Heading for Broke:

The State of Newfoundland and Labrador's Pension System

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OUR VISION
A SUSTAINABLE PENSION SYSTEM
THAT IS FAIR TO ALL CANADIANS

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INTRODUCTION

A robust provincial retirement system plays a critical role in recruiting and retaining talented employees on whom we depend for quality public services. Such a system is intended to provide secure retirement income to these employees.

A government’s commitment to provide retirement benefits to its civil servants must be balanced against the burden placed on private citizens, who ultimately pay for those benefits.

Private sector workers are well aware and are resentful of, retirement benefits offered to the public sector that well beyond what they, themselves could ever hope to receive. As well as raising serious equity/fairness issues, such generous benefit programs also impact the province’s social programs which are meant to benefit everyone.

A failure to act on this issue now will continue to increase the financial burden already being placed on our children’s and grandchildren’s generations.

Today the pension system in Newfoundland and Labrador is broken.

PENSIONS

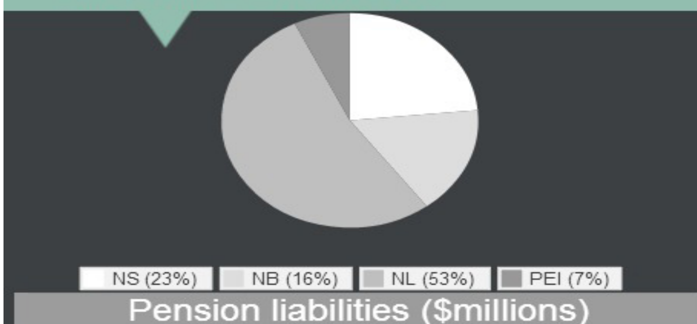
Heading for Broke: The state of Newfoundland and Labrador's Pension System

$7,500 of public pension debt per Newfoundlander and Labradorian

$900 million the bill for pensions and post-retirement benefits last year

$4.5 billion Special payments made to unfunded liabilities since 1997

APEC Winter Currents 2014



The total unfunded pension liability across the four Atlantic provincial governments was approximately $6.1 billion at the end of 2012/2013 – with Newfoundland and Labrador accounting for 53% of this total.

The province's debt

8.3 BILLION

67 % of that is pension debt = $5.6 billion

Double Digits

11 The per cent of private sector employees with defined benefit pensions

81 The per cent of public sector employees with defined benefit pensions

The Price Tag

This challenge is not unique to Newfoundland and Labrador. The CFIB estimates that the funds required to provide the pension benefits promised to government retirees and active public employees of municipal, provincial and federal employees across Canada are $300 billion short. This figure is more than the nation was prepared to pay for the bailout of the auto industry in 2008 ($10 billion) and the purchase of CMHC mortgages from the banks, which created a $55.5 Billion debt for the federal government in 2009-10.

Newfoundland and Labrador has been aware of the problem since 2008, when it implemented pension funding relief[i]. The awareness of the crisis gained steam in the fall of 2012 when the Province announced that they were making changes to the pensions for Provincial employees. Since then backroom meetings with the unions have produced little change.

Tom Marshall, the Premier stated that the pension plans of those in the civil service, "are not sustainable as they are, they are not going to last".[ii]

The pension system in Newfoundland and Labrador is one of the worst funded and most expensive retirement systems in Canada. Each year that the Province delays action to address its fundamental pension issues, the more risk the system faces and the harder it will be to fix.

Current Pension Plan Status[iii]

	2012 (000's)	**2011** (000's)
Plan Assets	$ 6,502,243	6,003,932
Accrued Obligations	11,824,371	10,605,818
Pension Deficit (Shortfall)	**$ 5,322,128**	**$ 4,601,886**

At the end of 2012, the plan a shortfall of $5.3 billion or had 55% (54.99 %) of the assets required to fund the promises made on pensions.
In addition the promises made for retiree benefits were short $2.3 billion
The Auditor, in a more recent report, for the year ended March 31, 2013 stated total liabilities were $ 8.4 billion combined. [iv]

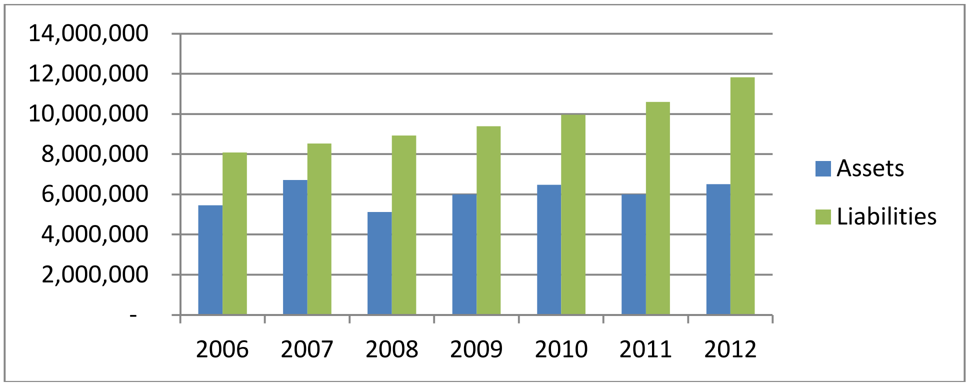
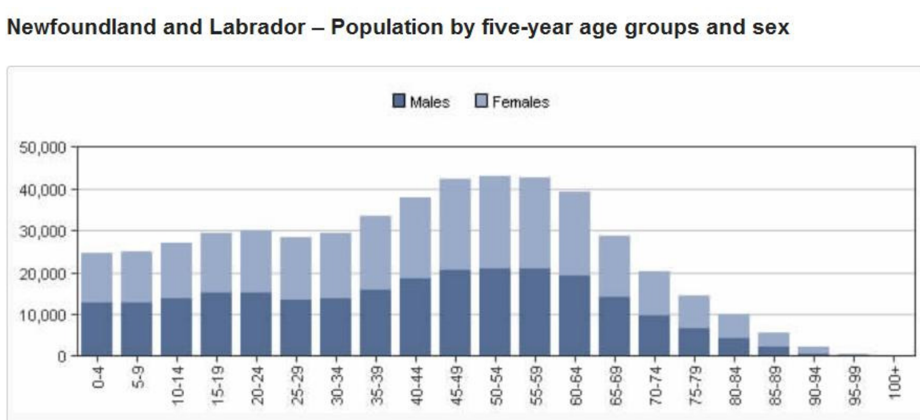


Table: Assets to Liabilities ($ '000's) [v]

It is imperative that employees who have been promised pensions are protected as well. Doing nothing could effectively cost Government employees everything. A pension cannot grow without a job attached to it, yet the current pension shortfall threatens to eat up $8 Billion in Government revenues over the next decade. Just as an example, this would amount to 16,000 nursing jobs over the next decade or fund education for twelve years. The Province urgently needs to fix this problem.

Demographic Tsunami

Changes need to be made urgently as the province is on the cusp of a demographic tsunami that will swamp public finances as the government faces much larger costs associated with an aging population.



Statscan - Focus on Geography Series, 2011 Census

N.L. Population Projections

	Ages		
	0 to 19	**20 to 64**	**Over 65**
2012	108,377	329,477	84,254
2026	110,205	281,547	130,055
Change	2 %	- 15 %	+ 54 %

Source: Department of Finance – Population Projections, N.L.

This is the third year of baby boomers turning age 65. It will continue for another 20 years with an estimated 500 boomers a month turning age 65, in the province.

As the number of people at retirement climbs dramatically the population of working age who pay for the current programs through income deductions, is dropping sharply.

The financial stress of an aging population will not be confined to insolvent pension plans. The same demographic that makes pensions unsustainable will severely impact the healthcare system very shortly.

The next challenge for the province will be the threat to healthcare which is the province's biggest current expense, already consuming almost 40% of the province's total spending. In 2011 Healthcare spending for seniors over the age of 55 consumed 63.6 % of the total healthcare budget. This allocation of funds for seniors is set to rise dramatically.

This report has three key objectives:

- Identify the extent of the problem and show why it is urgent that a fix be found
- Investigate the key drivers of the pension deficit
- Suggest possible remedial actions.

A common understanding of the current pension situation is critical to fostering a lively and informed debate among all stakeholders, including: public sector employees, and Provincial and municipal elected and appointed officials, and especially taxpayers, who ultimately fund the pensions, on how to fix it. This report is not an exhaustive empirical analysis of all the retirement system issues. Rather, it focuses on succinctly explaining those issues that most seriously challenge the retirement system and highlights those that must be addressed in any solution.

The plans included in this analysis are:

- Public Service Plan
- Teachers Pension Plan
- Memorial University of Newfoundland
- Uniformed Services
- Members of the House Assembly
- Provincial Court Judges

It is important to remember that *real* people and families are connected to every number in this report. Any proposed reform has immediate and direct consequences for hardworking Provincial employees and teachers, who have done nothing wrong and contributed what was asked of them to the pension system. The problem was not caused by them but by a poorly designed system that has been faltering for decades. An equally vital consideration must be the hardworking Newfoundlanders and Labradoreans outside the pension systems, who are struggling to save for their own retirements while being asked to pay higher taxes and surrender services to fund the pension plans of others.

Everyone will suffer if the Province has to make severe cuts to vital public services to maintain the current pension system.

Pension Realities

Public employees might appear to have little incentive to push for reforms, yet they will pay a price for inaction: salary freezes, layoffs, increased payroll deductions and the threat of a city or county bankruptcy. Doing nothing to current pension obligations will cost public employees everything. A pension cannot grow without a job attached to it.

Little Hoover Commission for Pension Reform[vi]

Pensions are a way for an employer to contribute to an employee's retirement years in recognition of a long life of hard work with the company or organization.

A typical pension until the 1990s was a type called a Defined Benefit plan, which would offer a "defined" income for the employee during retirement years. The income originally was calculated, using a funding formula that included the employee's years of service and average salary during those years. Over time, public sector funding formulas evolved to include such enhancements as a guaranteed salary based on the employee's final three or five years of employment, earlier retirement and many other additional enhanced benefits.

Beginning in the mid 1990s, the true cost of pensions became apparent. Unlike governments, private sector corporations that did not have access to the unlimited taxation powers were forced to change their pensions to become more affordable and more predictable. They dealt with the "legacy" costs in a variety of ways and for many companies this meant changing these plans to Defined Contribution plans which were based on investment returns rather than promises that were becoming less likely to be possible to guarantee.

By the middle of the 2000s most companies had converted their plans to make them sustainable. This evolution was accelerated as some high-profile bankruptcies occurred, which exposed the risk to retired employees.

Newfoundland Pensions Crisis - The Current Perspective

- If the pensions' unfunded liabilities and retiree benefits were accounted for on the same basis as pensions in the private sector, the total shortfall would be $8.4 Billion. Shortfalls account for 67 percent of the Province's net debt
- Unfunded pension liabilities for public sector pension plans and retiree benefits are recorded as having a shortfall of $5.6 billion.
- Since 2007-08, the unfunded liability has increased despite in excess of $3.6 billion in special payments over that period. These are in addition to the regular annual required contributions.
- Annual increases continue at an alarming rate. In 2012 there was a $400 million increase in the deficit from the previous year
- Unfunded liabilities do not include amounts required to pay for benefits related to future service[vii]
- The province's population is growing very slowly with the only growing segment of the population being those over the age of 65. One government report shows that the population grew by 139 in 2013.[viii]
- The number of retirees in the province is set to explode over the next decade

Provincial History

It was not until the 2008 financial crisis that the worst of the public sector pension problems became apparent. When the market crash happened, governments were forced to examine all of their costs and expenses. This event had a profound effect on the incomes of many Canadians. For Newfoundland and Labrador, it meant a drop of Government revenues from $8.4 billion in 2008-09 to $7.1 billion the following year. Fortunately the Province was still in a strong fiscal position with a budgetary surplus in 2008-9 of $2.3 B**.**

Pension Bailouts

The auditor general Terry Paddon, pointed out that in 2006, the $ 2-billion advance payment under the Atlantic Accord in 2005 was directed to the Teachers' Pension Plan. In addition, further special payments totaling approximately $1.6 billion were made between 2006 and 2013 to address the unfunded pension liability in the province.[ix]

Special rules were implemented in 2008 to allow for the proper funding of the Province's pension plans[x]. Unfortunately, after these rules were implemented there was no further monitoring of the plans or adjustments made towards making them sustainable. These rules have made the shortfalls in the plan even worse, as unrecorded shortfalls are coming onto the plans at the same time as the annual increased shortfalls are growing,

It is important to ask why, when the pension issue has been so highly visible in the news across the country, did it not surface in Newfoundland and Labrador until late 2012? It was not until the 2013 Auditor's annual report and the first report in 2014 from that auditor that these shortfalls were highlighted. The Alberta Auditors report on pensions comments that even the employees of the Auditor's office have a conflict of interest because they are members in the plans.

- Newfoundland and Labrador do not provide readily accessible information to the public on their Government employee pensions
    - Across Canada, most public sector pensions provide significant disclosure, including annual reports, annual financial statements and annual actuarial valuations.
- There was no motivation or incentive by unions or politicians to bring the pension crisis to light.
- Pensions are a political "third rail," and politicians are very reluctant to discuss an issue that could inflame their single biggest electoral voting block: unions.
- The size of pension bailouts for these plans was hidden in broader Government reports and not easy to uncover or find
- Pensions are very complicated vehicles, and it is often difficult to understand the important details.

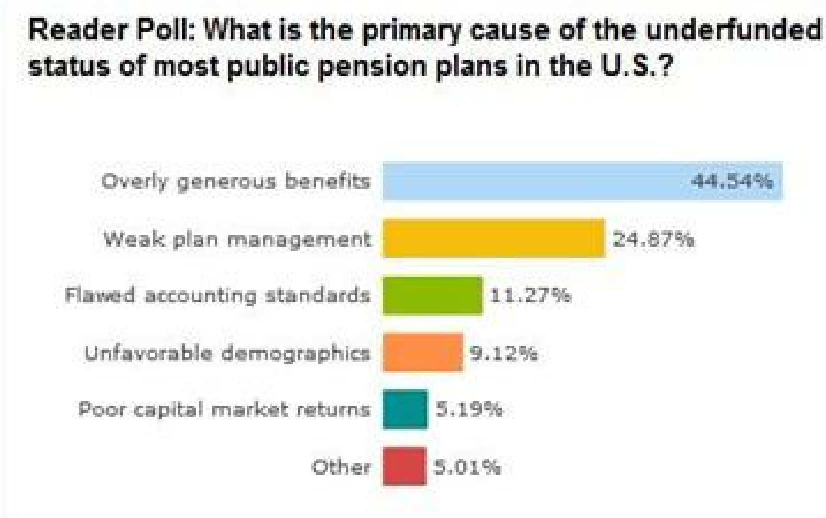
Summary of Benefits [xi]

Major public sector pension plans—range of pension plan rates	**Employee** Low	High	**Employer**
Plan	**As a % of salary**		
Public Service Pension Plan (2001-2012)	7.6% of	8.6% of pensionable salaries	Employer generally matches Percentage
Teachers' Pension Plan (2001-2012)	8.5% of	9.35% of pensionable salaries	
Uniformed Services Plan (2001-2012)	8.5% of	9.95% of pensionable salaries	

A Structural Problem That Needs to be Fixed

The math does not work - When we look at the current system it is clear that the numbers do not work. A major concern is the level of bailouts that have been put into the current system and the fact that the shortfalls have not disappeared but instead continue to increase every year.

The Provincial Auditor reported that "The liability related to employee future benefits totaled $5.6 billion at March 31, 2013, a $400 million increase from the previous year and represents 67% of the Province's Net Debt." However, when applying private sector pension accounting rules, the liabilities actually grew to $8.4 billion instead of the $5.6 billion reported. Included in these numbers are unfunded liabilities of $2.3 billion for health and life insurance benefits for retires and their families. "[xii] Unless the Province makes serious efforts to contain the pension crisis, it will not go away and continue to fester. A recent report from the Auditor in Alberta clearly illustrated the risk of growing shortfall by pointing out "unfunded liabilities, simply put, are the amount of money needed to be put into the plans today to fully support promises made to retirees and current employees for services *already provided.* Unfunded liabilities do not include amounts required to pay for benefits related to future service."[xiii]



Source: CFA Institute

The *Pension Ponzi* point - There comes a point when pensions have more retirees in them than active workers. It is at this point that they are no longer sustainable. Plans are based on the premise that there will always be new employees entering into them to fund the future payments of retirees. In 2012 the contributions into the plans were $375.8 million and benefits paid were $589.3. As the numbers of retirees increase so will the annual benefit costs and yet contributions are expected to stay the same. For example, from 2007 there was a 40% increase in annual benefits paid from $420.6 million, that year.

Another problem is the rapidly rising value of the average pension; in 2007 the average pension value was $ 19,693 rising to $23,098 by 2012. These numbers are misleading because as the Wall Street Journal reported, generally about pensions, they include "older employees who retired many years ago and whose benefits are far less than those of an employee retiring today; and by short-term workers who often receive tiny pensions but almost surely have retirement savings from another job." [xiv]

The relevant number is what a newly retired full career pensioner receives. From 2011 to 2012 pension benefits increased $30 million for an additional 803 retirees. This means that the average full-career employee actually received a pension valued at over $37,000 a year. Many pensions will be considerably more with some pensions starting in excess of $100,000 a year. Recent work that we completed in Ontario shows an estimated 14,000 retirees earning pensions over $100,000 a year.

All members of the province's pension plan will also be eligible to receive Canada Pension Plan (CPP) and Old Age Security (OAS). While the CPP is integrated into public sector pensions the OAS is "Stacked on top".

Fund Participation as of December 31, 2012	
Active Members	38,695
Deferred Members	5,550
Pensioners	25,513
Total	**69,758**

Source: Pension Investment Committee 2012 Activity Report

"Well, that tells you you've got a Ponzi scheme, because you have to keep bringing in new members and the current system itself is not in a sustainable position," .
California's Governor Brown, *LA Times*, December 1, 2011

Increasing life expectancies – In 1924, when major changes were made to the federal employee pension plan, the retirement age was 65.[xv] At the time the life expectancy of Canadians was age 59. So the average federal government employee was expected to be dead before they got their pension. Since then the retirement age has actually been lowered with fire and police pensions starting at an average age of 53, and the broader public sector average age at 58.[xvi] If the retirement age had been increased to keep up with increasing life expectancies, federal pensions wouldn't begin until after the age of 90.

Public sector employees live even longer – In recent testimony before the Senate, Jean-Claude Ménard, Chief Actuary, Office of the Superintendent of Financial Institutions stated; "at least five groups in the population live longer than Canadians on average: members of the RCMP, who have a stringent health medical test at entry and 40 years later, so we could see the difference in their mortality rates; judges, probably because they are nominated late in life and need to at least have good health to sustain their functions; members of Parliament; Ontario teachers; and teachers from British Columbia. It is probably true for all teachers in Canada… Once we factor in the survivor benefit, the age of 90 is the more appropriate figure to use." [xvii]

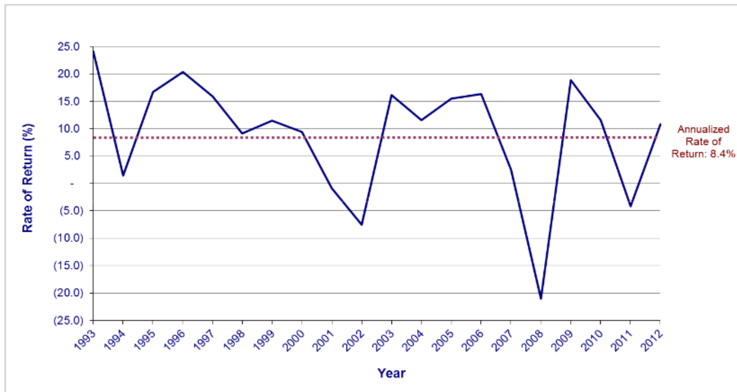
Over the next half century, Canadian life expectancy at age 65 is projected to increase by 3 years to reach 25 years. It means that half of Canadian retirees are expected to live past age 90.

Jean-Claude Ménard, Canada's Chief Actuary

Lower than anticipated Investment Returns

The current high unfunded liability cannot be discussed without highlighting the impact of lower than assumed investment performance.

Annual Rates of Return (1993 – 2012)



Source: Pension Investment Committee, *2012 Activity Report*

The Provincial pension funds' investment performance (net of investments and administrative expenses to run the system) has averaged only 2.2% over the last five years through December 31, 2012, which is significantly below its assumed 7.25% rate of return.

Given the current low interest rate environment, the overall expected long-term investment return has been reduced to 6.75% going forward[xviii]. As this expected rate of return appears to be a 'best estimate', it is reasonable to expect that there is a 50% chance that actual experience will fall short of this level. Lower than expected returns will translate into even greater underfunding. In comparison, the Canada Pension Plan currently uses a 4% real rate of return assumption, which translates into an expected nominal return of 5.2% when added to the inflation rate of 1.2%. A different target asset mix could explain the CPP's lower return assumption, but it may also be true that the CPP wants to have a higher degree confidence that their target returns will be achieved.

Since the Province is ultimately responsible for making good on their defined-benefit pensions whether the plans are underfunded or not, the higher the target rate of return used for planning purposes, the more employees escape higher contribution payments, which increases the risk to the Province. Even so, continued underfunding will negatively impact Provincial employees – particularly newer employees – as their pension contributions will be used, in part, to cover unfunded liabilities for past service rather than going to fund a pension for their own use.

Headed for Broke - If Nothing is Done

Unsustainable Cost for Taxpayers

The taxpayer contributions to the pensions fall far short of what is required on an annual basis just to stay even. Regular contributions into the plans have not increased substantially since 2006 while the shortfalls within the plans have skyrocketed. In 2007, the unfunded value of the pensions was $1.8 billion[xix]. By 2012, the assets in the plans were $6.5 billion, but the total accrued liabilities were $11.8 billion – a shortfall of $5.3 billion.

The size of the pension shortfalls has been further obscured by new accounting rules introduced under the Province's "Solvency Funding Relief Regulations."[xx] These rules, designed to mitigate the pension investment losses from the 2008 market crash, actually made true accounting of the plans harder to determine for policymakers who are without considerable pension accounting capability. The Provincial Auditor pointed out in her recent report on pensions that:

> *"The unamortized losses on employee future benefits ranged from $0.8 billion to $2.8 billion for the years ended March 31, 2004 to 2013. Without the ability to defer and amortize the experience losses, the employee future benefits liability would be much higher each year. Net Debt would also be higher as a result. For example, for the year ended March 31, 2013, the employee future benefits liability would have been $8.4 billion, instead of $5.6 billion as reported."*

The legacy costs associated with pensions and benefits for government employees are squeezing out all sorts for other government services that citizens' taxpayers are expecting for their tax dollars. In California, a Democratic mayor, Chuck Reed, who was strongly supported by unions in his election, stated:

> *"This is one of the dichotomies of California: I am cutting services to my low- and moderate-income people . . . to pay really generous benefits for public employees who make a good living and have an even better retirement,"* [xxi]

Major Expenditures: Where does the money go?

Total Budget $7,570,714,000

Health Care	$ 2,843,585,000	37.6 %
Pensions / Retiree Benefits	$ 875,613,000	11.6 %
Debt Expense	$ 847,569,000	11.2 %
Pension Shortfall Funding*	$840,000,000	11.1 %
Education	$795,350,000	10.5 %
Post-Secondary	$789,746,525	10.4 %

Source: Dep't of Finance - *Expenditures: Where does the money go?*[xxii]

* Does not appear in the Provincial budget – we added this line item for illustration purposes. We assume that assume that the shortfall is eliminated over 10 years.

Zombie Accounting

Why will universities with these defined-benefit plans be 'exempted' from more stringent tests for pension solvency that apply to businesses?

But why should we give their defined-benefit plans less stringent tests for solvency? Who is monitoring their performance and why isn't this information easily accessible to the public and updated on a regular basis? I can say the same thing about Canadian cities and municipalities, the other pension time bomb which is rarely discussed. Most people haven't got a clue of what the hell is going on at these city plans."

Leo Kolivakis*, Pension Pulse*

Unsustainable retiree benefits

The Province offers a second tier of benefits to its retirees for health costs over and above what it pays for all taxpayers through the Provincial healthcare system. The federal Government is in the process of changing their own plans, which have also been eliminated by most companies in the private sector. In addition to the $200 million a year annual cost, these supplementary health plans have their own unfunded liability, which is currently at $2.3 billion, equal to 17.3% of the Province's total debt. The Province has an adequate health plan in place for all Newfoundlanders and Labradoreans; the special benefits for Government workers should be eliminated based on fairness for all taxpayers.

Pensions are one of the fastest growing line-items in the Provincial budget. The budget for 2014 projects spending on pensions of $600 million, and an additional $200 million for retiree benefits. The total underfunding for pensions and benefits totals $8.4 billion. If paid off over a 10-year period as originally laid out in the solvency relief rules, additional payments of $840 million would be required from the public treasury every year for the next for next ten years.

To fund the promises that have been made to date, the Province and employees would have to dramatically increase the amount of money that they pay into the fund. As a comparison, at the end of 2012, the plans had accumulated $6.5 billion for the benefit of 69,758 members, or about $93,000 per member. The Memorial University plan, at the end of 2012, had 3,863 active employees and 1,549 retirees, but it had accumulated $886.4 million or $163,779 per employee. The University plan has a shortfall of $293.8 million or funded at a level of about 75%. The Province's funding level stands at only 54.9%.

A report from *Standard and Poors* last year looked at the worst funded US plans. Newfoundland and Labrador's plan would be better than only two of those states[1].

Table 1

Top Five And Bottom Five States By Funded Level

Top five states	Funded level (%)
Wisconsin	99.9
South Dakota	96.3
North Carolina	95.3
Washington	93.7
New York	92.7
Bottom five states	**Funded level (%)**
Illinois	43.4
Kentucky	53.4
Connecticut	55.0
Louisiana	56.2
New Hampshire	57.4

*Does not include Puerto Rico, which is 11.1% funded.

Burden on current employees

Compared to current retirees, active employees will need to contribute more toward their retirements but will receive lower levels of benefits. If changes are not made, they face the risk that retirement fund assets might not be there at all. Many younger employees are beginning to realize what is happening to their plans and feel that they would be much better off with a defined contribution type plan that at least will

[1] *Standard and Poor's*, July 16, 2013 'A Bumpy Road Lies Ahead For U.S. Public Pension Funded Levels'

guarantee that what they and their employer contribute to the plan will be available at retirement.

Currently, not even the extra payments made on an annual basis are enough to prevent a deterioration of the funding situation. A quick analysis shows that in 2012, for example, the shortfall *increased* by $720 million despite contributions into the plan of $456 million – almost a half billion dollars – including a special bailout contribution of $90 million.

The plans could run completely out of money – potentially within the decade – without taxpayer bailouts.

Attracts quality employees		Preserves funding for public services
	< >	
Provides security for retirees		Protects taxpayers

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"The unamortized losses on employee future benefits ranged from $0.8 billion to $2.8 billion for the years ended March 31, 2004 to 2013. Without the ability to defer and amortize the experience losses, the employee future benefits liability would be much higher each year. Net Debt would also be higher as a result. For example, for the year ended March 31, 2013, the employee future benefits liability would have been $8.4 billion, instead of $5.6 billion as reported"

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[xxii] Note: The original chart has been modified to reflect shortfall funding, some items have been excluded

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