Beware of the Hole!

This is the first publication from the Guernsey Policy and Economics Group LBG (GPEG). It is intended to inform debate as to the current arrangements and risks in the public sector pensions in the Bailiwick.

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Pensions attract strange language. This document is as far as possible in everyday terms. Given the lack of publicly available information in some areas, we have had to estimate numbers; where we have, we say so.

However, the potential errors in any of the estimates are not in any danger of leading to different conclusions. A late draft of this paper was sent to the States of Guernsey and helpful corrections received and incorporated.

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The Facts

The States of Guernsey provide pensions for civil servants. There are roughly 5,000 people still working or who have left and are not yet drawing a States' pension (around 300) and some 4,000 people already drawing a States' Pension.

The States' Accounts show assets of £1.5 billion (£1,500,000,000) in respect of the Superannuation Fund (an old-fashioned term for pension). This is a lot of money particularly in light of the current state of Guernsey's economy and tax revenues. The Superannuation Fund pays the pensions out of this figure.

A little more detailed and patient reading of the States' Accounts will, however, show that the liability in respect of these pensions was £2.6 billion last December (£2,600,000,000). This clearly a lot more than £1.5 billion. Those Accounts show a deficit or shortfall of £1.1 billion (£1,100,000,000), some three times the current annual tax revenues of the Island. Eek.

The Accounts show that the Island has "Net Assets" of £757 million. However, if you just adjust for the excluded pension deficit of £1.1 billion then we have net liabilities for the States. Not the comfortable position the population might like to see. In fairness, the rather arcane accounting used in the Accounts also omits some sizeable assets, such as States property, so perhaps we do have net assets.

The 2019 Accounts proudly boast of a £106 million "overall surplus" for the year. This includes £86 million of largely unrealised growth in the valuation of the State's investments. The markets enhanced the value of the investments but actually the same markets drove the pension liability higher and by a bigger amount of £152 million pounds.

> ***"Eight years of hard work resulted in a surplus of over £100m in 2019"***
>
> **Deputy Gavin St Pier, former Chief Minister**
>
> On any reasonable basis, there was no overall surplus

On any reasonable basis, there was no overall surplus but a deficit of £46 million pounds.

Last year, the amount paid out of the Fund as pensions exceeded the amount paid in as contributions. It seems probable that the same will happen this year.

Where is the money going to come from to pay for the pensions? The taxpayers guarantee to pay the quite generous and inflation proofed public sector pensions. Even if the States fired all the civil servants tomorrow, the promise must be kept. So, the deficit must be met from a mixture of further annual contributions from the taxpayers and an anticipated return from the invested assets.

We estimate the deficit has increased by around £300m since last December so if we want to stop the deficit tomorrow, we need to pay in around £1.4 billion. Then, we need to invest in government bonds that have index linking (or other assets with good inflation matching characteristics) to cover off the risk of future high inflation.

That equates to £51,000 per Guernsey household needed. £51,000 is 18 months gross earnings for the average Guernsey worker. Note average States employee pay in 2019 was £53,000 (from the 2019 States Accounts) whereas the median earnings of the whole population was £34,000 (from Guernsey Facts and Figures booklet).

Then we would pay in additional contributions each year (say £40m each year) and buy more index-linked bonds to avoid building up a new deficit.

We would have to sell a lot of the States investments and borrow further funds to "clear" the decks of this liability and it seems unlikely that this fairly massive change of direction would be readily adopted.

However, if the investments do really well then the future deficit and future contributions could be lower, but it is a "bet". If inflation rises and/or stock and bond markets are poor, then actually the deficit could increase. The risk lies almost entirely with taxpayers.

In a bit more detail

To give you an idea of how volatile things are, to arrive at the actual amounts we must pay out to pensioners we need to estimate inflation over something like 40 years. Neither actuaries nor soothsayers can provide reliable estimates of future inflation rates. The latest Bank of England report says that there is a 90% likelihood that annual inflation by the end of 2021 will lie between 5% and minus 1% (yes – it is a wide range!). If by any chance, that inflation was 5% over the next 25 years or so, rather than the 2.8% assumed by the Island's actuary, BWCI, then that single change would add over

£500m to the deficit. If there was no inflation it would have the opposite effect.

The "accounting" deficit is computed using the current low return available on exceptionally good quality corporate bonds as the assumed investment return. This return is nearly risk free. Efforts to get higher rates carry more and more risk as you raise the return target. BWCI noted this risk in their last report (Appendix A). The Public Accounts Committee also raised the same issue of high risk in 2016.

Long term rates of return have dropped from December last year which is when the States' Accounts were prepared. So, the low-risk investment will now generate still less return to pay pensioners. As a result of that rate drop alone, we estimate that the deficit went up by something like £200 million in the 9 months to September 2020. UK equities dropped by 20% in that same timeframe. We cannot tell you what that means for the deficit because the necessary information on what the investments in the fund are, is not made public. Maybe another £100 million?

In 2019, the pension deficit rose by £152 million.

But note that even in this terrible viral economy, the States' income deficit for 2020 is only estimated at £59 million.

This totally ignores this pension monster. It deserves a lot more attention.

Pension funds are long term things so a small difference in rates of return really makes a huge difference to long term liabilities. If you assume 3% inflation for 25 years £1 becomes £2.09. If the portfolio generates a return of 2% better than inflation for 25 years then £1 becomes £3.39p, make the return 4% better than inflation and it gets to £5.53p.

The States have justified the current contribution rate to the pension pot (14.1% of salaries) by assuming that the investments will generate 2.5% pa over inflation, basically for ever. It is important to note that the chosen return forecast is NOT given by the actuaries but is the States own choice.

This investment assumption was made in mid-2018. In 2018 the actual outturn for the year was a loss on the investments of £51million pounds!

The States use different estimates of return and inflation at different times and for different purposes. To establish the current contribution rate for pensions in June 2018, the States used a target return of investment of UK Retail Price Index estimated over the life of the pension liabilities to be 3.55% plus 2.5%, a total of 6.05%. The States' 2019 Accounts show an estimate then of an investment return of 1.9% and an inflation estimate of 2.8% a total of 4.7%. The States' 2021 budget has RPIX which is stated to be the States preferred (not for pensions it seems!) measure of inflation (RPIX is Guernsey inflation less mortgage payments) at 1.5% for 2021.

You get the picture; these are all rough estimates of the future.

The States have for some time targeted 4% over inflation as the investment return objective; a fairly high rate which involves significant risk of not being met, as in 2018 where a serious loss was incurred.

Actually, if we really believe that we can generate such good returns for ever, why shouldn't the States borrow a fortune at low rates and rely on our investment managers? This sounds ropey but think about it; we are already borrowing but calling it pension deficit rather than debt.

The same applies to the bond issue and the bank debt the States has drawn down. That cash has largely been used to fund the purchase of investments. Indeed, we are already borrowing from the recent bank facility to avoid selling investments!

Not many countries have simultaneously both a lot of debt and a lot of investments. That is a good idea if the return on the investments exceeds the cost and risks of borrowing but anyone who has ever purchased a financial product will know the warning that past returns are no guide to the future.

No-one knows what future returns will be. In fairness, both market returns and the Island's investment management have been decent, albeit variable, in recent years so that this current assumption looks historically not unreasonable but markets go up and down, pandemics do their worst. Someone bears the risk of missing the assumed return target and, for public sector workers, it's the current and future generations of taxpayers.

The rest of the population mostly have much worse pension provision with lower pensions and no inflation protection. Clearly, there is an issue about the overall generosity and competitiveness of civil service remuneration packages, but it is not difficult to see why people should see the current benefits as extremely generous for the civil servants.

Morality

The cost and risk of pensions should equitably be borne by those who benefit from the related service. Running a deficit progressively transfers cost and risk to people who were not around in the years when the obligation for future pension pay-outs arose.

But deferring pain, or better, transferring it, has always been politically popular.

As a result, quite a lot of jurisdictions simply pay public pensions as pensions fall due. The UK public pension liability (except for a few regional council funds) is almost entirely unfunded. It is called Pay as You Go.

The UK, however, has one great advantage over Guernsey. It has its own currency, which it can print if need be, to avoid ever running out of money.

On the other hand, Guernsey must stand on its own feet. It is not difficult to imagine a scenario where the financial services industry falls on hard times, over the next forty years or so. The Island's financial services driven economy is exposed to a wide variety of possibilities. We may not be able to find sufficient countermeasures to mitigate these. Artificial intelligence will perhaps reduce jobs; taxation, regulatory and competitive pressures will doubtless arise.

If things do go badly with the economy or with investments, then the pension fund debt will be difficult to fund.

Information Provision

For some reason, the information on the Superannuation portfolio that is available, is really sparse. We could not obtain a currency or geographic analysis or a detailed asset allocation of the portfolio. Many public funds globally give detail down to individual holdings. It is hard to see that such transparency is anything other than good.

Similarly, no detail of investment management or advisory costs is available. Investments may rise or fall but the investment fees will still be payable to a whopping 28 different investment managers and advisers. These fees are largely driven by the size of the portfolio and there will be some understandable preference from the advisers to maintain (or increase) the current investment level, even if it can only be maintained by further borrowing.

The potential for conflicts of interest or inappropriate investment would be considerably reduced if transparency were improved.

Who Owns the Superannuation Fund?

The assets allocated to the Superannuation Fund are shown on the balance sheet of the States, although currently the associated deficit is not.

Nearly all pension funds are in trusts held separate from the employer. The position in Guernsey is quite different from most pension funds. Here, the States Accounts are based upon the basis that there is no trust. The key difference is that if there is a trust then the States cannot spend these funds on other things.

There is another consequence of a trust; the pension trustees are tasked with protecting their pensioners. They would push for greater funding and more cautious investment. They dislike volatility.

If the States fell on hard times then the situation would be generally worsened by trustees (if we had any) pushing for rapid filling of the hole to diminish their risk.

At present, the Superannuation Fund is managed in the Consolidated Investment Fund and, apparently, with the same investment objectives. The other £800m of assets in the Consolidated Investment Fund might legitimately target higher and riskier returns than pension trustees would. Pension trustees would be more focussed on matching liabilities than just return maximisation. At present, the Consolidated Investment Fund has a main objective for all its investment of making 4% pa over inflation which is not a low target.

States Action

The States have grappled with this issue but insufficiently it seems. Since 2015, the relevant salary to determine pensions became largely based on career average earnings (a "CARE" scheme) rather than final salary which will reduce long term costs. Caps on inflation were introduced, though at a high level. Higher salaries got reduced pension provision. A defined contribution element was introduced (see Appendix B). Although stated policy limits were introduced on the percentage of payroll that the States would pay into the "pension pot", this frankly seems an invitation to adopt high side assumptions on the "valuation" to defer any crunch with employees. It is hard to see the States strongly resisting a need for a serious top up for high inflation or improved lifespan of the pensioners. Explicitly, all risk on investment returns is left with the States.

A reluctance to grasp the issue is clearly evidenced by the fact that the valuation at 31st December 2016 was only approved by the States in June 2018. The next valuation to 31st December 2019 has already been deferred due to COVID.

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. The triennial review (as of 31/12/19) of contributions should have been complete by now. However, this has now been deferred (not very credibly) by a year because of COVID-19.

This should be taken forward urgently together with a plan to address the issues rather than further avoidance of them.

The deficit will likely increase this year.....

Factual Sources:

- States Policy and Resources – Investment and Bond Committee – 2018
- BWCI Actuarial Valuation June 2018
- States of Guernsey Accounts 2019
- Social Security Contributory Fund Accounts 2019
- BDO Review of Investments 2016
- PWC Pension Accounting Trends September 2020
- Public Accounts Committee Review of the Investments of the States of Guernsey April 2016
- Guernsey Facts and Figures 2020

Appendix A

From 2016 BWCI (Actuarial) Report

Investment risk

"The majority of the Fund's liabilities are linked to inflation via either pension increases or pay increases.

The assets that most closely match the Fund's liabilities in terms of future cashflows are a combination of index-linked gilts and derivative instruments to match inflation-linked liabilities and fixed-interest gilts and/or investment grade corporate bonds to match the fixed liabilities. The Fund's investments are mismatched because the Policy & Resources Committee has (having taken advice) chosen to invest some of the Fund's assets in asset classes, such as equities, that are expected to produce higher future returns than gilts over the long term with the aim of reducing the contributions that would otherwise be required. The more mismatched the investment strategy is, the greater the potential risks. Equity markets can fall significantly and hence investing in equities exposes the Fund to the risk of falls in the funding level relative to accrued liabilities. These risks are compounded where additional returns from equities are anticipated in the discount rate. The Policy & Resources Committee will need to consider the States' ability to cope with the funding of the Fund in such situations.

Alternatively, the future investment return on the assets may be positive, but insufficient to meet the funding objective. The more mismatched the investment strategy is, the greater the risks.

The return achieved on the Fund's assets may be lower than allowed for in the valuation. It is for the Policy & Resources Committee to decide upon the level of the investment outperformance to assume for the valuation calculations. This will depend upon how much risk they are willing to accept for funding purposes. To the extent that the expected funds are not achieved from the investment returns, they would need to be met from additional Employer contributions."

Appendix B - Assorted issues

The BWCI actuarial report says that it should not be generally available. (It is on the web!)

Grant Thornton state in the States Accounts that "Our report is intended solely for the States and should not be distributed to or used by parties other than the States."

"This report is made solely to the Committee in accordance with our engagement letter dated 7 September 2017. Our audit work has been undertaken so that we might state to the Committee those matters we are required to state to them in an auditor's report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the Committee, for this report, or for the opinions we have formed."

In both cases should the population be entitled to rather more from their paid experts?

CARE - Career Average Revalued Earnings
A CARE scheme normally offers an income in retirement based on a proportion of your average earnings, after adjusting these for inflation, during the whole of your career.

A more general glossary of pension language may be found at https://www.tpt.org.uk/pensions-explained/jargon-buster-glossary#undefined

A **longevity swap** is a reinsurance structure where the client pays a fixed pre-agreed annual premium to the reinsurer plus an annual fee. The premium is equal to the expected annuity payment including a margin. The reinsurer pays the actual annuity payments for as long as each pensioner lives. In effect, the risk (or benefit depending on what happens) of changes in life expectancy may all be assumed by an insurer rather than by the employer. It is also possible to get insurers to cover the other risks of a pension fund such as investment performance or inflation rates.

Defined Benefit ("DB") Scheme – a scheme where the amount of pension payable is based on what the pensioner earned whilst with the employer not on the value generated by the investments made on their behalf.

Defined Contribution ("DC") Scheme – a pension arrangement where benefits are not guaranteed but fixed payments are made into a scheme and used to purchase an annuity at retirement. The disclosure of the States DC scheme in the 2019 Accounts is unclear. It is, however, not a large factor.

It is extremely unusual that defined contribution assets are not held in a ring-fenced fund.

Social Security Contributory Funds
This note does not address the States' Social Security Contributory Funds which are held separately.