STATES OF JERSEY

PENSION SCHEMES: DEALING WITH THE PAST SERVICE LIABILITY

Lodged au Greffe on 1st July 2009
by Senator B.E. Shenton

STATES GREFFE

PROPOSITION

THE STATES are asked to decide whether they are of opinion −

to request the States Employment Board and the Chief Minster, as appropriate, to renegotiate with the Committee of Management the terms of the Public Employees Contributory Retirement Scheme (PECRS) pre-1987 debt payment agreement and with the Management Board of the Jersey Teachers' Superannuation Fund (JTSF) the past service liability to ensure that this liability is dealt with within a realistic time frame, and in any event in a period not exceeding 20 years, and to ensure that this change, subject to the approval of the States, takes place within a 12 month period from the date of approval of this proposition.

SENATOR B.E. SHENTON

REPORT

Being Morally Responsible

What sort of parent would leave substantial liabilities for his children and his grandchildren (and even his grandchildren's children) in order to give the impression that he is better off today than they really are?

What sort of pensioner would take from the children of tomorrow in order to have a lavish lifestyle today? The answer is currently every parent in Jersey and every pensioner that is a member of the PECRS.

The aim of this proposition is to force Ministers to do what is right – both morally and, if you consider UK legislation, legally correct.

The problem with pension funds is that they tend to be both technical and boring. When the issue is normally raised eyes glaze over and excuses are made to change the subject. I shall, however, endeavour to keep this proposition as simple as possible.

Overview

The States of Jersey operates two principal pension schemes for certain of its employees –

- Public Employees' Contributory Retirement Scheme (PECRS)
- Jersey Teachers' Superannuation Fund (TSF).

In addition, one further pension scheme exists, the Jersey Post Office Pension Fund (JPOPF). This scheme, which relates to Jersey Post International Limited (a wholly owned strategic investment), is closed to new members. The assets of each scheme are held in separate funds.

The Jersey Post Office Pension Fund is accounted for as a conventional defined benefit scheme in accordance with Financial Reporting Standard (FRS17).

The Public Employees' Contributory Retirement Scheme and Teachers' Superannuation Fund, whilst final salary schemes, are not conventional defined benefit schemes as the employer is not responsible for meeting any ongoing deficiency in the schemes – albeit this point is open to debate as a constructive liability remains.

Employer contributions to the schemes are charged to revenue expenditure in the year they are incurred.

In agreeing P.190/2005, the States confirmed responsibility for the past service liability which arose from restructuring of the PECRS arrangements with effect from 1st January 1988. This liability is recognised in the accounts.

The Jersey Teachers' Superannuation Fund was restructured in April 2007. The restructured scheme mirrors the Public Employees' Contributory Retirement Scheme. A provision for past service liability, similar to the PECRS pre-87 past service liability, has been recognised, although this has not yet been agreed with the Fund's Board of Management. Apart from the liabilities detailed above, the employer is not

responsible for meeting any ongoing deficiency in the schemes - although this is open to question as a constructive liability remains.

There is a substantial deficit on the Jersey Teachers' Superannuation Fund (TSF) – in some ways disproportionately large in comparison with PECRS. The reasons for this disproportionate problem are significant.

TSF was carved out of the mainland teachers' scheme in 1979 or soon after. Although there was funding for the basic pension entitlement, there was no funding for annual increases of pensions in payment. These annual inflation increases were paid out of the Education Committee's annual budget.

From an early point it was known that the long-term effect of not funding these annual increases was potentially explosive and that the experience of the rest of the scheme was bad – i.e. teachers were living longer than had been expected. However, for many years, nothing was done to increase funding – i.e. to increase contribution rates. This would have had the effect of increasing current costs and thus of squeezing the Education Committee budget. Instead of taking decisive action, the political leaders of the day gazed into the headlights of the oncoming juggernaut – seemingly hoping for a miracle.

In the late 1990s, it was suggested that the TSF should be merged with PECRS. This was always doomed, since the PECRS Committee of Management has always demanded that any change in the structure of the scheme should be accompanied by any deficits being adjusted in cash immediately. In the case of a merger with TSF, this would have required the States to make a cash contribution equal to the TSF deficit which was and is substantial – and was not practical politics. When you have politicians telling everyone that there is no pension problem it becomes impossible for them to cover the shortfall without admitting the truth.

This proposal eventually failed and, a year or two ago, TSF was reconstructed on the PECRS lines, but independently. For all of the time that these negotiations continued, the TSF contribution rates were not revised – so that the deficit continued to grow (as people must have known it would) and the Education Committee budget remained unsqueezed.

This is yet another example of bad financial mismanagement by the States. Bad financial mismanagement by the politicians, and bad financial mismanagement by the States Treasury.

The Accounts show the cost of this mismanagement –

Provision for JTSF Past Service Liability	£103,100,000.00

Information on the schemes is presented in the accounts reflecting the cost of the schemes to the States as the employer. In particular, information specified in FRS17 is disclosed in a note to the accounts. As both these schemes limit the liability of the States as the employer, scheme surpluses or deficits are only recorded within the States' accounts to the extent that they belong to the States, an accounting practice that is, in my opinion, questionable.

Back in 2006 I asked some questions in the Chamber concerning the PECRS Scheme. In reply to one of these, Senator Le Sueur wrote –

> "It would appear from the questions tabled today, and on 6th June 2006, that because of the undoubted complexity of this issue there may be some misunderstandings that are, perhaps, the source of unnecessary anxiety. It might have been simpler for the Senator to contact me or Treasury officers and to express his concerns, which could then have been dealt with. I remain happy to offer the Senator, or other interested members, the chance to meet and to discuss these complex PECRS issues, in order to assist their understanding and address their queries."

However I was not asking questions because I don't understand pension schemes – I was asking them because I do.

Now Senator Le Sueur may think that I was just being mischievous or was political point-scoring. but this was not the case – although I did, at the time, take offence when former Senator Walker said on Radio Jersey that 'there are no pension problems' and 'that I should know better'.

My first concern is that the PECRS is a Defined Benefit Scheme but not a balance of cost scheme where the employer automatically makes up any deficit. As you will all know, the overwhelming majority of final salary schemes operated by employers in the UK are balance of cost schemes. Indeed the Minister for Treasury and Resources has made it clear that they will not step in to cover future deficits. This is indeed a very rare and unusual scheme.

When it comes to producing the States of Jersey Accounts the Scheme is not treated as a final salary scheme. When negotiating with the unions it is described as a very attractive final salary scheme. Technically both these statements are correct.

FRS17 provides that any deficit must be shown in the accounts if there is a "legal or constructive" liability. In the UK, this is not an issue because the 1995 Pensions Act made the Employer responsible for any deficit. All UK reporting entities therefore have to declare any deficit in their accounts. In Jersey the situation is not as clear-cut. There is no legal liability but there may be a constructive liability; it would depend upon the Court's decision as to what is generally understood by a "defined benefit scheme."

Needless to say, there is no case law and we, the States, are therefore faced with 3 choices: declare the deficit, not declare and accept a qualified audit opinion, or apply to the Court for directions. The most honest and morally acceptable choice would be to declare the deficit. I should therefore be interested to see the legal advice given to the States as to whether there is a constructive liability or not, if the question has been addressed at all.

If a Court were to deem that there was a constructive liability, then the States would have to declare the past service deficit in their accounts using the FRS17 methodology. They would also be liable for meeting any shortfall in the Scheme – which is contrary to the current understanding and accounting practice.

It has to be made clear to members that the scheme is not 'guaranteed'.

In reply to one of my questions the Minister for Treasury and Resources wrote –

> "The Scheme is "stand alone" and not a conventional final salary scheme. The employers are not responsible for meeting any deficiency in the Scheme other than the pre-1987 debt. Accordingly, the States has no obligation to meet the cost of any deficits in PECRS, which is why it has not recognised a liability in accounts in accordance with FRS17."

Furthermore, it was stated that members were aware that the Scheme no longer had an employee guarantee, through the following statement –

> "If, at a future valuation of the Scheme, the Actuary advises that its financial condition is no longer satisfactory, proposals agreed by the Committee of Management may be submitted to the States for members contributions and/or employer's contributions to be increased and/or member's benefits to be reduced which may affect pension increases."

It is my opinion that this does not clearly reflect the changes that have been made and members will not understand the ramifications of this statement. As a result the employer retains constructive liability.

The handling of the pre-1987 debt also causes me serious concern – and this is the basis of this proposition. The whole saga of debt transfer and 82 year repayments may not have been illegal, but it certainly has the taste of Enron accounting about it. New rules in the UK make it hard for companies to get out of their pension commitments. In the UK employers must agree plans to fill pension scheme deficits within 10 years if possible – not 82 years! How can we morally leave a deficit for our children and grandchildren?

Since the UK Pensions Act of 2004, many companies have taken steps to limit additional liabilities. The vast majority of UK defined benefits schemes have been closed to new entrants.

The lack of regulation in Jersey is therefore handy as it facilitates financial creativity. But this lack of pension regulation also causes problems.

If I was asked to make two predictions for the future they would be –

- The retirement age will rise and rise.
- Ordinary people will have to pay higher taxes in the future to pay for the generous civil service pensions.

Indeed, a highly qualified independent pensions' expert commented on PECRS in the following terms –

> "States employees should read carefully the notes to this year's accounts.
>
> > *'Whilst a final salary scheme (PECRS) is not a conventional defined benefit scheme as the employer is not responsible for meeting any ongoing deficiency in the scheme.'*

> This means that if the Scheme hasn't enough cash to pay its pensions either future employees will need to cough up more or current employees and pensioners will get less."

Turning to the Scheme Accounts he commented –

> "The fragile edifice that supports the minimal deficit in the pension scheme is further weakened by the import of other assumptions revealed in the document. *'A key element of PECRS funding since 1988 has been the underlying assumption that the size of membership would be maintained indefinitely by new members joining the Scheme in at least the same numbers as previous members retired or left it.'* What this means is that the States can only decrease its workforce at the expense of the scheme's deficit as the States' funding rate has been fixed for the next 80 odd years. The pension tail wags the dog, over-manning is justified by actuarial chicanery and any Admitted Body not willing to play ball will be required to "undertake contribution arrangements to cover difficulties incurred." This has proved no idle threat as testified by the Parish of St. Helier."

When dealing with pensions we are dealing with people's lives. Members have to receive certainty. You cannot take away benefits that have been promised and, conversely, you must not promise benefits that may not be delivered.

So we have now established that it is morally wrong to leave this liability for our grandchildren and that we need to face up to our responsibilities – not push them under the carpet. Let us now assess what this means financially –

Looking at the most recent Accounts (2008) we note the following long-term liabilities –

PECRS Pre-1987 Past Service Liability	£222,288,000.00
Provision for JTSF Past Service Liability	£103,100,000.00
Total Pension Fund Liability	£325,388,000.00

In addition there is a new past service deficit liability building up.

To put this into context, the private sector taxpayer is going to have to bail out the public sector to the tune of approximately £6,500 per person for this past service deficit alone. This is substantial and the public sector should be extremely thankful to a public willing to ensure that their public sector colleagues' pensions are safe whilst they are facing redundancy, pay freezes, and reduced salaries.

And let us not forget the following –

- The picture today is probably much worse due to weak investment performance.
- In future assets may not move in line with the value of benefits.
- Members could live longer than foreseen, which would mean that benefits are paid for longer than assumed.

This Proposition simply requests the States Assembly to deal with today's problems today – and not burden our liabilities on future generations. It also, at a time of increasing private sector wage freezes, redundancies, and wage reductions – highlights the true cost of the public sector final salary scheme.

The pre-1987 deficit was converted into a debt due by the States to the Scheme. That debt is backed by what is in effect a guarantee and provisions that enable the scheme to demand early payment. This debt is of some value to the Scheme since it dilutes what has on occasion been a controversially large reliance upon equities.

The current arrangement pays off the pre-1987 debt in 2084, at which point I shall be 124 years old. My youngest daughter (currently 15) shall be 91. She may well have children, grandchildren and even great-grandchildren. No doubt she will have contributed to today's problem for the whole of her working life. What a morally responsible society we live in these days. Stick your head in the ground and let future generations pick up the pieces. Abhorrent.

Taxpayers are going the have to bail out the public sector pension deficit at a cost of millions. Members of the PECRS and JTSF fund should be extremely thankful and, perhaps, consider the generosity of the taxpayer to be equivalent of a truly substantial pay rise.

Agreement for meeting the pre-1987 debt –

15. 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 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 1st 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."

Financial and manpower implications

There are no financial implications for the States in respect of their overall liability in respect of these schemes – they liability remains the same regardless of the repayment periods. However, there will be an impact on cashflows as the proposition seeks to remove the liability from the States Accounts within 20 years. This will have an impact on States Budgets as repayment over a shorter period will have implications on expenditure levels.

To clarify this position let us assume that a reckless Bank Manager gave an individual an inter-generational mortgage over 82 years in order that the homeowner could buy an expensive property and still have his winter ski holiday and summer cruise. His children and grandchildren would fund his lavish lifestyle today and could, in theory, be paying substantial amounts in 60 years' time for a property that no longer exists. They would, no doubt, be very angry about the legacy left to them.

Let us assume that the reckless Bank Manager was fired (his Bank was bailed out by the Government) and the individual found God and realised the error of his ways – that it was wrong to force his liabilities on to future family members that were not yet born. He agrees, therefore, to repay the mortgage over 20 years and as a result has to alter his living standards – no more ski holidays or summer cruises, and a much more prudent approach to financial management.

It is impossible to detail in this Proposition the exact financial implications, as negotiations will determine debt repayment levels. However, the liability is being passed back to this generation – to the financial benefit of future generations. As a result, this generation will have to face up to their liabilities – with obvious financial consequences. As previously stated, the overall cost remains similar, but the proposition will affect cash flows.

There are no manpower implications.