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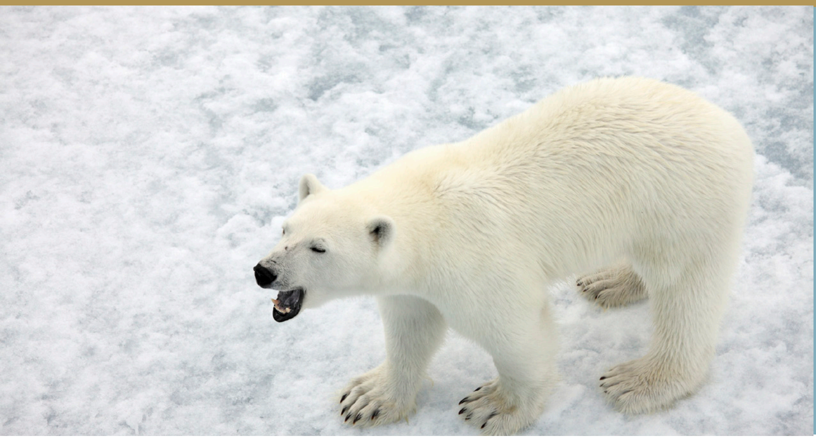
THE LONGWAVE ECONOMIC AND FINANCIAL CYCLE

ECONOMIC WINTER



The Pension Debacle

Introduction – Canadian Historical Context

In their 2013 publication Pension Law, authors Ari Kaplan and Mitch Frazer write: Essentially, because the establishment of a pension plan is voluntary in Canada, it is deemed to be a contract between an employer and his/her employees. The Supreme Court of Canada has affirmed that "pensions are now generally given for consideration rather than being merely gratuitous rewards" from an employer. An employee's consideration is the promise to contribute towards future income, deferred until retirement. Strictly speaking, while it is sometimes mentioned that "pension entitlements are separate and collateral to contracts of employment," it is nevertheless, accepted that pension rights and employment rights do not operate in a legal vacuum. The pension is an important component of the contract of employment. It is a negotiated benefit forming part of the employee's total wage package, so "there is a close relationship between salaries and pensions."

In 1900, there were approximately twelve employer-sponsored retirement plans in Canada. The inter-war period witnessed the beginnings of a Canadian pension system with the introduction of government pensions and an increase in the development of retirement plans sponsored by employers. The concept of a minimum level of post-retirement sustenance, as a matter of public policy, became a normative principle in 1927 when the Government of Canada introduced the Old Age Pensions Act (OAP). In 1952, the federal government replaced the OAP with the Old Age Security Act (OAS). The inter-war period also saw an increase in the number of employer-sponsored arrangements. In part, this increase was due to the philosophy of corporate welfare, which replaced the doctrine of individual responsibility, as well as the introduction of favourable federal income tax legislation. In 1908, legislation permitting individuals and corporations to purchase federal government annuities for employees was introduced. In 1917, the Income Tax War Act introduced rules allowing for the deduction of pension plan contributions and the exemption of those contributions from taxation. In 1938, employer pension contributions became tax deductible provided there was an express irrevocable divestment in favour of the pension fund.

Canadians' Low Pension Coverage

It is universally agreed that the biggest retirement issue in Canada is the matter of low pension coverage. Whether an employee is participating in a defined benefit pension plan (DBP) where the employer assumes virtually all of the risk; a defined contribution pension plan (DCP) where the employee assumes the risk, or a target benefit pension plan (TBP) where the risk is shared between employers and employees, the fact remains that only about 21% of employees in the Canadian private sector are covered by a pension plan in their workplace. Accordingly, during an Ottawa press conference on October 7th. Minister of State (Finance) Kevin Sorenson announced the five insurance companies which have registered to provide federal pooled registered pension plans (PRPP). This government initiative is intended to fill a huge retirement savings gap for Canadian workers who are currently without those benefits. Initially, the PRPP program will be limited to those employed by federally regulated industries, or people working in northern communities.

As reported by the Financial Post, to date just the Province of Quebec has instituted a similar plan – effective last July 1st. – although other provinces such as Saskatchewan, Alberta and British Columbia have pending legislation which they are expected to ratify at some juncture in 2015. In addition, Nova Scotia has announced it will be considering legislation soon. At his press conference, Mr. Sorenson was joined by representatives of the five insurance companies that will administer the federal program i.e. Sun Life Financial Inc., Great West Lifeco Inc., Industrial Alliance Insurance and Financial Services Inc., Manulife Financial Corp. and Standard Life. Mr. Sorenson commented: "For the first time ever, individuals in federally regulated industries, as well as those living in more remote areas – the Yukon, Nunavut and the Northwest Territories – will now be able to take advantage of the pooled registered pension plan. This represents a major milestone, a step towards helping those millions of Canadians, those 60% who do not have access to a workplace pension plan. Since a PRPP will be portable – wherever employees go, they can take it with them – employers should feel it's an incentive to stay with them. Another advantage is that legal burdens associated with a pooled registered plan will be borne by a qualified licensed third-party administrator. That's why we're encouraging all businesses and provinces, if they don't provide one now, to seriously entertain this option."

Canadian Minister of State (Finance) Kevin Sorenson. Source: Financial Post

Introduction – The Unstable States of America

While the Wall Street equity market crash and banking crisis captured a majority of the media headlines as the U.S. financial crisis began to unfold in 2008, another more stealthful predator was soon to join in the fray. Long unrecognized and overlooked was the fact that America's whole public sector was operating in a dreamland with respect to the subject of pension benefits and retirement entitlements, for which there appear to be few realistic plans to fully fund. Indeed, from the Congress in Washington to the City of Stockton, California and many states and municipalities in between, pension funding gaps are becoming an inexorable challenge. At the federal level, with America's national debt rapidly approaching $18 trillion (U.S.) – (that's $18,000,000,000,000), the majority of Congressmen and Senators; as well as members of the Obama administration, still believe the United States can grow its way out of this obligation. Dream on!

Largest American Public Pension Funds Face a $2 Trillion (U.S.) Shortfall

According to a recent study by Moody's Investors Service and reported by Bloomberg News, the twenty-five largest American pension funds face about $2 trillion U.S.) in unfunded liabilities, revealing that investment rates of return cannot keep pace with ballooning obligations. The twenty-five biggest systems by assets averaged a 7.45% return from 2004 to 2013, close to the expected 7.65% rate. However, Moody's warned: "Despite the robust investment returns since 2004, annual growth in unfunded pension liabilities has outstripped theses returns. This growth is due to inadequate pension contributions, stemming from a variety of actuarial and funding practices, as well as the sheer growth of pension liabilities; as benefit accruals accelerate with the passage of time, salaries increase and additional years of service mount." American states and cities are confronted with underfunded worker retirement systems. The economic recession, which officially ended in June 2009, destroyed asset values aplenty and forced cuts to employer contributions. Now, pension fund liabilities are crowding out spending for school budgets, social services and road maintenance.

The largest systems included in the Moody's study manage about 40%of the $5.3 trillion (U.S.) in American public pensions. They include the California Public Employees' Retirement System (Calpers), the California State Teachers' Retirement System and the New York State and Local Employees' Retirement System. In April 2013, Moody's announced it would take a more conservative approach to calculating liabilities than the states and cities, by using market-based discount rates to include both the top-line liability growth and the material decline in bond yields. As a result, Moody's placed twenty-nine municipal governments on a credit rating review with a negative outlook. In July, 2013, Moody's downgraded Chicago's credit rating by three levels, citing among the most-indebted U.S. cites, Chicago had the largest pension fund obligation.

The Washington Post Announces Cuts to Employee Retirement Benefits

Not only are pension fund obligations negatively impacting the funding ability of America's public sector, but also, the private sector is increasingly being drawn into the affordability fray. On September 23rd. the Washington Post announced large cuts in retirement benefits, declaring that it would eliminate future retirement medical benefits and freeze defined benefit pensions for non-union employees. The Post also stated that in negotiations which have just begun, it will seek to impose the same conditions on employees covered by the union; one of the first indications of how the Post's new owner – Amazon.com founder Jeffrey Bezos – will manage relations with the staff of the news organization. The changes will impact employees hired prior to 2009 the hardest, who could plan on receiving pension payments based upon their income and years of service. Each of those employees could see thousands of dollars less over the course of a retirement. More recent hires do not have traditional pension plans. The Post will create a new cash balance plan to replace the pensions for non-union employees and a separate but similar plan for those covered by the union. Those plans provide employees with a lump sum or annuity when they retire. However, they do not guarantee a particular level of retirement payments, thus reducing the risk that Mr. Bezos would have to add money to the pension if financial markets plunged.

A steady stream of firms has been eliminating pensions over the past decade and replacing them with plans which call upon employees to bear more of the responsibility for their retirement. The 2008 financial crisis made companies even more wary of promising benefits which they could have difficulty funding. The Post's existing pension plan totaled about $50 million (U.S.) – approximately 20% overfunded – when Mr. Bezos bought the Post a year ago. In a letter to its employees, the newspaper's management stated these pension plan changes were being made "with a goal of better positioning the Post for long-term success." The letter to employees did not mention changes in company contribution to 401 (k) plans, which were reduced in a little-noticed section of the Post's contract with Local 32035 of the Newspaper Guild, a union belonging to the Communication Workers of America. Effective this month, the Post will reduce its contributions to 401 (k) plans from a maximum of 5% to a maximum of 1% for workers in jobs covered by the guild contract. Instead, the Post will create another cash balance plan which will tap the pension surplus. The payments matching employee contributions to their 401 (k) plans are paid out of company operating expenses. The Post had made the same changes in 401 (k) matches for non-union-covered employees in 2012. In a Post interview, Josh Gotbaum, the former director of the federal Pension Benefit Guaranty Corp. noted: "Sadly, rather than cutting costs by sharing them, instead some companies are giving up on providing pensions at all."

Separately, Frederick Kunkle, a Post staff writer and co-chair of the union local, commented: "Once again, the Post dropped a bomb on the guild at its first meeting of contract talks. The last time we went to the table – more than a year ago – we said the publisher might have put forward the most contemptuous proposal in memory. We were wrong. We think this one is just as bad, maybe even worse."

U.S. Corporate Pension Dropouts Are on the Increase

As recently reported in the Wall Street Journal, Motorola Solutions Inc. and Bristol-Myers Squibb Co. are the latest American companies to cast off billions of dollars in pension burdens, fueling a trend that could weaken the U.S. government's ability to protect the payouts other employers have promised millions of retired workers. The two companies recently disclosed separate agreements which will shift a combined $4.5 billion in pension obligations to insurer Prudential Financial Inc. which will assume the responsibility for paying benefits to 38,000 retirees. The agreements are lucrative for the two companies' balance sheets. In addition, joining the dozens of companies that have shed their pension plans allows Motorola and Bristol-Myers to terminate paying millions of dollars in yearly fees to the Pension Benefit Guaranty Corp. (PBGC), the federal government's pension insurer. The problem is that the growing number of these corporate pension dropouts threatens the agency's resources for insuring the plans of those that remain in the system.

Last year alone, PBGC paid out $5.5 billion (U.S.) to 900,000 retirees whose pension plans had evaporated. Last December, in an attempt to shore up the system, Congress raised the mandatory insurance fees for companies; so the cost for each employee covered by a private pension will increase to $64 (U.S.) from the current $49 (U.S.) in 2016. At those rates, Motorola would save over $% million (U.S.) in total premium payments through 2016, while Bristol-Myers would save almost $1.5 million. One of the loudest corporate complaints is that all companies pay the same fees, regardless of their financial health. That means strong companies subsidize the weak, although companies with deeply underfunded pensions also pay yearly penalties. Assuredly, removing pension plans from the PBGC's jurisdiction also reduces the agency's potential obligations, but the net impact is uncertain.

While millions of American workers and retirees are covered by defined-benefit pension plans, their numbers are shrinking rapidly. The Employment Benefit Research Institute reports only 14% of the nation's private sector workers were covered by defined-benefit plans in 2011 – the most recent data available – less than half the 38% in 1979. Although many companies are reducing their exposure, others still believe that pensions are an important perk. The latest transfer agreements were the largest in the U.S. since 2012, when General Motors (GM) and Verizon Communications shifted billions in pension exposure to Prudential. The GM agreement covered 110,000 white-collar retirees and the Verizon transaction 41,000 workers. Transferring pensions to insurers, not only reduces companies' administrative costs, but also, protects them from the violent swings in the value of pension obligations.

The funded status of the 100 largest company pensions combined plunged to a record deficit of almost $392 billion (U.S.) at the end of 2012, from a surplus of nearly $68 billion (U.S.) at the end of 2007. According to actuarial consulting firm Milliman Inc. the gap had shrunk to $281 billion (U.S.) at the end of August, 2014. The pension transferring trend is accelerating partly because insurers are clamoring for the business. Motorola received five bids from insurers and paid no premium to transfer its pension obligations to Prudential.

A California Bankruptcy Judge Challenges the Sanctity of Pensions

As reported earlier this month in the New York Times, a federal bankruptcy judge has recently challenged the widely held belief that public workers' pensions have a special status in California, which makes them impossible to cut or reduce; further questioning the idea that pensions are sacrosanct in a municipal bankruptcy. The ruling, which occurred during a hearing on a plan by the City of Stockton to exit bankruptcy, did not order the city to cut its pension plan or take any specific action. Judge Christopher Klein of the Eastern District of California stated that he needed more time to reflect on Stockton's situation and would issue a decision on October 30th. whether the city could emerge from its two-year bankruptcy, or whether it still had more work to do. However, the judge's comments dealt a blow to California's giant Calpers pension system, which has been leading efforts to preserve defined-benefit pensions nationwide.

British Government to Encourage People to Work Longer

In its recently tabled business plan, as reported in the Daily Telegraph, The U.K. Department of Work and Pensions is recommending that the average retirement age be increased by as much as six months every year. At present, the average age of retirement in Britain is 64.7 years for men and 63.1 years for women. The number of people over 65 years of age is expected to increase by51% over the next 20 years and the numbers for those aged 85 and above will double by 2030. Accordingly, in a recent press conference, Pensions Minister Steve Webb stated: “Britons must accept dramatically longer working lives in order to avoid a National Health Service (NHS) funding crisis. If people just work an extra year, they can add 10% to their pension for life. What we are doing is catching up with decades of loner living. While we are living longer, the labour market and people’s retirement age has not been keeping pace.” U.K. Chancellor of the Exchequer George Osborne announced earlier this year that longer life expectancy dates for Britons will automatically trigger an increase in the state pension age, which is likely to increase to 70 within 50 years. The state pension age is currently 65 for men and is rising to 60 for women, eventually coming into line with men at 66 by 2020. According to government projections, the retirement age will continue to rise so people, who are now in their late twenties, will likely have to work until the age of 70.

Summation

In a recent Wells Fargo / Gallup survey of U.S. investors, nearly half of the respondents hadn’t planned how much money they need in order to retire. Such is the turbulent state of the subjects of retirement and pension funds in America. From public sector bankruptcy filings ranging from Detroit, Michigan to Stockton, California, many cities and states will ultimately discover their eventual pension liabilities through the rulings of the U.S. court system. In the private sector, a continuation of the accelerating trend of corporations to transfer pensions to insurers seems likely. In either case, with millions of ‘baby boomers’ hoping to retire in the coming decade and beyond, the pension turmoil currently unfolding in America will surely also beset untold numbers of workers in the future. It is evident that 401 (K) plans in the U.S. and Registered Retirement Savings Plans (RRSP’s) in Canada will be insufficient to enable a comfortable retirement.
Even though we have focused on three western developed economies outlined above, at Longwave Analytics, we believe the emerging pension crisis is global in nature. Indeed, no country will be immune from the developing catastrophe. Since most pension plans and private investment portfolios are invested in securities such as equities and bonds, they will be decimated when these markets succumb to the growing international debt crisis. Ergo, as the global economy cascades into a winter cycle of deflation, pensioners will not receive what has been promised them by their pension plan. An economic depression will ensue and hard times will be widely felt until the global debt problem is expunged.

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