TORONTO

STAFF REPORT
ACTION REQUIRED

Adequacy of Employee Benefits Reserve Funds

Date:	September 22, 2008
To:	Executive Committee
From:	Deputy City Manager and Chief Financial Officer
Wards:	All
Reference Number:	P:\2008\Internal Services\Cf\Ec08028Cf – et (AFS #7207)

SUMMARY

The purpose of this report is to report on the City's non-pension employee benefit liabilities as at December 31, 2006, extrapolated for the years 2007, 2008 and 2009. Specifically, these include the post-retirement, post-employment, sick leave gratuity and self-insured Workplace Safety Insurance Board (WSIB) benefit plans for the City of Toronto, Toronto Police Services and the City's Agencies, Boards and Commissions. Groups that are not part of this report include Toronto Hydro, Toronto Community Housing, Toronto Parking Authority and the Toronto Transit Commission.

This report will also comment on the adequacy of the employee benefits reserve funds and provide options to adequately fund the benefit liabilities.

By introducing measures to more fairly allocate the true cost of non-pension benefits across all Divisions and ABCs, it is possible to initially stop the growth in employee benefits net liabilities and allow the associated reserve funds to start building up to a recommended target of two times cash costs.

RECOMMENDATIONS

The Deputy City Manager and Chief Financial Officer recommends that:

1. Council set two years of employee benefit cash costs as a target balance level for the consolidated employee benefits reserve funds.

2. Consideration be given in the 2009 Operating Budget to increase the non-program contribution to the consolidated employee benefit reserve funds by $4 million to $43 million.

3. Council endorse, in principle, a plan to require Agencies, Boards and Commissions starting in 2010 to contribute annual funding to the Sick Leave Reserve Fund that matches budgeted withdrawals.

4. Staff revise the annual benefits charges to Divisions and applicable Agencies, Boards and Commissions on a staged basis over three years starting in 2011 to reflect additional funding requirements for retired employees, employees on long-term disability, workplace safety (pre-amalgamation) and sick leave gratuity payouts.

Financial Impact

The City has a projected employee benefit actuarial liability of approximately $2.1 billion as identified in a valuation report prepared by Mercer Human Resource Consulting for the year ended December 31, 2007. Mercer's projections of actuarial liabilities from December 2006 to December 2009 are provided in Appendix A. About $240.1 million of this liability is funded by reserves as at December 31, 2007, leaving a net liability of approximately $1.8 billion. The unfunded portion of this liability will be financed from future revenues. Left unabated, the liability will continue to grow as a result of additional accrued benefits and the increased value of accruals in current year dollars. The net liability has grown from approximately $1.5 billion on December 31, 2004 to approximately $1.8 billion on December 31, 2007.

The major credit rating agencies have identified the unfunded portion of employee benefits liabilities as a negative ratings factor. Standard & Poor acknowledged that while the City of Toronto does have a plan to fund these liabilities, however progress to-date has been slow.

The recommendations will have future year operating budget implications as estimated below:

Operating Budget Impact (in $ Millions)				
2009	2010	2011	2012	2013
4.0	11.3	11.7	11.7	11.7

DECISION HISTORY

City Council on May 4, 2005 adopted the following recommendations in a report entitled "Adequacy of Employee Benefits Reserve Funds" dated March 21, 2005, from the Deputy City Manager and Chief Financial Officer:

1. Council endorse in principle the Employee Benefits Reserve Fund replenishment plan contained in Table 2 whereby the net contribution to the City's Employee Benefits Reserve Funds be increased by $15 million per year beginning in 2006 until such time as these reserve funds maintain a balance of 4 years of employee benefit cash costs;

2. these funding recommendations be considered during the 2006 budget process; and

3. the appropriate City officials be authorized and directed to take the necessary actions to give effect thereto.

http://www.toronto.ca/legdocs/2005/agendas/council/cc050412/pof4rpt/cl022.pdf

ISSUE BACKGROUND

Due to budgetary constraints, only $4 million of the recommended $90 million (2006-2008) have been added to the Employee Benefits Reserves Contribution through 2008. The 2005 Council-endorsed plan recommended a $15 million infusion into the consolidated employee benefits reserve funds starting in 2006 with subsequent year infusions increasing by $15 million until such a time that the balance equalled at least 4 times the annual employee benefit cash costs.

COMMENTS

Benefit Liabilities

As directed by the Province, the City must follow the Generally Accepted Accounting Principles (GAAP) set by the Canadian Institute of Chartered Accountants' Public Sector Accounting Board (PSAB). PSAB requires that expenses be recognized in the books of an entity when:

- goods and services are received by the entity (as opposed to when they are paid for)
- when an event occurs which will likely result in a future payment by the entity (i.e. a liability has been incurred).

Both these principles apply to the City's "post employment", or future employee benefit liabilities. The first principle applies to benefits that are earned by employees during the time they work for the City but are payable to them when they have completed their service. Pensions, retiree health & dental benefits and unused sick leave are all benefits that are earned by employees during their years of service with the City but the actual payment of these benefits begin once they leave the City's employ.

In order to reduce operating costs and the future employee benefit liability, a new sick leave policy was implemented in March 2008. For management and non-union employees, those employees with less than ten years service with the City are no longer entitled to a payout of their banked sick days upon termination. Instead, these employees are placed in the new Short Term Disability Plan and will receive 130 days to be utilitized towards short term illnesses and non-compensable injuries throughout the year. Employees with over 10 years of service have their sick days and service frozen and will receive a payout of those frozen days upon termination, based on the various pre-amalgamation policy provisions.

The second principle applies to the City's Worker's compensation and long-term disability obligations. When a City worker is hurt on the job or contracts a serious long-term illness, it can trigger future medical and disability payments. The recognition of the entire expected expense and corresponding liability occurs at the time the injury or illness occurs even though the actual payment of the benefits may occur over several future years.

The amount of the liability does not represent the cumulative amount of benefits that will be paid to existing retirees and current staff upon their termination. Nor does the liability represent the City's liability if the City was "wound up". The liability represents the cumulative amount payable to existing retirees (discounted to its present value) and the amount "earned to date" of the current employees. For current employees, a "current service" cost is calculated each year to determine what portion of the benefit has been earned in that year and ultimately will be received when they cease working. The current service cost increases the liability each year. Actual payments made to retirees and terminating employees (in the case of sick leave) reduce the liability. For the past several years, the City's current service costs have been significantly larger than the actual payments being made to employees. In 2007, the City's consolidated current service cost of future benefits exceeded payments to employees such that as at December 31, 2007, the net liability grew to approximately $1.8 billion, or approximately $100 million per year over the past five years.

All of the City's employee benefit plans have been harmonized and provide for retiree benefits, equal to the level of benefits provided to active employees, to age 65. Although some former municipalities provided lifetime benefits (post age 65 retiree benefit plans), all retiree benefit plans at the city now cease at age 65. There is a small life insurance policy that continues after age 65. Some employees, due to their age, and/or length of service were grand-parented and continue to have access to the lifetime retiree benefits from their former municipalities.

Accounting vs. Funding

It is important to distinguish between the accounting recognition of the employee benefit liability for financial statement reporting purposes and how the liability is actually funded by the City.

Unlike pensions, there is no legislative requirement to fund post employment liabilities as they are earned. It is at the City's discretion to fund the benefit payments on a cash basis (actual payments in the year) or on an accrual basis (current service cost earned in the year) or somewhere in between.

Due to the permanent nature of the City, a portion of the liability will never become due. If the size and age profile of its work force remains relatively stable, the employee benefit liability would eventually stabilize as the size of the actual payments made to retirees and terminating employees matches the current service cost earned by current employees. In effect, the employee benefit obligation would continuously "turn over" as old obligations are "retired" (payments to retirees) and new obligations are "issued" (younger workers providing service). This is no different than the City's existing policy of replacing old debentures that have been repaid with new debentures for new projects that essentially stabilizes the City's debenture debt, exclusive of new debt requirements.

However, the City's workforce and the City's employee benefit liability may never reach a stable state. Growth, collective agreements, service transfers, service changes and legislative changes can all impact the City's workforce and the employee benefit liability. Actual payments of post employment benefits will also be affected by these changes and will be subject to peaks and valleys.

Therefore the City should base its funding on the objective of smoothing the peaks and valleys of the actual spending and the setting aside of a strategic amount of funding for extraordinary events such as large numbers of early retirements or employee terminations that would result in one-time significant payouts.

The consulting firm of Mercer Human Resources Consulting (Mercer) was retained to perform a valuation and funding analysis of the benefit plans for the City of Toronto as at December 31, 2006. In addition they were asked to extrapolate the valuation results for the purpose of reporting in the City's financial statements for fiscal years 2007, 2008 and 2009. Appendix A provides a breakdown of the $2.0 billion actuarial liability for the City by employee group and by benefit type as at December 31, 2006 and a projection of actuarial liabilities from December 2007 to December 2009.

A summary of the accrued benefit obligation (actuarial liability) as at December 31, 2006 and the projected results over the following three years are as follows:

TABLE 1
Summary of Actuarial Liability – December 31, 2006

(in $Mil.)	12/31/06	12/31/07	12/31/08	12/31/09	Average Annual % Change
Post-Retirement	$1,245.9	$1,303.6	$1,363.2	$1,423.8	4.8
Post-Employment	$271.6	$290.0	$309.2	$329.3	7.1
Sick Leave Gratuity	$276.7	$239.6	$229.2	$237.8	-4.7
Self-Insured WSIB	$230.7	$246.3	$262.3	$278.8	6.9
Total Liability	$2,024.9	$2,079.5	$2,163.8	$2,269.6	4.0
Employee Reserve Balance	$238.2	$240.1	$240.1*	$240.1*	-
Net Actuarial Liability	$1,786.7	$1,839.4	$1,923.7	$2,029.5	4.5
Increase over Prior Year		$52.7	$84.3	$105.8	

*assumes that reserve balances remain at current levels

The Sick Leave Gratuity is the only liability that is forecasted to decline between 2006 and 2009, at least in part due to Council's approval of the policy change in March, 2008 as noted earlier. However, because the Sick Leave Reserve Fund continues to be drawn-down, the net liability is projected to grow.

The total liability has been identified to be $2.0 billion as at December 31, 2006, and is projected to increase to $2.3 billion – an average annual increase of approximately $80.9 million. As of December 31, 2007, the City had employee benefit reserves totaling $240.1 million, resulting in a net unfunded liability of approximately $1.8 billion. The employee benefits reserve fund balances as at December 31, 2004 and December 31, 2007 are as follows:

TABLE 2
Reserve Fund Balances – Dec. 31, 2004 and Dec. 31, 2007

Reserve Fund ($mil)	Dec. 31, 2004 Balance	Dec. 31, 2007 Balance
Workers Compensation	10.8	$13.1
Employee Benefits	144.4	$163.6
Sick Leave	81.3	$59.4
Police Central Sick Pay	1.7	$4.0
TOTAL	$238.2	$240.1

Ernst & Young, in its 2004 Management Letter, recommended that the City put in place a process to ensure that the full valuations are performed on a routine basis. In addition, they recommended that for those periods in between formal valuations, the City estimate the impact of any benefit changes made through labour negotiations on the recorded liability.

The City has agreed with these recommendations and actuarial valuations are conducted every three years. During those years between formal valuations, the City retains an actuary to appropriately cost any benefit changes that would impact the employee benefit liability. This information is used not only during collective bargaining but also when dealing with grievances and arbitrations.

Problem Definition

Reasons for Stagnant Employee Benefits Reserve Funds

The employee benefit reserves have not grown with post-employment benefit liabilities for the following reasons:

- Extraordinary draws from the benefits reserves to pay for wage settlements and arbitration awards
- Excessive draws over Contributions from the Sick Leave Reserve Fund by the Police Services Board and other ABCs.
- Annual Employee Benefits Charges to Divisions only factor in the cash costs of funding active employee benefit plans and do not include costs related to retirees still receiving these benefits, long-term disability, pre-amalgamation WSIB claims, Sick Leave, pension deficit funding and employee separation costs.

The 2005 Council-endorsed recommendation to replenish the reserves was aimed at addressing this issue, however, other Council priorities have resulted in these funds not being made available.

Council-approved Extraordinary Draws

While extraordinary draws related to amalgamation (ie job evaluations, pay equity, etc.) are essentially completed, the City can always be subject to awards/decisions/pension deficits that have a significant financial impact for which the only source of funds is the consolidated employee benefits reserve fund.

Excessive Draws Over Contributions from the Sick Leave Reserve Fund

Since January 2002, the Sick Leave Reserve Fund has been drawn down from $92.8 million to $59.4 million at the end of 2007. A review of inflows and outflows during this period shows that some ABCs have been accessing this Fund, and while generally making a fixed contribution amount each year, withdrawals have been variable and in some cases, they have exceeded the contributions by a large margin. For all ABCs, the excess of draws over contributions amounted to approximately $11.3 million in 2007.

TABLE 3
Contributions and Draws from Sick Leave Reserve Fund ($ Mil.)

Year	Source	Contributions	Draws	Opening & Closing Balances	Net Draws
2002	ABCs	$8.7	$17.1	$92.8	
	Investment Income	$4.8		$89.2	3.6
2003	ABCs	$2.9	$14.0	$89.2	
	Investment Income	$5.0		$85.1	6.1
2004	ABCs	$9.0	$16.8	$85.1	
	Investment Income	$4.0		$81.3	3.8
2005	ABCs	$5.0	$16.1	$81.3	
	Investment Income	$3.8		$74.0	7.3
2006	ABCs	$5.4	$16.2	$74.1	
	Investment Income	$4.0		$67.3	6.8
2007	ABCs	$5.5	$16.8	$67.3	
	Investment Income	$3.4		$59.4	7.9
Average Annual Net Draw					**5.9**

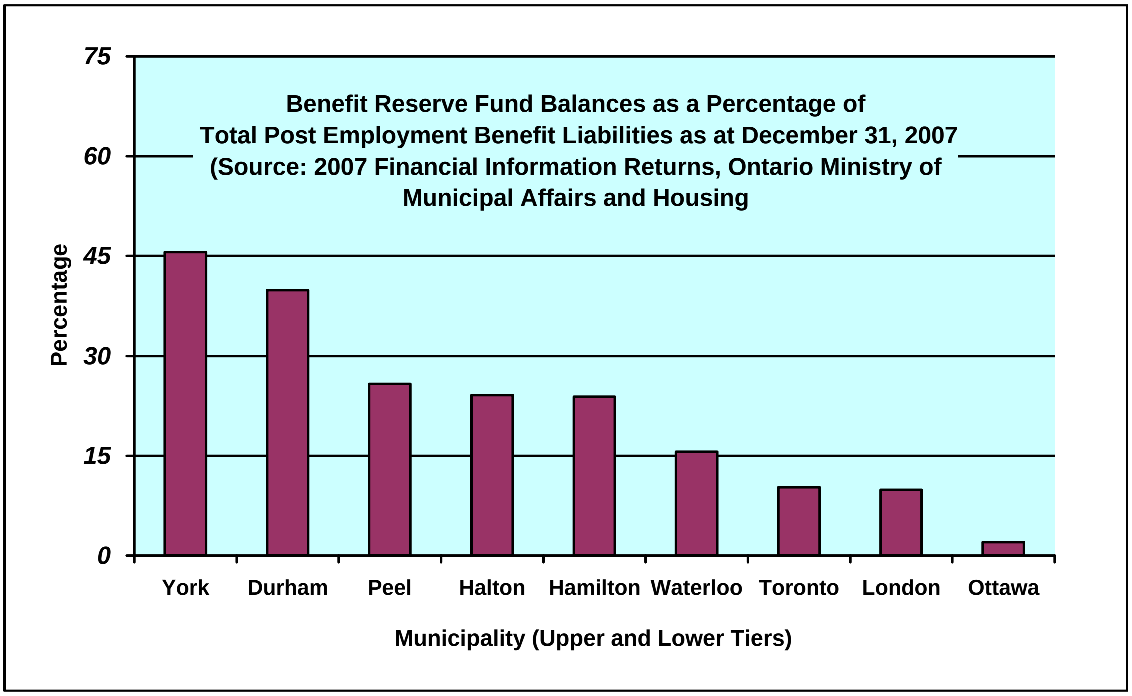
Long Term Funding Options

As previously discussed, the employee benefit actuarial liability (net of reserves) stood at $1.8 billion on December, 31st, 2007. Three options have been identified to address the liability in terms of sufficiency of funds being set aside to pay for the existing liability level. They are as follows:

Option 1: Reserve Balance as a % of Gross Liabilities

Chart 1 demonstrates that the City of Toronto is significantly under funding its employee benefit liabilities when compared to other GTA municipalities. The ratio of employee benefit reserve funds to total post-employment benefit liabilities is typically in the 15% to 45% range for most of the larger municipalities (upper and lower tier combined) in Ontario compared to 10.3% for the City of Toronto. Therefore, if the City of Toronto's employee benefits reserve fund balance was closer to $600 million, then it would be more in line with the comparable levels of other larger municipalities in Ontario.

CHART 1 – Benefit Reserve Fund Balance of Various Municipalities/Cities



Unlike the private sector, the public sector's existence as an on-going entity is reasonably assured, so in effect, there is no need for the City to fund 100% of the liability.

Mercer projects that the City would have to increase the tax levy by $218 million to fully fund the liability in 15 years and by $164 million to fund 60% of the liability in 15 years. This approach establishes a level amortization schedule that builds up the reserve over the fifteen year period through earned interest in order to draw down the net liability. By extrapolation, the extra tax levy needed to fund 30% of the liability would still be a prohibitive at approximately $82 million. Given the City's current financial situation, it is not financially feasible to implement such strategies at this time.

Option 2: Maintaining Net Liabilities at Current levels

According to the Mercer benefit valuation, it is estimated that a tax levy increase of $84 million would be required just to maintain the unfunded liabilities at their current levels. Given the City's current financial situation, it is not financially feasible to implement such strategies at this time.

Option 3: Maintaining Reserve Balances Sufficient to Fund Cash Costs Over a Period of Time – Recommended Option

A more financially feasible funding strategy is to build up a reserve balance sufficient to cover projected benefit cash costs over a number of years. The strategy adopted by Council in 2005 set a four year period subject to Council budget review. It is now being recommended that a two year period would be a more reasonable and achievable target, as well as an improvement on the current balance level of 1.5 years. The immediate implication would be achieving a consolidated employee reserve funds balance of approximately $312 million within 2-3 years of implementation, an increase of $72 million from the existing balance. This could be achieved by implementing the recommendations outlined in this report.

Recommended Funding Approaches

Increase the non-program contribution to the consolidated employee benefit reserve funds by $4 million to $43 million.

During the 2008 Operating Budget process, the non-program contribution base contribution to the consolidated reserve funds was increased from $35 million to $39 million in recognition of 2005 Council-endorsed plan to bolster funding. Due to other Council priorities, a higher amount was not possible.

It is advised at this time that consideration be given in the 2009 Operating Budget to increase the non-program contribution base to the consolidated employee reserve funds by $4 million to $43 million.

Full funding of Sick Leave Benefit in 2010

In advance of the 2010 budget year, staff will determine an administrative approach to ensure that Agencies, Boards and Commissions are making annual contributions related to the Sick Leave Benefit that equal budgeted withdrawal amounts. To give effect to this action, it is recommended that Council endorse, in principle, a plan to require Agencies, Boards and Commissions starting in 2010 to contribute annual funding to the Sick Leave Reserve Fund that matches budgeted withdrawals.

Full Recovery of Non-Pension Benefit Costs from City Divisions in 2011-2013

Each year, staff determine the Fringe Benefit Rate to be used by City Divisions, and Agencies, Boards and Commissions for budgeting purposes. The rate takes into consideration both government regulated and employer sponsored plans including the Canada Pension Plan, Employment Insurance, Employee Health Tax, OMERS, Long-term Disability, Extended Health Care, Dental and Life Insurance.

Some costs that are not as easily attributed to specific program areas have been excluded from the rate and instead they are included in the non-program budget as funding to the benefits reserves. They are:

- Benefits for employees on LTD
- WSIB (pre-amalgamation)
- Sick Leave Gratuity Payout
- Retiree Benefits

Other noted uses of employee benefits reserves during 2007 included employee separation costs ($0.5 million) and Pension Deficit Funding ($7.6 million).

The implication of using employee benefits reserves each year to fund these costs is that the full benefit of the annual operating budget contribution to the consolidated employee benefit reserve funds is used to fund these benefits instead of funding growth in the reserves to keep up with the annual liability growth.

In order to achieve a fair and equitable recovery of the full cost of Non-Pension benefits going forward, staff can revise the annual benefits charges to Divisions and applicable Agencies, Boards and Commissions on a staged basis over three years starting in 2011 to reflect the additional funding requirements for retired employees, employees on long-term disability, workplace safety (pre-amalgamation) and sick leave gratuity payouts.

CONTACT

Len Brittain, Director, Corporate Finance Division; Telephone: (416) 392-5380;
Fax: (416) 397-4555; E-mail: lbrittai@toronto.ca

SIGNATURE

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Joseph P. Pennachetti
Deputy City Manager and Chief Financial Officer

ATTACHMENT:

Appendix A – Projection of Actuarial Liabilities from December 2006-December 2009

Appendix A

Projection of Actuarial Liabilities from December 2006 – December 2009

	12/31/2006	12/31/2007	12/31/2008	12/31/2009
City of Toronto	$1,439,978,722	$1,488,380,287	$1,552,186,422	$1,627,039,651
Toronto Police Service	$508,887,814	$513,092,268	$530,159,907	$556,564,633
Toronto Public Library Board	57,494,423	58,345,267	60,564,063	63,643,916
Toronto Zoo	8,815,502	9,178,456	9,714,055	10,353,011
Exhibition Place	7,184,216	7,713,047	8,241,428	8,804,836
Other ABCs	$2,572,219	$2,761,501	$2,978,324	$3,220,352
Grand Total	$2,024,932,896	$2,079,470,826	$2,163,844,199	$2,269,626,399