STATES OF JERSEY

PENSION SCHEMES: DEALING WITH THE PAST SERVICE LIABILITY (P.110/2009) – COMMENTS

Presented to the States on 3rd November 2009
by the Minister for Treasury and Resources

STATES GREFFE

COMMENTS

This Proposition will increase the 2009 States' contribution to PECRS and JTSF from £6.7 million to in the region of £19 million, an increase of £12.3 million, with similar increased costs being incurred for the next 19 years. Whilst the current arrangements and those proposed by Senator Shenton both pay off the debt over a period, because Senator Shenton is proposing a much shorter payback period, the annual amount is naturally significantly higher. These increased costs would have to be met from either a reduction in services or an increase in taxation of £12.3 million. The size of the pre-87 debt is already known and acknowledged, and the increased costs of early repayment could only be warranted if there were significant actuarial or legal reasons which justified a shorter period of repayment of the debt.

This proposition will have no impact on the benefits paid to members of the scheme. The proposition will result in extra costs for the States of Jersey over the next 20 years but will not reduce or enhance benefits paid to scheme members.

Senator Shenton poses questions which suggest that he is uncomfortable with the generational burden created by the debt arrangements. The States actuary comments on this as follows: '"In many ways the changed incidence of cost in respect of the debt can be looked at as correcting a lack of pre-funding of increases for a former generation, whilst the change to pre-funding of future increases can be looked at as ensuring that the same doesn't happen again. It is the current generation that is picking up the lion's share of that cost and adopting a shorter period for the Pre-1987 Debt would increase that burden". In other words, the current generation is already suffering costs that were built up by a former generation.

The report states that the length of time agreed (82 years) is unacceptably long and out of step with the U.K. The States actuary comments: "The new funding regime does not apply to public sector schemes in the U.K. and, indeed, most of the larger U.K. public sector schemes are unfunded and operate on a pay as you go basis". The PECRS is therefore in a significantly better funding position than its U.K. counterparts at present by virtue of the States having agreed this scheme for repayment of the debt.

Senator Shenton further states: "In the U.K. employers must agree plans to fill pension scheme deficits within 10 years if possible, not 82 years". The States actuary comments on this as follows: "The comment referring to the 10 years is not correct. This refers to a 'trigger point' that the U.K. Pensions Regulator uses for managing its own workload – generally it will not ask for further information about a scheme's funding plan where a number of criteria are satisfied. One of these criteria is that the deficit recovery period is less than 10 years. The Pension Regulator has been at pains to point out that this not a limit or a target, and that longer recovery periods may be justified. This has been emphasised by a recent statement issued by the Pensions Regulator." The States actuary goes on to say that "The debt mechanism appears to be designed to ensure that the liabilities are properly funded."

In summary the debt arrangement as it currently stands provides for an affordable negotiated settlement of the debt of a previous generation over a justifiable timescale and is way ahead of many other similar U.K. central government schemes. Accordingly this proposition is not required. Moreover, accepting this proposition would result in an extra cost of £12.3 million per annum increasing each year over the next 20 years.

Further details on the origin and history of the pre-1987 debt are laid out in the Appendix to this comment – Paper on the PECRS past service liability by Richard Raggett, Secretary to the Committee of Management, prepared for and approved by the Committee of Management, September 2009.

Briefing Note: Origins and History of the PECRS Pre-1987 Debt
Executive Summary

a) Senator Shenton's proposition that the repayment of the Pre-1987 Debt should be accelerated to a 20 year period is likely to place the Scheme in media and member spotlights. The purpose of this note is to ensure that COM members are fully aware of the issues arising from the Pre-1987 past service liability Debt and how they were eventually addressed through the Ten Point Agreement, in order that the COM is prepared for any enquiries from whatever quarter on PECRS funding arrangements.

b) A past service liability of c.£2.5m came about in 1967 when the Scheme first became contributory. Favourable Scheme experience in the early eighties covered this. The Pre-1987 Debt arose during the transfer in 1988 of the liability to pay pension increases from the States on a pay as you go basis to PECRS on a funded basis. It was not identified at that time in Projet 123 of June 1987 that there was a past service liability involved.

c) The fact that there was a Debt not being funded sufficiently emerged over time. It has subsequently been valued at c.£55m at the time of the transfer of the debt; by the time it was dealt with by the Ten Point Agreement, it had reached c.£192m.What had been an unspecified 3.2% margin within the 15.6% Employer contribution rate established in 1988 intended to deal with the past service liability had dwindled to less than 1%, largely due to the increase over time in the rate for New Entrant benefits from 12.4% to 14.29%. By the year 2000 the COM had become concerned that there was a past service Debt no longer being repaid and barely being serviced.

d) The fiduciary responsibilities of the COM as PECRS trustee in the face of States reorganisations, incorporatisations, and a possibility that the number of employees in the Scheme might reduce over time rather than stay stable (stability of membership numbers was a fundamental element of the 1988 arrangements) led the COM to seek from the Principal Employer explicit funding arrangements for the Pre-1987 Debt.

e) The Ten Point Agreement fixed a repayment period of 82 years from 1 January 2002. The Ten Point Agreement was not, however, just about fixing the repayment period. A shorter period would have been preferable, but the COM accepted the extended period arising from proposals by the States Treasurer as part of the outcome of protracted 4 year negotiations because the Agreement confirmed the States acceptance of recognition of responsibility for the servicing and repayment of the Debt in a way which would not prejudice members' benefits. Also, the Debt repayments themselves were de-linked from payroll and so insulated from any future States reorganisations which might reduce the number of employees in the Scheme. Finally, the Agreement incorporated the principle that if an event occurs which means that the Actuary is no longer able to treat the

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Debt repayments as an asset of the Scheme, renegotiation of repayment terms has to be undertaken to rectify the position.

f) As a Government organisation, the ability of the States to repay the Debt is strong. Taken as a whole, the Ten Point Agreement significantly strengthened the finances of PECRS and hence the security of members' benefits.

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Briefing Note: Origins and History of the PECRS Pre-1987 Debt

1) Objective

1.1 The purpose of this report is to provide COM members and officers working on PECRS with a briefing note summarising the history of the PECRS Pre-1987 Debt (the "Debt").

1.2 The Technical Subcommittee requested the note to be prepared in anticipation of increased media and member enquiries which might come to the COM in the build up and aftermath of the States debate in November 2009 of Senator Shenton's proposition (P110 dated 1 July 2009) to accelerate the repayment of the Debt.

2) 1987/1988 Restructuring of the Scheme

2.1 In 1987 the States approved proposition P123 dated 30 June 1987 which recommended significant changes to PECRS. This arose from an agreement negotiated between the Establishment Committee as Employer of the day and staff representative bodies.

2.2 The main changes brought about were:

a) The benefit structures current at the time were closed to future members

b) New benefit structures were introduced, Existing Members Regulations maintaining a 60th accrual rate option and New Members Regulations providing an 80th accrual rate.

c) Pension increases under the new benefit structures were no longer guaranteed by the States; the guarantee remained in place for those opting to remain under the 1967 Regulations and the Former Hospital Scheme Regulations

d) The liability for payment of pension increases was transferred from the States to PECRS

e) An employer contribution rate of 15.6% of members' salaries was agreed

f) Arrangements for dealing with surplus and deficit arising from Actuarial Valuations were set out in the Regulations; in simplest terms, in the absence of agreement between the COM and Employer (now in the person of the Chief Minister) on adjustment to contributions, the default position was:

1) surplus to be shared one third to benefit the members, two thirds to benefit the Employer; and

2) deficits to be dealt with by benefit reductions beginning with appropriate reduction in the rate of increase of index-linked pensions.

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g) The Regulations provided for establishment of the Committee of Management which was set up in January 1990.

h) The valuation method adopted at the time was known as the New Entrant method using the existing dividend discount methodology.

2.3 In 1987 Scheme members were offered the choice of staying with the same benefits under the 1967 Regulations which included the States guarantee of index-linked pension increases whilst foregoing possible benefit improvements which might be made to the new benefit structures should surplus emerge at Scheme Valuations. The alternative was to opt for the Existing Members Regulations or the New Members Regulations which do not benefit from guaranteed index-linked pension increases but which might be improved through the members' share of any surplus emerging from Scheme Valuations.

3) Funding Methodology in 1988

3.1 The Funding Methodology adopted from 1988 had the following important features:

a) An aggregate approach taking into account past and future liabilities, Scheme investments and future contributions

b) Funding over an indefinite future: in short it was assumed that the membership of the Scheme would remain stable with leavers being replaced by new joiners for ever; there is no process for Scheme winding up under the Regulations

c) The agreed stable contribution rates from the members and the Employer were set out in the Regulations. In 1988 the Employer rate was 15.6%; following the 1992 Valuation that rate was reduced to 15.16% to utilise the Employer's agreed share of the surplus emerging from that Valuation.

d) Prudent valuation assumptions were expected to make it more likely that surplus rather than deficiency would emerge from Valuations over time.

4) Origin and funding of the Debt

4.1 The Debt came about from the 1988 transfer of the liability to pay pension increases from the States to PECRS. This was subsequently identified by the Actuary in 1986 terms as c.£55m. (There had been an earlier shortfall of c£2.5m with no specific funding taken into the Scheme on its becoming a contributory scheme in 1967. However, the Actuary had confirmed that by 1983 favourable Scheme experience had more than covered this shortfall.)

4.2 No capital sum was paid into PECRS in 1988 to fund the take-on of the £55m pension increase liability. The Employer's contribution rate had been set at a rate sufficiently above the then cost of benefits (the "New Entrant Rate") to leave a

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margin which was expected to pay off this liability over the long term future. (Although not identified in the 1987 Proposition (P123), this margin was c3.2% because the New Entrant Rate at that time was calculated to be 12.4% - hence the Employer contribution rate of 15.6%.)

5) Why did the Debt become a source of worry for the COM?

5.1 Three factors emerged over time after 1988 which led the COM in recognising its responsibility as trustee, to investigate the nature and size of the Debt and to seek with the Employer a specific funding arrangement to meet the Debt. These were:

a) Plans for States Departments to become stand alone organisations whose continued participation in PECRS was uncertain

b) The removal by the UK Government of the ability of all pension schemes to recover Advance Corporation Tax (ACT) levied on UK dividends

c) Past service benefit improvements for certain categories of member

5.2 So called incorporatisations of States Departments, in short the hiving off of States Departments or parts of States Departments into separate entities which became Admitted Bodies under the Scheme, accelerated from the mid to late 1990s. Examples are the Jersey Financial Services Commission (JFSC), Jersey Telecom (JTL) and Jersey Post (JPL). This process made it clear that the continued participation of these three entities in PECRS was by no means certain. JFSC ceased admitting new staff into PECRS shortly after its creation as an entity separate from the States; one of the objectives of the incorporation of JTL and JPL was to enable their sale at a future date, should opportunity arise. These developments showed that the assumption that the Scheme's membership would remain stable was not as secure as had been thought; the membership might decrease through States re-organisations. This possibility undermined one of the fundamental planks of the Scheme's funding methodology. Funding a Debt into the indefinite future could not be regarded as satisfactory.

5.3 In 1997 the UK budget removed the right of pension schemes to recover ACT on UK dividend income. This significant reduction in future investment returns effectively increased the cost of provision of PECRS benefits and further increased the New Entrant Rate, the cost of provision of benefits for new joiners to the Scheme, thus eating into the margin within the Employer contribution rate which had been expected to repay the Debt.

5.4 The granting of Category A status to certain ambulance staff in 2000 led to similar discussions because the improvement had been backdated leading to a past service shortfall. In the end the Employer and the COM agreed upon a period of 11 years for the payment of this past service shortfall. The need for upfront payment or at least payment for backdated benefit improvements over a short period of time which was established through the ambulancemen case has discouraged further past

service benefit improvements. A similar improvement for Customs officers was mooted but not implemented.

6) Negotiations on the Debt

6.1 In June 2000 the COM commissioned a report on the funding of PECRS from Martin Slack of Lane Clark & Peacock. The report was produced in November 2000 and was entitled “The Public Employees Contributory Retirement Scheme – An independent report on the funding arrangements”. This report explained how the original margin within the Employer contribution rate (3.2% out of the 15.6%) which had been expected to pay off the Debt had, due primarily to the increasing cost of Scheme benefits but also because of the reduction of the Employer contribution rate to 15.16% following the 1992 Valuation (and benefit improvements agreed at the same time), reduced to less than 1%. The Debt was barely being serviced; it certainly was not being paid off. By the 1998 Valuation, the New Entrant Rate had increased to 14.29% of salaries (12.4% at 1988). The report recommended that the COM negotiate specific deficiency funding payments from the Employer. The report was provided to the Finance and Economics Committee.

6.2 In June 2000 at the request of a trustee in April 2000, Bacon & Woodrow (B&W), the Scheme’s Actuary at the time, presented a report to the COM entitled “Mortality and Indefinite Funding”. The report comments on the unique nature of PECRS funding introduced in 1988 as part of a negotiation process which had resulted in, amongst other things, a stable long-term cost with deficiency contributions payable over an indefinite period. This was seen by the Employer as preferable to continuing to have pension increases paid from the annual revenue of the States. Uncertainty as to future Scheme membership numbers led B&W in 2000 to support the COM in seeking to change the contribution structure and to consider alternative methods of financing the past service structure.

6.3 Negotiations commenced in earnest with the Employer in July 2002. The principles and objectives of the COM in these negotiations were as follows:

a) The States should accept responsibility for the Debt

b) The Debt should be repaid over a finite period of time

c) Debt Repayments should be de-linked from the States’ payroll

d) A list of contingencies (discontinuance of the Scheme, for example) which would trigger immediate repayment of the Debt in full or a shortening of the repayment period

e) Neither the existence nor the agreed method of repaying the Debt should be allowed to have any adverse impact on the benefits of PECRS members.

6.4 In September 2003 the COM confirmed the Ten Point Agreement which provided for achievement of these objectives. The Additional Funding Regulations implementing those parts of the Ten Point Agreement requiring legislation were approved by the States on 27 September 2005.

7) The Ten Point Agreement

7.1 The framework agreed between the Policy & Resources Committee and the Committee of Management for dealing with the Pre-1987 Debt was documented in a ten point agreement approved by Act of the Policy & Resources Committee dated 20 November 2003. The text of the agreement is reproduced below.

i) 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.

ii) 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 two 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.

iii) 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.

iv) 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.

v) 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 (i) above (Point i) continues to be fulfilled.

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

vii) 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.

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viii) 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.

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

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

8) What did the Ten Point Agreement achieve for the COM?

8.1 The negotiations leading to the Ten Point Agreement and its implementation through the Additional Contribution Regulations on 27 September 2005 were protracted, taking just over 4 years in all.

8.2 An 82 year repayment period for the Debt is a long time. For UK private sector schemes there is no legal maximum repayment period but the UK Pensions Regulator said in 2006 that repayment periods of longer than 10 years would trigger his specific attention. In practice he has approved recovery plans lasting up to 20 years or longer in specific cases, but an 82 year period would still be considered very long relative to UK private sector practice. In the UK local government sector, repayment periods of up to 40 years have been encountered; a number of other major UK public sector schemes are unfunded; different considerations apply for such schemes.

8.3 The COM reached the best agreement available at the time. A shorter period would have been much preferred but the Ten Point Agreement is not just about the time over which the Debt is to be repaid. Before the Ten Point Agreement the Debt was not being repaid; contributions were sufficient at most to service that Debt; moreover, even this servicing was in doubt as costs of benefits were increasing due to factors such as longevity. Moreover, the existence of the Debt had not been explicitly acknowledged by the Employer and the assumption of a stable membership for the Scheme in terms of leavers being replaced by new starters remained in doubt. For the COM the Ten Point Agreement achieved the following:

a) The States acknowledged and accepted responsibility for the Debt so that its existence will not place members' benefits in jeopardy.

b) The Debt repayments have been delinked from payroll; so, even if the numbers of States employees in the Scheme reduce, the Debt repayments continue to grow, indexed to average salary growth of States employees.

c) The States publicly acknowledges the Debt through disclosure in its Annual Accounts

d) The COM has a mechanism to examine the covenant of the States, ie the States' ability to pay off the Debt as at each Valuation date (every three years) via a certificate from the Comptroller and Auditor General of the States of Jersey.

e) A proposal to discontinue the Scheme or any other unforeseen event which causes the Scheme Actuary to be unable to continue acceptance of the future Debt repayments as an asset of the Scheme triggers a renegotiation of the Debt repayments.

f) Consideration has to be given to using the Employer's share of any surplus emerging at a Valuation to repay some or all of the outstanding Debt.

8.4 Because of these contingencies built into the Agreement, the Scheme's Actuary is able to take the value of the Debt repayments as an asset in a Valuation. The value as at 31 December 2007 was £225m. This is critical if the Debt's existence is not to have an adverse impact on members' benefits. If the Actuary says he is no longer able to treat the outstanding Debt as an asset of the Scheme in Valuations, a renegotiation would be required under the Ten Point Agreement. As an asset the stream of Debt Repayments represents a good match with the Scheme's liabilities in that it provides a partial hedge against Jersey inflation and salary inflation.

8.5 In addition, the covenant of the Employer, the States of Jersey, is significantly stronger than a public company; it is a government body with tax raising powers.

9) Recent Funding Developments

9.1 The Ten Point Agreement significantly improved arrangements for the repayment of the Debt which arose from the transfer in 1988 of the liability to pay pension increases from the States to PECRS.

9.2 Following advice from and detailed consultation with the Scheme's Actuary and the Principal Employer, the assumption that all leavers will be replaced with new joiners has been removed. The 2007 Valuation does not take into account the benefits of or contributions in respect of new joiners into the indefinite future; it stops with the benefits (past and future service) and expected future contributions of current active members (current employees who are Scheme members). This step further strengthens the Scheme's funding arrangements should there be downward pressure on membership numbers in the future.

10) Reference Documents

a. Projet 123 dated 30 June 1987
b. Mortality and indefinite funding (Bacon & Woodrow June 2000)
c. An independent report on funding arrangements (Lane Clark and Peacock November 2000)
d. Herbert Smith legal advice to the Attorney General 14 August 2001
e. Bedell Cristin legal advice to the Attorney General 1 November 2001

RJR
10 September 2009