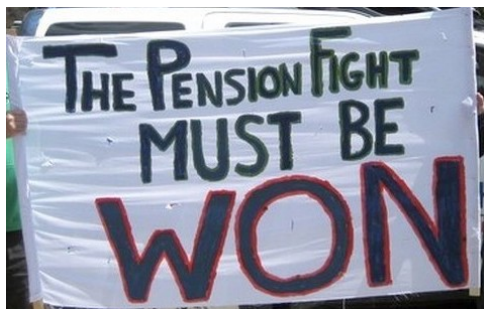


## Public Sector Pensions (Part Two) - The Way Forward

Written by Chris Blyth

Monday, 07 September 2015 00:00 - Last Updated Wednesday, 09 September 2015 22:16

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**The History** –The Government Unified Scheme (GUS) was introduced in 2012, following lengthy negotiation with staff. It simplified the administration of some 15 different public sector pension schemes and increased some employee contributions, but made no substantial difference to their affordability or sustainability, nor indeed their fairness to taxpayers and the private sector. It followed tortuous negotiations with the unions and their members (and at a cost of well over £1 million, paid to the consultants Hymans Robertson). Shortly afterwards, it was proclaimed by government spin as a major success story, quite forgetting both the financial implications and that it constituted a desperately sad situation of "pensions apartheid" - dividing the public sector (where 90% of workers have a salary linked pension heavily subsidised by the taxpayer) against the private sector where less than 50% now apparently have any form of pension scheme applicable at all.

Inevitably, soon after the launch of the scheme in 2012, it quickly became apparent that the GUS had serious if not fatal funding difficulties.

Accordingly, at the January 2014 sitting of Tynwald, a motion was passed :

“That Tynwald views with concern the continued rising cost and liabilities associated with public sector pensions including Tynwald Members’ pensions, and calls upon the Public Sector Pensions Authority:

(a) to undertake a full and comprehensive valuation of the Government Unified Scheme, Tynwald Members’ pension schemes and relevant pension schemes as applicable; and

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---

(b) with the Pensions Working Group to report to Tynwald by December 2014 on the feasibility of implementing further cost sharing and other measures to reduce the long term liability in order to provide for a sustainable and fair pension scheme.”

As a result, and under the chairmanship of Chris Robertshaw, the then Minister of Policy and Reform, a Public Sector Pensions Joint Working Group (PSPJWG) was established to undertake the work. Their report, issued in December 2014, acknowledged that the future service costs of providing pension benefits for all schemes is an average of 28.8% of pensionable pay (but varies considerably depending upon which scheme - in the case of Tynwald Members, as well as the judiciary and the police, the cost is well over 40% of salary). Employees currently contribute an average of 6.4% of salary, and the departmental employer a further average of 6% of pay (at which level, broadly equivalent to a private sector employer). However, the difference of 16.4% of pay is currently met by transfers from the Pension Reserve Fund and by taxpayers.

Put in money terms, the total annual employee / employer contributions are approx. £31 million at present – but benefits paid out are running at £89 million in 2014 – with the difference of £58 million being met by transfers from the Pension Reserve Fund of £32million and from taxpayers of £26million – clearly unsustainable in the longer-term.

As it stands, the total liability of public sector pensions - the accrued benefits of all past and current employees on the island - is now calculated to be in excess of £3 billion - and increasing significantly every year, whilst the Pension Reserve Fund is expected to be exhausted by 2025..... meaning that public sector pension commitments will require ever greater funding from taxpayers, and thus diverting funds from public services (which is what taxpayers expect in return for their taxes!) It is forecast that by 2025, public sector pensions expenditure will have increased to some £150 million per year.....

The Joint Working Party undertook extensive research in compiling their report, which included a large amount of helpful background information and various ideas and proposals to address the issues.

The Major Recommendations of the Joint Working Group were :

## Public Sector Pensions (Part Two) - The Way Forward

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---

1. To increase the standard employee contribution rate from 5% to 8% of salary, raising an additional £8 million per year, but which has relatively minor impact on the total benefit payout currently running at £89 million in 2014 and rising.
2. To increase the minimum retirement age from 55 to 58 – with possible subsequent increases linked to longevity tables.
3. To amend the definition of final pensionable pay such that it would become the average of the best three years in the last thirteen years of service – estimated to reduce pensionable pay by 4-6%
4. To review the accrual rates on those retiring before 60 or 65 (depending upon the former schemes' normal pension age) is taken to ensure that the pension growth rates (for current members) and actuarial reductions (for deferred members) on earlier retirement are truly reflective of both members options (e.g. taking the lump sum in most cases) and anticipated longevity
5. The Working Group did not recommend capping of the lump sum on retirement but instead, recommended consideration of two options in respect of the payment of large lump sums:
  1. Firstly: that Treasury considers whether any member who is able under Scheme rules (and so chooses) to take a lump sum in excess of £200,000 should pay tax at their highest marginal rate on the excess above £200,000. It is expected that this will in practice affect only a limited number of retirees (less than 3% of overall pension scheme memberships)
  2. Secondly: that the commutation rate i.e. the amount of pension given up in return for taking a lump sum, is amended from the current 18:1 to 12:1 in respect of that part of any lump sum over and above £200,000. The current commutation rate for most UK public sector schemes is 12:1 and therefore for those members choosing to take a large lump sum, members will need to give up pension in return for taking the lump sum on the excess over £200,000 at the same rate as in the UK.
3. To restrict inflation increases to pensions to 3%
4. In the short term, all employers should pay a 15% of pensionable pay contribution for both current and future employees. Based on current Scheme memberships, this should improve visible cash flow into all schemes by around £27 million per annum. The longer term aim should be to fund benefits at a level of 20% employer contributions. Based on current Scheme memberships, this should improve cash flow into schemes by a further £13 million per annum;

In addition, as Tynwald confirmed, any changes to the scheme require extensive and time-consuming negotiations with staff and unions - but there is no mention of consultation with taxpayers or the private sector.

Unfortunately, the suggested amendments to the public sector pension schemes would appear

## Public Sector Pensions (Part Two) - The Way Forward

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---

to be too little and too late – and their work has anyway now been negated by subsequent delays actioned by Tynwald and by the Pensions Committee within the Public Sector Pensions Authority – the need allegedly for more time, more analysis, more consultation.

**Latest Developments** – the PSPJWG report of December 2014 was debated in Tynwald, but met vociferous objections as to content and timing. Subsequently, Mr Robertshaw resigned his position as Minister of Policy and Reform, his post being given to John Shimmin, who has taken over responsibility as Joint Chair of the Public Sector Pensions Committee. In June 2015, the Committee confirmed to all members of the Govt Unified Scheme (GUS) that the recommendations given in the Joint Working Group report were not being actioned, with the changes now as follows :

**Timescale** – the original aim was to reach agreement on recommended changes by July 2015. It has now been moved to end 2015 (and now further delayed by Mr Bell until October 2016 and a new government following the September 2016 general election – perhaps a “kick of the can down the road” for someone else to sort out ?)

**Raising of the Minimum Retirement Age** from 55 to 58 – has been removed.

**Taxing or changing the commutation rate** for lump sums above £200,000 – has been removed.

**Increases to Employee and Employer Contributions** before 2020 – no agreement, but both sides to work in partnership to achieve a fair outcome for all.

**Further Study** – the actuarial figures in the PSPJWG report are to be validated by an independent actuary and to report back.

Unfortunately, a willingness by current Tynwald members to “kick the can down the road” and allow later administrations to take responsibility is all too evident, at which time the problem will have become that much more serious. It should also be noted that all members of the Working Party were either Tynwald members or public sector employees and thus beneficiaries of one or

other Government Pension Scheme with an obvious conflict of interest or vested interest - no independent members were allowed - and no representatives for the taxpayer nor private sector employers and employees who fund 80% of the public sector scheme.

### **The Issues Now Facing Society in General**

The Joint Working Party having acknowledged the unaffordability, unsustainability, and unfairness of the current GUS, two major issues arise for the island :

#### **1. Public versus Private Sector Pensions**

That the Government Unified Scheme needs major surgery is now beyond doubt. However, it is a comparison with equivalent pension provisions in the private sector that reveals the yawning gap between the two sectors - and hence the resulting so-called "pensions apartheid". The issue behind the differences is that private sector schemes have to be fully funded by contributions from both employer and employee – with plans agreed with the authorities to fund any deficit which may exist over a number of years with extra payments. By contrast, most public sector schemes (excluding local authority workers who have separate funding arrangements) are currently largely unfunded – and pensions are paid “as you go” from current contributions by employer and employees plus a large top-up from the taxpayer.

More than half of private sector employees on the island have no pension scheme provision whatsoever. For those fortunate enough to have a private sector pension, most employers have now closed their final salary schemes (due to the ever increasing costs and liabilities resulting from our increased longevity), and replaced them with defined contribution (money purchase) schemes - which generally result in much smaller pension payouts, usually only 25-30% of a salary-linked scheme.

In the UK, all larger (and eventually, all minor) private sector employers are now required to establish an employee workplace pension scheme with automatic enrolment of all employees - this is to ensure that as many workers as possible make some provision for their pension needs in old age - albeit currently with only modest contributions of just 4% of salary by the employee and 3% by employer (plus 1% tax relief from the UK Government) – unlikely to generate the sort of pension we would all like.

## Public Sector Pensions (Part Two) - The Way Forward

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By comparison, our Treasury Minister has only recently announced the intent to consult further with employers and pension providers in the Isle of Man regarding the introduction of a compulsory workplace pension, and report back to Tynwald in July 2016 on the feasibility of the proposal. This is a complete “about turn” by the Treasury Minister as it has previously been declared there was no such intention - partly due to concerns about the impact upon local employment with the extra costs for employers, and partly due to the legislative load on Tynwald required to re-negotiate the existing GUS.

So - the 20% of workers employed in government currently retain their extremely generous final pensionable pay scheme with no changes. Meanwhile, the other 80% in the workforce will be contributing as taxpayers to public sector pensions BUT with much inferior or perhaps no provision for their own pension needs..... not something that most will look forward to in old age. ...and giving rise to the potential for a major schism in our society.

It is certain to become a significant social issue in the future.

### □□□□□□□□□□ 2) Inter-generational Impacts

The longer the delay in enacting the radical changes required to public sector pensions, the greater the impact upon future generations of the liability. The demographic changes - the increased longevity, and the resulting rise in the proportion of older people to those of working age, means that the working population will be supporting an ever greater ratio of older, retired people. Perhaps weighed down by university fees and the credit card debts of the "I want it now" generation, our children and grandchildren are already struggling to do the things we expect of young adults - having families, buying property, making provision for savings and their own pensions. The expectation that they will have incomes sufficient to fund hospitals, education, social security, defence, police and all the other services government is required to provide appears to be a step too far.

### Conclusion and Suggestions

It would thus be reasonable that public sector pensions should become much more self-funded

## Public Sector Pensions (Part Two) - The Way Forward

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than currently, and less of a charge upon future taxpayers.

As a matter of contractual commitments, all benefits already accrued by public sector employees must obviously be honoured. However, the urgency of the situation is such that a rapid transition to a new pension package is required, with all employees subject to new terms and conditions from a specified future date, say 2018. Having said that, the continuation of a "defined benefits" scheme such as the current final salary scheme is taken as a given - the disruption likely to result from any suggestion of a move to a defined contributions (cash purchase) scheme such as seen in the private sector is seen as insurmountable.

The major components in determining public sector pensions and their liability currently include :

- total years in service and in pension contributions
- salary in the final years of service
- the "accrual rate" (currently 1.5% of final salary per year of service for someone retiring at 65 years of age). Thus someone retiring at 65 after 40 years of service receives a pension of 60% of final salary. There are penalty adjustments to the accrual rate for those taking early retirement and favourable adjustments if taking later retirement.
- additional benefits such as inflation index linking, death in service, spouse residual pensions etc
- lump sum payments on retirement are currently given very favourable commutation rates as well as being tax free.

Amendments to all these factors will be necessary to address the problem of the overall liability, and to ensure affordability, sustainability and fairness - and which will necessitate the use of a fully independent actuarial adviser to assess any changes to the scheme. However, the package must also mirror the pension changes in the private sector - if not in the fine detail, then at least in terms of their impact. Public sector employees and their unions will see this as a "race to the bottom" and deeply unfair - but this must be balanced against the impact upon the rest of society of the deeply unfair nature of the current situation, and the economic certainty that private sector employers will NEVER be able to afford pension provisions to match the public sector.

1) Given the generosity of defined benefit salary-linked schemes, with the expectation of large (and unlimited) employer contributions, an increase in employee contributions is a necessary first step towards a fairer public sector pension package - and a "staggered" increase from the

## Public Sector Pensions (Part Two) - The Way Forward

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current 5-6% to at least 10% spread over a period of 4-5 years does not look unreasonable and perhaps 15% in the medium term.

2) Many private sector pensions have now moved to an “indexed career average” salary calculation rather than a “final salary” basis. With annual salary increases and seniority, older workers tend to have maximum earnings in the last few years of their employment. The move to “career averages” is seen as fairer in recognising earnings over the employee’s years in service, and has the obvious benefit of reducing the employers pension liabilities. The alternative, of the average of the best three years in the last thirteen years of service as suggested by the PSPJWG is also a possibility.

3) The key reason for reducing the generosity of accrual rates is affordability. It is a reform that fits well with an increase in the normal state pension age, since a proportionately less generous accrual rate allows a pension of the same annual amount to be accrued from a longer working life. Alternatively, a lower pension could be received from the same age.

A reduction in the accrual rate, together with an increase in the normal pension age, simply means working longer for the same pension:

For example, in a final salary scheme offering a 60ths accrual rate, a pension of two-thirds of final salary can be accrued from 40 years’ service. If the normal pension age was increased to 65, and the accrual rate reduced to 67.5ths, a pension of two thirds of final salary would be accrued from 45 years’ service.

Conversely, if in the above example the normal pension age were increased to 65, but the accrual rate was left unchanged, a pension of three quarters of final salary could be accrued from 45 years’ service.

If the accrual rate were reduced, but the normal pension age left unchanged, the effect would simply be a reduction in the proportion of final salary that could be accrued. In the above example 40 years’ service at a 67.5ths accrual rate would allow a pension of 59.25 per cent of final salary to be accrued.



## Public Sector Pensions (Part Two) - The Way Forward

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---

4) The “fringe benefits” of a pension are also significant, and include, for example, inflation indexing to the Retail Price Index or the Consumer Price Index. Private sector pension schemes are usually indexed with an upper limit currently of 2.5% - which obviously sets a limit on pension liability.

Fringe benefits include half pension to the surviving partner or spouse in the event of the death of the pensioner – a not unreasonable provision, but with obvious costs to the pension provider.

5) The PSPJWG in their report pointed out the very generous lump sum arrangements currently applicable to GUS when compared with equivalent UK schemes – the commutation rate i.e. the amount of pension given up in return for taking a lump sum, is currently 18:1 in GUS, whereas only 12:1 in most UK public sector schemes. An alignment with UK schemes would also reduce the incentive to “cash-in” with the lump sum option – apparently an outflow from GUS of £10 million+ being paid out in lump sums in 2014, and in one instance, a single payment of £420,000. In light of such expenditure, some consideration should also be given to making an element of the lump sum liable to income tax – after all, the contributions into the pension scheme were not subject to tax at the time.

The suggestion that the GUS issues can be addressed simply by increasing the employers contribution rate to 20% of pensionable pay is derisory – creative accounting which is massively out of line with private sector employers, designed to ensure that the current shortfalls in contributions get accounted in a different and less obvious way. It is indicative of the self-serving processes within government, of working for themselves and not for the public. The employer contribution is currently approx. 6% (broadly comparable with the private sector for equivalent schemes) but there is a funding gap of 23% - being met currently from pension reserves and the taxpayer. So by increasing the employer contribution to 20%, the funding gap will automatically be much reduced – effectively “hiding” the true extent of the increase in taxpayers liability – rather than questioning the fundamental unfairness of public sector pension schemes as currently evolving.

Pension schemes are immensely complex, and mathematically fraught, with outcomes varying depending upon a whole set of assumptions about probability theory, rates of return on investments, longevity, let alone contractual obligations, the power of union negotiators, the morality and ethics of “fairness” etc. What is clear is that we currently have public sector pension arrangements which are not sustainable and are unaffordable – so change is essential.

Tynwald and public sector employees must recognise this, and set up appropriate discussions to agree a way forward. The current proposals from the Joint Working Party are inadequate in the long term – accepting them as they are will only require further adjustments in five or ten years as they in turn are recognised as not sustainable. That Tynwald and the Pensions Committee have “kicked the can down the road” and delayed decisive action on what is a major priority for our economy and for a fairer society is totally unacceptable. As Chris Robertshaw

## Public Sector Pensions (Part Two) - The Way Forward

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has recently said, “Is Government working for us, or for themselves?”

Any discussions will require a “clean sheet” approach, with no limits set, no prior briefings or “understandings”, no protection for vested interests, and a transparent and open process with full taxpayer involvement – not the “old boys club” and the closed doors with conflicts of interest readily apparent in the participants.

Do I think Tynwald and the manx public sector unions capable of such a programme ? I regret.....