To: Faculty, Librarians and Staff, University of Toronto

Date: December 15, 2010

Re: George Luste's Pension Tragedy: Titanic Misinformation

I write in response to yesterday's communiqué from the president of the Faculty Association.

With regret, I observe that Prof. Luste's commentary seems designed primarily to provoke unwarranted panic about the University's pension plan. There is absolutely no rational basis for the picture that he paints. In a nutshell, Prof. Luste has envisioned a very adverse scenario that depends on idiosyncratic assumptions and the wildly hypothetical situation of a complete and permanent cessation of the University's operations. The latter assumption is absurd. However, even were the University to cease operations, its total assets on wind-up would more than sustain the pension plan for all enrollees. Returning to reality, I can affirm that the Administration is following the Ontario Government's new framework for all pension plans. We shall soon be seeking input on a suite of strategies to reduce our pension deficit and put the U of T plan on a stronger long-term footing. For a more detailed response, please read on.

In private exchanges, I have occasionally challenged some of the hyperbole and pessimistic assumptions in Prof. Luste's commentary on the pension plan. My responses have been tempered by personal respect for his decades of service to the institution, and my own agreement with various of the critical comments raised by Prof. Luste about both the pension plan and UTAM.

Today, however, I find myself compelled to express deep disappointment at the alarmist tone and misleading content of Prof. Luste's communiqué. It is arguably irresponsible for a senior member of our community to use his position of influence to circulate an inflammatory analysis of a pension plan that affects thousands of people. To do so just in advance of the holidays is particularly unfortunate, notwithstanding Prof. Luste's attempt at leavening his commentary with an apology for being "a Grinch".

By way of context: The University of Toronto is not alone in having to deal with a significant pension deficit. Many defined benefit plans in the broad public sector in Canada as well as in the US are in the same position. Some plans have opted to reduce future benefits – for example, the Ontario Teachers Plan and the University of California Plan. Most are also seeking to increase member contributions.

Past members of the University of Toronto have enjoyed excellent pension benefits, and I want to assure retirees that they can count on those benefits continuing for their lifetimes. For current members, the plan can be put on a sustainable footing with moderate increases in contributions that align us appropriately with our peers. To ensure, however, that future generations of students and staff are not forced to underwrite the plan unfairly from tuition revenues and the University's operating budgets, we must take action to reduce the past service deficit in the plan.

The size of that deficit is currently $1.1B – a total that is daunting, but bears little relationship to the much larger amount projected by Prof. Luste. That difference arises because Prof. Luste's

projections are based on constructs and assumptions that represent his personal view of the history and future of the plan and the long-term prospects for the global economy. It is truly puzzling that Prof. Luste would promote his projections as definitive without obtaining independent actuarial advice.

As members of our community can imagine, the Administration has been steadily working through a set of strategies that will enable the institution to deal with this cumulative pension deficit. We are in a very long-term game here. However, the earlier we take steps to change the trend-lines, the faster this situation will resolve itself.

Our goal is therefore to balance the positive impacts of faster remediation against the need to contain the negative impact of significant additional payments on the fabric of the institution. While some short-term commitments must be made to start the process, we shall be considering a range of financing strategies that amortize the impact on the operating budget. Our frustration with this situation is doubtless more than matched by the feelings of the members of our community who are also affected. We shall be seeking input and ideas on strategies early in the new year, not least through the governance process. But I am confident that, while there will be difficult choices, the impacts will be time-limited and manageable. That view, I repeat, is shared by many who have both relevant expertise and experience derived from analyzing countless institutions and pension plans.

How then does Prof. Luste arrive at his doomsday scenario?

The first and over-riding failure of his analysis is an insistence that everyone must think about the pension deficit primarily in terms of 'wind-up' costs. The wind-up solvency test for pension plans is the one that has repeatedly been criticized as poorly applicable to public institutions. It was designed for private corporations that can go out of business in the near or medium term. Plan assets should therefore be sufficient to ensure that pensions are covered, given the harsh reality of bankruptcy proceedings in the private sector.

A second's reflection will show that such a scenario is nonsensical in our context. The University has operated for 183 years. We have sister institutions that are more than 800 years old. This "great good place" will be here and thriving hundreds of years hence.

Let us imagine, however, that we were somehow to close our doors. The land and buildings of the University on three campuses have a value amounting to several billion dollars. Combining the pension plan assets and the real estate assets, and subtracting current borrowing, the net proceeds exceed the actual pension wind-up deficit by a margin well in excess of a billion dollars. This, moreover, is true without factoring in what would by that time be a major endowment fund.

A second problem arises from Prof. Luste's interpretation of the history of the pension plan. Indeed, Prof. Luste favours an independent inquiry into past pension "holidays", as if the process of putting his predecessors or mine in the docket would somehow generate funds for the plan. The reality is that contributions were not taken away mindlessly for the 18 years he highlights. For much of that period the pension surplus was sufficiently high that the Income Tax Act

simply prevented the University from making any contributions – as was the case for many other plans in those years.

Furthermore, a substantial tranche of the money that did not go to the pension plan was used to fund pension improvements for active and retired plan members. Improvements included initiation of the Supplemental Retirement Arrangement (SRA) that enabled plan members to have pension coverage for salaries above the usual cap set by the Canada Revenue Agency. Surplus funds also catalyzed the hugely successful Campaign for U of T by matching donations for scholarships, endowed chairs and professorships, and other academic priorities.

Finally, during the time of the Social Contract, the Ontario Government suggested that pension contribution holidays could be used to meet the some or part of the required compensation reductions – and the University did so with UTFA's agreement. Indeed, many of these initiatives were negotiated with and agreed by the Faculty Association. All were discussed fully and openly and incorporated into the University's budget reports.

Nonetheless, to support his view that these contribution holidays were wrong-headed, Prof. Luste alleges that the plan actuary wilfully manipulated assumptions over the years to create an artificial surplus. Our actuary is nationally respected for his integrity and expertise, and the assumptions for U of T have consistently been in full alignment with the standards for other plans. In contrast, Prof. Luste's analysis depends on unusual assumptions about investment returns. His assumptions, if widely applied, would put the vast majority of pension plans in Canada into a solvency crisis. Small wonder, then, that Prof. Luste's analysis inflates the anticipated deficit for the U of T plan. Furthermore, he projects forward the value of the "missing contributions" as if they are relevant and factors them into his wind-up solvency projection. The result is an elegant exercise in perfecting chagrin.

I should add that this Administration has repeatedly affirmed that we are opposed to pension contribution holidays. We have also signalled our interest in working with UTFA to lock in contributions and ensure a safe haven for funds in the event that a surplus is again generated in the plan many years from now.

As to UTAM, George Luste was the most visible of a number of internal critics of the previous oversight mechanisms and investment philosophies. In yesterday's communiqué, however, he continues a pattern of post-hoc investment analysis, emphasizing a missed opportunity to buy high-yield inflation-proofed bonds in 2000! In investing, hindsight is both perfect and unhelpful. Financial markets, moreover, rise and fall and rise again. A constant prediction of adverse events will always be validated at some point but should not be confused with keen foresight.

Notwithstanding these differences of perspective, I have fully shared Prof. Luste's frustration with UTAM, and undertook a comprehensive restructuring of its governance last year. An entirely new group now oversees the investment strategy. That group consists of outstanding individuals who are focused on long-term portfolio management. The membership, which I will introduce more formally in the new year, includes leaders with experience in risk management, large-scale trusts, insurance assets, and pension funds. Major changes continue at UTAM and I believe they will pay off handsomely in the years ahead.

For now, suffice it to say that we lost more money than most other Canadian plans in 2009, while we made more than most in 2007. Neither fact is very relevant because our focus is long-term. And, on that longer-term basis we are tracking back towards our return target – a target that Prof. Luste chops more or less in half to generate his doomsday scenario.

Given the assumptions underlying that scenario, it is regrettable that Prof. Luste framed his analysis with inflammatory language that could cause needless anxiety for University pensioners and current members of our community. Prof. Luste goes so far as to counsel current faculty to consider retiring and cashing out their pensions. He also suggests that new faculty should not join the plan – advice that amounts to a direct attack on recruitment and renewal in every department of the University. I suggest we instead consider the University as others see it, even as the President of the Faculty Association calls for current faculty and librarians to head for the lifeboats and for others to avoid the good ship that has given him a livelihood for more than thirty-five years.

The University's finances have very recently been reviewed by private credit agencies. These agencies have become more cautious after stringent criticism of their methodologies in the wake of the financial crisis of 2008. Yet this fall, the Dominion Bond Rating Service, a Canadian company, gave U of T a stable AA rating -- slightly better than the credit rating of the Province of Ontario itself. DBRS was fully aware of the University's pension liabilities. Moody's, an international company, rated U of T as Aa1 stable, and wrote as follows: "Over the medium term, the impact of increased unfounded pension liabilities and the policy to provide scholarships to all qualified students could place additional pressure on expenditures. Nevertheless the university's prudent budgetary policies provide comfort that it will be able to successfully manage these cost pressures."

Then there is the Province of Ontario, which has undertaken a comprehensive analysis of each university's pension plan as part of a general review of public and private pensions. The relevant Ministries have recently set out their expectations for exactly what steps should be taken and what funds must be committed for each University's plan to be considered sustainable and solvent. These steps and funding requirements align with everything that has been communicated repeatedly by my Administration – and those funding requirements bear no resemblance to Prof. Luste's Titanic numbers.

Let me therefore conclude this message on a happier note. We have an amazing University, full of outstanding faculty, staff and students. Our performance in myriad dimensions of our mission is extraordinary. We will need to tighten our belts for a limited time to put the pension plan back on a firm footing, and we also must contribute appropriately for the post-retirement benefits we are slated to receive. However, I am personally committed to a long view and to examining how to leverage our varied institutional assets to reduce the pension deficit. Our intent is to strike a balance between making the requisite payments early to start containing the deficit, and ensuring that we mitigate the effects of those payments on our core academic operations. I don't expect it will be easy sailing. However, the University of Toronto is wonderfully resilient and enjoys a massive base of external support. We also enjoy a certain immunity, born of a remarkable history over more than 180 years, from the overwrought prognostications of those who see

icebergs in the waters all around us. I am confident that the voyage of the next few years will have its stresses and strains, but will be marked above all by high achievement and continued institutional success.

I wish you a wonderful holiday season, and look forward to seeing you in 2011.

Yours sincerely

David Naylor