INDEPENDENT RESEARCH, ANALYSIS & ADVOCACY

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How do you cut contributions to the States Superannuation Fund?

GPEG

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Introduction

GPEG's first paper on launch in October 20202 was entitled 'Beware of the Hole!', this was intended to inform debate as to the current arrangements and risks in the public sector pensions in the Bailiwick.

Earlier this year we released 'Inflation – The States Employee Pension Fund – A Huge Risk to the Island's Finances'. Highlighting the risks to the Island's finances of the effect of inflation of the pension deficit.

As we mentioned previously the last formal valuation of the States' pension scheme prepared by the external experts was in 2016, this has now been updated and the States' recently released an updated valuation as at 31 December 2020 which can be found here.

This report is a review of that valuation.

Review of the actuarial valuation

On the 13 June 2022 the States released some good news – Employer contributions can be cut from £35 million each year to £26 million. And the Fund is in surplus to some £115m! This follows on from the release of an Actuarial Report on the Fund by the States as at 31 December 2020.

> Yet the States Accounts show a deficit of £1.3 Billion. How does this happen?

Simply the accounts are prepared on a conservative set of assumptions set by accountants. The surplus you are being told of is the result of serious optimism.

Actually, the only rock solid number in a pension fund is the assets held at a date – here the recently published (2 years late) actuarial valuation (now as at 31 December 2020 rather than the originally promised and required 31 December 2019) starts its computations as to the financial health of the States Superannuation Fund and the need for contributions.

Discrepancy between the accounts and the valuation

A review is not much helped by a strange discrepancy between the Actuarial Report produced in June 2022 and assessing the Fund's position as at 31 December 2021 and the States Accounts, produced a few weeks ago.

It is a bit of a mystery why the Combined Pool either has nothing in for the Teachers' Fund and does have the Electricity fund – or vice versa. Both funds are closed to new entrants and their assets are kept on the States balance sheet. The Electricity fund is dignified with the title of being a separate "Actuarial Account." We think this means very little.

Take your pick of the definition of Combined Pool.

Assets In £s million at 31/12/2020	June 2022 Actuarial Report (para 1.4) £m	States Accounts to ye 31/12/20 (pg61) £m
Combined Pool	1,575	1,547
Guernsey Electricity	37	
Teachers' Fund		64
States Members' Fund	4	4
Total	**1,615**	**1,615**

Assumptions

> The biggest assumption as to the funding needs of the Fund are inflation and the investment return.

First of all here are the results of a broad spectrum of the investment results shown by publicly available indices for the first half of 2022.

FTSE *Down 4%*

NASDAQ *Down 27%*

Dow Jones *Down 14%*

AIM *Down 26%*

Bloomberg Bonds *Down 15%*

FTSE Russell UK Gilts *Down 14%*

Thomson Reuters Venture Capital Index *Down 51%*

There is no very useful Property Index available (it's a very diverse sector) but broadly it seems that there has been a negative return in the first half of at least 6%.

Weighted roughly by the proportions of the Fund as at 31 December 2021 the expected outcome for a diverse investor such the States would be around **19% down**. However, the alternatives portfolio (private equity etc) is heavily weighted towards assets which are valued annually or sometimes quarterly so the extent of the reported drop lags a lot. Reported valuation of the States Investments will therefore also lag. A result of perhaps 12% down across the portfolio in the last six months would seem a not too gloomy view.

We do not know what percentage of the assets are dollar denominated but the pound has lost 10% this year which means dollar assets will improve returns. Equally we know nothing of hedging against markets and currencies or of any new directions in investment so the 12% is admittedly rough and ready.

Performance of the investments in 2021 was not great – according to the States Accounts (para 8.8 of the Treasurer's Report) the performance was a positive 9.7% (but 10.3% in the Actuarial Report? (page 25)).

By comparison investing in the FTSE index would have yielded about 19% in 2021 and the Dow (US) index would have yielded 21% (including dividends).

The Fund missed its target return of RPI plus 4% too.

Forecasts

However, we now get to the really important point. The decisions on the level of required funding reflect the position at 1 January 2021 where investment returns are assumed are forecast to be 5.6% pa.

> But times have changed in 2022.

The reported gain of 10% in 2021 on the Fund assets has probably now been wiped out by the losses since then. In round numbers the fund is probably £100m smaller than it was planned to be now.

On inflation the assumptions were made that (on three different but similar bases) that inflation was going to be around 3% pa. Clearly nonsensical today – the Bank of England predicts 11% in December and the outlook is not great. This blows up the liabilities of the Fund. One year at 11% followed by an immediate (and improbable) drop to 3% pa would, on its own, do a very large amount of damage to the Fund and more than eliminate the reported surplus.

It is (hopefully) too pessimistic to forecast inflation at 11%pa for the indefinite future but if the assumption of 3%pa turns out to be (say) 6%pa then according to the sensitivity calculator (page 46 of the Actuarial Report) liabilities rise by £660m.

(Hopefully not a predictive piece of history - but the last time UK inflation reached 11% (1976) it took a decade to get back down to 5% - after rising to 27%.)

Guernsey inflation is helped for the next couple of years by the fixed cost component of our electricity supply. Sadly, it seems probable that we will catch up in cost at that time. Guernsey must expect a worse than UK inflation over the next few years as a result.

Investment returns are assumed in the Actuarial Report to be inflation plus 2.5%, which is not unreasonable in recent history, but against inflation at 11% and impending UK recession it looks improbable to assume that this target can be met. Again, using the calculator if the 2.5% drops to even 1.5% then £232m is added to the pension liabilities. Worse, even much worse, is clearly possible.

It seems silly to set future contribution rates using assumptions that are already seen to be very much overtaken by events. The delayed decision was made very recently to reduce funding, apparently by disregarding the post 1 January 2021 economic developments.

This wall of optimism has the effects of reducing the contribution to the Superannuation Fund and enabling the reporting of a surplus which make good news for a political announcement.

One final interesting piece of the Actuarial Report is that it suggests climate change measures could cost the Fund as much as £212m from reduced investment returns (see the calculator again.) This has not yet been incorporated in the numbers. We sincerely hope that this is not really a big factor.

The answer to the question in the title of this paper is simple; ignore what is happening around you.

We repeat our recommendations from our previous papers.

This pension fund gives our civil servants a far better (three or four times the best of private sector defined contribution schemes) retirement income than the private sector gets. The scale of this monster liability needs addressing.

In reality things got worse, even a lot worse, for the cost of the pension scheme.

Taxpayer pays – sooner or later.

Recommendations

1. The level of risk that the community, present and future, must bear deserves greater visibility and consideration.
2. The state of the Island's finances shows a less rosy picture than has been politically portrayed. Future public expenditure budgeting needs to bear this in mind.
3. Not putting the Superannuation Fund's deficit on the States balance sheet is really bad accounting. The deficit is just "noted", not included. This needs correction, perhaps when the planned and long desired international standard accounts are published.
4. Consider the use of financial structures such as longevity swaps (see Appendix B) and partial risk transfers to specialist funders to diminish the scale and volatility of the problem.
5. Seek to move away from index linked defined benefits to a defined contribution scheme for service beyond a fixed future date. This is critical albeit doubtless difficult to do.
6. Consider whether the objectives of investing the Superannuation Fund should be different from the objectives of the rest of the Consolidated Investment Fund.
7. Become transparent on investments and their associated costs. Strong governance is required on the Island's assets in order to carefully manage risk.
8. This should be taken forward urgently together with a plan to address the issues rather than further avoidance of them.
9. Some of the pensions are paid to people living overseas and paying tax on the pension in another country. A fixed withholding tax would keep that tax in Guernsey and provide a modest amount for the States' coffers. Most people affected by this would be able to get the cost back in reduced local taxes.
10. Increase Employee Contributions.
11. Close the inflation linked defined benefit scheme and CARE schemes for future service and replace the schemes with a defined contribution scheme as the private sector generally has.
12. The States have some discretion to fix the method and limits of future inflationary increases in pensions. They could at least cap their exposure at say 4%.

References

1. The States of Guernsey 2021 accounts can be found on their website https://gov.gg/article/186879/States-Meeting-on-Tuesday-28th-June-2022
2. GPEG's first paper was intended to inform debate as to the current arrangements and risks in the public sector pensions in the Bailiwick https://www.gpeg.org.gg/_files/ugd/58aa14_4938e2f597fa4b0a97763197f7127993.pdf
3. GPEG's later paper on the pension scheme covered inflation, the States Pension fund and the huge risk it poses to the Island's finances https://www.gpeg.org.gg/_files/ugd/b1f5f7_f1bb27671dcb40f1aac40eb27af2c80b.pdf
4. The States Superannuation Fund – Actuarial Valuation https://gov.gg/article/189745/Superannuation-Fund---Actuarial-Valuation
5. The States new article dated 13 June 2022 https://gov.gg/article/189750/Policy--Resources-recommends-9m-reduction-in-States-contribution-to-public-sector-pensions