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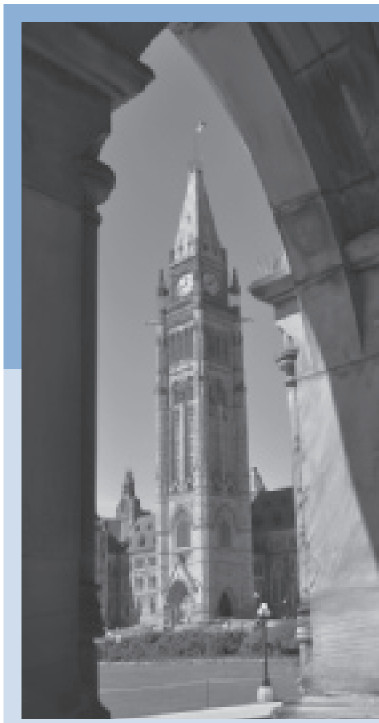

Report of the Auditor General of Canada

CHAPTER 1
Public Sector Pension Plans

Office of the Auditor General of Canada

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CHAPTER 1

Public Sector Pension Plans

Performance audit reports

This report presents the results of a performance audit conducted by the Office of the Auditor General of Canada under the authority of the *Auditor General Act*.

A performance audit is an independent, objective, and systematic assessment of how well government is managing its activities, responsibilities, and resources. Audit topics are selected based on their significance. While the Office may comment on policy implementation in a performance audit, it does not comment on the merits of a policy.

Performance audits are planned, performed, and reported in accordance with professional auditing standards and Office policies. They are conducted by qualified auditors who

- establish audit objectives and criteria for the assessment of performance,
- gather the evidence necessary to assess performance against the criteria,
- report both positive and negative findings,
- conclude against the established audit objectives, and
- make recommendations for improvement when there are significant differences between criteria and assessed performance.

Performance audits contribute to a public service that is ethical and effective and a government that is accountable to Parliament and Canadians.

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Public Sector Pension Plans

Main Points

What we examined

The Government of Canada sponsors pension plans covering almost all employees of the public service (as well as certain public service corporations as defined in the *Public Service Superannuation Act*), the Royal Canadian Mounted Police (RCMP), the Canadian Armed Forces, federally appointed judges, parliamentarians, and employees of territorial governments. Overall, pension net liabilities totalled almost $152 billion in the 2012–13 fiscal year, while pension assets totalled $72.2 billion. The same year, interest expense on the pension liabilities, which are part of the government's public debt charges, totalled $9.2 billion.

This audit focused on the public service pension plan, the Canadian Forces pension plan, and the RCMP Pension Plan. Together, these three plans represent 95 percent of the government's public sector pension liability.

The audit examined whether the Treasury Board of Canada Secretariat, the RCMP, National Defence, and the Department of Finance Canada, in keeping with their respective responsibilities, considered the relevant information, analyses, and scenarios that could affect the plans' costs and thereby impact their sustainability. It also examined whether these entities carried out selected key aspects of their governance and management responsibilities with regard to the pension plans. Finally, we examined whether the information provided to stakeholders, who include taxpayers and parliamentarians, is understandable.

Audit work for this chapter was completed on 17 January 2014. More details on the conduct of the audit are in **About the Audit** at the end of this chapter.

Why it's important

Public sector plans have a large impact on the government's financial position, in particular on the public debt. In addition to the employer contributions, taxpayers contribute to the plans when there is a funding deficit. Because the plans are also financed from investment earnings, low investment returns can lead to unforeseen charges that can also have a negative impact on the budgetary balance. Conversely, the budgetary balance could be improved if investment earnings were above expectations. In a context of volatile returns on assets, and with beneficiaries living longer, the sustainability of the plans could be at risk. It is important that the pension plans be designed in a way that protects employees and taxpayers, and that is fair to current and future generations.

What we found

- The Treasury Board of Canada Secretariat, National Defence, and the RCMP performed their mandated responsibilities properly. The entities used relevant information and analyses to perform their mandated responsibilities. They reviewed pension plan provisions that were found ineffective, and they complied with the process established for selecting actuarial assumptions for calculating the pension obligations.

- The Department of Finance Canada monitors and communicates the different fiscal risks associated with the public sector pension plans. It performs various analyses to assess the potential budget impact of its exposure to capital markets and alternative interest rate scenarios.

- The responsibilities and governance framework are dispersed among a number of entities. There is no single entity exercising overall stewardship on behalf of the Government of Canada, which is the plan sponsor. Given the shared responsibilities among various organizations and the plan sponsor, it is important that roles and responsibilities be clearly defined.

- Key aspects of the governance framework for the public sector pension plans do not reflect good practices and could be strengthened to better align with current and future circumstances. The current governance framework does not require the plan sponsor to assess the sustainability of the plans. The Treasury Board of Canada Secretariat supports the plan sponsor, who is responsible for ensuring the sustainability of the pension plans and protecting taxpayers. The Secretariat is accountable only for the responsibilities assigned to it through legislation and policy, such as the responsibility for recommending contribution rates and producing the annual report of the public service pension plan. In addition, the governance framework does not include a funding policy. Without an expressed level of risk tolerance by the plan sponsor, the Public Sector Pension Investment Board assumes that the funding risk is acceptable to the plan sponsor.

- Entities do not inform stakeholders in a clear and consolidated fashion. Although there have been improvements and full financial information is available, the information is dispersed among several reports and is not easy to read. This makes it difficult for parliamentarians and Canadians to readily understand the potential impact of pension liabilities on the budgetary balance of the government.
- The Department of Finance Canada has not concluded its analysis on the costs and benefits of funding the pre-2000 pension obligations. Given the significance of the potential financial benefits vis-à-vis the risks, it is important that the analysis be concluded.

The entities have responded. The entities agree with all of the recommendations. Their detailed responses follow the recommendations throughout the chapter.

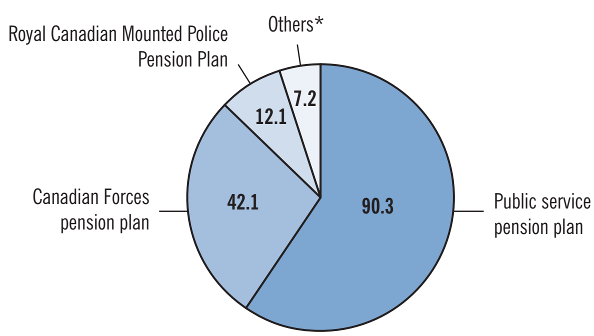
Introduction

1.1 Good management of public affairs depends on the calibre and the performance of the public service. Pension benefits are an important part of the total compensation offered to public servants in an effort to recruit and retain highly skilled workers. The Government of Canada sponsors **defined benefit pension plans** and has a statutory obligation for the payment of their benefits.

Defined benefit pension plan—A type of pension plan that promises a certain level of pension, which is usually based on the plan member's salary and years of service.

1.2 In this chapter, our references to "public sector pension plans" specifically refer to the plans of the federal public service, the Canadian Forces (excluding the Reserve Forces Pension Plan), and the RCMP. With over 430,000 contributors, more than 291,000 pensioners, and almost 82,000 survivors as of 31 March 2012, these three plans combined represent 95 percent of the government's pension liability (Exhibit 1.1).

Exhibit 1.1 **Liabilities of the public sector pension plans on 31 March 2013 ($ billions)**



Total: $151.7 billion

*Other public sector pension plans include the Reserve Forces Pension Plan ($0.3 billion), members of Parliament ($0.4 billion), federally appointed judges ($2.3 billion), and various retirement compensation arrangements ($4.2 billion).

Source: Public Accounts of Canada, 2012–13, Volume I

Key aspects of public sector pension plans

1.3 The financial situation of the plans is captured in the government's consolidated statement of financial position, which presents its liabilities and assets. The plans have a direct impact on the financial position of the government. **Public sector pension plan liabilities** are part of the **non-market debt** of the Government of Canada's interest-bearing debt. As of 31 March 2013, these net liabilities totalled $151.7 billion and represented the government's second-biggest liability after **market debt**, which totalled $668.0 billion. Pension assets totalled $72.2 billion as of that date.

Public sector pension plan liabilities—The government's net obligations related to the pension plans it sponsors. "Pension obligations" refer to the amount calculated by the Chief Actuary.

Non-market debt—Debt that is principally made up of public sector pension plan liabilities and also includes other liabilities, such as government employees' and veterans' future benefits.

Market debt—Debt that the Government of Canada raises in financial markets, including marketable bonds in either domestic or foreign currency, treasury bills, and retail debt.

Public debt charges—Interest related to market and non-market debt.

Actuarially determined obligations—The value of the retirement benefits payable to current and former employees, based on the service rendered as calculated by the Chief Actuary of Canada.

1.4 Interest on the pension liabilities are included in the **public debt charges**. In 2012–13, interest related to public sector pensions totalled $9.2 billion or 31.5 percent of the $29.2 billion total public debt charges. In addition, special payments using public funds can be made to bring the pension fund into line with **actuarially determined obligations** to cover actuarial deficiencies. In 2012–13, these special payments totalled $741 million.

1.5 The pension plans are generally financed from employee and employer contributions, as well as from interest credited and investment earnings. Their annual costs include the benefits and the interest. In 2012–13, these expenses combined totalled $15 billion, representing approximately 5.5 percent of the government's total expenses.

1.6 The pension plans comprise two types of accounts created under legislation: superannuation accounts and pension fund accounts. Superannuation accounts record employer and employee contributions made before 1 April 2000, but hold no actual assets. Interest on those contributions continues to be recorded in these accounts. Contributions made since 1 April 2000, after the creation of the Public Sector Pension Investment Board (PSPIB), have been credited to pension fund accounts. Contribution amounts that exceed benefits paid out (and minus administrative expenses) are transferred regularly from the pension fund accounts to the PSPIB to invest in capital markets. More information on the pension plans' structure can be found in Appendix A.

Who manages the pension plans?

1.7 Public sector pension plans are not regulated by the Office of the Superintendent of Financial Institutions or subject to federal pension benefits standards legislation, but they are governed by several federal laws, with responsibilities shared among a number of ministers supported by various federal entities. These include the Treasury Board of Canada Secretariat, the RCMP (under Public Safety Canada), National Defence, the Office of the Chief Actuary, the Department of Finance Canada, Public Works and Government Services Canada (PWGSC), and the Public Sector Pension Investment Board (PSPIB).

1.8 The President of the Treasury Board, the Minister of National Defence, and the Minister of Public Safety are responsible for the pension plans of their respective departments. The Treasury Board of Canada Secretariat, National Defence, and the RCMP manage their respective pension plans in support of their ministers and are responsible for the development of policy and legislation, program advice and interpretation, financial analysis, and the preparation of annual reports for their pension plans. The RCMP and National Defence are also responsible for their plans' day-to-day administration, including determining eligibility for benefits, and calculating and paying benefits.

1.9 In addition, the Secretariat supports the Treasury Board, which represents the Government of Canada (the employer and plan sponsor, which has overall responsibility for the public sector pension plans). In this capacity, the Secretariat coordinates the government's stewardship duties for other public sector pension plans and other retirement programs and arrangements. However, the day-to-day administration of the public service pension plan, including the calculation of contribution and benefit amounts and the payment of benefits, is the responsibility of PWGSC. The Department of Finance Canada analyzes Canada's budgetary situation and outlook.

1.10 The Secretariat, the RCMP, and National Defence have established various internal committees to support them in managing the plans. As per the statutes, each entity has a Pension Advisory Committee (PAC), which provides advice to their responsible minister on matters relating to the pension plan's administration, benefit design, and funding. Members of the three PACs also meet jointly each year to discuss common issues.

Key changes related to the public sector pension plans

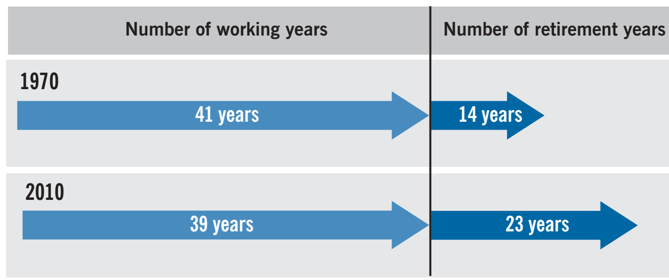
1.11 **Challenging market conditions.** Since the 2008 financial turmoil, we have been witnessing market conditions characterized by numerous episodes of strong volatility and a prolonged period of very low interest rates. These conditions had a significant financial impact on pension plans. Pension plans calculate their obligations by using a **discount rate** linked to long-term interest rates applied to future cash flows. When long-term interest rates go down, obligations increase. While financial markets have recently improved, the economic conditions affecting the pension plans may have a significant impact on the federal government's financial position. The **budgetary balance** could also be affected.

Discount rate—Rate used to calculate a present value of future benefit to determine the pension plan's obligation.

Budgetary balance—The balance between total public spending and revenue over the fiscal year. A positive balance results in a surplus, and a negative balance results in a deficit.

1.12 **Longevity.** The longevity of Canadians has increased steadily over several decades. Retirees now live longer than anticipated just a few years ago. The significant reduction in mortality rates can be best illustrated by the increase in life expectancy at age 65, which directly affects how long pension benefits will be paid. According to the Canada Pension Plan 26th Actuarial Report, the trend of increased longevity is expected to continue in the future, but at a slower pace than most recently observed over the 15-year period ending in 2009. As shown in Exhibit 1.2, a comparison of 1970 to 2010 data shows that Canadians, on average, work fewer years, and retire earlier and for a longer period. The same trend applies to public service employees, who are retired 27 years on average.

Exhibit 1.2 Changes in the length of retirement of Canadians, 1970 and 2010



Source: Canada Pension Plan data provided by the Office of the Superintendent of Financial Institutions and calculations from the Office of the Auditor General of Canada.

1.13 **Budget 2012.** In Budget 2012, the government announced changes to the way costs are shared for public sector pension plans. The act governing the public service pension plan was amended to raise the pensionable age by five years for employees entering the plan on or after 1 January 2013 and to increase employees' share of contributions to 50 percent. In addition, the employee contribution rates for the RCMP and Canadian Forces pension plans were increased to equal those of the public service pension plan. The government estimates that these changes will result in cumulative savings of over $2 billion for Canadian taxpayers by the 2017–18 fiscal year.

Focus of the audit

1.14 The audit focused on the three main public sector pension plans (public service, Canadian Forces, and RCMP plans). The audit examined whether the Treasury Board of Canada Secretariat, the RCMP, National Defence, and the Department of Finance Canada, in keeping with their respective responsibilities, considered the relevant information, analyses, and scenarios that could affect the plans' costs and thereby impact their sustainability. It also examined whether these entities carried out selected key aspects of their governance and management responsibilities with regard to the pension plans.

1.15 The audit covered the period between 1 April 2011 and 31 March 2013. The period under examination extended back to 1 April 2008 for the examination of the pre-2000 unfunded pension obligations. More details about the audit objectives, scope, approach, and criteria are in **About the Audit** at the end of this chapter.

Observations and Recommendations

Roles and responsibilities

1.16 According to the *Public Service Superannuation Act*, the *Canadian Forces Superannuation Act*, and the *Royal Canadian Mounted Police Superannuation Act*, the President of the Treasury Board, the Minister of National Defence, and the Minister of Public Safety are responsible for the overall management of the three pension plans the audit focused on.

1.17 We examined whether these three entities, in their roles as administrators of their respective pension plans, exercised their responsibilities. For the purpose of this audit, we examined selected responsibilities assigned through legislation.

The Secretariat, the RCMP, and National Defence have carried out their responsibilities

1.18 We found that the entities provided program and policy advice and financial analysis, and they developed legislation for managing the provisions of the pension plans, such as determining contribution rates and producing annual reports, as required by the acts.

1.19 **Review of pension plans' provisions.** We found that the entities have recommended policy changes to existing provisions of the pension plans. For example, the RCMP and National Defence have raised issues related to pension portability and benefits of survivor for members who marry after age 60, respectively. For those two issues, in collaboration with the Secretariat and the Office of the Chief Actuary (OCA), the responsible entity for each issue performed analyses to assess the costs of proposed changes. The entities were able to document the impact of the proposed policy changes, and they communicated them clearly.

Pension buyback—A legally binding agreement to purchase a period of prior service to increase an employee's pensionable service under the public sector pension plans.

1.20 Officials from the Secretariat have also identified other issues relating to **pension buyback** for the public service pension plan. According to the Secretariat, the government could generate significant savings if service buybacks were reviewed. The Secretariat believes that the current method of costing them (based on contributions and interest) does not provide an accurate reflection of the true cost of the liability of the service being bought. No changes had been made to buyback provisions for the public service pension plan at the time of the audit. According to the RCMP, the RCMP Pension Plan has service buyback provisions that better reflect the true cost of the liability.

Actuarial valuation—A type of appraisal that requires making economic and demographic assumptions in order to estimate future liabilities.

1.21 **Selection of assumptions.** We found that the Secretariat complies with the legislation that guides the selection of economic and demographic assumptions used for calculating the pension obligations. For the Public Accounts, **actuarial valuation** is led by the Secretariat. The Office of the Comptroller General of Canada (within the Secretariat) chairs the Central Agency Meeting on Pension Accounting, which occurs once a year so it can evaluate and decide on the assumptions to be used in the Public Accounts. The other participants are the OCA and the Department of Finance Canada.

1.22 The economic assumptions used for the Public Accounts are presented by the Department of Finance Canada (for example, interest rates, the inflation rate) and the Secretariat (for example, expected rate of return of pension assets, salary increases, population growth in the public service). A funding valuation is used to set many demographic assumptions used for the Public Accounts, such as retirement age and mortality rates.

1.23 According to the *Public Pensions Reporting Act*, the President of the Treasury Board is responsible for asking the Chief Actuary to prepare actuarial reports. At least every three years, the OCA prepares an actuarial report that determines the difference between the actuarial obligations and the amount of the reported assets. Following the tabling of the report, the President of the Treasury Board determines what measures should be taken to address the resulting surplus or deficit, within the parameters established by the respective superannuation acts.

1.24 The OCA determines the demographic and economic assumptions for funding valuations, which occur every three years, in an independent manner. All actuarial assumptions used are best-estimate assumptions made by the OCA. We found that the Secretariat, National Defence, and the RCMP respected the independence of the Chief Actuary.

Sustainability of public sector pension plans: Understanding risks

1.25 The affordability and **sustainability** of public sector pension plans have recently attracted a lot of attention in Canada and abroad. The province of New Brunswick has reviewed the design of its pension plans while other provinces (such as Quebec and Alberta) are considering options because historically low interest rates and increases in life expectancy are increasing the cost of the pension obligation. Lower returns on assets are another risk that plan sponsors

Sustainability—The degree to which a government can maintain its existing financial obligations both in respect of its service commitments to the public and financial commitments to creditors, employees, and others, without increasing the debt or tax burden relative to the economy within which it operates.

must manage in their effort to protect the interests of employees and taxpayers. Taking note of these issues, we present in this section some fundamental aspects and risks related to the sustainability of the pension plans.

Risks to the financial position of the government could be significant

Funding deficit—A situation where the funds projected to be available in the future are less than the estimated pension payments to departing members.

1.26 The Chief Actuary prepares an actuarial valuation to assist the President of the Treasury Board in making informed decisions on financing pension obligations and to determine whether funds are sufficient to cover them. Over the last three years, pension funds experienced **funding deficits** totalling $6.5 billion. Special payments were required to cover the gap. For 2013, special payments totalled $741 million. Over the last two years, these payments totalled approximately $1 billion. This disbursement does not affect the government's financial results. Rather, the difference between expected and actual results, as determined through the actuarial valuation, is amortized yearly.

1.27 As explained in paragraphs 1.11 and 1.12, pension plans face a number of emerging risks and challenges. Factors such as prolonged low interest rates, lower than expected returns on assets, and increasing longevity could have a significant impact on pension liabilities and on the financial position of the government. The fiscal projections and actuarial calculations we developed, which are detailed in paragraphs 1.29 to 1.33, underscore the importance of properly managing public sector pension plans. The plan sponsor needs to be aware of emerging risks. It also needs to ensure that the plans are appropriately designed and that proper policy options are in place to protect current and future employees, beneficiaries, and taxpayers as well as the employer.

Pension promises—Refers to the pensions to be provided directly to employees (as opposed to the pension liability portion of the government's debt).

1.28 The Public Sector Pension Investment Board (PSPIB) has developed an investment strategy with the aim of achieving a return over the long term at least equal to the Chief Actuary's long-term return assumption (currently 4.1 percent real rate of return). This is the rate necessary to ensure that there will be enough assets to cover current **pension promises**, given the current level of contributions and assuming no other factors affect the funding of the pension plans. To achieve this return, the PSPIB needs to take on investment risks. In addition, returns could be significantly above or below the set target, particularly over the short term. In 2012, the PSPIB projected that over 10 years, there is a 35 percent probability that its investment strategy will not achieve the target. This probability could increase or decrease over the years.

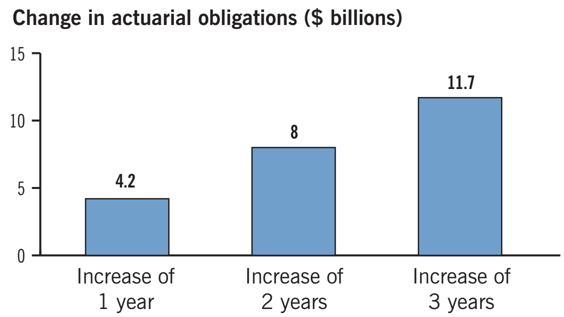
1.29 Impact of changes in assumptions on the budgetary balance. Demographic and economic assumptions affect the valuation of the pension obligations. For example, the expected rate of return on PSPIB investments is an economic assumption. The difference between the expected and actual return is reported against the pension obligations in the Public Accounts. Assumptions are reviewed and adjusted annually, and the new difference between the expected and actual return is also reported. These cumulative differences are recognized gradually to mitigate short-term volatility. As of 31 March 2013, the cumulative budgetary impact of these differences (gains and losses) is expected to result in a charge to the government of about $700 million in 2014 and $6 billion over the next nine years.

1.30 Impact of return at PSPIB on the budgetary balance. Interest on the public debt is offset by the expected returns on PSPIB investments. (These investments are related to post-2000 service.) Fluctuations between actual and expected returns on PSPIB investments are averaged out over a period of five years to reduce volatility. If the investments underperform, the government will face higher interest on the debt. Conversely, if the investments perform above expectation, the government will have lower interest on the debt.

1.31 To illustrate the impact of the PSPIB's investment return on the budgetary balance, we simulated alternative scenarios for the PSPIB's expected rate of return for the 2009–13 period. The results of our analyses show that if the PSPIB rate of return had been even 2 percentage points lower than it was in 2009, 2010, and 2011, for example, it would have increased the federal deficit by about $750 million over the 2010–13 period. Conversely, if the PSPIB rate of return had been 2 percentage points higher, the federal deficit would have been reduced by approximately $800 million over the same period.

1.32 Impact of improving longevity. We performed actuarial calculations to illustrate the impact of different longevity rate assumptions on the public service pension plan's actuarial obligations. Alternative longevity assumptions simulate an increase in life expectancy for plan members by one, two, and three years. The results show that pension plan actuarial obligations, as of 31 March 2013, would increase by roughly $4.2 billion (3 percent) if plan members lived a year longer, $8.0 billion (5.9 percent) for a two-year increase, and $11.7 billion (8.6 percent) for three years (Exhibit 1.3). Recently, the Chief Actuary concluded that improving life expectancy at age 65 for members of the three major public sector pension plans would increase the total actuarial obligation by more than $7.7 billion as of 31 March 2013. Based on past experience, this increase in life expectancy would happen gradually over a period of many years. This change in actuarial assumptions would be spread over approximately 13 years, and the associated impact of pension liabilities on the budget would be amortized over the same period.

Exhibit 1.3 Projected impact of different longevity assumptions on the public service pension plan funding obligations



1.33 Increasing share of total program expenses. Finally, based on publicly available data from the Office of the Chief Actuary and the Department of Finance Canada, we projected that between 2017 and 2050, the employer's share of the pension benefits expense for the three major pension plans could increase from 1.2 percent to 1.6 percent of total program expenses, or from approximately $3.3 billion in 2017 to $13.5 billion in 2050. This assumes that program expenses will increase at the rate projected by the Department and that actuarial assumptions regarding future inflation, interest rates, return on investments, general wage increases, workforce composition, retirement rates, and mortality rates will be met.

1.34 In summary. Public sector pension plans could pose risks to the government's financial position. The plan sponsor needs to ensure that the plans are appropriately designed and that the proper risk management and policy options are in place to protect current and future employees, beneficiaries, and taxpayers as well as the employer. In the following section, we present our findings on governance—that is, how the plans are currently organized, assessed, monitored, and communicated—in light of the risks we have described here.

Governance

1.35 Governance frameworks for regulated pension plans set rules that define the relationships between various parties and influence how the plans operate. According to best practices issued by organizations such as the Office of the Superintendent of Financial Institutions, the Canadian Association of Pension Supervisory Authorities, and the Pension Investment Association of Canada, properly designed governance should focus on implementing the principles of fairness, accountability, and responsibility to all stakeholders. In addition to these best practices, the government can refer to various policies—for example, the Policy Framework for Financial Management and the Policy Framework for the Management of Risk—that provide sound management principles applicable to the pension plans. Good governance supports effective decision making, which should be based on an accountability framework that includes clear communication and an understanding of roles and responsibilities. Good governance also includes robust performance and financial risk reporting.

1.36 The governance framework that applies to the public sector pension plans is based on a specific set of rules and policy expectations grounded in legislation. Although the public sector pension plans share some of the features of other private and public sector defined benefit pension plans, they differ in many significant respects, as noted in the following examples:

- They are not subject to federal or provincial pension standards legislation, nor are they supervised by an external regulator, as are other plans governed by pension standards legislation.
- They are not trustees' pension plans and do not "own" the pension fund established by the acts. No fiduciary responsibilities were assigned because the government is ultimately responsible for the payments of pension promises.
- No boards of directors or boards of trustees were established because the authority to manage each plan is provided by the legislation.
- They are not negotiated plans. They are excluded from collective bargaining by the *Public Service Labour Relations Act*.
- Pension benefits are paid out of the Consolidated Revenue Fund from government funds, not plan assets. The government's liability for pension benefits is owed directly to beneficiaries, not to the plans.

The legislative framework disperses responsibilities among a number of entities

1.37 We examined how the governance framework is distributed among the entities. We found that the roles and responsibilities related to the pension plans are dispersed among a number of entities, with each Minister (President of the Treasury Board, the Minister of National Defence, and the Minister of Public Safety) being responsible for the overall management of the pension plans. Sound governance practices would require that the sponsor, in collaboration with the plan administrators, clearly describe and document the roles, responsibilities, and accountability of participants in the pension plan governance process. This is even more important given the shared responsibilities among various organizations and the plan sponsor. For example, the ministers exercise neither direct nor indirect control of risk policies because the authority is vested with the President of the Treasury Board. We also found that the entities had not considered their respective roles and responsibilities, notably on funding and design, to go beyond what is prescribed in the governing legislations.

1.38 In 2009, the Treasury Board of Canada Secretariat developed a framework of activities that included completing the documentation of roles and responsibilities within legislative authorities. An internal audit of the Management Control Framework of the public service pension plan done by the Secretariat in December 2011 noted the limited extent of formal definition. It noted that further clarification is required for certain roles, specifically, the Secretariat's oversight role and financial advisory role. The Secretariat has since clarified these roles.

1.39 We found that the Secretariat supports other plan administrators in reviewing certain plan provisions on occasion, as well as pension accounting issues. Despite their shared responsibilities for the pension plans and the committees put in place, such as the pension advisory committees, entities tend to operate independently. We noted that they see themselves as accountable only for their legislated responsibilities under the superannuation acts and the corresponding regulations.

The current governance framework has not assigned responsibilities for assessing the sustainability of the plans

1.40 We examined whether the Secretariat's governance framework considers the sustainability of the three major public sector pension plans. The President of the Treasury Board stated in his annual report on the public service pension plan that the government is committed to maintaining the long-term stability and sustainability of the plan in a way that is fair to both public servants and taxpayers. The other plan administrators do not refer to this long-term commitment in their respective annual reports.

1.41 The government has a statutory obligation to pay pensioners and is fully responsible for any funding deficit. In this context, it would be reasonable to expect that the plans be designed to ensure that they are sustainable and affordable. As noted in paragraph 1.34, the plan sponsor must be aware of emerging risks and ensure that appropriate mitigation measures and proper policy options are in place to protect current and future employees, beneficiaries, and taxpayers, as well as the employer.

1.42 We found that the Secretariat, when requested by the government, performed analyses related to the budgetary impact and the sustainability of the pension plans. For example, it considered the financial impact and the savings associated with the new contribution rates and increased age of retirement (from 60 to 65) announced in Budget 2012. The legislation does not require the Secretariat to proactively or regularly address challenges to pension sustainability in order to offer policy advice and recommendations. For the Budget 2012 reforms, Secretariat officials stated that they had analyzed other pension designs, such as defined contribution plans, hybrid plans, and changes to the age of retirement. However, the Secretariat advised us that it was not able to share that information with us. Instead, the Secretariat provided limited evidence of its analyses. We were unable to assess these analyses, including whether or how they were used. The options that the Secretariat analyzed, or others, might have served to strengthen the sustainability of the plans over the long term.

1.43 The plan sponsor is responsible for the financial sustainability of the public sector pension plans. It has not delegated the responsibility for assessing the sustainability of the plan to the Secretariat. The Secretariat informed us that it is responsible for only what is assigned to it through legislation and policy, such as the responsibility for recommending contribution rates and producing the annual report prescribed by the *Public Service Superannuation Act*. We found evidence that it was authorized in 2009 to increase the amount it charges to the Public Service Superannuation Account and the Public Service Pension Fund to acquire and develop expertise (staff) with the appropriate knowledge to support a modern strategic management of pensions. It acknowledged at the time that it was a challenge to perform all the activities necessary to assure the viability of the plans. These additional resources would have provided for assessing the plans' competitiveness or improving their design and administration. At the time we were completing this audit, the Secretariat (Pension and Benefits Sector) was still not fully staffed.

1.44 The legislation is silent on specifically identifying the entity responsible for ensuring the sustainability of the pension plans and for protecting taxpayers. The protection of the government's interests, as well as those of plans' members and beneficiaries—in other words, the sustainability of the pension plans—rests with government, represented by the President of the Treasury Board. In our view, given its role in supporting the President, the Secretariat is positioned to recommend measures that would ensure that the plans are sustainable.

1.45 We also believe that preserving intergenerational fairness is an important consideration when managing pension plans and assessing their sustainability. This would prevent the situation where one generation is subsidizing the other.

1.46 **Recommendation.** To support the plan sponsor—represented by the President of the Treasury Board—the Treasury Board of Canada Secretariat, with the collaboration of the RCMP and National Defence, should assess periodically the pension plans' sustainability. If deemed appropriate, the entities should recommend changes to plan designs so that they are up to date, affordable, and fair to current and future generations.

The Secretariat's response. Agreed. The Treasury Board of Canada Secretariat is committed to regular assessments and provision of expert advice regarding government pension plans to ensure their sustainability, and already undertakes this work. Due to Cabinet and Budget confidentiality, the Treasury Board of Canada Secretariat could not share much of its analysis with the Auditor General; however, work on sustainability supported pension plan changes announced in Budget 2012, which raised employee contribution rates to 50 percent over a five-year period and increased the normal age of retirement to 65, as of January 2013. These changes will provide $2.6 billion in savings by the 2017–18 fiscal year, and over $900 million in annual savings thereafter, thereby helping to ensure the affordability and sustainability of federal employee pensions.

To further strengthen collaboration between government departments on sustainability, in the 2014–15 fiscal year, the Treasury Board of Canada Secretariat will establish a senior interdepartmental committee with the Department of Finance Canada, the RCMP, and National Defence as members. The committee will coordinate analysis across departments to ensure the government has the information and expert advice it needs to make informed decisions on the management of employee pension plans.

The governance framework does not include a funding policy

1.47 A funding policy is an explicit document that defines the funding objectives and guidelines of a pension plan. It is an important element in the governance of a pension plan, and the plan sponsor is solely responsible for its development. The funding policy supports the decision-making process and should be consistent with the purpose and goals of the pension plan. A funding policy also

- provides direction to the plan administrator and all decision makers involved in the funding of the plan;
- improves the understanding and management of the risk factors that affect the funding requirements;
- sets the risk tolerance and the funding preferences, and gives direction for the investment manager to develop investment policies that support the funding objective;
- improves transparency and stakeholders' understanding of funding decisions; and
- provides direction with respect to the actuarial valuation process.

1.48 In practice, the funding policy provides guidance to ensure that the plans are appropriately funded to meet obligations to members. It sets the parameters for the management of surplus and deficits and determines the circumstances under which the level of contributions or the benefits needs to be reviewed.

1.49 We found that the governance and management framework does not address risk tolerance. A funding policy has not yet been completed. We noted that the Secretariat's Pensions and Benefits Sector started to draft a funding policy for the public service pension plan in the 2010–11 fiscal year. At the time, the funding policy was expected to be finalized by the end of the 2013–14 fiscal year. The draft included preliminary work on core funding issues, such as financing objectives, funding risks, and the risk tolerance of the sponsor. It also discussed certain aspects of managing this policy. The issue of intergenerational fairness was also addressed in the draft policy and in later documents. However, at the time of our audit, the policy had yet to be completed.

1.50 Funding for the three major public sector pension plans is currently prescribed in the statutes (the superannuation acts and *Public Sector Pension Investment Board Act*). However, key funding issues—such as the maximum level of funding risk (risk tolerance) that the plan sponsor (the government) is willing to take on plan assets, or the maximum contribution level acceptable to the employees and employer—are not determined by legislation.

1.51 In the absence of an explicit funding policy, we found that both the Office of the Chief Actuary and the Public Sector Pension Investment Board (PSPIB) must make assumptions regarding the sponsor's risk tolerance and funding preferences. According to the Secretariat, in effect, the PSPIB determines aspects of a funding policy by setting its investment policy. In accordance with the Act, the PSPIB is to invest the funds under its management while considering the funding, policies, and requirements of the plans. However, the Act does not prevent the sponsor from communicating a funding policy to PSPIB, which it must then consider when setting the investment strategy.

1.52 The PSPIB has assumed that the funding risks required to meet the rate of return on assets set by the actuary are acceptable to the pension plans' sponsor. These assumptions have funding consequences that may not be consistent with the government's preferences on an acceptable level of risk. Excessive risk taking could increase the volatility of returns and increase the probability of large fiscal losses. Conversely, too little risk taking could reduce actual return and also increase the cost to the taxpayers.

1.53 Funding decisions related to the public sector pension plans could have an impact on the government's budgetary framework and on the employers, employees, other beneficiaries, and taxpayers. In our view, the government, as the plan sponsor, would benefit from the guidance offered by a comprehensive funding policy. Such a policy would need to take into account factors such as the demographics of plan members, the financial position of the sponsor (government), and the stability and affordability of contributions, including current service cost and annual special payments. Completing the work that started in 2010 and implementing a funding policy would be a major step toward strengthening the governance framework for the public sector pension plans.

1.54 **Recommendation.** To support the plan sponsor—represented by the President of the Treasury Board—the Treasury Board of Canada Secretariat, with the collaboration of the RCMP and National Defence as well as other supporting entities, should finalize on a timely basis a funding policy for all three plans. The entities should implement the policy to better manage the financial risks and to strengthen the governance framework of the public sector pension plans.

The Secretariat's response. Agreed. The Public Sector Pension Investment Board (PSPIB) already engages regularly with the Treasury Board of Canada Secretariat and the government to review its investment strategies and risk management policies. The *Public Sector Pension Investment Board Act* requires the PSPIB "to maximize returns without undue risk." The Secretariat recognizes the value of a funding policy in strengthening the guidance provided to the PSPIB and communicating it to Canadians.

The Secretariat will continue to work with the RCMP, National Defence, and the Department of Finance Canada to implement a funding policy for the three major plans.

The Department of Finance Canada monitors the budgetary impact of the pension plans

1.55 The Department of Finance Canada is responsible for analyzing Canada's budgetary situation and outlook. We examined whether, as part of this work, the Department prepared analyses on the budgetary impact of pension plans. We found that the Department of Finance Canada monitors the different fiscal risks associated with the public sector pension plans by conducting **sensitivity analysis** and **stress tests**. It analyzed the budgetary impact of changes in interest rates and PSPIB investment returns. It projected the size of superannuation accounts under different interest rate scenarios and performed sensitivity analysis of the normal cost of benefits. Finally, the Department assessed the budgetary impact (budget at risk and budget volatility) of post-2000 investment fund returns if pension liabilities had been fully funded during the 2000–08 period.

Sensitivity analysis—In the context of the pension plans, an analysis to determine how different assumptions will affect the returns and liabilities of the plans.

Stress test—A simulation technique used on a model or a system to find out its reactions to different, sometimes hypothetical and extreme, scenarios.

1.56 We found that senior management was informed of the impact pension plans could have on the budgetary balance. This information was used to guide policy choices. This information and related analyses were also provided to the Secretariat.

Information on public sector pension plan liabilities is not user-friendly

1.57 We looked at whether the Secretariat and the Department of Finance Canada have made progress in publishing, in a consolidated manner, clear and understandable information related to the public sector pension plans and their budgetary impact.

1.58 Pension accounting and actuarial valuation of pension obligations are complex in nature and difficult for a general audience to grasp. Thus, clear and complete information on the pension plans and good reporting on the budgetary impact of government liabilities is essential to allow for better transparency and accountability. The International Monetary Fund has recommended that budgetary information be presented in a way that facilitates policy analyses and promotes accountability.

1.59 In our performance audit on the interest-bearing debt (Chapter 3 of our Spring 2012 Report), we recommended that the Secretariat and the Department of Finance Canada report, in a consolidated manner, clear and understandable information on the public sector pension plan liabilities (including supporting methodology and assumptions) and explain their impact on the government's finances. We also recommended that—given the magnitude of debt charges related to the pre-2000 pension obligations—interest charges for the market debt and non-market debt be segregated in the **Estimates**.

Estimates—Documents prepared to support appropriation acts. Appropriation acts specify the amounts and broad purposes for which government funds can be spent.

1.60 We found that since then, the Department and the Secretariat have added some text to the 2012–13 Public Accounts of Canada to help provide a clear and understandable summary of the government's public sector pension liabilities and their impact on the government's financial results. Also, the Secretariat and the Department have clarified information on interest charges in the Estimates documents. The projected interest charges for the market debt and other interest charges, mainly related to public sector pension plans, are now disclosed separately in the Estimates published by the Secretariat.

1.61 We are encouraged by the positive steps taken by the Department and the Secretariat, but further improvement is needed for the reporting to be easier to understand and be used. For example, the plan sponsor could report on the sustainability of the pension plans, how the plans could affect the surpluses or deficits of the government, and how taxpayers could be affected.

1.62 In addition, users must currently refer to eight separate legislated reports to gather all the available information on the public sector pension plans covered by this audit (Public Accounts of Canada, Public Sector Pension Investment Board annual report, annual reports for the three pension plans, and three actuarial reports). The annual reports of the three plans are usually published close to one year after their fiscal year-end, just within the statutory reporting date. In our opinion, these reports could be published earlier to increase their usefulness and timeliness. When we raised this issue with management of the RCMP and National Defence, they claimed that readership of these reports is very limited.

1.63 While the Secretariat coordinates the stewardship duties of the government with respect to major public sector pension plans, it has not been assigned the responsibility for reporting information on these plans, in a consolidated manner. As we observed in 2012, no single organization is responsible for reporting on the public sector pension plan liabilities.

1.64 Reporting that includes a complete description of the methodology, the assumptions, and the discount rates used to assess the liabilities, as well as the interest charges related to public sector pension plans, would allow parliamentarians and Canadians to understand the financial implications of the public sector pension plan liabilities. It would also help inform them of the plans' sustainability as well as the impact on the government. This information could also include discussion on emerging risks and their possible impacts. The Government of Canada (as employer) needs to make sure employees understand the degree to which they can rely on the pension promise. As well, taxpayers need to understand the impact on public finances.

1.65 **Recommendation.** The Treasury Board of Canada Secretariat, with the collaboration of the RCMP and National Defence, should prepare a proposal for a consolidated report with clear and understandable information on the public sector pension plans for consideration by the President of the Treasury Board for public and periodic reporting. This report should include the total size of assets and liabilities, a description of the methodology and assumptions used in actuarial valuations, information on the sustainability of the plans, as well as the potential impact on public finances.

The Secretariat's response. Agreed. Pension plan reporting is inherently complex, and clear and understandable reporting is important for communicating to stakeholders. The government publishes comprehensive information on each of its pension plans in accordance with its legislated obligations. Each report is intended to provide its respective audiences, including Canadians and parliamentarians, with clear and understandable information on the public sector pension plans. A consolidated and simplified report would help Canadians better understand public sector pension issues.

The Treasury Board of Canada Secretariat will work in collaboration with the other entities to prepare a proposal for a new consolidated report for the government's consideration. The objective will be to introduce a new report that follows the release of the 2014–15 public sector pension annual reports.

The plan sponsor's governance framework does not adhere to good practices

1.66 As we have noted throughout this report, the Secretariat is tasked with supporting the pension plan sponsor (the Government of Canada, represented by the President of the Treasury Board) with respect to the public sector pension plan. We examined whether, in this role, the Secretariat has put in place governance practices that allow for mechanisms to provide proper stewardship to the other public sector pension plans.

1.67 In general, pension plan sponsors are assigned **fiduciary responsibilities**. The Crown does not owe pension plan members a fiduciary duty because it would create a conflict between the Crown's responsibility to act in the public interest, on one hand, and its obligation to act in the best interests of beneficiaries, on the other. In addition, the entities' legislative responsibilities are limited to the obligations set out in statutes. Officials from the Secretariat stated that they principally consider the interest of the employer.

Fiduciary responsibility—Responsibility to act as owner of assets, on behalf of the beneficiaries of a pension plan, and to exercise the care, skill, and diligence of a prudent person in carrying out related duties.

1.68 The statutory framework sets all plan provisions; as such, the framework could limit the entities' flexibility and ability to react proactively to pension challenges in a timely fashion. The different acts set out the entities' obligations vis-à-vis the pension plans, but they do not prevent the adoption of modern pension plan governance practices to manage those statutory obligations. The entities believe that they are responsible only for managing their obligations prescribed by the relevant legislation. The RCMP, for example, argued that it would be risky to implement governance principles that are not specifically set out in legislation. The Secretariat, in its role of supporting the President, is responsible for the management of the provisions of the public service pension plan, such as the determination of the contribution rate and the production of the annual report. With respect to the other plans, the Secretariat's responsibilities encompass a narrower set of duties, which do not include the plans' administration or design.

1.69 Officials from the Secretariat said that it coordinates the stewardship duties of the government with respect to the other major public sector pension plans and performs management and oversight responsibilities for the other pension programs and arrangements. However, the Secretariat was not able to demonstrate that it exercises stewardship in its support of the plans' sponsor (the government, represented by the President of the Treasury Board). For example, we found no evidence that the Secretariat performed a comprehensive review of the plans' design.

1.70 While we are cognizant of this statutory framework and of the distributed governance model for the plans, we believe that without strengthened governance practices that better address plan management, there is a risk that not all aspects related to the appropriateness of the design and funding are adequately considered in various decisions. Strengthened governance principles, in step with those of other public and private sector plans, need to be implemented to allow for better risk management, to improve cost-effectiveness, to protect affordability and long-term sustainability, and to improve accountability and reporting.

1.71 In 2009, the Secretariat identified the need to modernize the governance framework. This work would include revising and streamlining the governance models so that the plans can be rapidly adjusted and improved; undertaking activities to improve the plans' design, administration, and competitiveness; and developing an explicit funding policy, as explained in paragraphs 1.47 to 1.53. Inadequate governance could translate into excessive costs and risks for current and future taxpayers. In our opinion, the adoption of the full range of good governance practices is necessary, even though the legislation requires public funds to cover funding deficiencies.

1.72 **Recommendation.** To support the plan sponsor—represented by the President of the Treasury Board—the Treasury Board of Canada Secretariat, with the collaboration of the RCMP and National Defence, should review governance practices so that they are aligned with current and future circumstances. Recommendations regarding good governance principles should be presented to the plan sponsor for consideration. The Secretariat should also assume a stewardship role that is more proactive in managing the pension plans.

The Secretariat's response. Agreed. Sound governance ensures sustainability and helps protect employees and taxpayers. A robust governance framework is already in place that includes regular audits and valuations. The Secretariat already has a Governance Committee to exercise oversight across the organization. The Secretariat will build on this by continuing development of a funding policy, providing the government with recommendations for consideration, and collaborating with National Defence and the RCMP to review governance practices.

The Secretariat will also continue to strengthen key elements of its governance practices by consulting with the Public Service Pension Advisory Committee (PSPAC), which is composed of employer-side and bargaining agent representatives. The PSPAC provides additional oversight, accountability, and transparency through its review of administration, design, and funding of benefits and provides expert advice in making recommendations to the Minister.

The Secretariat already provides stewardship and exercises a management oversight role by reviewing administration costs, providing accounting advice, and reviewing proposed legislative amendments. The Secretariat provided policy advice and supported the implementation of Budget 2012 changes that will result in over $2.6 billion in savings by the 2017–18 fiscal year, and over $900 million thereafter. The Secretariat will continue to ensure affordable and sustainable pension plans that are fair to taxpayers and employees.

Pre-2000 pension obligation

1.73 As part of our audit, we examined whether the Department of Finance Canada and the Treasury Board of Canada Secretariat take into account analyses and information to support recommendations that are in the best interests of plan members, beneficiaries, and taxpayers. Specifically, we looked at the work performed by the Department of Finance Canada, which considered options on how to manage the pre-2000 pension obligations. The pension obligations that relate to service before the year 2000 are not funded. These **unfunded pension obligations** total approximately $151 billion.

Unfunded pension obligations—A situation where pension obligations to employees are paid out of current income rather than from a separate fund to which contributions have been made over time.

The Department of Finance Canada has not concluded on the merit of funding the pre-2000 pension obligations

1.74 We found that, in 2008, the Department of Finance Canada considered funding the pre-2000 pension obligations. An interdepartmental committee was established but never concluded on the advantages and disadvantages of funding the obligations.

1.75 According to the Department, funding the pre-2000 obligations could be achieved by issuing government bonds and treasury bills to raise funds, and investing the proceeds in a portfolio at the Public Service Pension Investment Board (PSPIB). The Department estimated that significant economic savings could be generated depending on the difference between the rate of return on the market investments and the interest rate paid by the government on the issuance of market debt. However, it also recognized a risk that the savings would not materialize if the PSPIB's rate of return were lower than the borrowing rate paid by the government on the issuance of market debt.

1.76 While the return on assets could outperform, on average, the cost of borrowing (that is, the average yield of government bonds and treasury bills), the Department is aware that funding the pre-2000 obligations could introduce volatility to the government's budgetary balance.

Notional interest—Nominal or face amount of interest calculated on the employer and employee contributions recorded in the superannuation accounts.

1.77 In contrast, by funding the pre-2000 pension obligations, the true borrowing cost would replace the **notional interest** (which totalled $8.5 billion in 2012–13) on these pension obligations, ending the debate among pension experts over the appropriate discount rate to be used and the resultant value of the pension obligations (see Appendix A for further information). From an accounting perspective, funding the pre-2000 parts of the plans would have no impact on the overall pension liability in the Public Accounts of Canada at the moment of the transaction.

1.78 The Department also saw other positive impacts for the federal debt program. Issuing debt instruments to fund the pre-2000 obligations could help maintain liquidity in the market for Government of Canada bonds as the financial requirements are declining.

1.79 The Department noted that the government could be seen as improving and modernizing the methodology used to record and report on future pension obligations. It would allow for greater transparency, accountability, and simplicity.

1.80 Funding the pre-2000 pension obligations could result in a number of significant benefits. However, the government needs to carefully assess the associated risks, such as determining the appropriate size of the amount to be funded and the potential impact of lower return on assets relative to borrowing costs. Volatility in the performance of investment funds could put pressure on the fiscal position of the government. Given the significance of the potential benefits vis-à-vis the risk, it is important that the analysis be concluded.

1.81 **Recommendation.** The Department of Finance Canada, in consultation with the Treasury Board of Canada Secretariat, should conclude its assessment on the costs and benefits of funding the pre-2000 pension obligations and present its recommendations to the plan sponsor for consideration.

The Department's response. Agreed. The Department of Finance Canada, in collaboration with the Treasury Board of Canada Secretariat, will conclude this assessment in the 2014–15 fiscal year and take this assessment, along with any other relevant information, into consideration in evaluating the funding of the pre-2000 pension obligations.

Conclusion

1.82 We concluded that the Treasury Board of Canada Secretariat, National Defence, and the RCMP used the relevant information and analyses to carry out their responsibilities. For example, they reviewed pension plan provisions that were found ineffective, and they complied with the process established for selecting assumptions. In addition, the Department of Finance Canada prepared and used sound analyses on the budgetary impact of the pension plans.

1.83 While entities carried out their responsibilities, we concluded that the current governance framework for the public sector pension plans, and the way it is distributed, needs to be strengthened to properly protect current and future employees, beneficiaries, employer, and taxpayers. First, the plan sponsor does not address the sustainability of the plans. Second, the governance framework does not include a funding policy for the pension plans.

1.84 We also concluded that the entities do not inform stakeholders in a clear and consolidated fashion. Although there have been improvements, information on pension plans needs to be clarified and further improved.

1.85 Finally, the Department of Finance Canada has not yet concluded on the merit of funding the pre-2000 pension obligations.

About the Audit

The Office of the Auditor General's responsibility was to conduct an independent examination of public sector pension plans to provide objective information, advice, and assurance to assist Parliament in its scrutiny of the government's management of resources and programs.

All of the audit work in this chapter was conducted in accordance with the standards for assurance engagements set out by the Chartered Professional Accountants of Canada (CPA) in the CPA Handbook—Assurance. While the Office adopts these standards as the minimum requirement for our audits, we also draw upon the standards and practices of other disciplines. All members of the engagement team hold a negligible financial interest in the public service pension plan. This is because all members of the engagement are contributing members of the plan. The Office has concluded that because any potential benefit derivable from this association will not be gained from any individual engagement member or to the engagement team as a whole, the risk of possible conflict is extremely remote. The risk of a perceived lack of independence was also assessed and found to be acceptably low based on the same logic mentioned above.

As part of our regular audit process, we obtained management's confirmation that the findings reported in this chapter are factually based.

Objectives

The audit examined whether the Treasury Board of Canada Secretariat, National Defence, the RCMP, and the Department of Finance Canada, consistent with their respective responsibilities and acting in the interest of current and future employees, beneficiaries, employer, and taxpayers, considered relevant information and analyses in managing the public sector pension plans to make them sustainable. It also examined whether these entities carried out selected key aspects of their governance and management responsibilities with regard to the pension plans. The audit had the following sub-objectives:

- to determine whether the Treasury Board of Canada Secretariat (supporting the Government of Canada, as sponsor of the three plans, represented by the President of the Treasury Board) and the Department of Finance Canada, consistent with their respective responsibilities, regularly assessed the financial impact of the pension plans' obligations and benefits on government expenditures, on public debt, and on current and future employees, beneficiaries, employer, and taxpayers;
- to determine whether the Treasury Board of Canada Secretariat (for the public service pension plan as well as for the support it provides the plan sponsor, the Government of Canada, represented by the President of the Treasury Board), National Defence, and the RCMP exercised key selected aspects of governance using sound analyses and information; and
- to determine whether the Treasury Board of Canada Secretariat, National Defence, the RCMP, and the Department of Finance Canada have informed stakeholders in a timely and clear fashion.

Scope and approach

The audit focused on the main three public sector pension plans (public service, Canadian Forces, and RCMP plans). We looked at whether the entities carried out selected key aspects of their governance and management responsibilities for these plans. The audit examined whether the governance and management framework considered the costing and funding of pension plans and whether risk management practices were adequate. We examined whether the Secretariat prepared and used analyses on financial sustainability of the pension plans and whether the Department of Finance Canada analyzed the budgetary impact. Finally, we examined the information provided to stakeholders, including taxpayers and parliamentarians.

We performed actuarial calculations to project the cost of pension obligations and possible budgetary impact. We interviewed officials from the Office of the Chief Actuary (OCA) and the Public Sector Pension Investment Board (PSPIB) as well as ex-senior officials and Canadian pension experts.

The audit did not assess the sustainability of the pension plans. The audit did not examine the administrative processes, investment practices, and actuarial methods for valuation calculations. Hence, Public Works and Government Services Canada, the PSPIB, and the OCA were not included within the scope of the audit. Finally, the audit did not examine the measurement of the liability for accounting purposes reported in the Public Accounts of Canada.

Criteria

Criteria	Sources
To determine whether the Treasury Board of Canada Secretariat (supporting the Government of Canada, as sponsor of the three plans, represented by the President of the Treasury Board) and the Department of Finance Canada, consistent with their respective responsibilities, regularly assessed the financial impact of the pension plans' obligations and benefits on government expenditures, on public debt, and on current and future employees, beneficiaries, employers, and taxpayers, we used the following criteria:	
The Treasury Board of Canada Secretariat assesses the appropriateness of the assumptions used for establishing the funding cost of the pension benefits.	• Funding in Public Sector Pension Plans: International Evidence, Organisation for Economic Co-operation and Development (OECD) • Report of the Task Force on Public Policy Principles of Pension Plan Funding, Canadian Institute of Actuaries
The Department of Finance Canada and the Treasury Board of Canada Secretariat prepare sound analyses on the budgetary impact and the financial sustainability of the pension plans.	• Policy Framework for the Management of Compensation, Treasury Board • Pensions Outlook 2012, OECD • Economic and Fiscal Implications of Canada's Aging Population, Department of Finance Canada
The Department of Finance Canada and the Treasury Board of Canada Secretariat take into account analyses and information to support recommendations that are in the best interests of plan members, beneficiaries, and taxpayers.	• Policy Framework for the Management of Compensation, Treasury Board • Policy on Financial Resource Management, Information and Reporting, Treasury Board • Policy on Management, Resources and Results Structures, Treasury Board, 2010 • Economic and Fiscal Implications of Canada's Aging Population, Department of Finance Canada

Criteria	Sources
To determine whether the Treasury Board of Canada Secretariat (for the public service pension plan as well as for the support it provides the plan sponsor, the Government of Canada, represented by the President of the Treasury Board), National Defence, and the RCMP exercised key selected aspects of governance using sound analyses and information, we used the following criteria:	
The Treasury Board of Canada Secretariat, National Defence, and the RCMP, consistent with their respective responsibilities, have put in place a governance and management framework that addresses the costing and funding of pension plans. The Treasury Board of Canada Secretariat has put in place a governance and management framework that addresses risk tolerance and risk management.	• *Public Service Superannuation Act* and regulations • *Canadian Forces Superannuation Act* and regulations • *Royal Canadian Mounted Police Superannuation Act* and regulations • *Public Pensions Reporting Act*, 1985 • *Financial Administration Act*, 1985 • *Public Sector Pension Investment Board Act*, 1999 • Policy Framework for the Management of Compensation, Treasury Board • Pension Plan Governance Guidelines and Self-Assessment Questionnaire, Canadian Association of Pension Supervisory Authorities (CAPSA) • Asset Management Significant Activity Pension Supervisory Guidance Note RAF4, Office of the Superintendent of Financial Institutions • Pension Plan Funding Policy Guideline, CAPSA
To determine whether the Treasury Board of Canada Secretariat, National Defence, the RCMP, and the Department of Finance Canada have informed stakeholders in a timely and clear fashion, we used the following criteria:	
The Treasury Board of Canada Secretariat, National Defence, and the RCMP have published their annual reports on a timely basis.	• Pension Plan Governance Guidelines and Self-Assessment Questionnaire, CAPSA • Public Sector Accounting Standards, PS1000, Financial Statement Concepts • Policy on Financial Resource Management, Information and Reporting, Treasury Board
The Treasury Board of Canada Secretariat and the Department of Finance Canada publish, in a consolidated manner, clear and understandable information related to the public sector pension plans and their budgetary impact.	• Policy on Financial Resource Management, Information and Reporting, Treasury Board • Manual on Fiscal Transparency, International Monetary Fund (IMF) • Code of Good Practices on Fiscal Transparency, IMF

Management reviewed and accepted the suitability of the criteria used in the audit.

Period covered by the audit

The audit covered the period between 1 April 2011 and 31 March 2013. The period under examination extended back to 1 April 2008 for the examination of the pre-2000 unfunded pension obligations. Audit work for this chapter was completed on 17 January 2014.

Audit team

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Appendix A Public Sector Pension Plans: Current Practices

Superannuation accounts

The government is required by law to pay federal public sector pension benefits. Until 1 April 2000, these plans were recorded in superannuation accounts to keep track of payments, contributions, interest, and pension buybacks, rather than being funded through investments. Superannuation accounts are maintained in the Accounts of Canada for each pension plan, according to the relevant legislation. Benefit payments for service earned under the accounts and the allocated portion of the plans' administrative expenses are also charged to the superannuation accounts.

The accounts portray a notional portfolio of long-term bonds. No formal debt instruments are issued. While the superannuation accounts hold no actual assets, their governing legislations require that interest be credited quarterly and recorded in the accounts. This interest must be calculated as though the amounts recorded in the superannuation accounts were invested quarterly in a portfolio of Government of Canada 20-year-plus bonds held to maturity. This rate (a **moving average** of the past 20 years' long-term bonds) is set by the Treasury Board of Canada Secretariat and the Department of Finance Canada, according to the superannuation regulations. (See Exhibit A.1 for a discussion of this rate.)

Moving average—A set of averages taken over a series of overlapping time periods. It serves to reduce short-term fluctuations and highlight more stable, longer-term trends.

Pension fund

The Public Sector Pension Investment Board (PSPIB) was created to invest contributions, in excess of benefits and administrative expenses, made after 1 April 2000 to the public service, Canadian Forces, and RCMP pension plans. These investments are made in capital markets through pension funds.

The PSPIB aims to achieve maximum rates of return without undue risk, while respecting the requirements and financial obligations of each of the public sector pension plans. For example, the PSPIB's Board of Directors has established an investment policy whereby the expected real rate of return over the long term is at least equal to the actuarial rate of return and the consumer price index (CPI) assumptions used in the last funding actuarial valuation. As of the last valuation date, the pension fund account obligations were about half the size of the superannuation account obligations. This situation will change over time, as an increasing proportion of the total obligations will be related to service after the year 2000. As well, net contributions now far exceed payments to pensioners. Over time, these contributions as a percentage of the plan's revenue will decrease, and investment income, which is more volatile, will represent a bigger share of revenue. This volatility in market return could increase pension costs.

A major risk all pension plans face is funding risk—not having enough assets to meet pension promises. If funding deficiencies continue for an extended period of time, risk is transferred from one generation to another and may ultimately take the form of an increase in contribution rates or a decrease in benefits.

Exhibit A.1 The discount rate for the unfunded pension obligation

A pension fund accounts for the future pension payments by reporting the size of the pension liabilities. The pension obligation is essentially the cost of paying out these future pension payments, but at a discounted value. Currently in Canada, this cost is determined by calculating the present value of expected pension payments using a discount rate. In the public sector, the choice of a discount rate for calculating pension plan obligations has been a subject of debate, because not all public sector pension plans hold assets. (Some are unfunded, like the superannuation accounts.) The discount rate (the rate at which future pension payments are converted into a single, current value) has a large impact on the size of the government's pension obligation and, therefore, on the government's budgetary balance.

There is a wide variety of discounting practices around the world. According to finance theory, the appropriate discount rate should reflect the riskiness of the pension obligations. Much of the recent financial and economic literature proposes that public pensions should be calculated based on the yield of some government bonds. The debate is still raging regarding the application of market-based discount rates, or the appropriateness of using real return bond rates.

This being said, the government has a unique risk-bearing profile compared with private sector employers because of its ability to raise funds from future taxpayers. As such, some say that setting the discount rate in line with gross domestic product (GDP) growth would reflect the fact that pensions from the unfunded public service pension plans will be paid for out of future tax revenues, as opposed to a fund of assets. Pensions could therefore be valued by discounting at the rate at which tax revenue is expected to grow. Over the long term, an appropriate guide to the growth rate of tax revenues is the long-term future rate of GDP growth. Ultimately, it is up to the federal government to decide if there is a need to revisit the current practice.

In light of the discussions outlined here, we calculated the impact of changing discount rates on the service prior to 1 April 2000 of the public service pension plan. The assumptions we used are within the range of various discounting practices discussed here. The results show that reducing the discount rate by up to 3 percentage points would increase the pension obligation by approximately $50 billion. On the other hand, increasing the discount rate by 3 percentage points would reduce the obligation by approximately $27 billion.

Changes in projected yields (discount rate) – Impact on PSPP superannuation account actuarial obligations

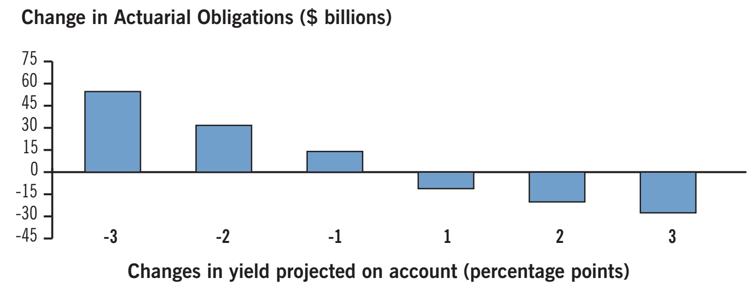

Chart source: Calculations from the Office of the Auditor General of Canada

Text sources: Adapted from Brown, J. R., and D. W. Wilcox (2009), *Discounting State and Local Pension Liabilities*; Her Majesty's Treasury (2010), *Consultation on the Discount Rate Used to Set Unfunded Public Service Pension Contributions*; and Ponds, E., C. Severinson, and J. Yermo (2011), "Funding in Public Sector Pension Plans: International Evidence," *OECD Working Papers on Finance, Insurance and Private Pensions*, No. 8, OECD Publishing.

Funding valuation

A funding valuation is an assessment of the long-term financial health of a pension plan. The valuation shows whether the plan has a surplus of assets, a shortfall of assets, or the right amount of assets to cover the cost of future pension benefits. As required by the *Public Pensions Reporting Act*, the Chief Actuary performs this review of pension benefits and contributions every three years, or whenever the pension plan is amended in a way that affects the cost of benefits or creates an unfunded liability.

The purpose of the valuation for the plans is to determine the state of the superannuation accounts and pension fund accounts as well as to assist the President of the Treasury Board in making informed decisions regarding the financing of the government's pension obligation.

As part of this valuation, the actuary determines how much money is required to pay for pensions by making assumptions about the future inflation rate, future return on invested assets, future salary increases, age at retirement, life expectancy, and other factors. The assumptions must be reasonable and provide a plausible snapshot of the plan's future health. The assumptions are determined by the Chief Actuary of Canada.

As a result of the funding valuation, the President of the Treasury Board will determine whether changes are required to employee contribution rates and how the actuarial surplus or deficit will be adjusted. According to the superannuation acts, in the case of a surplus or deficit, monetary adjustments should be made to the superannuation accounts or the pension fund accounts. The adjustments could be for a period up to 15 years, at the discretion of the President.

Valuation for accounting purposes

In order to support the liability disclosed in the Public Accounts of Canada, and at the request of the Office of the Comptroller General, the Office of the Chief Actuary conducts an actuarial valuation to estimate the obligation of the public sector pension plans.

For this valuation, the economic and the demographic assumptions are selected at an annual meeting involving key representatives from the Secretariat, the Department of Finance Canada, and the Office of the Chief Actuary (OCA). Those assumptions are considered as management's best estimate and are reviewed as part of the annual financial audit of the Public Accounts of Canada. Other demographic assumptions, such as the mortality rate, are derived from the funding valuation. Although members from the OCA participate at the annual meeting, the Chief Actuary does not provide an opinion on those assumptions in his report.

Appendix B List of recommendations

The following is a list of recommendations found in Chapter 1. The number in front of the recommendation indicates the paragraph where it appears in the chapter. The numbers in parentheses indicate the paragraphs where the topic is discussed.

Recommendation	Response
Governance	
1.46 To support the plan sponsor—represented by the President of the Treasury Board—the Treasury Board of Canada Secretariat, with the collaboration of the RCMP and National Defence, should assess periodically the pension plans' sustainability. If deemed appropriate, the entities should recommend changes to plan designs so that they are up to date, affordable, and fair to current and future generations. **(1.35–1.45)**	**The Secretariat's response.** Agreed. The Treasury Board of Canada Secretariat is committed to regular assessments and provision of expert advice regarding government pension plans to ensure their sustainability, and already undertakes this work. Due to Cabinet and Budget confidentiality, the Treasury Board of Canada Secretariat could not share much of its analysis with the Auditor General; however, work on sustainability supported pension plan changes announced in Budget 2012, which raised employee contribution rates to 50 percent over a five-year period and increased the normal age of retirement to 65, as of January 2013. These changes will provide $2.6 billion in savings by the 2017–18 fiscal year, and over $900 million in annual savings thereafter, thereby helping to ensure the affordability and sustainability of federal employee pensions. To further strengthen collaboration between government departments on sustainability, in the 2014–15 fiscal year, the Treasury Board of Canada Secretariat will establish a senior interdepartmental committee with the Department of Finance, the RCMP, and National Defence as members. The committee will coordinate analysis across departments to ensure the government has the information and expert advice it needs to make informed decisions on the management of employee pension plans.

Recommendation	Response
1.54 To support the plan sponsor—represented by the President of the Treasury Board—the Treasury Board of Canada Secretariat, with the collaboration of the RCMP and National Defence as well as other supporting entities, should finalize on a timely basis a funding policy for all three plans. The entities should implement the policy to better manage the financial risks and to strengthen the governance framework of the public sector pension plans. **(1.47–1.53)**	**The Secretariat's response.** Agreed. The Public Sector Pension Investment Board (PSPIB) already engages regularly with the Treasury Board of Canada Secretariat and the government to review its investment strategies and risk management policies. The *Public Sector Pension Investment Board Act* requires the PSPIB "to maximize returns without undue risk." The Secretariat recognizes the value of a funding policy in strengthening the guidance provided to the PSPIB and communicating it to Canadians. The Secretariat will continue to work with the RCMP, National Defence, and the Department of Finance Canada to implement a funding policy for the three major plans.
1.65 The Treasury Board of Canada Secretariat, with the collaboration of the RCMP and National Defence, should prepare a proposal for a consolidated report with clear and understandable information on the public sector pension plans for consideration by the President of the Treasury Board for public and periodic reporting. This report should include the total size of assets and liabilities, a description of the methodology and assumptions used in actuarial valuations, information on the sustainability of the plans, as well as the potential impact on public finances. **(1.57–1.64)**	**The Secretariat's response.** Agreed. Pension plan reporting is inherently complex, and clear and understandable reporting is important for communicating to stakeholders. The government publishes comprehensive information on each of its pension plans in accordance with its legislated obligations. Each report is intended to provide its respective audiences, including Canadians and parliamentarians, with clear and understandable information on the public sector pension plans. A consolidated and simplified report would help Canadians better understand public sector pension issues. The Treasury Board of Canada Secretariat will work in collaboration with the other entities to prepare a proposal for a new consolidated report for the government's consideration. The objective will be to introduce a new report that follows the release of the 2014–15 public sector pension annual reports.

Recommendation	Response
1.72 To support the plan sponsor—represented by the President of the Treasury Board—the Treasury Board of Canada Secretariat, with the collaboration of the RCMP and National Defence, should review governance practices so that they are aligned with current and future circumstances. Recommendations regarding good governance principles should be presented to the plan sponsor for consideration. The Secretariat should also assume a stewardship role that is more proactive in managing the pension plans. **(1.66–1.71)**	**The Secretariat's response.** Agreed. Sound governance ensures sustainability and helps protect employees and taxpayers. A robust governance framework is already in place that includes regular audits and valuations. The Secretariat already has a Governance Committee to exercise oversight across the organization. The Secretariat will build on this by continuing development of a funding policy, providing the government with recommendations for consideration, and collaborating with National Defence and the RCMP to review governance practices. The Secretariat will also continue to strengthen key elements of its governance practices by consulting with the Public Service Pension Advisory Committee (PSPAC), which is composed of employer-side and bargaining agent representatives. The PSPAC provides additional oversight, accountability, and transparency through its review of administration, design, and funding of benefits and provides expert advice in making recommendations to the Minister. The Secretariat already provides stewardship and exercises a management oversight role by reviewing administration costs, providing accounting advice, and reviewing proposed legislative amendments. The Secretariat provided policy advice and supported the implementation of Budget 2012 changes that will result in over $2.6 billion in savings by the 2017–18 fiscal year, and over $900 million thereafter. The Secretariat will continue to ensure affordable and sustainable pension plans that are fair to taxpayers and employees.
Pre-2000 pension obligation	
1.81 The Department of Finance Canada, in consultation with the Treasury Board of Canada Secretariat, should conclude its assessment on the costs and benefits of funding the pre-2000 pension obligations and present its recommendations to the plan sponsor for consideration. **(1.73–1.80)**	**The Department's response.** Agreed. The Department of Finance Canada, in collaboration with the Treasury Board of Canada Secretariat, will conclude this assessment in the 2014–15 fiscal year and take this assessment, along with any other relevant information, into consideration in evaluating the funding of the pre-2000 pension obligations.