Inflation – The States Employee Pension Fund – A Huge Risk to the Island's Finances

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Headline findings

- The recent rise in inflation will add hundreds of millions, and maybe billions, to the amounts due to be paid out as pensions to States Employees – dwarfing most other financial numbers on the island.

- If inflation goes to the projected 7% p.a. (note even higher forecasts now from the Bank of England) and stays there for a year and then, instantly and magically, returns to the States prior prediction of 2.7% p.a. then that alone would add £100m to the payments made to the State's employees and pensioners. The Guernsey inflation index (RPIX) is already at 4.6%.

- Every year that passes with higher inflation will merely increase the amounts payable to pensioners – there is no obvious limit to the obligation to fund that.

- A typical private sector defined contribution pension scheme will generate less than one third the indexed pension that a Guernsey civil servant will get on a similar salary.

Letting this carry on would be a real failure by the States of Guernsey. The States need to responsibly deal with this massive problem that needs immediate resolution and if left will just keep growing.

Introduction

The first paper that GPEG released upon launch, in December 2020, was entitled Beware of the Hole! It was intended to inform debate as to the current arrangement and risks in the public sector pensions in the Bailiwick.

In the last 15 months this issue has only worsened. In that first report we noted that in 2019 the pension deficit rose by £152 million. This has continued to rise during 2020 by a further £100 million. The recent rise in inflation will only further increase the pension deficit.

As part of this exercise we have reviewed in detail the States of Guernsey 2020 Accounts, the Pension rules and the 2016 Actuarial report.

> Letting this carry on would be a real failure by the States of Guernsey.

Background

The island's financial position is at present best seen by the levels of borrowings it has. However defined they are rising.

We have the Bond issue and recent and growing bank debt.

Essential, but deferred, capital expenditure is another form of debt – indeed the current plan seems to be to borrow to execute much, if not all, of this capital expenditure. This forms no part of the justification for an £80m annual tax increase that some of the politicians are pushing.

Borrowings are not all from ordinary lenders – the States' public employees' pension funds are a big source of something that is a less obvious kind of borrowing. Basically, the staff work for a pension post-retirement and the States pay those pensions later. A normal approach to funding this is to invest cash in a fund to meet those liabilities when they fall due. The adequacy of the fund is mostly affected by increases in pensions due to inflation and the return on the investments that the cash buys.

If you put aside an amount derived from expected life expectancy and use a reasonable estimate of both the investment return and future inflation, then the Fund is viewed as fully funded as resources will be available to meet the pensions when they are due. In reality, the estimate will probably be close to the right number but future investment returns, and inflation are not predictable over a long term so there is a need to keep an eye on things as they develop and maybe the employer has to top up the Fund.

(Of course, things can be a lot more complicated if there are changes in the pension terms or life expectancies and so on. But this is the basic principle.)

In Guernsey, our civil servants are on average better paid than the private sector, have greater job security and have much richer pension arrangements than the private sector.

By way of comparison a typical private sector defined contribution pension scheme will generate less than one third the pension that a Guernsey civil servant will get on a similar salary.

The unfunded deficit

At 31st December 2019, the civil service pension funds had liabilities of some £2.6bn and investments of £1.5bn. £1.1bn is therefore the unfunded deficit which the taxpayers of Guernsey will have to deal with.

On 31st December 2020, the pension fund's liabilities had risen to £2.8bn and the assets had risen to £1.6bn. Therefore the unfunded deficit is now showing at £1.2bn.

So, in 2020 the taxpayers saw their exposure rise by some £100 million. This is not accounted for in the States' financial accounts. It's obviously bigger than the £80m or so, bandied around as the annual cash shortfall we have, but you will not find any consideration of this massive liability in the 2022 budget or the States Funding and Investment Plan. Yearly movements in this deficit are easily half the annual budget of the States.

Cash contributions and inflation

Actual cash contributions to the pension scheme by the States have risen from £13m in 2004 to £33m in 2020. The States funds paid out substantially more in benefits in 2020 than was put into the funds.

You probably noticed that the funds are far from fully funded using conservative assumptions that are prescribed by accounting rules. For the 2020 States accounts the key assumptions were that future inflation would run at 2.7% p.a. and that the return on investment (derived from low risk bond returns) would run at 1.4% p.a. The vast majority of UK corporate pension funds use similar assumptions and are close to fully funded on that basis (or were before Ukraine). Indeed, any UK corporate pension fund that is underfunded to the extent of the Guernsey civil servants' fund, would find a Regulator dictating a Recovery Plan (and lots of more money demanded).

Here we do not show the actual change in liability in the States accounts as a cost but simply the amount the States choose to put in. This arbitrary accounting was banned decades ago by accounting standards, as obviously that discretion allows payments that have nothing to do with actual cost.

Given the relatively large deficit here the change in liability can be substantial for even relatively small movements in assumption.

However, UK inflation has leapt up recently to 5.5%. (Next month it was forecast (before Ukraine) to reach 7%, and most recently threatening 10% later this year.) If we make the assumption, that the 5.5% level will persist for decades, (thankfully not very likely) this would if extrapolated to the Fund result in roughly a £3bn increase in the deficit on its own, because of the large impact of compounding. (We lack the data for a precise calculation, so we apologise if wrong by a few hundred million – it hardly matters!) In reality, the stated return on investment would also likely rise at some point to help but because the assets are only a little over half the deficit to keep at the same relative level of funding requires something over a 10% long term return on investment (assuming 5.5% inflation continues) which would be at an heroic level to predict.

> Even GPEG has no ability to forecast future inflation or future investment returns but for certain, our predecessors landed the Island with an unpredictable monster to worry about.

The Actuarial Report

There is a requirement for triennial reviews of the funding of this plan (done by BWCI in Guernsey historically) but there has been no published review since the 2016 review. The 2020 States Accounts also stated there would be a report by the end of 2021.

The 2016 review was also much delayed – there was a preliminary (unseen) report issued in August 2017 and the final was only issued in May of the following year. We assume that initial recommendations, or indications, for funding, were not politically acceptable and revised assumptions were needed to be adopted - perhaps this process is being repeated.

To arrive at an acceptable contribution rate a forecast investment return of 6.85% p.a. was adopted in the 2016 report – more than twice the general assumption in the UK. BWCI do not endorse the decision on contribution level in their report.

What can be done to reduce the pension issue?

Recommendations

The room for easy, rapid and considerable impact on the Fund is less than you might think as over half the liability relates to people who have left their jobs or are already pensioners.

Easiest first:

1. 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.

2. Increase Employee Contributions.

3. Harder - but will make a substantial impact going forward: 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.

4. 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%.

The first of these is fairly easy but is not very large, and the others have obvious employer/employee issues which will not be easy. Anything that affects the current entitlements of staff, especially those who have left or retired would be called, not without justification, as breaking a promise regardless of the strict legal position.

Some of the politicians will tell you there is a cap on the proportion of staff salaries that the States can put into the pension scheme. This "cap" realistically does not exist – the section below is a bit tedious but lays out that there is no real protection.

> Continued inaction and delay is simply not the right thing. The States need to grasp this difficult issue.

What the rules say

Participating Employers: paying contributions, Cost Cap and Cost Floor

"The Ordinary Employer Contributions payable by the Principal Employer and determined by the Committee in a year of assessment to this Scheme must not exceed
(a) in the case of CARE New Members 14%; and
(b) in the case of CARE Transition Members and Final Salary Protected Members 14.5%,
of the Member's Pensionable Salary for that year of Service (the Cost Cap). The actual contribution shall be that made in accordance with the provisions of this Rule 30.

30.4 The Ordinary Employer Contributions payable by the Principal Employer will be reviewed and compared with the Cost Cap every three years to coincide with the Actuarial Valuations carried out under Rule 18, the first review to be with effect from the valuation due on 31st December 2019.

30.5 At each review, if the cost of the Scheme would result in the Ordinary Employer Contributions rate payable by the Principal Employer exceeding the Cost Cap, negotiations will take place through the Pensions Consultative Committee to either reduce the future accrual rates for Pensions or to increase Member Contributions or both to bring the Ordinary Employer Contributions to the Cost Cap. The default position, in the absence of agreement, will be a reduction in the future accrual rates. The Ordinary Employer Contribution rate for the purposes of comparison with the Cost Cap in Rule 30.4 (and the Cost Floor in Rule 30.8) will only include:
(a) the Future Service Contribution Rate less Member Contributions; and
(b) any past service costs or savings in relation to the Scheme in relation to Pensionable Service from the Transition Date relating to improving or reducing longevity of Active Members.

*The **Future Service Contribution Rate** means the rate to be paid in respect of the cost of future Service accrual.*

30.6 The calculation of Ordinary Employer Contributions for comparison with the Cost Cap in Rule 30.4 (and the Cost Floor in Rule 30.8) will identify any change in Members' costs which relate to the profile and options of Members including changes in life expectancy, changes to the age profile of the membership, changes to the way Members select options, changes to the dependency details and the incidence of leavers and retirements.

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Cost Cap in Rule 30.4 (and the Cost Floor in Rule 30.8) will identify any change in Members' costs which relate to the profile and options of Members including changes in life expectancy, changes to the age profile of the membership, changes to the way Members select options, changes to the dependency details and the incidence of leavers and retirements.

*30.7 For the avoidance of doubt those elements of the change in the calculation of Ordinary Employer Contributions for comparison with the Cost Cap (JPM – 14.5% of 14% of salary) in Rule 30.4 (and the Cost Floor in Rule 30.8) which are Employer's costs, bring those decisions and assumptions that must be made to carry out a valuation and are financial and technical in nature**, including changes to the discount rate (which may be driven by a change in investment strategy), actuarial methodology for calculating Scheme costs and changes in the price inflation assumption, shall be the responsibility of the Employer.***

What was shown to the States and shown in the States Accounts 2020

2020 accounts

Superannuation Fund

9.25. The Superannuation Fund exists to pay the pensions of the employees of the States of Guernsey and other members of the Scheme. It is predominantly a defined benefit scheme funded by contributions from both the employer and employee. In 2015, the States agreed revised pension arrangements for members joining after 1 May 2015 and for service from 1 March 2016 for those members who are not protected members (those close to retirement age). The revised arrangements replace the final salary defined benefit arrangements with defined benefits on a career average re-valued earnings (CARE) basis up to a salary cap (which was £87,434 from 1 May 2016, increasing to £92,236 from 1 December 2019) with a defined contribution scheme for earnings in excess of this cap. The revised arrangements include a fixed cost ceiling (excluding the investment risk) on the employer's future contribution rate.

The capped Ordinary Employer Contribution (averages out at c14.1% but see below!) is merely a very partial cap on the percentage level of provision for future service for continuing employees plus a quite limited exposure to changes in mortality, changes in early retirement and other relatively minor things in respect of past service.

So, inflation (=wage increases in respect of future service), investment return forecasts or any changes in actuarial practice are all for the account of the taxpayer.

The statement in the States communications and the Accounts may be calming but it is very misleading.

In summary:

Who bears investment return risk on past service liabilities? **Taxpayer**

Who bears investment return risk on future service liabilities? **Taxpayer**

Who bears the cost of higher future inflation? **Taxpayer**

Who bears the risk of actuarial process change? **Taxpayer**

Who bears the risk of improved life expectancy? **If the 'Cap' is reached it brings rule 30.5 into play. If agreement to increase employee contributions is not reached pensions will be reduced – this is a difficult thing to do**

At what level does the cap even enter play? **Its not 14.1% - which is the percentage of pensionable salary that is the future service current contribution. The cap "bites" when the future service contributions less member contributions (c7% today)(Rule 30.5) reach 14%. In other words, the cap is actually at around 21%**

In short, the cap is about as much use as the proverbial waterproof teabag.

Recommendations

As noted above our recommendations are:

1. 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.

2. Increase Employee Contributions.

3. 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.

4. 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. Pension Rules https://www.gov.gg/article/171037/Public-Servants-Pension-Scheme---Amendments-to-the-Rules

2. 2016 Actuarial Report https://www.gov.gg/CHttpHandler.ashx?id=113597&p=0

3. 2020 States of Guernsey Accounts https://gov.gg/accounts