STATES OF JERSEY

PENSION INCREASE DEBT: OPTIONS FOR EARLY REPAYMENT

Presented to the States on 18th June 2013
by the Minister for Treasury and Resources

STATES GREFFE

REPORT

Background

The Medium Term Financial Plan included an increase in the Public Employees Contributory Retirement Scheme (PECRS) Pre-1987 debt repayments by £1 million in 2013, £2 million in 2014 and £3 million in 2015 in order reduce the long-term costs to the States of the repayment.

In November 2012, the States approved P.69/2012 Amd.(6) to the Medium Term Financial Plan, which requested that in order to effectively manage the States Balance Sheet and reduce the long-term financing costs of the Public Employees Contributory Retirement Scheme (PECRS) Pre-1987 debt, and the Jersey Teachers Superannuation Funds (JTSF) Pre-2007 debt, the Minister for Treasury and Resources be requested to present to the States no later than 31st July 2013 further options for the early repayment of the PECRS Pre-1987 debt and the JTSF Pre-2007 debt.

This report considers the background to the PECRS Pre-1987 debt and the JTSF Pre-2007 debt and considers options for further early repayment that could deliver long-term cost reductions.

History of the pension PECRS pre-1987 debt

In 1987 the States approved proposition P.123 dated 30th June 1987, which recommended significant changes to the Public Employees Contributory Retirement Scheme (PECRS). This included the transfer of responsibility for payment of pension increases from the States to PECRS. This transfer of liability created a debt known as the PECRS Pre-1987 Debt. This was identified by the Actuary in 1986 terms to be in the region of £55 million.

No capital lump sum was paid into PECRS to fund the take-on of the £55 million pension increase liability. The Employer's contribution rate was set at a rate which at the time was thought to be sufficiently above the then cost of benefits, to leave a margin which was expected to pay off the liability over the long term. Since the 1980s, there have been significant improvements in longevity, which have meant that the cost of providing pensions has increased by around 30%. Such significant improvements in longevity were not predicted in the 1980s and could not have been expected to be predicted.

Over time it became evident that the Employer's contribution rate was not providing the funding necessary to repay the Pre-1987 debt and, in November 2003, a framework was agreed by the then Policy and Resources Committee for dealing with the Pre-1987 debt. This agreement, known as the 10 point plan (*see* **Appendix**), confirmed the States' responsibility for the Pre-1987 Debt which, by 31st December 2001, had grown to £192.1 million. An 82 year repayment period for the debt was established. The States commenced annual repayments in respect of the Pre-1987 Debt which started at £2.55 million in 2002, and have subsequently increased to £4 million per annum in 2012, in line with the agreement to increase payments by salary inflation over the 82 year term. The PECRS Pre-1987 debt is valued by discounting future repayments by relevant interest rates. Changes to market rates and in particular the reduction in long-term interest rates, have contributed to increases in the value of the Pre-1987 Debt such that, as at the end of 2012 it was valued at £250 million. The current low level of interest rates therefore means that the Pre-1987 debt is currently valued at a high level. A future change in the direction of interest rates would increase the interest rate by which future repayments are discounted, and could have a significant impact on reducing the value of the debt outstanding. The Scheme Actuary has estimated that a 1% increase in the interest rate used to discount future payments would reduce the debt by £41 million (17%) to £209 million. A 1% reduction in the interest rate, on the other hand, would increase the value of the debt by £55 million (22%) to £305 million. The value of the debt outstanding is highly sensitive to changes in long-term interest/discount rates.

History of the pension JTSF pre-2007 debt

In 2007 the Jersey Teachers' Superannuation Fund (JTSF) completed a similar transfer of liability to the one PECRS had completed in 1987. From 2007 onwards, the responsibility for payment of pension increases for teachers transferred from the States to JTSF, and the associated debt has been shown on the States balance sheet. Since 2007 the States has been paying an additional 5.6% of teachers' pensionable salaries over and above the normal employer contribution rate to reflect the need to repay this debt over an 82 year period. This arrangement was established pending a formal agreement between the States and the Management Board to establish a repayment plan.

In January 2013 the Scheme Actuary signed the 2010 JTSF Actuarial Valuation. This valuation was completed on the basis that the States would formally accept a JTSF Pre-2007 debt of £91.6 million as at the valuation date of 31st December 2010. The Actuarial Valuation included a proposal from the JTSF Management Board on how debt repayments could be structured. This included the flexibility for the States to make early repayments of the JTSF debts.

The Scheme Actuary has calculated that the level of the JTSF pension increase debt has increased to £97.7 million by the end of 2012.

Existing repayment plans

The PECRS Pre-1987 Debt is structured such that repayments are linked to the increase in pensionable salaries. This means that debt repayments are heavily weighted towards the end of the 82 year period. The increased funding made available in the Medium Term Financial Plan of £1 million in 2013, £2 million in 2014 and £3 million in 2015 is expected to reduce the total cost of repayment from £2,708 million to £935 million, and enable the debt to be repaid by 2054.

Repayments for the JTSF Pre-2007 Debt have been made from the employer contribution rate since 2007. The signing of the 2010 Actuarial Valuation in January 2013, and the Management Board proposal on how the debt could be structured, enables further work to be progressed on a repayment agreement. The current level of repayments within the employer contribution rate was set with the intention of repaying the debt over 82 years.

The rationale for early repayment

The original decision to repay the PECRS Pre-1987 debt over 82 years and the 10 point agreement was made with the best information and level of resources available at the time. No-one could have anticipated that interest rates would fall to the lowest level for over 300 years. This change in circumstances means that it is now appropriate to consider the early repayment of the debt. The structure of the PECRS and JTSF pension increase debts with the repayments linked to pensionable salary increases, and the interest rate assumptions inherent within the calculations of the repayment profile mean that with the reduction in long-term interest rates it is advantageous for the States to repay the Debt early.

The linking of repayments to increases in pensionable pay means that the debt outstanding will increase in the early years, as the States is not paying a sufficient amount to meet the interest costs. The Medium Term Financial Plan went some way to address this by increasing the regular PECRS repayments to over £7 million per annum by 2015. However, it remains the case that given the structure of the PECRS and JTSF pension increase debts, repayments in the early years will continue to be insufficient to cover the interest until such time as they increase in line with pensionable salaries by a sufficient amount to cover the interest costs.

The additional funding in the Medium Term Financial Plan is expected to secure repayment of the PECRS Pre-1987 debt over the next 41 years, by 2054. A 25 year repayment period, equivalent to the period of retirement over which pension increases are paid for a typical scheme member, would require the annual repayment for the PECRS Pre-1987 debt to be in the region of £12 million.

PECRS Pre-87 Debt repayment options

	Annual repayments £ million	Expected Year of repayment	Expected projected payments £ million
Original plan	4	2082	2,708*
MTFP 2013–15 agreed plan	7 (by 2015)	2054	935*
25 year plan	12 (from 2013)	2037	584*

**This represents the payments in cash terms over the period of the repayment. The effect of inflation over the period of repayment will reduce the real terms cost of repayment.*

At the time the PECRS Pre-1987 Debt agreement was reached, the structure of the debt arrangement appeared attractive, but the market environment has now changed and interest rates have fallen to levels previously unexpected. The interest rate/discount rate within the PECRS Pre-1987 debt structure and JTSF Pre-2007 debt assumptions are dependent on the investment strategies adopted by the respective pension schemes. There is an interest rate/discount rate of 5.45% within the PECRS Pre-1987 debt structure and 6.50% within the JTSF Pre-2007 debt assumptions. Long-term interest rates are now at all-time lows, and these interest rates now appear high compared to market rates. In addition, the structure of the debt means that the States is paying interest on the interest at this relatively high rate during the early years of the debt. It is for this reason that it would be appropriate to consider further options for the early repayment of the PECRS Pre-1987 Debt and the JTSF Pre-2007 Debt.

The States has a strong balance sheet, and further options to manage the balance sheet with respect to pension scheme debt should be carefully considered. By managing the States assets and liabilities more effectively, a solution to reducing the very considerable costs of the pension debts could be achieved.

A number of possible options are available which could be adopted to a greater or lesser extent to secure long-term cost reductions in the repayment of the PECRS Pre-1987 and JTSF Pre-2007 pensions increase debts. These options could be applied in proportion to the level of debt outstanding to the 2 pension schemes to ensure consistency.

Option 1 – Further additional regular repayments

The Medium Term Financial Plan 2013–2015 included additional funding for the early repayment of the PECRS Pre-1987 debt, such that the expected date of repayment for the debt was reduced from 2083 to 2054. It will be necessary to include additional funding in the Medium Term Financial Plan 2016–2018 to ensure that the JTSF Pre-2007 Debt is dealt with on a consistent basis and repaid by 2054. It is estimated that it will require additional funding of £1.2 million in 2016, £2.4 million in 2017 and £3.6 million in 2018 in order to repay the JTSF Pre-2007 debt by 2054.

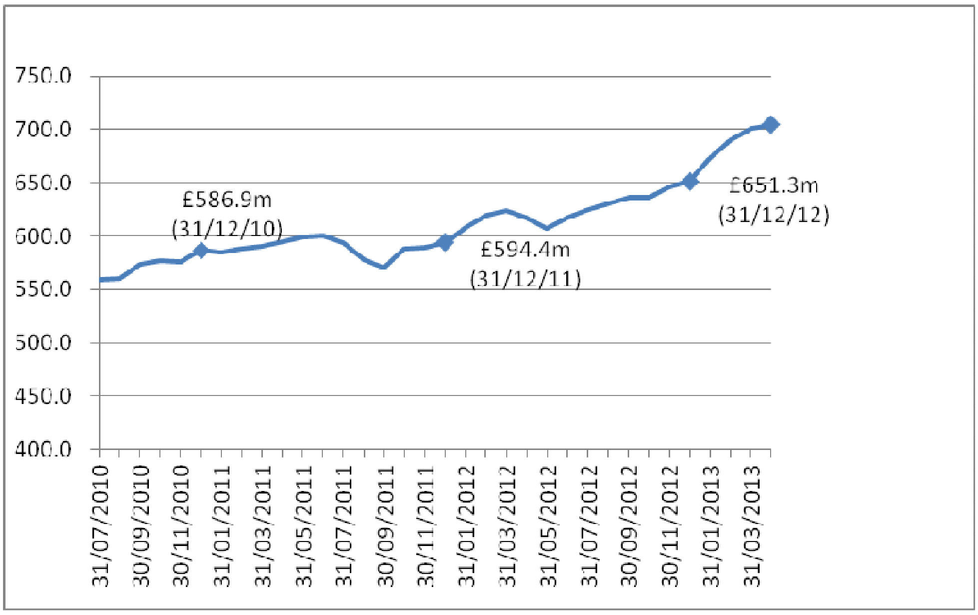
Further proposals to increase the regular repayments could be brought forward as part of the next Medium Term Financial Plan or Budget 2014. If this is affordable, it would be a prudent step to increase repayments so as to further reduce the cost of repaying the debt. In order to secure repayment over 25 years, annual repayments would need to be increased to in the region of £12 million for the PECRS Pre-87 debt and £7 million for the JTSF Pre-2007 debt.

The level of the pension increase debt changes with long-term interest rates, and it could be more or less expensive to repay the debt at particular points in time. This option has the advantage of making additional repayments over many years and will ensure that the States repays the debt at an average cost over time.

Option 2 – Utilising the interest earned on the Strategic Reserve to fund further early repayments

The Policy for the Strategic Reserve agreed by the States in 2006 outlined that a suitable long-term aspiration for the strategic reserve would be to grow the strategic reserve to an amount 20% of GDP, which at the time was £600 million. By December 2012 the Strategic Reserve had grown to £651 million, and strong investment performance has contributed to a further increase in value during 2013.

Strategic Reserve



One possible option could be to use a proportion of the future growth in the Strategic Reserve to repay the pension increase debts. The States' decision made it clear that the Strategic Reserve is only to be used for defined purposes. Over the years there have been a number of calls to utilise the returns or income from the Strategic Reserve. The current and previous Ministers for Treasury and Resources have resisted such calls to use for revenue purposes, saying the Reserve should not be used as it is the Island's long-term safety fund. However, this option has been considered for completeness.

In theory, 20% of the income from the Strategic Reserve in any financial year could be used to repay the pension increase debt subject to the Strategic Reserve not falling below a minimum level, such as £600 million. The long-term investment growth assumption for the Strategic Reserve is 5.13%. Assuming this is achieved each year over the period of the current and next medium term financial plan, it would be expected that an additional £32 million would be available to reduce the PECRS Pre-87 debt and an additional £12 million to reduce the JTSF Pre 2007 Debt. The Strategic Reserve would be expected to continue to grow to £820 million by the end of 2018 even if 20% of investment growth was used for early repayment of the pension increase debts.

Model of possible additional debt repayments

End of Year	**Strategic Reserve £ million**	**Retain in Strategic Reserve (80%) £ million**	**PECRS Pre-87 Debt Repayment (15%) £ million**	**JTSF Pre-2007 Debt Repayment (5%) £ million**
2012	651	24	5	2
2013	675	27	5	2
2014	702	28	5	2
2015	730	29	5	2
2016	758	30	6	2
2017	788	31	6	2
2018	820			
		Total repayment expected:	32	12

It should be noted that this is a model of possible additional repayments. It is not expected that investment growth will be a consistent 5.13% every year but will be vary significantly between years. The minimum level for the strategic reserve below which the policy would be suspended would ensure that the long-term position of the Island is safeguarded.

This approach could be expected to deliver sufficient funds over the long term, to secure repayment of the debt within a shorter period. It has the potential to secure repayment of the PECRS debt within 25 years (by 2037) which could reduce the cost of repayment by a further £350 million. It would also be expected that that this approach has the potential to secure repayment of the JTSF pre-2007 debt within 25 years, which would reduce the cost of repayment by around £200 million compared to a repayment plan that would repay this debt by 2054.

This approach also has the advantage of making additional repayments over many years and will ensure that the States repays the debt at an average cost over time, but using the Strategic Reserve in this way has its disadvantages.

Option 3 – Borrowing to repay

It would be possible for the States to borrow on the money markets and fully repay PECRS and JTSF pension increase debts. Long-term interest rates are at historic lows and it would be possible for the States to enter into long-term borrowing at a low fixed rate of interest. It would not be unreasonable to assume that in the current environment the States could secure external borrowing at an average of 2% less than the interest rate assumed in the calculation of the pension increase debt. This would reduce the interest being added to the debt by around £7 million in the first year.

The total pension increase debt of £347 million, comprising £250 million PECRS Pre-1987 debt and £97 million JTSF Pre-2007 debt, could be repaid with the funds borrowed. Payment would be made to the pension funds as full and final settlement of the pension increase debt, and the respective pension funds would have the funds to pay past service pension increases. The pension schemes would invest this money in accordance with their investment strategies.

To secure long-term cost reductions in this way would, however, involve replacing one form of liability on the States balance sheet with another. This option could involve repaying the pension increase debts in full at a point in time when the pension increase debt is valued expensively due to the level of long-term interest rates. A change in future direction of interest rates could have a significant impact on reducing the future value of the debt.

Recommendation

Jersey is in a very strong position compared to most other countries in not funding pensions out of current revenues. The pension increase debts in Jersey are small in comparison to the pension deficits in most other countries. However, the Jersey Treasury wishes to tackle this remaining issue to ensure our position is strengthened further still.

The Minister for Treasury and Resources will consider these options, consult with States Members and other interested parties and bring forward proposals for the next Medium Term Financial Plan or Budget 2014 with the aim of reducing the long-term costs for repayment of the PECRS Pre-1987 and JTSF Pre-2007 pension increase debts.

APPENDIX

The 10 Point Agreement

The framework agreed between the Policy and Resources Committee and the Committee of Management for dealing with the pre-1987 debt was documented in a 10 Point Agreement approved by Act of the Policy and Resources Committee dated 20th November 2003. The provisions of the Agreement, which have subsequently been reflected in Regulations approved by the States of Jersey on 27th September 2005, enable us to treat the pre-1987 debt as an asset of the Scheme for valuation purposes. The text of the Agreement is reproduced below.

"1. The States confirms responsibility for the Pre-1987 Debt of £192.1 million as at 31 December 2001 and for its servicing and repayment with effect from that date on the basis that neither the existence of any part of the outstanding Debt nor the agreed method of servicing and repayment shall adversely affect the benefits or contribution rates of any person who has at any time become a member of the Scheme.

2. At the start of the servicing and repayment period, calculated to be 82 years with effect from 1 January 2002, the Employers' Contribution rate will be increased by 0.44% to the equivalent of 15.6%. These contributions will be split into 2 parts, namely a contribution rate of 13.6% of annual pensionable salary and an annual debt repayment. The Employer's Contribution rate will revert to 15.16% after repayment in full of the Debt.

3. During the repayment period the annual Debt repayment will comprise a sum initially equivalent to 2% of the Employers' total pensionable payroll, re-expressed as a cash amount and increasing each year in line with the average pay increase of Scheme members.

4. A statement of the outstanding debt as certified by the Actuary to the Scheme is to be included each year as a note in the States Accounts.

5. In the event of any proposed discontinuance of the Scheme, repayment and servicing of the outstanding Debt shall first be rescheduled by the parties on the advice of the Actuary to ensure that paragraph (1) above ("Point 1") continues to be fulfilled.

6. For each valuation the States Auditor shall confirm the ability of the States to pay off the Debt outstanding at that date.

7. If any decision or event causes the Actuary at the time of a valuation to be unable to continue acceptance of such servicing and repayment of the Debt as an asset of the Scheme, there shall be renegotiation in order to restore such acceptability.

8. In the event of a surplus being revealed by an Actuarial Valuation, negotiations for its disposal shall include consideration of using the employers' share to reduce or pay off the Debt.

9. As and when the financial position of the States improves there shall be consideration of accelerating or completing repayment of the Debt.

10. The recent capital payment by JTL of £14.3m (plus interest) reduced the £192.1m total referred to in (1) by £14.3m and if any other capital payments are similarly made by other Admitted Bodies these shall similarly be taken into account."