*	Econometrician & Head of Economics Department
Andrew Simpson*	Vice-Principal (Operations & Finance)
David Brown**	

* members of the Pension Committee of the Board

** a senior actuary at Eckler Partners, Mr. Brown was hired by the Pension Subcommittee to assist in its deliberations.

During 2004 and early 2005, the Subcommittee held numerous meetings with the Plan’s actuaries (Michael Banks and Lorne Cohen of Mercer Human Resources Consulting). At these meetings, the Subcommittee examined in detail a wide range of possible changes to the Plan’s provisions and settled on the following set of amendments as the best combination to restore the financial health of the Queen’s Pension Plan while preserving its long-standing attractiveness to members.

II-2 Money Purchase Contributions

The increased longevity of our pensioners means that Plan members will need larger Money Purchase account balances at retirement. Since future investment returns are not expected to be as favourable as in the past, increasing the Money Purchase contributions to the Plan is essential.

Therefore, the Pension Committee recommends an increase in contributions equal to 1% of salary, to be shared equally between Plan members and the University. The recommended contribution levels would become:

- for Plan members 5.0% of salary up to the YMPE and 6.5% above the YMPE.
- for the University 6.5% of salary up to the YMPE and 7.5% above the YMPE.

Contributions at various salary levels are shown in the following table (current contributions are shown in brackets):

<u>Salary</u>	<u>Contributions by Plan Members</u>	<u>Contributions by the University</u>
\$40,000	\$2,000 (\$1,800)	\$2,669 (\$2,463)
\$60,000	\$3,284 (\$2,984)	\$4,200 (\$3,891)
\$80,000	\$4,584 (\$4,184)	\$5,742 (\$5,330)

II-3 Minimum Guarantee Benefit Provisions

As mentioned earlier in this paper, the Minimum Guarantee was originally designed as a “floor of protection”. Because long-term investment returns have been so favourable, the majority of retirees have not needed this protection and have retired under the Money Purchase provisions. An analysis from 1993 to 2004 shows that only 16% (176 out of 1,070) of retirees retired under the Minimum Guarantee provisions

While the Pension Committee supports the concept of the Minimum Guarantee, the Committee believes that its application has grown beyond its original intention. This provision is now providing unintended and expensive benefits to higher-earning, short-service Plan members, many of whom have undoubtedly already provided for their retirement savings to some extent through their previous-to-Queen's employment. It is the Pension Committee's view that the Plan can no longer afford to provide the full extent of this unintended and unnecessary benefit.

In order to address this problem, the Pension Committee recommends that, for the purpose of calculating the Minimum Guarantee Pension, pensionable earnings be capped at 2 x YMPE *for future service*. As the YMPE is \$41,100 in 2005, this means that the cap would apply at approximately \$82,000 in 2005. In subsequent years, the cap will increase since the YMPE increases each year. Thus the present Minimum Guarantee benefit will be preserved in its entirety for Plan members whose pensionable earnings are below this cap, while the benefits in respect of future service would be reduced for those with earnings in excess of the cap.

Benefit reductions would only occur for service after the date of the change; the Minimum Guarantee formula *for past service* would be based on earnings without application of the cap.

II-4 Indexing of Pensions-in-Pay

The Pension Committee concluded that a number of changes to the Plan's indexing provisions would also be appropriate. These can be summarized as follows:

- a change from the present four-year average to a six-year average fund return in the indexing formula;
- the use of the geometric or compound average of fund returns, rather than the arithmetic average, in calculating "excess interest";
- the use of the fair market value of account balances at retirement date to determine the amount of a member's initial pension; and
- for calculating the six-year average return, use a standard 7%, instead of actual fund returns, for years prior to retirement.

As these changes are somewhat complicated, additional details are provided below.

(a) Six-Year Average

As noted earlier in this paper, the four-year average return has been below 6% for the last two years. As a consequence, the Reserve for Non-Reduction (RNR) is being utilized to support pension payments at current levels.

Changing to a six-year average will reduce the volatility in investment returns used to calculate "excess interest". This will reduce expected future draws from the RNR (which would otherwise deepen the Plan's deficit) while still providing post-retirement pension increases commensurate with the growth in retired-members' account balances.

(b) Geometric Average

A simple example will illustrate the difference between the arithmetic and geometric average. Suppose an investment at January 1, 2005 has a value of \$1,000, and that investment returns are 10% in 2005 and -5% in 2006. Therefore, the investment grows to \$1,100 at December 31, 2005 but then loses 5% (\$55) in 2006 to end the year at \$1,045.

The arithmetic return is 2.5% per year, i.e. $(10\% - 5\%) \div 2$. The geometric return is approximately 2.2% per year, i.e.

$$\$1,000 \times 1.022 \times 1.022 = \$1,045$$

The geometric or compound average – while slightly more difficult to calculate – is the proper approach to use to determine “excess returns” because the size of retirees’ account balances, whose growth justifies pension increases, grow over time by compounding up annual returns. They do not grow by the arithmetic average return.

The geometric or compound average is always slightly lower than the arithmetic average. However, the differences are relatively small. According to our estimates, the impact on pension payments after retirement under a number of different realistic investment scenarios would reach 0.5% or less – that is, \$250 annually on a \$50,000 pension – after 10 years. For further details on these investment scenarios, please refer to the Pensions Office website [<http://www.queensu.ca/fins/dept/pension.html>]

The Pension Committee believes that the geometric average should be applied consistently in future. Therefore, this administrative change would apply to current retirees *on a go-forward basis* as well as to current active Plan members when they retire.

(c) Fair Market Value

Currently, if a Plan member retires during a Plan year, the initial pension is based on the Money Purchase balance at the prior August 31st increased by subsequent contributions from the Plan member and the University. In effect, a 0% return during the year of retirement is initially assumed.

If a Plan member retires in a year when the investment return is negative, this initial pension is higher than it should be. Reflecting the actually-realized investment return during the retirement year is an administrative change that is consistent with the current Plan provisions. This change will reduce the incidence of the application of the non-reduction guarantee.

(d) Backfill at 7%

Under the current system, investment returns prior to retirement are double counted, i.e.

- in the Plan member’s accumulated account balance at retirement, and
- in the average return used for calculating retiree increases during the first few years after retirement.

This “double counting” works to the advantage of those who retire after a year or two of high returns (from which they benefit twice) but disadvantages those who retire after a year or two of poor returns, as they are penalized twice.

The use of a 7% “expected long-term return” for the pre-retirement return values is designed to provide equal treatment to Plan members with respect to calculating pension increases in their early post-retirement years.

In summary, all four indexing-related changes will impact current Plan members when they retire. Only change (b) will impact current retirees and their spouses. This latter group will not see any reduction in their current monthly pensions, but future increases will be reduced *slightly* from the increases which would have occurred under the current approach.

II-5 Overall Impact of Proposed Plan Changes

Member Perspective

Employee contributions will increase by 0.5% of pensionable earnings.

With the increase in annual contributions of 1% of pensionable earnings (including 0.5% from the University), Money Purchase pensions at retirement will be improved. Our goal is to have Plan members retiring in future with comparable pensions (as a percentage of salary) to those Plan members who have already retired.

The cap on earnings for the purpose of the Minimum Guarantee formula will have no effect on Plan members whose salary is less than 2 x YMPE. Pensions at retirement for these members cannot be less than under the current plan.

Minimum Guarantee pensions at retirement for future retirees with pensionable earnings above 2 x YMPE will be reduced, although many long-service employees in this salary range likely will not be affected because their pensions will be based entirely on their *improved* Money Purchase balances. Also, the cap on credited earnings will apply only to *future* service, which will moderate the impact of this change on existing Plan members.

The largest pension reductions will be for high-paid, late-career hires where the Minimum Guarantee pension would typically apply.

For Plan members who have not reached retirement age, the expected extent of future, post-retirement pension increases will be moderated slightly.

There are two tables at the end of this Discussion Paper. The first table provides some examples of the likely impact of the proposed set of plan changes on a number of hypothetical Plan members. In reviewing the figures in the table, please note the following:

- The first four columns give information at the **current date**.
- The remaining figures are **projections**, showing the annual pension amounts at retirement under three different investment return scenarios – 6%, 7.25% and 8.5% per year.

The second table provides a summary of the key provisions of the current plan and the proposed changes.

Financial Perspective

The proposed changes are projected to stabilize the Plan's projected unfunded liability at August 31, 2006 at \$8 million vs the projected \$24 million under current plan provisions (and the actual unfunded liability of \$10.7 million at February 29, 2004).

The projected University contribution rate at September, 2006 is projected at 7.94% of payroll vs an expected 9.05% under the current plan (and the actual rate of 8.24% as at February 29, 2004).

The projected deficiencies and contribution rates above are based on a “best estimate” of future investment returns of 7.3%. Although the proposed plan changes moderate potential cost increases, it is still possible that the University contribution rate could go significantly higher in future. Mercer has projected possible **long-term** average University contribution requirements, as follows:

University Contribution Rate (% of Pensionable Earnings)		
Annual Investment Return %	Current Plan %	Proposed Plan %
6.0	11.36	9.79
7.25	8.18	7.69
8.5	6.72	6.81

The Pension Committee concluded that the proposals represent a reasonable balance among maintaining benefit expectations, a modest increase in the contributions of employees, and mitigating potential increases in University contributions.

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