

BRIEF

Would Your Pension Be Better Off In Canada?

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Abstract

We've received mail from many U.S. AFM Members who feel our pension fund would have been better off under Canadian management. Existing comparisons of the two pensions are incomplete and contain some serious mistakes, so we did our own. Here's a summary of our results:

Transparency The U.S. Pension system is vastly more transparent than Canada's, which appears completely opaque. This is a serious problem which makes it impossible for a third party to evaluate the health of Canadian pensions. On the other hand, the Canadian pension plan does a better job communicating with its members than the U.S. AFM-EPF has made great strides in this area but still lags behind Canada.

Regulation The Canadian pension system is much more conservative and involved in pension plan operations than the U.S. pension system is. While this has made Canadian benefits lower it may have contributed to a healthier pension system.

Investment Performance The Canadian Pension plan has superior investment performance and 50% lower investment costs compared to the U.S. plan. The U.S. plan is larger which may account for some of its difficulties.

Benefits Both plans have had difficulties which have led to pension cuts. The U.S. plan had several cuts, including lowering its benefit multiplier to \$1.00 USD in 2010. The Canadian cuts were later, reaching a low of \$1.26 USD in 2013, levels that each plan still has today. **Perhaps the most serious mistake made in analyzing the Canadian plan is the claim that the current benefit multiplier is three-times the size of the U.S. benefits multiplier. This is incorrect. It is only \$0.26 USD higher.**

Expenses The U.S. plan spends substantially more per participant than the Canadian plan. Some of this is explainable by the much larger size of the U.S. plan, but not all.

General Health Due to the opacity of the Ontario pension plan system, it is impossible to say how healthy the Canadian pension plan is. They have suffered recent setbacks and been forced to reduce benefits to levels close to the American plan. Whether this is temporary or a sign of more trouble to come is impossible to say without more information.

Conclusion Superior expense and investment performance has not saved the Canadian plan from the need for reducing benefits and the Canadian plan's benefits are currently very close to those in the U.S. The Canadian plan may be healthier than the U.S. Plan; if it is, we believe this is due to more conservative financial management forced on it by regulators. While we encourage the U.S. plan to continue to improve investment performance and cost controls, these will not solve the existing structural problems faced by the AFM-EPF. Both plans (and regulatory systems) could learn some good lessons from each other.

1 Background

U.S. federal law governs the AFM-EPF and other funds of this type. Canadian funds follow the Income Tax Act, administered by the Canada Revenue Agency (CRA) and the laws of the province where the majority of their participants live. Since most AFM Canada members live in Ontario, the Canadian fund is regulated by the Ontario regulator and follows the laws of the Pension Benefits Act of Ontario. Pensions originating in other provinces will have different rules and regulations, but these won't apply to the Canadian pension plan. The location of the pension office has no influence on the laws applied.

2 Fund Transparency and Regulation

2.1 Transparency

The Canadian pension's website currently hosts audit statements from 2004-2016 and Annual Reports from 2013-2016. The audit reports are about 24 pages long and include the plan's balance sheet, a summary description of the plan and associated notes. The annual reports are intended to be reports to the membership and are more readable than the audit reports. They summarize the information from the audit reports and provide a discussion of the fund's situation and future. The Canadian plan's website contains much more historical information than the AFM-EPF's site.

The Annual Reports are beautiful and a model of clarity. They provide more information in a more useful form for the typical fund participant than the one-page plan funding notice we are all used to receiving from American pension plans such as the AFM-EPF. The greater transparency of the U.S. system does make it possible for plan participants to assemble comparable information for themselves, but that would require a significant amount of time and effort. We applaud the recent improvements made by the AFM-EPF in this area, but they still need to do better to catch-up with Canada.

The Canadian audit statements are disappointing. They contain a tiny subset of the information we are accustomed to getting from U.S. pensions plans. Missing from Pension-CANADA: government filings, actuarial schedules, actuarial reports (including the crucial actuarial assumptions), compensation for each employee, compensation for each financial adviser. Well, you get the picture. Without this information, a thorough evaluation of all aspects of the Canadian pension plan is impossible.

In an attempt to acquire some of the missing information, we contacted the Canadian pension plan. We were especially interested in obtaining the discount rates used by the fund actuary. Jill D. Giustino, Director of Administration, told us that our request would have to be approved both by the Board of Trustees as well as the Fund's Actuary. About a month later, our application was politely denied.

We then contacted the Financial Services Commission of Ontario (FSCO). We asked for access to the filings of the Canadian pension plan, explaining that those were available to any person for U.S. pension plans. Sobha Haumeer, Pension Analyst at the FSCO also

turned down our request, citing Ontario law. Apparently only “plan beneficiaries” can obtain such information. There is an option in Ontario law to have a plan beneficiary appoint a representative in writing, who would then have access to plan documents. We haven’t taken that step so crucial plan information remains inaccessible to us and to any other scholars who would be interested in seeing it.

We have also made the same request to the CRA. Months after we made it, we are still waiting for an answer. We do not expect a “yes”.

Based on these experiences, we are forced to conclude that the Ontario pension system is incredibly opaque and very much in need of reform. The situation in the U.S. is vastly superior.

2.2 Regulation

Pension regulation in Ontario appears much more conservative and “hands-on” than it is in the United States. For example, pension are not allowed to use previous years surpluses to cover newly accrued liabilities. These need to be covered by investment returns and employer contributions occurring in the same year. In Canada, pension benefit increases are only effective after approval by the CRA (Canada’s “IRS”).

In the U.S., pension trustees can increase benefits without getting government approval and utilize surpluses as they see fit. The only constraint on their decisions is their legal obligation to function as fiduciaries of the plan. We do not believe any plan in the U.S. has ever followed such a fiscally conservative program as the one imposed by FSCO on Ontario pensions. It’s possible that pensions in the U.S. would be much better off today if we had done this in the U.S.

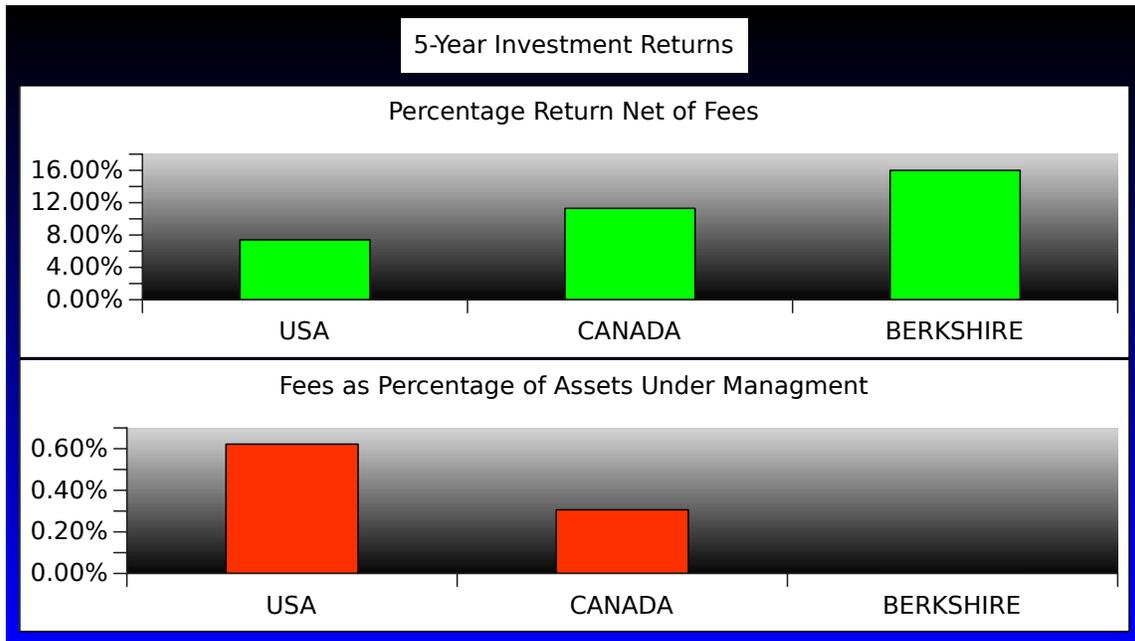
3 Investment Performance

There’s a lot to admire about the Canadian’s pensions investment style. They spend a lot less and have achieved higher returns than the AFM-EPF. To measure their performance, they compare each asset to a market-based index of similar assets and disclose this to members in their yearly annual report. This was one of the recommendations in section five of our paper and we are happy to see that the AFM-EPF has started to do the same thing. We feel it is an essential component of the periodic reporting owed to participants. Unfortunately, the AFM-EPF reports returns gross of expenses, which overstates the actual returns. A blemish shared by both funds is that neither one compares their total return to any benchmark. We provide that here.

The Canadian plan is significantly smaller than the AFM-EPF. The Canadian’s net investments for 2016 were about \$0.75 billion CAD, while Pension-USA’s were around \$1.75 billion USD. Significant returns are much more difficult to get once you cross the billion-dollar mark. Many investing experts (including Warren Buffett) have made this point. Keep it in mind as you evaluate each fund’s performance.

Year-over-year investment comparisons are quite difficult between Pension-CANADA and Pension-USA due to the differences in their fiscal years. However, both report five-year returns. Comparing these is reasonable, since the longer period should reduce the effect of any end-point noise. Figure 1 gives the results for each as well as our benchmark Berkshire Hathaway¹.

Figure 1: 5-Year Investment Returns



Unfortunately, the AFM-EPF is on the wrong side of both of these metrics. They have historically paid more for lower returns. They have recently made some changes in their investment advisers and process. We are all hopeful that these changes will correct the problems. The Canadian plan has done much better, but as the comparison with Berkshire shows, there is plenty of room for improvement.

As far as we can tell, each fund's investment managers are paid the same no matter how well they perform. Historically, better returns have occurred when pay is related to how well the investment manager performs.

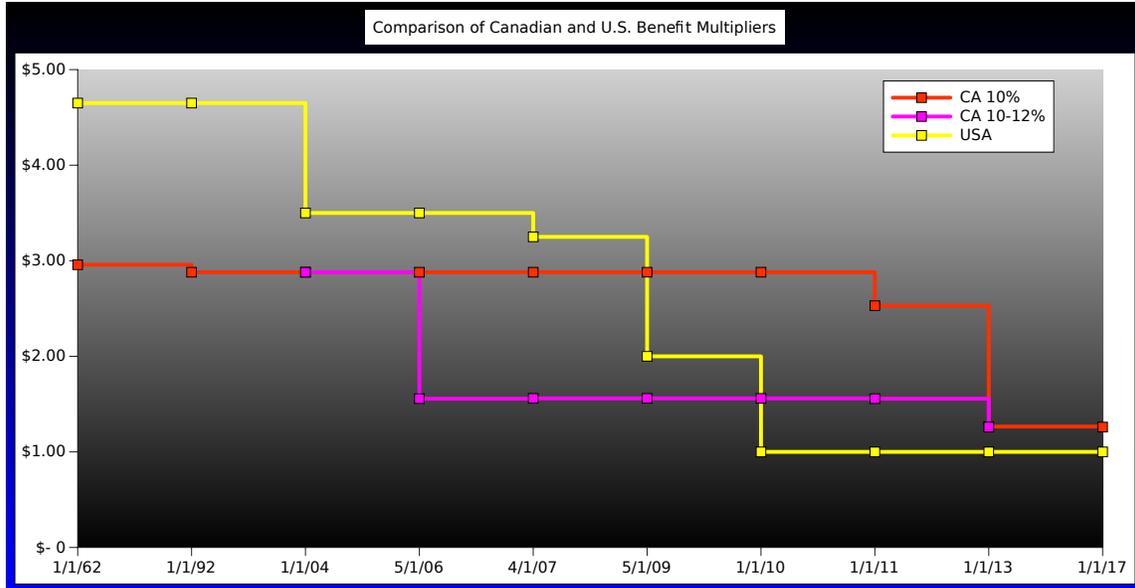
4 Benefits

Figure 2 shows how the benefit multiplier looks to us today. Due to the retroactive nature of the U.S. plan's \$4.65 increase, this is something of a revisionist history but it does

¹Disclosure: The authors are Berkshire shareholders.

reflect how benefits are calculated today.² We could not locate any historical data on the Canadian benefit multiplier. As far as we know, this is how it has always been in Canada.

Figure 2: Benefit Multiplier “Revisionist” history (all figures in USD).



As you can see, the U.S. multiplier was substantially higher than the Canadian one until 2004, when it began its decline to the \$1.00 BM we have today. The Canadian BM took a bit longer to decay, but since 2013 it is barely higher than the U.S. multiplier (\$1.26 USD/\$1.625 CAD). Between May 2006 and January 2013, the Canadian Fund instituted a “progressive” benefit multiplier system where contributions of up to 10% of wages use a higher multiplier (red line) while contributions between 10%-12% of wages use a lower multiplier (purple line). Contributions over 12% of wages were returned to the employer. That limit was raised in January 2013 to 18%. This is not a decision of the pension fund, but a ruling of the CRA.

The Canadian Trustees chose an unusual method for their most recent benefit multiplier reduction. Instead of cutting the benefit multiplier in half, the pension contribution accrual for the participant is reduced by one-half. In other words, one half of a player’s contribution will apply to the benefit calculation; the rest will support the general health of the Canadian pension fund. So if a player had \$1,000 in actual pension contributions, it would be treated as a contribution of \$500 in calculating his monthly benefit. The other \$500 goes into the general fund. Many commentators have claimed that the current Canadian benefit multiplier is three-times the size of the U.S. one. As you can see, after accounting for the reduction by half and the currency differences, it is only \$0.26 higher. Since this claim

²For more details on the benefit multiplier, please see our paper The AFM Pension Crisis Section 1.3

seems to be controversial, here is the math:

Monthly benefits are calculated in the same way for each plan: Divide the contribution amount by 100 and then multiply by the benefit multiplier. The current Canadian benefit multiplier is \$3.25. Assuming \$1,000 CAD of contributions, the monthly benefit for this amount would ordinarily be:

$$\$1,000 \div 100 \times 3.25 = \$32.50$$

However, since 2013, only 50% of the participants' contributions are used in the Canadian benefit calculations. So the actual monthly benefit today is:

$$\frac{\$1,000}{2} \div 100 \times 3.25 = \$16.25$$

A moment's thought will show you that this is exactly the same as using a multiplier of $3.25 \div 2 = 1.625$, or, in other words, the same as a 50% benefit reduction:

$$\$1,000 \div 100 \times 1.625 = \$16.25$$

To compare the Canadian BM to the U.S. BM, you need to express them both in the same currency. We convert the Canadian one to U.S. dollars using an exchange rate of \$1 CAD = \$0.778349 USD:

$$\$1.625 \times 0.778349 = \$1.264716125 \approx \$1.26$$

This odd method of benefit reduction seems like a sneaky way to make the Canadian Fund look better on paper. It has certainly fooled a few U.S. observers. But we do not believe this is the motivation. The Canadian Trustees are very open about the policy and state it clearly in several places. It appears that, since Canadian pension plans must apply to the tax authority for permission to raise the benefit multiplier, the Canadian trustees feared that if they cut the multiplier the tax authority might not let them grow it again. They chose this alternate route as being in the better interests of their members.

As a final comparison of benefits under the two plans, we take the Canadian Trustees' example of "Mark", a musician who retired in 2014 with \$22,700 (CAD) in contributions. His pension would be \$784 CAD/month. If the Canadian Pension Fund used the U.S. benefit multipliers, Mark's pension would \$762.50 CAD/month, or only 2.8% lower using the current U.S. methods.

5 Expenses

The Canadian plan is much smaller than the U.S. plan which makes comparing expenses a challenge. It is clear from the annual report that the Canadians are making constant efforts to improve their spending. Of particular note: the Canadian plan recently moved

to reduce their rent expense. Relocation for cheaper rent is a frequent recommendation by friends of the U.S. plan.

In 2016, the Canadian plan spent \$273.73 USD per participant, compared to \$503.57 USD paid by the U.S. plan. The U.S. expenditures were 84% more per participant than the Canadian plan. Included in the U.S. expense are the \$28 of PBGC premiums. The view in Canada is that, due to tighter regulation, Canada's pension plans are much less likely to fail and so a PBGC-like safety net is not required.

While we acknowledge the greater complexity of the U.S. plan over Canada's, we think an 84% expense differential suggests that there is plenty of room for improvement in the U.S. plan's cost control.

6 General Health

Unfortunately, due to the opacity of the Canadian plan, a general assessment of its health is not possible. Refusing to disclose essential aspects of the plan (such as the discount rate, number of orphans and inactives, etc.) protects the Trustees and their actuary from scrutiny. This policy does not benefit any participant of the Canadian plan.

As illustrated by the changes in the benefit multiplier, the Canadian plan has some challenges. Whether these are temporary or an onset of the pension influenza that affects the U.S. plan is impossible to say. As far as we can tell, the Canadian plan appears to be well run on many levels, although improvement is possible. It's certainly the case that the many years of a lower benefit multiplier (22%-25% lower) would stress the Canadian plan far less than those used in the U.S. For this reason alone, we suspect that the Canadian plan may be in much better shape than the AFM-EPF.

7 Conclusion

The differences between the two plans are not as vast as many commentators have suggested. In particular, the differences between the actual benefits delivered by both plans to participants is small. While the U.S. Trustees have improved their communications with members, something along the lines of the Canadian Fund's Annual Report would be an improvement. They have already adopted actual market indexes for benchmarks, reporting results net of fees (rather than gross of fees) could would bring it on a par with Canada. Both plans would see an improvement in investment-related fees and performance from a greater use of indexed investing or direct investment in Berkshire Hathaway. The Canadian plan seems to have a better grip on their expenses, and the U.S. plan should undoubtedly try harder. However, even if the AFM-EPF were to equal the cost and investment performance of the Canadian plan, this would not solve the existing structural problems faced by the American plan.

As far as the regulatory environment is concerned, Ontario could make several steps in the right direction by emulating the disclosure policies required by the U.S. for all pension plans. Meanwhile, the U.S. plan would be in better shape if their benefit increases had to be approved by the U.S. Treasury or IRS, as is done in Canada.

It's possible that the Canadian plan is healthier than that AFM-EPF. If so, we believe this is primarily due to the more conservative fiscal policies forced on it by regulators, such as restricting benefit increases and requiring that the normal costs be funded by money coming into the plan for that year, rather than by surpluses.