BIRMINGHAM CITY University Centre for Brexit Studies

Centre for Brexit Studies

Blog Post

Did EU Commission deliberately just quietly inflate the Brexit bill with dodgy pension figures? Real questions now for the UK Treasury and negotiators.

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The EU commission has just quietly published its 2017 accounts. About just over a week ago, they slipped out. Did you spot that? No? Well….very few did.

John has spent the last week or so here at the Centre for Brexit Studies at BCU pouring over them. And we think that if you look closely at the boring bits, something of a bomblet is contained. The Brexit bill has just soared upwards. And the UK needs now to ask some tough questions of the EU Commission about their figures – questions which, to be frank, the Treasury and our negotiators should have been asking a long time ago.

Annual accounts of the European Union 2017

LIABILITIES

2.9. PENSION AND OTHER EMPLOYEE BENEFITS

Net employee benefit scheme liability

EUR millions

	Pension Scheme of European Officials	Other retirement benefit schemes	Joint Sickness Insurance Scheme	31.12.2017 Total	31.12.2016 Total
Defined Benefit Obligation	*63 951*	*1 854*	*7 756*	*73 560*	*67 664*
Plan assets	*N/A*	*(137)*	*(301)*	*(438)*	*(432)*
Net liability	**63 951**	**1 717**	**7 455**	**73 122**	**67 231**

The liabilities included in the accounts for the EU's civil service Pension Fund liabilities have just hit €73Billion. The problem is that the UK, on leaving next March, has to commit to pay its share of that huge figure. It is one of the biggest items on the Brexit bill. You'd have thought everyone would have been clear what it was. And we're meant to be sorting this by October's end.

But in all of the calculations by all of the apparent numbers experts very few have gone on to ask serious basic questions about this huge figure. Especially as there is actually no pension fund in existence.

Like our doctors and nurses in the NHS, our Teachers, the UK armed forces, judges and civil servants, there is a "pretend fund" for accounting purposes. But in reality it just pays out monthly pensions and takes in monthly contributions and they mostly balance at year end. If there's a shortfall the treasury plugs the gap, and if there's a surplus (there usually is) the Treasury happily gobbles it up.

So with the EU. There's no Fund. Just an annual accounting exercise.

But the accounts say there's a big bill now of €73Billion. That's how much the EU has already committed to pay today's EU civil servants and expects to have to pay those same civil servants over the next few decades. They come up with a figure every year.

The problem is that just 5 years ago the figure was only(!) €42Billion. So the first obvious question you will be asking (and our negotiators should have asked) is ***what on earth has happened to almost double the EU Pension Fund bill in five years?***

It is, after all, rather unfortunate timing for the UK.

But why also so much of an increase just this last 2 years? It's gone up €10Billion since 2015 and over €6Billion since the last accounts. Surely this isn't the EU commission or its negotiators pulling a fast one at the last? So ***what happened this year to end up with such a shock increase in liabilities at year end?***

They EU will also have another go on 31st December this year at naming the figure. ***Do we expect the December 31st 2018 figure to be substantially higher again?***

If we do, then we should start seriously to question the entire basis for the EU's figures.

Our judgement is that there is, actually, an explanation (if not an excuse) for these quickly inflating figures. And we need quickly to halt the train before it hurtles towards us at the last minute.

The explanation is that the EU has literally got its figures wrong. It has failed to reflect in its calculations the actual market conditions (or, rather, lack of them) which led to the €73 Billion calculation. In fact it could even be questioned as to whether it has in effect created false market conditions to come up with the figure.

When the EU calculates its accounts, it uses bond figures prevailing at the time to set the Discount Rate. This interest rate is the biggest factor when it calculates its final pension fund liabilities. It values future liabilities and cash flows at today's prices by discounting a certain amount off the future big figure every year and calculates backwards to today. Over history discount rates have settled at around 7% for funded pension funds.

Perhaps counter-intuitively, the lower the discount rate, the higher the liabilities become, and vice-versa. You can think of the future liabilities as a massive iceberg – the discount rate sets how many ice cubes you chip away or the rate you chip away from the iceberg over time, back to today, which gives you a smaller but prudent iceberg. On one level, if you chip away 7000 ice cubes a minute rather than 300 then your 7000 cube-cut iceberg's gets a lot smaller over time than the other.

Research also tells us that when you go below 3%, and the nearer you then get to zero, the then exponential effect makes liabilities sky-rocket. That's what's happened here.

So the biggest of the other big questions we should have been asking relates to one actual accounting figure. ***Why has the EU used a nominal discount rate of only 1.9% to come up with the bill?***

This figure when combined with inflation in the EU is the single reason why the bill has sky rocketed in the couple of years. And similar (completely wrong) decisions as to this rate since the crash have caused the liability to almost double.

Why didn't the EU make a policy decision to freeze or place a ceiling on this discount rate when it was clear at each year end that it was causing ridiculous liability increases in the pension fund?

Another explanation (again not an excuse) is that nobody ever really bothers about this obscure, arcane entry in these annual notional figures.

But all of a sudden, this figure, it's real: Brexit has given it life and legs. Because the EU wants the UK to pay them a share of the liability as we "shut the door" and "leave".

A further explanation is that two parts of the European set-up (i.e., the Commission and the European Central Bank, or ECB) were not talking to each other which could have meant the figures were put right years ago.

When Mario Draghi at the European Central Bank got his bazooka out, his officials should have warned the EU Commission then and since that their annual accounting figures would go haywire. Draghi's "whatever it takes" humongous state and corporate bond-buying QE programme had an immediate, fundamental impact on markets across Europe.

In the "old days" (before 2015) the normal bond markets had settled post-crash, but wider interventions in bond markets in the U.K. and U.S. had depressed yields on sovereign and corporate bonds generally. But ECB quantitative easing (QE) changed the game. There suddenly wasn't a real market. So using it to set the discount rate in the EU accounts was madness.

The Central Bank's intervention was so hugely impactful that there was no real market in corporate Bonds. The fully functioning bond market ceased as soon as central interest rates collapsed after the Crash due to central (not market) interventions. When deflation threatened and recession came the ECB's utterly unprecedented intervention effectively dismissed the market in bonds in Europe in its entirety.

But elsewhere, the EU, simply continued as if nothing had happened. It pretended the figures coming out of a dysfunctional, effectively non-existent bond market were real. Worse, it came up with a discount rate every year that was just wrong. And those pension fund liabilities soared each year.

In addition, the very intention of the ECB was clearly expressed in its policy statements to actually "increase inflation" to 2% (this worked – achieving this aim in early 2018). This was seen as the healthy level after which the QE would start to stop.

The problem was the double whammy of ultra-low discount rates and increasing inflation at the same time. Once you just ***start*** the pension fund liability question with the 1.9% discount rate, you then deduct inflation for what they call the ***real*** discount rate. An Alice in Wonderland set up then occurs where liabilities are set at effectively negative discount rates. That could happen this year when the EU calculates the bill. If they do, then the Brexit bill won't just soar, it will go into orbit.

So let's see all of the actual calculations. And let's ask the Treasury and our negotiators to do alternative calculations. In particular, based on European Bond rates over 25 years, not now. And if we did that, then we could apply discount rates nearer to the norm of 5-7%, not next to zero. And the EU pension fund would see its pretend liabilities actually evaporate. There could even be a surplus.

We will blog again with some further detail on the effects of Eurozone QE inflation and discount rates as part of preparing a wider report on this issue. Subsequently John will also make a different, but linked point, in a blog as to: "Why on earth we should be paying a cent to the EU for its pension fund on Brexit?" And that could instead be spent on the NHS, perhaps?

Indeed, it would be no inconsiderable irony if the promises made out by the "Leave" camp regarding extra money for the NHS turned out to have some grain of accuracy to them, but not – we would suggest – due to any conscious prior reasoning on their part.

Nor - and we should stress this - are we seeking to be deliberately or necessarily anti-EU in tone. The methodologies adopted by the EU are common-place and used within the UK also (e.g., calculating local government pension fund liabilities).

This raises wider issues – and, we would suggest – distinctly uncomfortable ones for the UK Treasury also as to how pension fund liabilities are calculated. Suffice to say, our concerns should also be of interest to the other 27 EU member states as regards to their own financial contributions to the EU budget.

In the meantime, let's see the EU's calculations, its policy statements on Discount Rates and the ECB's QE policy (if any), and what the Treasury and negotiators have done so far to challenge the figures.

Because at the moment it looks to many that, with negotiations to be sorted by October's end (which appears increasingly optimistic), the EU just over a week ago appeared to have pulled a "fast one" at exactly the right time.

Use of our work does not equal endorsement.