

Public Sector Pensions– A Review (Part One)

Written by Chris Blyth

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The Problems - Put in its simplest form, the problems with public sector pension schemes are two-fold – their funding arrangements and increasing life expectancy.

1.

The schemes, with defined benefits relating essentially to salary and years of service, have origins dating back to the 1920's and 1930's – when life expectancy of approx 60 years was considerably shorter than today's expectation of perhaps 85 years, and thus pensions – if paid at all - were paid for relatively short periods following retirement.

2.

As a result, staff pension contributions of typically 5% of pay, and matched by the employer, were historically sufficient to fund the liabilities of these schemes. However, because life expectancy has increased so significantly and so rapidly in the past 2-3 decades (with resultant increases in long-term pension payouts) but with funding arrangements (via employee and employer contributions) having remained unchanged, these schemes are today proving to be too generous, and requiring massive additional “top-ups” from the taxpayer. They are thus unsustainable.

It should be noted that the UK Government in Westminster had major concerns with the costs of the directly equivalent UK public sector pensions. An interim report published in October 2010, and a final report published in March 2011 by the Independent Public Service Pensions Commission under the chairmanship of Lord Hutton had declared the then current UK schemes “unaffordable, unsustainable, and unfair to the taxpayer”. Despite the direct comparability of the schemes, these reports were totally ignored by the manx government in negotiations with its employees.

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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.

This was not the fault of the consultants, Hymans Robertson. It was the fault

a) of Government and the senior civil service advisers who set the parameters within which Hymans Robertson had to work, and a requirement for the continuation of a final salary scheme

b) of Tynwald members, who approved the scheme, all of whom had a vested interest and a straightforward conflict of interest as beneficiaries

c) and of a lack of independent governance in the establishment of the GUS – no taxpayer nor private sector involvement in the process whatsoever – the very sources of the great bulk of the funding for public sector pensions.....

In addition, and to compound current difficulties, the Government, as part of the negotiating position with their employees, confirmed that the analysis provided in the setting up of the GUS and the forward projections for the scheme were sufficiently robust that there would be no need to increase employee contribution rates again until at least 2020 – a statement which unions and employees took on trust, and which Government is now expected to uphold.

Today, the typical government employee pays an average 6.4% of salary as a pension contribution to the Government Unified Scheme (but varying widely depending upon function and scheme). Someone retiring at age 65 after 45 years of service will have paid total contributions equivalent to less than 3 years salary, but will receive a pension of 67.5% of final

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pensionable salary for the next 20 years (equal to 13.5 years full salary) – a very high rate of return for what is a very modest investment..... In effect, the high cost of the public sector pension is worth an additional 30% on salaries of (already well paid) public sector employees – which some (though not the Staff Unions) consider unaffordable in the context of a Government facing serious financial issues.....

The Current Situation - 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

(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.

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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.....

Given the actuarial work undertaken, the PSPJWG believed there to be a projected long term gap between income (contributions) and expenditure (benefit payments) of about 23% of pay. This long term gap indicated that further sustainability changes were required to all public sector pension schemes. Understandably, their report concluded that measures were urgently necessary to address the funding issue.

Action Recommended by the Public Sector Pensions Joint Working Group

Actions recommended by the PSPJWG were quite specific and wide-ranging. For the purpose, I have included only the recommendations for the GUS, though recommendations were also covered for the Tynwald Members Scheme, Teachers, Police and Judicial Schemes.

Recommendations for GUS members:

Future new members :

1.

Move the current accrual rates upwards by five years such that the present level of benefits achieved at current ages would not be achieved until 5 years later.

2.

Increase the rate of employee pension contributions from 5% of pay to 8% of pay, raising an estimated £4 million per annum in year ten given an average turnover of public servants

Current members :

1. A 3% increase in contributions of pensionable pay across all sections and members to improve the cash flow position. Phased-in over three years, this increase was estimated to raise additional £8.4 million, based on current GUS membership

2. Amend the definition of Final Pensionable Pay such that, going forward, it will now be the average of the best three consecutive years pensionable pay figures in the last thirteen years before retirement or leaving. This should also be applied to future new members of GUS. On average, this should reduce the final pensionable pay figure by between 4-6% over time and should end the position whereby the Final Pensionable Pay calculated is often higher than a member's current Pensionable Pay

3. Raise the minimum age of retirement from 55 to 58 with immediate effect, with progressive future increases as longevity improvements continue. This should also be applied to future new members of GUS

4. Review the actuarial terms on which retirement 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. Changes to the contributions or benefits for current members of GUS should only be introduced via due process (consultation by the PSPA with affected members and their representatives, together with Employers and Treasury, in line with the Public Sector Pensions Act 2011 and for a three month period and, where required, negotiation of the changes)

6. 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.

Deferred members

1. Raise the minimum retirement age from 55 to 58 with progressive future increases and review the actuarial terms on which early retirement benefits are taken
2. Consider changes to large lump sums payable on retirement in the same manner as for current members of GUS
3. Restrict annual pension increases to the level of UK CPI inflation subject to a maximum 3% per annum, for future service for existing members and also for any new members once members retire, but not for existing deferred members
4. In times of inflation above 3%, measured over three consecutive years, it is recommended that Treasury is required to review the level of pension increases with a view to making additional increases over and above the 3% level depending upon what is affordable at the time

Future Pensioners under GUS

1. Restrict annual pension increases to the level of UK CPI inflation subject to a maximum 3% per annum, for future service for existing members and also for any new members once members retire, but not for existing deferred members
2. In times of inflation above 3%, measured over three consecutive years, it is recommended that Treasury is required to review the level of pension increases with a view to making additional increases over and above the 3% level depending upon what is affordable at the time

Employer Pension Contributions

1. In the short term, all employers should pay a 15% of pensionable pay contribution into GUS 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;
2. The longer term aim should be to fund benefits at a level of 20% of contributions. Based on current Scheme memberships, this should improve cash flow into schemes by a further £13 million per annum;
3. The 15% contribution (followed by an increase to the 20% employer contribution) is

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introduced across the non-GUS schemes for Police, Teachers, the Judiciary and Tynwald Members;

4. A system of monitoring the future utilisation of the Pensions Reserve on an annual basis is set up between Treasury and the PSPA.

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 Early 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.

Personal Observations and Conclusions – the recommendations of the Working Group are themselves inadequate, and fail to address the long-term issues of unaffordability, unsustainability and unfairness.

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1. The recommendation to raise contributions for employees is a reasonable start (but not the end) – and the pension package remains an excellent investment for the employee.

2. The recommendation to raise the employer contribution to 20% of pay is “creative accounting” sophistry of the worst kind – and 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 – but massively increases the taxpayers immediate liability – rather than questioning the fundamental unfairness of the whole pension scheme.

The decisions by the Pensions Committee to delay implementation of all the recommendations made in the JWG report is an indictment of the whole process – it fails yet again to tackle admittedly difficult issues, it leaves the taxpayer with continuing major liabilities, there remains a stench of self-interest and of conflict of interest, and there remains a total lack of involvement by those taxpayers actually funding public sector pensions. So much for manx democracy !

It was suggested in a recent newspaper article that Tony Blair, about to speak at a symposium led by Sir Philip Green (owner of TopShop and BHS) asked him what he was required to do. Sir Philip allegedly replied “you’re a politician – I don’t expect you to do anything”.....

I wonder if any member of Tynwald recognises or acknowledges any similarity ?