CAPE Pension Update
Partially Sunny with Storm Clouds on the Horizon

June 2014

This spring we've seen a raft of pension developments, including a government announcement on "target benefits", a new report on "fair value" accounting from the C.D. Howe Institute, significant press coverage on public service pensions, and most notably, the spring 2014 report from Canada's Auditor General. Unfortunately, most analysis done up until now have been based on short term accounting principles rather than on more long term actuarial considerations. As you will see below, if the Public Service Pension plan is doing well in difficult economic times, it will do even better when the economy improves.

No Immediate Changes to Federal Pension Plans

Following the release of the Auditor General's Report on Public Sector Pension Plans, the government indicated that its employees will be given a period of pension peace for the next three years:

> *"… I've indicated over the next round of collective bargaining that for the next three years, the focus is going to be on sick leave and absenteeism, not on further pension reforms, and I feel comfortable that that's the right thing to do,"* said Treasury Board President, Tony Clement.

Such news comes as a welcome respite for beleaguered government employees facing a difficult round of collective bargaining.

> *"The Treasury Board President surely must be aware that federal legislation restricts the bargaining in good faith of pensions, as well as classification and staffing matters. To imply that pension reforms are not on the bargaining agenda is misleading,"* said CAPE President, Claude Poirier.

The Auditor General's Report on Public Sector Pension Plans

In his latest report, Auditor General Mr. Michael Ferguson highlighted shortfalls in pension plan governance and combined economic and demographic challenges facing Canada's public service pension plans. Other revelations in the report raise concerns regarding the direction of federal public sector pension plans.

ACEP
Association canadienne des employés professionnels

CAPE
Canadian Association of Professional Employees

Good Governance and Sustainability

If one had to summarize succinctly the main findings of the Auditor General's report, the key words would be "governance" and "sustainability". As Mr. Ferguson expressed it:

> *"…The government has a statutory obligation to pay pensioners and is fully responsible for any funding deficit… In this context, it would be reasonable to expect that plans be designed to ensure they are sustainable and affordable."*

While acknowledging that government organizations responsible for overseeing these pension plans have met their statutory obligations, there is no organization responsible for ensuring sustainability. In general, the audit found that the governance framework for public sector pension plans does not reflect good practices and needs to be strengthened. The Auditor General best expressed the need:

> *"…Think about a brand new employee in the government starting today at, say 22 years old; they want to know that the pension plan is going to be around for, let's say 70 years. So it's very important that somebody have that responsibility."*

Additionally, the report found that the pension governance framework does not include a funding policy with an expressed level of risk tolerance; the financial information produced by the responsible entities is dispersed among several reports and is not easy to read, and consequently Canadians and concerned stakeholders (plan members) are not informed in a clear and consolidated manner; and the Department of Finance has not concluded its analysis on the costs and benefits of funding the pre-2000 pension obligations. As expected, the government responded and will take action to meet all the recommendations contained in the report.

> *"CAPE supports all efforts to improve pension administration, good plan governance and communications to plan members and the public. However, we are concerned about demographic change and remain steadfastly opposed to government initiatives to shift plan costs and risks to our members. We have to keep in mind that the current information available comes mostly from think tanks or politicians, not from the plan managers or the investment managers,"* said Association President, Claude Poirier.

Economic and Demographic Challenges

The report further noted that since the 2008 recession and financial turmoil, financial markets have seen increased volatility and low interest rates. At the same time, federal government pension plans have experienced lower than expected earnings, while life expectancy has been increasing. These factors all work to increase plan costs and could potentially impact plan sustainability. In the last three years, public sector pension funds experienced a gap of $6.5 billion compared to actuarial evaluations. Special payments were made to fill the gap, on a yearly amortized basis, with no impact on the government's financial position. However, given returns on investment achieved last year and over the last ten years by the Public Sector Pension Investment Board (PSP Investments) – 10.7% last year and an annualized return of 8.4% over ten years, plan members and other stakeholders must rest assured that their plan is sound.

As CAPE has demonstrated previously, despite the government's expressed obligations, opportunities to download costs and risk to employees are exploited whenever possible (read the article "Pension Issues — Supreme Disappointment" in CAPE Annual Report, 2012-2013). In responding to the Auditor General's observations on sustainability, the TB Secretariat indicated that:

> *"…Sustainability supported pension plan changes announced in Budget 2012, raised employee contributions to 50% over a five-year period and increased the normal age of retirement to 65, as of January 2013. These changes will provide $2.6 billion in savings by the 2017-18 fiscal year, and over $900 million in annual savings thereafter."*

One has to wonder if such changes would have been necessary had the government not taken the nearly $30 billion surplus from the pre-2000 pension plan. Over the next 30 years, the increased employee contributions should almost total the surplus confiscated by the federal government. With reduced benefits afforded to new plan members, is this government preparing another surplus that it will then appropriate?

> *"One would expect that given current economic circumstances, there would have been a comment from the Auditor General on the prudence of the past government's pension surplus grab. Unfortunately, the scope of the audit did not include that time period",* commented CAPE President Poirier.

Further concerns

All entities associated with the governance of the public serve pension plans have agreed to the recommendations of the Auditor General. However, while the Treasury Board Secretariat has acknowledged in its response that it is committed to regular assessments and expert advice to ensure the sustainability of government pension plans, it would not share its analysis with the Auditor General, citing Cabinet and budget confidentiality. Secretariat officials had admitted to the Auditor General that they had analyzed other pension designs, such as defined contribution plans, hybrid plans, and changes to the age of retirement. Clearly all employees and their representatives should be concerned about this work and its implications going forward. Why are these new pension schemes being analyzed and why is there no consultation or public discussion?

> *"Consultation could easily be done through the existing Public Service Pension Advisory Committee. Unfortunately, the PSPAC has not met formally for almost two years",* according to President Poirier.

Moreover, the conservative government has unilaterally imposed a 50/50 contribution arrangement on its employees without offering an appropriate governance change from employer-only management of the pension plan to co-management of the plan. Employee representatives on a management board would certainly have an interest in both sustainability and transparency. As we have witnessed so far, it is questionable that an employer-only management of the fund can meet these requirements. The Auditor General's report is silent on this matter.

Proposed Pension Changes for Federally Regulated Employees

In addition to the previously noted concerns, CAPE has noted other pension related actions by the federal government harmful to employee interests. In late April 2014, the Minister of State for Finance announced the consideration of "target benefit" pension plans for federally regulated workers, who currently contribute to defined benefit plans. The minister announced that there would be rushed consultations on its proposal and that it would require amendments to the federal pension laws. Such targeted plans provide for a reduction in benefits to both contributing employees and pensioners. There is no guarantee that promised benefits will be maintained in retirement. Such a pension scheme shifts all risk from employers to employees. While the government gave assurances that such changes are not intended for the core public service, these actions open the door to the erosion of public service pension benefits. CAPE is opposed to the introduction of any such schemes in the federal public service.

> *"We don't want to see our members facing suddenly reduced or discounted pensions in retirement like Nortel employees experienced",* added CAPE President Poirier.

The Public Perception

Naturally, in the period leading up to the release of the Auditor General's Report, the media and other interest groups were active in attacking public sector pension plans. The press, for its part, referred to these plans as "gold plated" or "most generous". Such descriptors are inaccurate given the objective comparisons that have been made as part of the federal government's own benchmarking studies. In a 2007 study commissioned by the Treasury Board, consultants compared the federal public service plan with 18 other large private and public sector pension plans. CAPE's reporting of this analysis (Read the article "Federal Public Service Pensions – The Cadillac Myth" in Professional Dialogue, August 2010) demonstrated that, by all measures, public service pension plans are average when benchmarked against other large comparable plans. Budgetary changes in 2007, and more recent changes to federal pension plans contained in the 2012 budget, could only have reduced their relative ranking.

Nonetheless, it should be appreciated that only 40% of Canadians have access to an employer assisted pension plan The federal government's plan is certainly the largest and therefore it is a convenient target for the media, willing to feed public misperceptions and stereotypes. For example, it is never mentioned by the press that the federal government's plan is coordinated with the Canada Pension Plan or the Régime des rentes du Québec. So part of the benefits received by retirees of the Federal Public Service, and described by the press and many think tanks as a "gold plated" plan, are the same as what most Canadians receive.

Perhaps the best defense of federal government pension plans comes simply from the Auditor General's Report:

> *"… Good management of public affairs depends on the caliber and performance of the public service. Pension benefits are an important part of the total compensation offered to public servants in an effort to recruit and retain highly skilled workers."*

Even the C.D. Howe Institute, long critical of the accounting practices used for the public sector pension plans, has characterized public sector plans favourably:

> *"…The pensions are good, but not unreasonably so, typically replacing about 50% of employment income for long service employees retiring in their late 50s or early 60s. In this regard, they are similar to the pensions that financial planners recommend to their clients."*

Fair Value Accounting

In the latest run up to the Auditor General's Report, the C.D. Howe Institute was once again active in pushing for the use of "fair value" accounting. In its latest report on public sector pensions (March 2014), it again laid out an argument for the use of such accounting methodology. CAPE has consistently demonstrated that these accounting methods (more commonly known as "mark to market") were never intended for pension plans, and their application would create volatility. In addition, there has been criticism of this approach by the insurance and banking industries, and well-known CEOs of major corporations. It has been argued that the use of such methodology in major financial markets was partly responsible for the spiraling recession of 2007**.** The Institute acknowledged, in its own report, that the private sector's adoption of "mark to market" accounting for pension purposes has been "slow". More importantly, the Institute acknowledged some of the shortcomings and undesirable consequences in using "mark to market" accounting:

> *"…Marketing pension obligations to market in a world where long-term interest rates can, and do, move in a wide range introduces a layer of complexity and volatility to public sector financial statements that is unwelcome…"*

As well, the Institute's report reveals its reasons for moving in this direction. It is part of a strategy to transfer risk from the federal government employer to its employees and plan members:

> *"…The risks that taxpayers are being asked to bear without compensation should be transferred in whole or in part to the plan members…"*

It comes as no surprise that in discussing the independent work of Canada's Chief Actuary, in analyzing and evaluating public sector pensions, the Auditor General's latest report makes no reference to "fair value" accounting practices.

Summary

While CAPE welcomes the recommendations of the Auditor General and actions of the Government to improve pension plan governance, and the assurance of no further pension reforms for the immediate future, there are serious medium term concerns over the government's intentions and the future direction of public sector pensions.

> *"We are steadfastly opposed to all efforts to further shift plan costs and risks to government employees. Any attempts to introduce target benefits will be strongly resisted. There is a need for increased government transparency on pension matters,"* concluded CAPE President Poirier.

This analysis was prepared in large part by CAPE past President Bill Krause. Mr. Krause served as a longtime member of the Public Service Pension Advisory Committee, and is considered an expert in this field.