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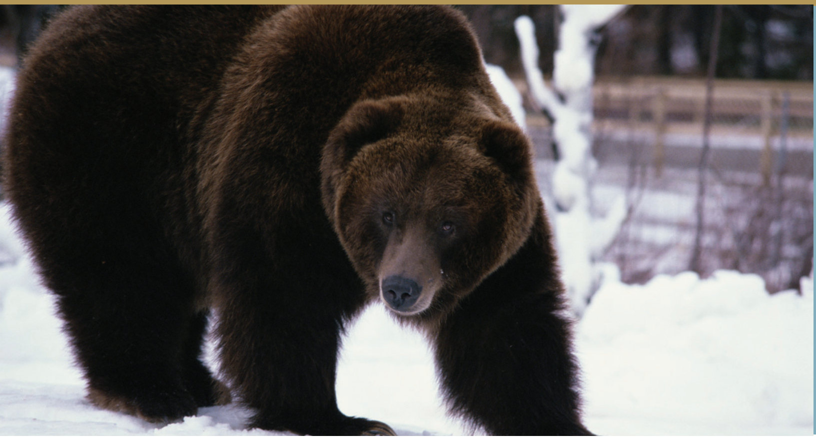
THE LONGWAVE ECONOMIC AND FINANCIAL CYCLE

# ECONOMIC WINTER



## The Pension Predicament (2)

In our July 2009 Economic Winter of the above title, we concluded: 'For many years, Longwave Analytics has been forecasting the collapse of the retirement benefit system during the next global economic depression. Now that hard economic times have become a reality, for millions of workers in the public and private sectors alike, employees should not assume that all of their pension expectations are guaranteed. Naturally, while no corporation or government wants to willfully cut pension commitments during difficult economic periods, eventually, it becomes a matter of affordability.' Given the interim period of almost three years, we have deemed it appropriate to revisit the issue and assess the intervening developments of our prediction.

### New European Union Rules May Double Pension Liabilities

As reported in the Daily Telegraph U.K. last month, the European Commission (EC) is considering introducing new rules that would force corporate pension funds to contribute extra cash into their plans, in order to reduce their deficits and make plans more financially robust. However, the proposals, dubbed "Solvency II for Pensions," would increase FTSE 100 liabilities by at least one billion pounds and maybe as much as 2.5 billion pounds, a survey by Deloitte has determined. Seventy-five per cent of corporate pension funds – together representing more than 100 billion pounds of liabilities – responded that the new proposals would increase liabilities by between 20% and 50%. Experts fear that the high cost to pension funds for meeting the new EC rules would force many of the U.K.'s 6,850 companies with final salary pension plans to close. Fergus Mitchell, head of Deloitte's pension services warns: "Given the current business climate, when pension deficits are already high and the economic outlook is uncertain, now is not the time to introduce new obligations that will incur further expenses and increase deficits. The proposal will accelerate the decline of defined benefit pensions in the U.K."

Steve Webb, U.K. pensions minister, warned last year that the European Union (EU) proposals were "destructive" and would land British companies with a "huge bill" of 100 billion pounds. The National Association of Pension Funds and the Confederation of British Industry (CBI) have also criticized the rules, suggesting they would unfairly affect Britain. The EC is due to publish draft EU legislation in the autumn, following a consultation on the solvency-style rules, which closed earlier this year. However, some FTSE companies are bolstering their pension funds ahead of the potential EU legislation. Last week, British Telecom confirmed it will pay 2 billion pounds into its fund this month, in what is considered to be the biggest ever corporate injection. Elsewhere, a report from Eversheds law firm revealed half of City firms think the new capital rules under Solvency II will be damaging to London's economic position and could cause businesses to depart for the likes of Hong Kong or New York. Michael Wainwright, an Eversheds partner, added: "Ongoing increased regulatory pressure from Europe will drive businesses out of London to other financial centers."

## FSA May Reduce Its Intermediate Growth Projection Rate

A new study by Pricewaterhouse Coopers, the chartered accountancy firm, is likely to lead the London City regulator Financial Services Authority to lower its intermediate projection rate from the current 7%. Reacting to the report, Peter Smith, the director of investments policy at the FSA, stated: “It is crucial that projection rates are set at a realistic level in order that investors are not misled. Today’s independent research indicates that our maximum projection rates should be reduced.” As reported in the Daily Telegraph U.K. last week, Pressure has been mounting for regulators to alter “wildly inaccurate and grossly optimistic” standard growth figures, following complaints that millions of investors are being misled as a result. Many investments sold in Britain use these set projection rates – approved by the FSA – to provide customers with an idea of how their money will grow in the future. However, investors are kidding themselves if they think that returns are likely to mirror the examples used. Currently, the FSA sets out three different scenarios: a low growth rate of 4%, a mid-rate of 6% and a high rate of 9%. Although it is explained in all documentation that these figures are only projections, based upon past performance, most savers will naturally assume that returns are likely to be within this range. However, after a decade of poor investment returns, even the best performing funds have struggled to post annual returns of 4%, particularly once charges have been taken into account. Obviously, different projections can cause a huge variance. If a 30,000 pound fund grows by 9% per annum over 20 years, it would be worth 124,273 pounds (assuming a 1.5% annual charge). However, if the same fund managed to grow by only 3%, it would be worth just 40,000 pounds.

## Pension Risks Threaten U.K. Finances: IMF

In a recent analysis of the financial impact of longevity risk, the International Monetary Fund warns: “The public finances of countries across the western world would become unsustainable, if the average lifespan of their citizens rose by just three years beyond expectations. For the U.K. this would mean – using the reasonable assumption that if the entire cost were to fall upon taxpayers – that the nation’s public debt would increase from 76% of gross domestic product (GDP) to as much as 135%, or to approximately 750 billion pounds. The extra costs would surface from public sector pensions, the liabilities for which the U.K. Treasury recently calculated already stand at 1.13 trillion pounds. Also, part of the increase would come from the state having to rescue failed private sector funds, which are equally unprepared for a small increase in life expectancy. Globally, governments must address the potential crisis now, by raising retirement ages, demanding higher annual contributions, or reducing payouts. An essential reform is to allow retirement ages to increase along with expected longevity. This could be mandated by government, but individuals could also be incentivized to delay retirement. To the extent that governments are not acknowledging longevity risk, fiscal balance sheets become more vulnerable. If not adequately addressed soon, it could potentially further threaten fiscal sustainability. Moreover, it is not unreasonable to suppose that the financial burden of an expected increase in longevity will ultimately fall on the public sector.”

## In Rome, Tens of Thousands March Against Pension Reforms

As reported by the Associated Press, last week tens of thousands of union activists and workers protested against the labour and pension reforms recently approved by the Italian government of Prime Minister Mario Monti. The protest in central Rome was organized by the country’s three main unions seeking to draw attention to the hundreds of thousands of workers who took early buyouts, which were intended to hold them over until the official retirement age. However, the retirement age has now been raised, leaving many facing the prospect of being both out of a job and too young to officially retire. The Labour Ministry reported that only 65,000 people fall into that category and that it is studying ways to guarantee they are covered. While the state pension agency has put the number at 130,000 the unions say the number is in the hundreds of thousands.

Workers march in downtown Rome, Friday, April 13, 2012 Source: AlessandraTarantino / AP

## Pricey Pensions of Canadian Government Bureaucrats under Fire

As reported in the Vancouver Sun last month, a little-known government pension would only exist in the fantasy world of most Canadians. Deputy ministers, the top bureaucrats who manage federal government departments and agencies, can earn an inflation-protected annual pension reaching 90% of their best five salary years. That's 20 percentage points higher than the maximum amount earned by ordinary public servants who have worked for a minimum of 35 years in government. Members of Parliament, in most cases, earn a maximum of 75% of their top earning years, although they'd need to serve 25 years in Parliament to reach that level. Deputy ministers earn from $185,800 (CAD) per annum, with a maximum 'performance award' that would add 26% to that total, up to $315,100 (CAD) with a potential 39% bonus. Moreover, the special arrangement for deputies allows them to depart the public service early, under certain conditions, to accept a position in the private sector or academia while continuing to contribute to the government pension plan. This additional perk, which requires contributors to pay double the normal contribution rate, allows them to add to the ultimate value of their federal government pension, since their future pension will be calculated based upon their last five years as contributors, even if they're working in the private sector for some or all of those five years. Canadian Taxpayer Federation representative Gregory Thomas suggested the deputy minister pension plans be renamed 'deferred six-figure payoffs for life.' C.D. Howe Institute President Bill Robson, who has undertaken several studies pointing to potential huge taxpayer liabilities in the government pension plan, commented: 'Hardly anyone, especially not the taxpayers who have to cover them understands these ultra-generous schemes.'

## Canada's Public Sector Pension Crisis Still Looms

As reported in the Financial Post last week, the recent federal and Ontario budgets produced a plethora of headlines about how the public sector should brace for changes to its costly pension plans. The dramatic language was in part provoked by headlines like this from the Ontario budget: 'Pension costs are one of the fastest-growing line items' and 'the status quo is not an option.' A reminder of how true that is came with the announcement this week of another unfunded liability in the Ontario Teachers' Pension Plan – $9.6 billion (CAD) this time. That's in addition to the previous $17.2 billion (CAD) unfunded liability, which was to be 'solved' with three years' worth of contribution hikes for teachers and taxpayers alike. As a 'teaching moment' on unsustainable public sector pensions, it doesn't come much clearer than that. However, the supposed reforms may be less than advertised. The Ontario budget announced that contributions to public sector pension plans will soon need to be split 50-50 between employees and taxpayers, where that doesn't already occur. Interestingly, Ontario's taxpayers already have a 50-50 split with employees on the three major public sector pension plans for which the provincial government is either solely or jointly responsible: the Public Service Pension Plan, the Ontario Public Service Employees Union Pension Plan and the Ontario Teachers' Pension Plan. The Healthcare of Ontario Pension Plan is another major plan for which the government is not statutorily responsible, but to which taxpayers contribute through health care tax dollars … Most dramatically, the Public Service Pension Plan, of which the province is the sole sponsor, is scheduled to receive 'special payments' of $142 million (CAD) per year, for 15 years. Given that's 'already been agreed to,' taxpayers are out of luck if they think Ontario pension reforms will address the generous benefit side of public sector pensions anytime soon. Missing from both Ontario and Federal promises are better cost-saving ideas that would bring the public sector closer to private sector norms … Given that taxpayers are most often called upon to fund public sector pension shortfalls, it seem reasonable for them to also expect the benefits and the design of public sector plans to more closely follow private sector norms. That will require provincial and federal governments to enact more significant reforms than they have suggested to date.

## State of Illinois: A Pension Basket Case

Earlier this month, the Teachers' Retirement System (TRS) of the State of Illinois issued a dire omen to its members. TRS, which includes most public school teachers in Illinois outside of Chicago – numbering more than 360,000 members – made the following announcement: "If the General Assembly does not continue to provide all of the funding (stipulated) in State law, calculations made by TRS actuaries indicate that the System could be rendered insolvent as soon as (the year) 2030. Preventing insolvency may include significant changes for TRS, pointedly, new revenues must be generated, (otherwise retirement) benefits may have to be reduced." As reported by Bloomberg News, the teachers' fund is one of America's worst-financed statewide pension systems, disclosing that it is only 47% funded. That's only the case if you accept the system's rosy accounting assumptions, including that it will achieve 8.5% annual rates of return on its investments. This level is tied for the most aggressive investment assumption among state pension funds in the country and TRS has initiated some creativity in an effort to meet it.

Pensions & Investments Magazine reveals TRS has the fourth-riskiest investment portfolio in the U.S., with less than 15% of its holdings in fixed income (securities) and cash … Indeed, the System's funding status is so poor that it achieved a 23.6% return on investments in 2011, but only managed to shave $2 billion (U.S.) off its $46 billion (U.S.) unfunded liability. However, it's not as though the fund can generate good returns consistently; in 2009, it returned a negative 22.7%. Closing the TRS 36% funding gap at the State Retirement Systems of Illinois, will depend upon taxpayers' willingness to begin paying far more than they ever have for pensions. As the TRS statement makes clear, pensioners may still see their benefits reduced. Public pensions are a problem all across America, but they are a special problem in Illinois, mostly because for decades, the State has failed to make proper contributions to its pension funds. More than most states, Illinois has used its pension funds as vehicles for off-balance sheet borrowing, financing high spending without high taxes, erstwhile, making unfinanced pension promises.

No individual is more personally responsible for allowing this to happen than Rod Blagojevich, elected governor in 2003, impeached in 2009 and currently serving a 14-year prison term. Illinois is not unique … as many states have similarly failed to act responsibly over the last four years. It is much more notable as a State which let its fiscal problems spiral out of control while the economy was strong, leaving an unusually daunting mess for future lawmakers … Moreover, the State hasn't taken the steps needed to reform its precarious pension system. Michael Madigan, the Democratic Speaker of the State Assembly, has belatedly become an advocate for aggressive pension reform, but Governor Pat Quinn and public employee unions stood in his way through 2010 and 2011. The State did sharply reduce benefits for workers hired after 2010, but material savings from those changes won't materialize for decades. Ironically, over the recent near-term, the State used those estimated savings to shave a few hundred million dollars off its annual required pension contributions. Meanwhile, Governor Quinn has set an April 17th. deadline for state legislators to develop a new plan to overhaul the pension system.

## U.S. Public Pension Funds Discover Risky Investments Fail to Reward

As recently reported by the New York Times, searching for higher rates of return to bridge looming payout shortfalls, public workers' pension funds across America are increasingly turning to riskier investments in private equity, real estate and hedge funds. While their fees have soared, their returns have not. In fact, the number of retirement systems which have remained conservative with more traditional investment investments in stocks and bonds have performed better in recent years, for a fraction of the fees. Consider the contrast between the state retirement fund for Pennsylvania and the one for Georgia. The $26.3 billion (U.S.) Pennsylvania State Employees Retirement System has more than 46% of its assets in riskier alternative investments, including nearly 400 private equity, venture capital and real estate funds. The System paid about $1.35 billion (U.S.) in management fees over the last five years and reported a five-year annualized return of 3.6%. That is less than half the 8% target needed to meet its financing requirements and it also lags behind a 4.9% median return among public pension systems. In Georgia, the $14.4 billion (U.S.) retirement system, which is prohibited by state law from investing in alternative investments, has earned 5.3% annually over the same time frame and paid about $54 million (U.S.) in total fees. The two pension funds represent the extremes, with Pennsylvania in a group of pension systems with some of the highest percentages of investments in alternatives and Georgia in a group of ten with some of the lowest, according to groupings of funds identified by the London-based research firm Preqin. An analysis of the sampling presents an unflattering portrait of the riskier investments: the funds with a third to more than half of their money in private equity, hedge funds and real estate had returns that were at least one percentage point lower than the returns of the funds which largely avoided those assets. They also paid nearly four times as much in fees.

While managers for the retirement systems insist that a five-year period is not long enough to judge their performance, nevertheless, those fees add up to hundreds of millions of dollars each year for some of the country's largest pension funds. The $51.4 billion (U.S.) Pennsylvania public schools pension system, for instance, which has 46% of its assets in riskier investments, pays more than $500 million (U.S.) in fees. Whether the higher fees charged by private equity firms and hedge funds are worth it, has been hotly debated within the investment community for years. Do these investment entities, over an extended period of time, either offset the volatile swings in asset prices during rough patches in the markets, or provide significantly higher gains than could be found in less-expensive bond and stock investments? While both sides of the debate can point to various studies, the topic is assuming a sharper focus as more pension funds embrace a riskier investment strategy. By September 2011, retirement systems with more than $1 billion (U.S.) in assets had increased their stakes in real estate, private equity and hedge funds to 19%, from 10.7% in 2007, according to the Wilshire Trust Universe Comparison Service. Public retirement systems are struggling to earn sufficient rates of return with the prevailing level of interest rates near record lows and increasingly more workers qualifying for retirement. Their pension costs are growing rapidly, but state government rates of return are not keeping pace.

## New York Lawmakers Vote to Limit Public Pensions

As reported last month by the New York Times, lawmakers in Albany recently approved a hard-fought measure to cut the retirement benefits for future public employees in New York City, as well as across New York State, dealing a defeat to the State's powerful public employee unions. The pension changes were less drastic than those sought by Governor Andrew Cuomo, applying to fewer employees and saving less money than he had hoped. In a statement, the Governor commented: "This bold and transformational pension reform plan is an historic win for New York taxpayers and municipalities. Without this critical reform, New Yorkers would have seen significant tax increases, as well as layoffs to teachers, firefighters and police." The pension changes are enacted as state and local governments across America take similar steps to reduce retirement costs, often prompting pitched battles with labour unions. Between 2009 and 2011, forty-three states have enacted major changes to retirement plans for public employees and teachers, according to the National Conference of State Legislatures. Ronald Snell, a senior fellow at the Conference, commented: "The message is that the traditional package of retirement benefits has become unaffordable. The deal approved in Albany is similar to measures passed in other states, in that it reduced the benefits offered to some public employees, instead of overhauling the structure of the pension system itself."

State and city officials contend the pension reforms will save in excess of $80 billion (U.S.) for state and local governments over the next 30 years – including $21 billion (U.S.) for New York City – by reducing the benefits promised to new workers. While the legislation raises the minimum retirement age to 63 from 62 for state workers, it will also require most workers to increase the portion of their salaries that they contribute to the pension system from the current 3% to as much as 6% for the highest earners. New York City Mayor Michael Bloomberg commented: "Mr. Cuomo must get an A-plus for persuading lawmakers to resist pressure from labour unions and approve the changes. This is real (pension) reform and for the taxpayers of the State, gives them a better deal for their money. It does not hurt any of our current employees, or any of our current retirees. Down the road, if people don't want to come to work for the City or the State, they don't have to, but I think this is still a phenomenally generous plan."

Subsequently, thousands of public employees across New York State rushed to register for pensions, seeking to lock in generous retirement benefits before the cuts approved by the State Legislature took effect on April 1st. At the New York City Employees' Retirement System, more than 12,000 workers applied to enroll in the pension system and the New York City Board of Education Retirement System received nearly 9,000 applications. A spokesman for Mr. Cuomo's budget office noted the spike in pension enrollments would not have a measurable impact on the State's pension system. The bulk of the projected savings from the pension changes – while $82 billion (U.S.) over 30 years – only $1.2 billion (U.S.) is expected to be saved over the next five years.

## U.S. States Face Legal Action over Pensions

As reported last week in the Financial Times, American states are increasingly being blocked from changing public employees' retirement benefits, as the fight over shoring up chronically underfunded public pension systems moves from state legislatures to the courts. While some states have successfully altered terms for future employees, plans to force all current public workers to contribute more to state pensions have been ruled unconstitutional in Florida, Arizona and New Hampshire in recent weeks, a significant victory for public sector employee unions.

Other states are expected to face similar legal battles as they plan to close large holes in their public pension funds by redrawing benefits. U.S. state and local pensions could face a shortfall of as much as $4.4 trillion (U.S.), up from $3.1 trillion (U.S.) in 2009. Changes enacted in Rhode Island are expected to face a legal challenge soon. Bobby Jindal, Governor of Louisiana, wants to replace the state's existing system – which allows workers to retire as young as 55 – with a retirement age of 67 for many public sector workers, but the state's legislative auditor has warned that could be ruled unconstitutional.

Amy Monahan, associate professor at the University of Minnesota Law School notes: "With public employee pension plans, it is state law that governs. Every state goes into this with a different set of legal rules. Some states had provisions in their constitutions protecting pension benefits and laws protecting those benefits, or protection dictated by previous court decisions. It is always true that new hires are fair game." The courtroom battles are being fought over the extent to which state laws protect benefits for existing workers. In many cases, the question is where the defining line from which workers accrue benefits begins, whether from the first day of employment, or the day of retirement, with courts assessing benefits the employee has already accrued, versus future benefits.

Florida proposed that both current and future public employees pay 3% of their income into public pension funds, overturning its 37-year old non-contributing system. A county court judge ruled the law unconstitutional last month and Florida's Supreme Court will hear the case this year. Mark Pudlow, of the Florida Education Association – a teaching union – commented: "For the folks who are already employed, part of the promise made to them was that they wouldn't contribute to the pension system." Lane Wright, spokesman for Florida Governor Rick Scott, noted: "The (new) law did not change the terms of employees' current contracts. We're only proposing to change contracts on a going-forward basis. The constitution only protects services rendered, not future services."

In New Hampshire, lawmakers raised contributions for all workers who were not yet retired. Unions argued that legal protection for existing benefits began on the day of hiring. A judge ruled that contributions could be raised only for employees with less than 10 years on the job. The decision may end up in the state supreme court.

## Summation

Whether one considers the pension system of the United Kingdom, Italy, Canada, Ontario, Illinois, New York or elsewhere, reforms of varying nature have definitely been enacted or remain under consideration, either by the appropriate legislatures, or wending their way through the courts. Assuredly, pension benefit changes and reforms will remain 'a work in progress' on several levels in many countries for a considerable time yet. At Longwave Analytics, over the last decade we have continuously warned that during the Kondratieff Winter economic cycle, pension crises will erupt in both the public and private sectors wherein "pensioners will not receive the monies they have been promised." Eventually, it becomes a matter of affordability.

**Written By: Christopher Funston**