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Public Sector Pensions – Addressing the Legacy Funding Gap

A Report by the Cabinet Office
endorsed by the Council of Ministers

Draft -16 March 2016

PUBLIC SECTOR PENSIONS – LEGACY FUNDING

CABINET OFFICE REPORT

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Note: This is an updated version of the draft circulated to Members of Tynwald for the briefings on 9 & 10 March 2016. Small corrections/amendments have been made to paragraphs 4.26 to 4.31, and assumptions added to Appendix 1.

1 Introduction

1.1 The Public Sector Pensions Working Group ("the Working Group") reported to December 2014 Tynwald on the fairness and sustainability of public sector pensions in the Isle of Man. Tynwald noted the report and the resolution arising from the debate requested the Public Sector Pensions Authority (PSPA) to consult on the proposed reforms, to have the actuarial figures independently verified and to negotiate with staff sides if reforms were required. In the July 2015 sitting of Tynwald, it was resolved that the PSPA should conclude the consultation and negotiation process by 31 December 2015 and submit final proposals to Tynwald for approval in February 2016.

1.2 The PSPA's report was submitted to the Council of Ministers at the end of January 2016. Whilst Council was comfortable with the findings of the report in relation to sustainability of current schemes for existing members, it decided that further work was required to examine the options for managing the legacy funding issues associated with public sector pensions. Council noted that the cost of funding public sector pensions was due to rise substantially in the coming years. Whilst the reforms proposed by the PSPA would bring about sustainability for future service costs, they would not, and could not, address the current and expected expenditure on benefits accrued to date by current and former members of the schemes, including pensioners.

1.3 Council therefore asked the Cabinet Office for a further report into this issue with the purpose of:

- bringing greater transparency to, and understanding of, the costs of public service pensions,
- identifying the options for addressing the legacy funding gap,
- reaching conclusions and making recommendations on how the legacy funding gap should be managed in the long term.

1.4 As a consequence, it was not possible to submit the PSPA report to Tynwald in February 2016, but the report will now be submitted to the April 2016 sitting along with this additional report.

1.5 This report has been compiled by the Cabinet Office in conjunction with the Treasury and the PSPA.

1.6 **The report is issued as a draft and will be finalised at the end of March 2016 for submission to Tynwald for debate in April 2016.**

2 History of Public Sector Pensions

Pay as You Go Schemes

2.1 All of the Island's schemes (excluding Post Office and Local Government Schemes) are "Pay-as-you-go" Schemes as they are generally in the UK. There is no fund of money building up via contributions and investment returns, therefore the contributions received by employees and employers go straight out to pay both pensions, tax free lump sums and other benefit payments. Any shortfall is then met from the Public Sector Employees Pensions Reserve Fund and from General Revenue as determined by Treasury each year.

2.2 The original Isle of Man public sector superannuation schemes were established in the 1960's, through the application of UK public sector schemes to Isle of Man Government employees. This was done at a time when the public service was relatively small, low wages were compensated for by a good pension and the contributions received, exceeded payments made. The schemes were initially designed to be self-funding with contributions from members and employers used to pay the benefits of current retired scheme members.

2.3 Historically, income was adequate to meet expenditure and therefore there was limited need to set aside additional monies. However, we now have to fund the benefits built up over the last 50 years for an older workforce who are living longer. This has led to current and projected expenditure v income issues. There has been high wage growth, high benefits and growth in the public service and considerable improvements in longevity, all of which impacts upon pension costs.

2.4 When the schemes were introduced in the 1960's average life expectancy was early 70's, meaning pensions would be in payment for only about 10 -15 years, assuming a retirement age of 60. Life expectancy is now in the mid 80's meaning pensions will be in payment for about 20 - 25 years. By the middle of the century it is expected that average life expectancy will exceed 90 years. So, pensions earned by today's employees give rise to payment obligations extending potentially, seventy years or more into the future.

2.5 The average current age of retirements from public sector schemes is between 58 and 59 whereas three years ago it was around 62. There are many potential reasons for this:

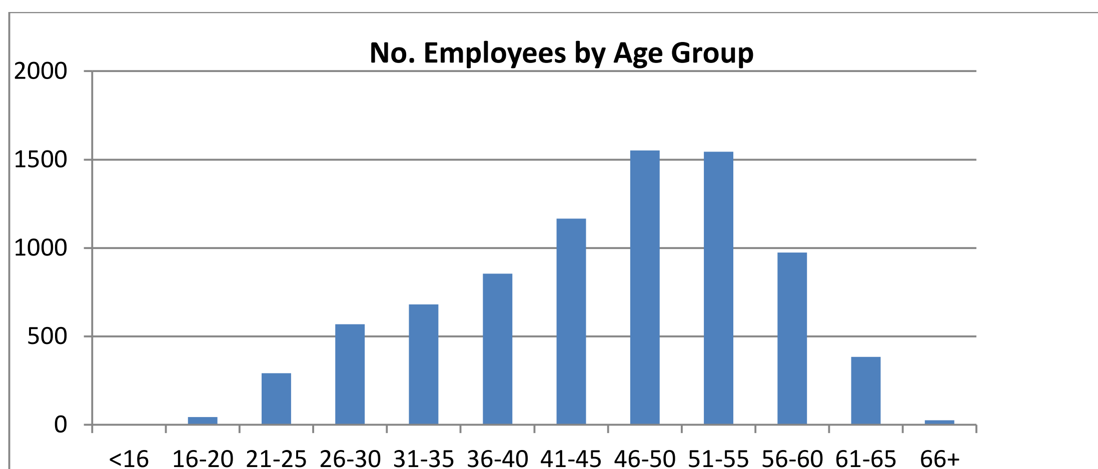
- departmental restructuring and downsizing;
- uncertainty about job security; and
- uncertainty about future pension provision.

2.6 The numbers of people who have retired and claimed benefits from a public sector scheme in recent financial years are as follows:

- 224 in 2010/11
- 353 in 2011/12
- 368 in 2012/13
- 366 in 2013/14
- 399 in 2014/15
- 295 to 31 December 2015

2.7 Of these retirements, approximately 2/3rds are what could be regarded as early retirements.

2.8 The increasing number of retirements is also driven by an ageing workforce, as shown in the chart below:



2.9 The chart shows the age profile of the Government workforce in January 2016.

2.10 It is expected that this trend of more people retiring early may continue for several more years whilst Government continues to downsize and restructure.

2.11 The rising cost of Public Sector Pensions is placing a significant amount of pressure on Government's finances, and this represents the single largest risk to efforts to fully rebalance the budget and reduce reliance upon reserves. Due to a number of factors, in recent years the cost of pensions has increased beyond expectations and the cashflow gap between pension benefits payable and contributions paid into the schemes under current scheme rules has widened.

Pension Reserve

2.12 Pay-as-you-go pension schemes contrast with funded schemes, in which contributions are used to create assets in a pension fund, which is invested and, at the point of retirement, is usually sufficient to meet benefits for the scheme member. Whilst the Isle of Man Government has maintained a pension reserve since 1994, it is important to emphasise that the reserve is not a pension fund in the same way as a private sector pension fund operates. The Pensions Reserve was primarily established to accumulate the receipt of transfer values in respect of incoming employees. Its secondary purposes were to stabilise the annual financing of

a) transfer values payable from outgoing employees,
b) lump sums payable to retiring employees, and
c) the emerging pensions liability

2.13 Since its inception the Public Sector Employees Pension Reserve (PSEPR) has increased substantially although initially this was only at a moderate rate. The reserve benefited from positive fiscal conditions towards the end of the last decade. However, following the renegotiation of the VAT agreement combined with the worldwide financial crisis which commenced in 2008, there is no longer an expectation of growth in the pension reserve. Instead it will be exhausted in the next decade as it is used to fund the growing cost of benefits accrued to date. The value of the Reserve for each year since 1997 is set out below:

Date	PSEPR Market Value
31/03/1997	£8,125,300
31/03/1998	£16,347,353
31/03/1999	£25,029,674
31/03/2000	£36,892,336
31/03/2001	£46,892,721
31/03/2002	£51,278,691
31/03/2003	£43,888,294
31/03/2004	£53,906,316
31/03/2005	£76,812,899
31/03/2006	£95,424,350
31/03/2007	£155,484,917
31/03/2008	£182,751,763
31/03/2009	£183,403,262
31/03/2010	£231,611,859
31/03/2011	£249,414,296
31/03/2012	£244,334,114
31/03/2013	£250,808,666
31/03/2014	£237,344,320
31/03/2015	£226,422,615
31/03/2016 (Forecast)	£178,000,000

2.14 Government is committed to increasing the level of minimum employer pension contributions to 15% in April 2016 (initially through a reallocation from centrally held budgets) and phasing up to 20% over the following 5 years. This assumption is included within the 2016 Budget.

2.15 Given current and future projected benefit levels, and even assuming increased member contributions as proposed in the PSPA report, this is still insufficient to avoid a rapid run-down of the Pension Reserve Fund which will mean that an increasing proportion of the cost of paying benefits will need to be met from General Revenue.

2.16 In the 2016 budget, provisional figures for the future use of the Pensions Reserve indicated that it would be depleted by the end of 2020/21. The projected positon on the Pensions Reserve as published in the 2016 Budget assumed, in the absence of agreement otherwise, that there are no immediate changes agreed to public sector pension schemes and contribution levels, other than the introduction of the employer superannuation contribution escalator, which has already been accepted by both sides.

2.17 However, as part of this further work on legacy funding issues, estimates have been produced on the basis of the cost envelope proposals and member contribution increases contained within the PSPA report. It has therefore been proposed by Treasury to lengthen the transition of the drawdown of the reserve until 2022/23. This is explained in more detail in Section 6 below - Managed allocation of income growth.

3 The Legacy Funding Gap

Liability

3.1 The public sector pension liability is approximately £2.1 billion as at 31/3/13 as calculated by the PSPA's actuary. In the audited accounts at 31 March 2015 the liability is shown as £3bn when calculated on the prescribed accounting basis. The liability will continue to grow for the following reasons:

- members continue to accrue/earn more benefits each year as their service in the schemes continues;
- the effect of wage and price inflation acts to increase benefits each year for both current members, former members who have not yet retired and pensioners, however there will be no increase in pensions for the 2016/17 year due to the low level of CPI.;
- members are now living considerably longer and therefore their pensions in payment are continuing for many more years than could have been expected;
- the effect of actuarial assumptions on the calculation of the liability: the calculations are sensitive to the assumptions around salary and price inflation, mortality, and in particular, interest rates. Whilst interest rates are low, pension liabilities will often appear higher due to the way that future cashflows are discounted.

3.2 However, this significant long-term liability will not be crystallised at once, as the majority of the liability relates to benefits that will only be paid to members when they retire, to be paid over the expected lifetime of all scheme members (i.e. to their mid 80's).

Expenditure Forecasts – Cashflow Figures

3.3 The table and chart at **Appendices 1 and 2** set out:

- estimated gross expenditure on public sector pension benefits from 2016/17 to 2034/35,
- the amount that will be received through employee contributions,
- the amount that will be received from budgeted employer contributions, and
- identifies the shortfall that will need to be met either from the pension reserve, or when this is exhausted, from general revenue.

3.4 The figures are calculated using 2016/17 prices (i.e. no adjustment for inflation) and assume that the proposals contained in the PSPA report for reforms of public sector pension schemes are accepted and implemented. Therefore, they are also based on the following assumptions:

- Once current transitional contribution increases (as a consequence of the introduction of the Unified Scheme), are complete in 2017/18 employee contributions will rise further by 1% per annum in 2018/19 and 2019/20 and by 0.5% in 2020/21.

- Employer contributions will be set at 15% for all employers from 2016/17 increasing by 1% per annum until they reach a level of 20% in 2021/22.

- Employee and employer contributions are adjusted to take account of reductions in salary costs arising from New Terms for New Starters and Promotions of Public Services Commission staff groups (approximately 45% of public sector workforce). Otherwise, overall salary budget is constant, assuming similar workforce size.

- These assumptions do not take account of any other changes which may be introduced as a consequence of the PSPA's report.

3.5 The difference between Employee and Employer contributions (at £62.4m in 2016/17, rising to £84.9m in 2034/35) and the total gross expenditure (at £107.23m in 2016/17, rising to £155.9m in 2034/35) is the unfunded funding requirement to be met by means other than contributions. This figure is £44.9m in 2016/17, rising to £96.4m in 2034/35.

3.6 This is the legacy funding gap.

Expenditure Forecasts – Actuarial Assumptions

3.7 The PSPA's Actuaries (Hymans Robertson) have produced a long term model of the impact of the proposed reforms based on the composition of scheme membership as at the last formal actuarial valuation date (31 March 2013) and using standard actuarial assumptions for inflation and longevity etc. **Appendix 3** shows the shortfall of projected income against expenditure of public sector schemes to 2062/63 without the reforms. **Appendix 4** shows the position after the reforms – the solid black line shows the effect of the overall contribution increases, the dotted light-blue line is the Employers' share of the overall contributions and the dashed-purple line is the Employees' share. The net shortfall position is therefore much improved after the reforms.

Addressing the Funding Gap

3.8 In its review of public sector pensions (which is annexed to the PSPA report) First Actuarial said:

A number of suggestions have been made as to how to deal with the "funding gap" which has been identified. Our assessment is based on the following principles:

- ***The benefits members have accrued should not be cut back.*** *So, for instance, any change to accrual rates, definitions of pensionable pay, taxation treatment of pension commencement lump sums, etc., should apply only to benefits built up in the future.*

- ***Similarly the exercise of member options in respect of accrued benefits (such as the age at which early retirement can be taken) should not be restricted.*** *Restrictions are likely only to delay cash flows rather than reduce the long term cost and can have unpredictable results (such as a rush to retire before new restrictions are imposed).*

- *The above principles mean that* ***over the short and medium term, the funding gap can only be covered by additional contribution income****.*

- ***The role of the Pension Reserve must be clarified**. For example, will it make a regular contribution or will it be used only to cover volatility in cashflows so that schemes need to be broadly self-sufficient? This will influence the level of contributions required.*

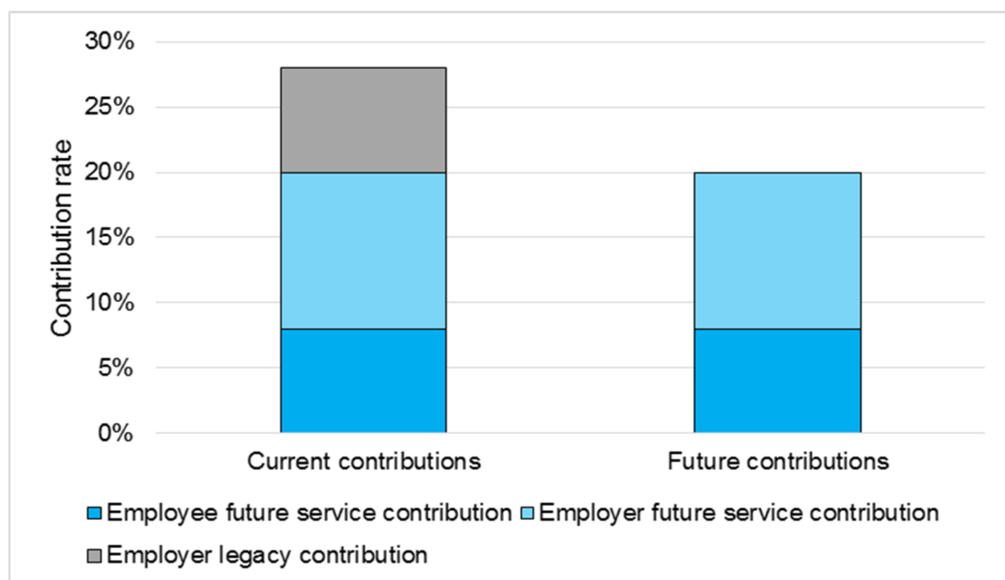
- ***Employers will underestimate the true cost of employment of new staff if employer and employee contributions do not cover the cost of future accrual**. Although ultimately additional employer contribution may have to be supported by the Government, the discipline of having to make realistic contributions will help employers remember these costs.*

- ***Realistic contributions should be far fairer amongst employers than the current system where contribution rates differ greatly in a way which is not necessarily related to the benefits offered**.*

- *The benefits granted for future accrual will largely determine the eventual cost in the longer term. **These should be designed to give members an adequate retirement income when taken together with state pension**.*

- ***Member contributions should then be a reasonable proportion of the cost of these benefits.** It does not seem fair to ask members to pay a contribution which is much higher than value of the benefits they will be receiving themselves. This would effectively be asking them to pay for legacy issues. Therefore, the gap between the current contribution rate and the future service cost needs to be as close as possible, within the objective that contributions meet benefit outgo.*

- ***Member communication will also be crucial.** For example, consider members paying 8% pa, while employers pay 20% pa (total of 28% pa). If the future service cost is say 20%, members may feel hard done by if they perceive their contribution is going towards paying current pensions. Instead, this can be viewed as an 8% contribution from the member and a 12% contribution from employers in respect of future service benefits, plus an 8% contribution from employers in respect of legacy benefits. This is shown in the chart below:*



3.9 In considering the views of First Actuarial it is important to emphasise the following points:

Cutting back of accrued benefits

3.10 By virtue of Section 7(4) of the Public Sector Pensions Act 2011 ("the Pensions Act"), The PSPA does hold limited power to apply Schemes or Amendment Schemes retrospectively. However, in doing so the PSPA may not remove any benefits or rights that have already been accrued by members unless all members of the relevant scheme have agreed to the provision in writing. Historically the ability to apply retrospective changes to schemes has been used to implement UK changes to those relevant Isle of Man schemes which are still linked to the UK (i.e. Police or Teachers) to the date they were introduced in the UK, if for whatever circumstance those changes were unable to be brought in at the same time.

3.11 Having said that, the Pensions Act does enable retrospective changes to also be made if "the provision is required in order for the scheme to comply with the law of the Island" (clause 7(4)(d)). Broadly, this might apply if by virtue of a change to overriding legislation a scheme was deemed not to comply with that legislative change and therefore required retrospective amendment. This clause could be interpreted as to allow a general retrospective reduction in accrued benefits and rights but this would undoubtedly lead to a legal challenge by scheme members and unions as it is unlikely that use of the clause in this way would have been envisaged when it was drafted.

3.12 Clause 7 was queried by the UK Ministry of Justice when the Pensions Act was going through the process of Royal Assent. The Ministry had concerns that the clause would infringe European Human Rights legislation and therefore would be vulnerable to challenge if the power was used to reduce accrued rights in a way that could not be objectively justified as being in the public interest. They therefore sought reassurances that the powers under this clause would not be "used in a way that may reduce accrued rights", and this assurance was provided at the time.

Member Contributions

3.13 First Actuarial indicate that it is not fair to ask members to pay a contribution which is much higher than value of the benefits they will be receiving themselves. If, for example, it was determined to require current GUS scheme members to share the gross pensions expenditure on the same basis as the PSPA recommends for future service cost, the contribution rates payable by members would need to be as follows:

Year	Employees £m	Funding Gap £m	Current E'ee Contribution	Extra cost £m	Future E'ee Contribution
2016/17	17.94	44.86	7.4%	15.0	13.6%
2021/22	26.08	51.47	9.9%	17.2	16.4%
2026/27	25.83	66.15	9.9%	22.1	18.4%
2031/32	25.58	84.53	9.9%	28.2	20.8%
2034/35	25.43	96.45	9.9%	32.2	22.4%

3.14 Such a move would likely lead to significant industrial unrest and potential legal challenge.

Role of Pensions Reserve

3.15 The Pensions Reserve was set up initially in 1994 to help manage the future increase in pensions payable. However, over the last few years there have been drawdowns from the reserve to meet the shortfall between the actual expenditure budget and that contained in the revenue budget.

3.16 Once the Reserve has been fully utilised, the full annual pension liability will need to be met from revenue.

Restricting Member Options

3.17 Whilst restricting options for members in terms of, for example, early retirement or lump sum quantum, may have short term cash flow benefits, they are likely to be more costly in the longer term. In addition they may have negative short-term impacts, such as a rush to retire before new restrictions are imposed. The uncertainty generated by the original Working Group report published in November 2014, led to an increase in the number of health service employees, in particular, retiring earlier than had been planned, most notably amongst medical professionals.

3.18 However, it is important that all options for managing the legacy issue are explored, and this is done in Section 4 below - Options for addressing the funding gap.

4 Options for addressing the funding gap

4.1 Consideration has been given to the following options for addressing the legacy funding gap:

- Reduce accrued rights and benefits
- Close all current public sector schemes
- Cap value of public sector pensions
- Reduce lump sum commutation factor
- Reduce amount of lump sum available
- Taxation options
- Move to Career Average benefits

Reduce accrued rights and benefits

4.2 As indicated in Section 3 above, legislation on the Isle of Man prevents retrospectively changing accrued rights to pension benefits. It would therefore be necessary to change primary legislation. If such a change sought to provide for retrospective application to accrued rights and benefits then it would almost certainly result in legal challenges from those affected. This would apply not only to current pensioners but existing scheme members who are, in many cases, already paying increased contributions for the protection of the benefits of previous schemes.

4.3 Parallels are often drawn with the Republic of Ireland, and it is acknowledged that as a condition of receiving funds for its bailout, Ireland's finances were subject in October 2010 to approval of a Council made up of members of the ECB, IMF and EC. This "troika" demanded radical reform of the Irish public sector.

4.4 Five pieces of legislation were introduced to reduce the cost of the public service and public sector pensions between 2009 and 2013 under Financial Emergency Measures in the Public Interest legislation. The wording in the various Acts stressed the extreme seriousness of the economic situation. The changes to pension provision included a pensions levy averaging 7% imposed on all public sector employees (which was also applied to pensions in payment) and pension scheme reforms for new entrants.

4.5 In January 2016, however, many elements of the overall reforms are in the process of being reversed. This included increasing the amount of public service pensions by amending the thresholds by which the original pensions were reduced in the 2009 legislation. A more extensive summary of the changes in the Republic of Ireland is shown in Section 5 below - Comparisons with other jurisdictions.

4.6 Whilst the precedent therefore exists for reducing accrued rights and benefits, this was achieved in exceptional fiscal circumstances in the Republic of Ireland in response to demands from its creditors. The Isle of Man is not in that position, nor is it expected to be so, assuming the continuation of economic growth as forecast in the budget. Furthermore, if this option were taken, it would potentially send out a message that the Government was "in trouble", and may have a negative impact on economic growth.

4.7 Therefore it not proposed to pursue the option of reducing accrued rights and benefits.

Close all current public sector schemes

4.8 Consideration has also been given to the option of closing current public sector schemes and replacing them with defined contribution schemes. This has been discounted on the basis that as public sector schemes are unfunded, a flow of new members is required to maintain income into the schemes and therefore any alternative e.g. a switch to a defined contribution basis, would result in an unacceptable cost increase.

4.9 Government would still have to find the money to fund benefits in payment as well as accrued benefits payable in the future, which would require supporting for 70 or more years. Employee contributions (currently £18m per year, rising to approximately £26m) would no longer be available to support pensions in payment. Government would also have to meet contribution payments into the new defined benefit scheme for new entrants and future service of existing employees. All this money would therefore have to be found in addition to meeting the legacy funding gap. For example if the schemes were closed to new members only the following table shows a comparison between the amounts payable over the next 18 years:

Year	Govt Liability Existing Members £m	Govt Liability Closed to New Members £m	Extra Funding Required £m
2016/17	89.3	90.97	1.68
2021/22	112.3	123.31	11.06
2026/27	126.44	147.48	21.04
2033/34	150.64	185.58	34.94

This highlights the additional cashflow which would be required.

4.10 If the Scheme was closed to all members then additional cashflow of over £42m would be required immediately. This would comprise approximately £18m to make up for "lost" employee contributions (which would no longer be available to use towards accrued benefits) and £24m of employer contributions (at, say, 10%) which would go into a defined contribution scheme along with future employee contributions. Existing employer contributions and legacy funding would still be necessary at current levels to begin with (and any reductions would be gradual over the next 30-40 years), in order to meet the ongoing liability for pensions in payment and accrued rights for employees due to retire in the years ahead. It would therefore have a profound negative effect on short term cashflow, and this is not affordable.

4.11 Even if such an option were affordable, it would inevitably cause problems with recruitment and retention, most particularly in the health and education sectors, where the Island is heavily reliant on importing labour from elsewhere. We are already in an increasingly competitive market for such labour, and the retention of public sector pension schemes which are broadly comparable to that available elsewhere is essential for the effective operation of our schools and hospitals.

4.12 It has been suggested that the retention of a defined benefit scheme could be preserved only for essential workers such as those in health and education. Between them, the Departments of Health and Social Care and Education and Children employ roughly 50% of the Government workforce. Even if arrangements were made to restrict final salary schemes to certain professions within those Departments, there would still be the affordability questions to address, in terms of "lost" contributions.

4.13 For these reasons, it not proposed to pursue the option of closing existing public sector schemes.

Cap value of public sector pensions

4.14 A further option considered was imposing a cap on the maximum pension which could be payable under a public sector scheme. We have looked at the option of a maximum £30,000 pension per annum. In 2014/15, 49 retirees were entitled to a pension of £30,000 per annum or more. If a cap had been applied this would deliver a saving of £520,000 per annum, but only if applied to all previous service, and that wouldn't be possible under current legislation because the benefits had been accrued under previous entitlements. Therefore any savings could be achieved by introducing such a cap now, are negligible.

4.15 A cap of this nature does not exist within UK or Jersey public sector schemes and so, once again, the Isle of Man Government would be at a competitive disadvantage in terms of recruitment and retention if it was to contemplate this approach. Having said that, in Guernsey, access to defined benefit schemes has been limited for high earners above £85,000 per annum, and any earnings beyond this level form part of a separate defined contribution scheme.

4.16 In conclusion, capping the value of public sector pensions would have minimal financial benefit in the short term, but there may be merit, in the long term, in considering options similar to those introduced in Guernsey, and this will be referred to the PSPA to consider. However, it is not considered appropriate for such changes to form part of the immediate PSPA reforms as outlined in its report. Instead, it is something the PSPA should consider in conjunction with relevant stakeholders, at a later date, and following the completion of appropriate research and costings.

Reduce lump sum commutation factor

4.17 At present, members of all Isle of Man public sector schemes can take a one-off cash lump sum on retirement by exchanging some of their annual pension for cash. This amounts to £18 of lump sum for each £1 of annual pension exchanged under the Unified Scheme, and therefore is at a commutation rate of 18:1. In most UK public sector schemes the rate is 12:1.

4.18 Reducing the commutation factor would have no impact on cash flow assuming that the value of pension that can be converted into a lump sum stays the same at 30% (the option to change this percentage is explored further below). It would provide ongoing savings in pension payments only, and based on the retirements from the Government Unified Scheme in 2014/15 the saving would be about £179,000 per annum.

4.19 The opportunity to reduce the lump sum commutation factor is being considered by the Technical Advisory Group formed by the PSPA, as indicated in its report, as part of the proposed scheme design changes within the agreed cost envelope. Therefore, even if the commutation rate was changed there will be no additional savings achieved from this as any savings will be offset by other scheme design changes (e.g. such as increased accrual rates) in order to keep the overall scheme within the cost envelope.

4.20 In conclusion, the option to reduce lump sum commutation factors is being considered as part of scheme design, but it will not assist in contributing to the legacy funding issue.

Reduce amount of lump sum available

4.21 Currently 30% of the pension value of Government Unified Scheme pensions can be converted into lump sum, compared to 25% in the Police and Teachers Pension Schemes, whose provisions mirror equivalent UK provisions. This provision mirrors the rules applicable to pension schemes generally on the Island, as a result of recent changes to Income Tax legislation relating to Pension Lump Sums, specifically, Section 2A of the Income Tax (Retirement Benefit Schemes) Act 1978. The 30% value for the Unified Scheme was adopted, as opposed to the 25% in other schemes, because despite providing an initial higher lump sum, it provides a long term saving to the Scheme as pensions in payment are more expensive than commuted lump sums.

4.22 In the United Kingdom the maximum value of pension that can be converted into lump sum is 25% and that was the position with Isle of Man schemes prior to the introduction of the Government Unified Scheme. Such a move would have a negative financial impact in the very long term (as it would increase the value of pensions in payment, for a longer period of time), although it would provide some immediate savings in cash flow terms.

4.23 However these savings would only be marginal, unless it was proposed to alter accrued rights of existing members. It is likely it would be strongly resisted by scheme members and regarded as a retrospective change of accrued rights.

4.24 If it were to be introduced by changing all overriding Social Security legislation so that it applied to both public and private sector schemes it could have significant wider implications for investment in Isle of Man pension products. However it would be possible to apply it only to public sector schemes through a change in scheme rules, but again, this would potentially be subject to challenge.

4.25 Nonetheless, it is recommended that the option to reverse the 30% policy on the amount of lump sum available, and revert to the previous policy of 25% (bringing it back into line with UK schemes), should be explored further by the PSPA, as part of the detailed discussions on scheme design.

Taxation options

4.26 In the 2014 Joint Working Group report, it was recommended that consideration be given to imposing income tax on the excess of lump sums above £200,000. At present, pension commencement lump sums calculated in accordance with scheme rules, are tax free. It was estimated that this would in practice affect only a limited number of retirees (less than 3% of overall pension scheme memberships).

4.27 As part of the consultation and negotiation process requested by Tynwald in December 2014, this proposal was discarded as it would deliver only marginal immediate cash flow benefits and potentially cost more in the long term through higher pensions in payment. It also had the potential to cause significant recruitment and retention issues in some parts of the public sector.

4.28 Furthermore, it would be seen as discriminatory to public sector employees if it did not apply equally to all people on the Island, and may therefore be open to legal challenge on that basis.

4.29 However as part of this further work, consideration has also been given to other taxation options to assess whether or not they too are achievable or desirable. The options considered included imposing higher taxation on public service pensions in payment or restricting tax relief on pension contributions to public sector schemes.

4.30 Higher tax on public sector pensions in payment would in the opinion of Treasury be discriminatory. There are also a number of issues including:

- Interaction with tax allowances
- Issues with pensioners living off Island, for those individuals resident in the UK we could not charge tax on their payments due to the double taxation agreement
- Public sector pensions paid to an Isle of Man resident from another jurisdiction
- Result in exodus of staff to other jurisdictions and pension scheme transfers

The restriction of tax relief on contributions to public sector pension schemes could also be viewed as discriminatory. This would raise more revenue for Government but not directly affect the pension scheme. Currently a 1% rise in pension scheme contributions costs Treasury approximately £300,000 in tax. Any change would require to be phased in as the effect on take home pay could cause issues for lower earners.

4.31 Therefore, it is not proposed to take any action in respect of taxation options.

Move to Career Average

4.32 A switch from a "final salary" to a "Career Average Revalued Earnings" (CARE) basis for new members has been considered but discounted on the basis that CARE in itself does not lead to sustainability or lower costs, but rather the accrual rate that is applied is what determines the cost effectiveness of a scheme.

4.33 CARE is likely to lead to cost and benefit increases whilst inflation is higher than wage growth and for employments where there are not significant pay increases and many individuals remain on the same grade. Thus it is believed that a switch to CARE alone would not lead to any cost savings for Isle of Man public service schemes.

4.34 In any event, GUS is no longer a "final salary" scheme as final pensionable pay is determined by taking a consecutive three year average of pay over a 13 year period rather than just taking pay in the last year of employment. Thus any large increases in pay that may occur are already "averaged out".

4.35 Moving to a CARE system would have limited impact on current cashflow position or legacy funding issues.

4.36 Therefore, it is not proposed to pursue the Career Average option.

5 Comparison with other jurisdictions

United Kingdom

5.1 The UK National Audit Office reported in 2010 that payments from all UK Public Sector schemes were estimated to rise to £79.1 billion by 2059-60 from an estimated £25.4 billion in 2009-10 (expressed in 2008-09 prices). The reasons for the increase are the rising number of retirements directly linked to number of staff in post.

5.2 In order to seek to address this growing legacy funding issue the UK Government has introduced the following changes to its main "Pay as You Go" schemes:

- Moved to career average for new starters and future service after 1 April 2015, but benefits much higher than proposed in the Isle of Man,
- Increased member contributions, but these are still lower overall compared to those proposed on the Isle of Man. For example the UK Civil Service contribution rates are tiered, (dependant on salary) and range from 3% to 8.05%,
- Rates of pension increase are comparable to the Isle of Man (based on UK Consumer Prices Index),
- Normal Pension Age is now linked to increasing State Pension Age, a proposal which is under consideration in in the Isle of Man, as part of the further scheme design discussions,
- Provided 10 year protection for current members from April 2012 – enabling retention of existing benefits.

5.3 However, the UK Government has not:

- Reduced accrued benefits,
- Changed the lump sum from its current 25%,
- Taxed or capped lump sums (although the commutation rate for most schemes is still 12:1, compared to 18:1 in the Isle of Man),
- Moved to defined contribution schemes, or
- Closed their defined benefit schemes.

Republic of Ireland

5.4 As indicated in Section 4 above, five pieces of legislation were introduced in the Republic of Ireland to reduce the cost of the public service and public sector pensions between 2009 and 2013 under Financial Emergency Measures in the Public Interest legislation.

5.5 A summary of the overall package of measures imposed since 2009 is as follows:

- pensions levy averaging 7% imposed on all public sector employees (graduated by salary, max 10%) deducted at source (raised around €0.9 bn each year between 2009 and 2013),
- Public sector pay cut from 1/1/10 – public sector pay cut by at least 5%, with cuts of up to 10% on the higher paid, average cut 6.5%,
- June 2010 - New terms and conditions for all public servants including provision for redeployment, improved performance, new work processes, extended hours of work for no extra pay, lower overtime,
- The December 2010 Act further reduced pay for members of the Government and also reduced the pensions of retired public servants by an average 4% for pensions in excess of €12,000,
- July 2013 - further cut in public service pensions over €32,500 under 2013 Act and further cuts in pay for those earning more than €65,000.

5.6 The overall impact on average earnings of around €50,000 for the combined levy and pay cut was a loss of around 13.5% of gross pay.

5.7 A new scheme was announced for new public servants from 1/1/13 (except Judiciary, Police, Defence Force, Prison Officers and Fire Fighters), but those in service prior to 1/1/13 remained relatively unaffected. The new scheme provisions included:

- Career Average – integrated with state pension provision;
- Pension Age equal to and rising with State Pension Age;
- Early retirement from age 55 allowed with actuarial cost neutral factors;
- Contributions: 3.5% of Net Pensionable Remuneration (i.e. Pensionable Remuneration less 2 x the rate of State Pension Contribution) plus 3% of Pensionable Remuneration;
- Pensions uprated by Irish CPI (previously uprating in line with public sector salary increases on the grade your retired from);
- Lump sum on retirement is tax free up to of €200,000. Above €200,000 there is a 20% tax rate up to €500,000 and above this, tax is at the individual's marginal rate.

5.8 In addition, and as part of a drive to reduce the size of the public sector, a scheme was introduced for those retiring before March 2012, which included benefits calculated on "pre-cut" salaries and no implementation of the new tax measures.

5.9 However, the Irish Government has recently announced a restoration of around €2,000 to the pay of most public servants in three phases from January 2016 to September 2017 and also some restoration of pension reductions. From 1 January 2016, there is a full reversal of the reductions introduced in 2009, for those receiving pensions of up to €26,083 per annum. Pensions above that continue to be reduced by approximately 10%.

5.10 And, as indicated in Section 4 above, it is important to emphasise that these changes were made in exceptional fiscal circumstances in the Republic of Ireland in response to demands from its creditors.

Channel Islands

5.11 Recent reforms in the Channel Islands have seen a moved to career average for new starters and future service but with benefits still higher than proposed in the Isle of Man. They have lower overall member contributions than proposed on the Island, and higher rates of pension increase. Normal Pension Age is to be linked to increasing State Pension Age, a proposal which is under consideration in in the Isle of Man, as part of the further scheme design discussions.

5.12 However, both jurisdictions have better funded schemes to subsidise reforms. Jersey has pension assets of approx. £1.6bn and Guernsey has £1bn set aside for public sector pensions.

6 Managed allocation of income growth

6.1 The 2016 Budget set out a medium term financial strategy which estimated future growth in Government income as follows:

2017/18 £35m
2018/19 £35m
2019/20 £28m
2020/21 £31m
2021/22 £32m

6.2 Long term projections of income growth are anticipated to be in the region of 2-3% per annum, which at current rates amounts to approximately £20-30m per annum. The chart at **Appendix 5** sets out the estimated annual growth in government income compared to the estimated annual growth in unfunded pensions expenditure.

6.3 The table also shows the unfunded pensions expenditure as a percentage of estimated annual income growth.

6.4 This shows that the pension growth can be covered by the projected growth in Government income with an average of about a quarter of growth each year being required to cover the annual increase in pension expenditure.

6.5 It is proposed by Treasury to lengthen the transition of the drawdown of the Reserve until 2022/23. This will help deal with the impact of the legacy issue and smooth the process of depletion. **Appendix 6** highlights the changes that this would make to the pension table (table 10) on page 24 of the 2016 Budget. This includes an analysis of how these changes would impact on the Medium Term Financial Strategy surpluses as detailed in table 3, page 8 of the 2016 Budget.

6.6 As indicated in section 4 above, it is the intention of the PSPA and Treasury to further review some of the additional options for managing the legacy funding gap. However, even if any such changes were contemplated, they will need to be considered carefully, and progressed in a way that is legally permissible and does not have unintended consequences on scheme membership or recruitment and retention. Even if progressed, these changes will likely have only a minimal impact on the overall funding gap.

6.7 Therefore, it has been concluded that the most appropriate means for addressing the legacy funding gap is to ensure managed allocation of income growth, such that the over the course of the next 18 years, an average of one quarter of income growth is formally allocated to cover the annual increase in pension expenditure.

7 Conclusions and Recommendations

Conclusions

7.1 As indicated in the PSPA report, its proposals for reform of public sector pension schemes cannot fully address the historic position of the current deficiency between income and expenditure. The process initiated by the Resolution of Tynwald in December 2014 was not intended to do this but rather to address the requirement to make current schemes more affordable and sustainable.

7.2 As stated, addressing the issue of public sector pension sustainability is therefore a two part process:

- **Part One:** setting an affordable and, in the long term, reducing cost envelope for the funding of future benefits; setting a reasonable level of employee/employer contributions to meet future benefit payments and future cost changes.

- **Part Two:** addressing the historic cash flow position i.e. the deficit between income and expenditure for legacy members who have already retired, or will in the medium term be retiring, on higher benefits for their service already completed, where insufficient financial provision has been made in the past.

7.3 The Legacy Funding Gap is estimated to continue until 2054/55, at which point the revised schemes are expected to be fully sustainable assuming the proposals in the PSPA Report are accepted and implemented and given the appropriate assumptions built into those proposals.

7.4 Options for addressing the legacy funding gap have been explored in this report and the conclusions on each are as follows:

- **Reducing accrued rights/benefits**: will give rise to legal challenges, would be difficult to justify and could have unintended consequences for future economic growth.

- **Closing current schemes**: will require immediate and significant additional funding for defined contribution schemes for new members and the past service of existing members as well as pensions already in payment.

- **Capping pensions**: will have limited effect on current expenditure.

- **Reduce lump sum commutation factor**: will have limited effect on current expenditure.

- **Reduce amount of lump sum:** achieves short term expenditure savings, so will be explored further but may affect accrued rights, will impact on recruitment and retention of staff and increase long term pension costs. It may also cause a significant exodus of members once the reforms are announced.

- **Taxation options**: will be seen as discriminatory and likely to give rise to legal challenge.

- **Career Average**: may not lead to any long term cost savings, and there would be no immediate reduction in expenditure.

7.5 The preferred primary means for addressing the legacy funding gap is through managed allocation of future income growth.

Recommendations

7.6 Having regard to the forgoing, it is recommended that at its sitting in April 2016, Tynwald is asked to:

a) receive the Report of the Cabinet Office entitled "Public Sector Pensions - Legacy Funding";

b) note that the Medium Term Financial Strategy has identified that the Public Sector Pension Reserve will soon be depleted and by controlling expenditure on public services, Treasury has accommodated the legacy funding requirements within the revenue account, and

c) note that as part of future budget setting processes, the PSPA and Treasury has identified options for managing the issue in the long term, through managed allocation of income growth together with exploration of other options for reform.

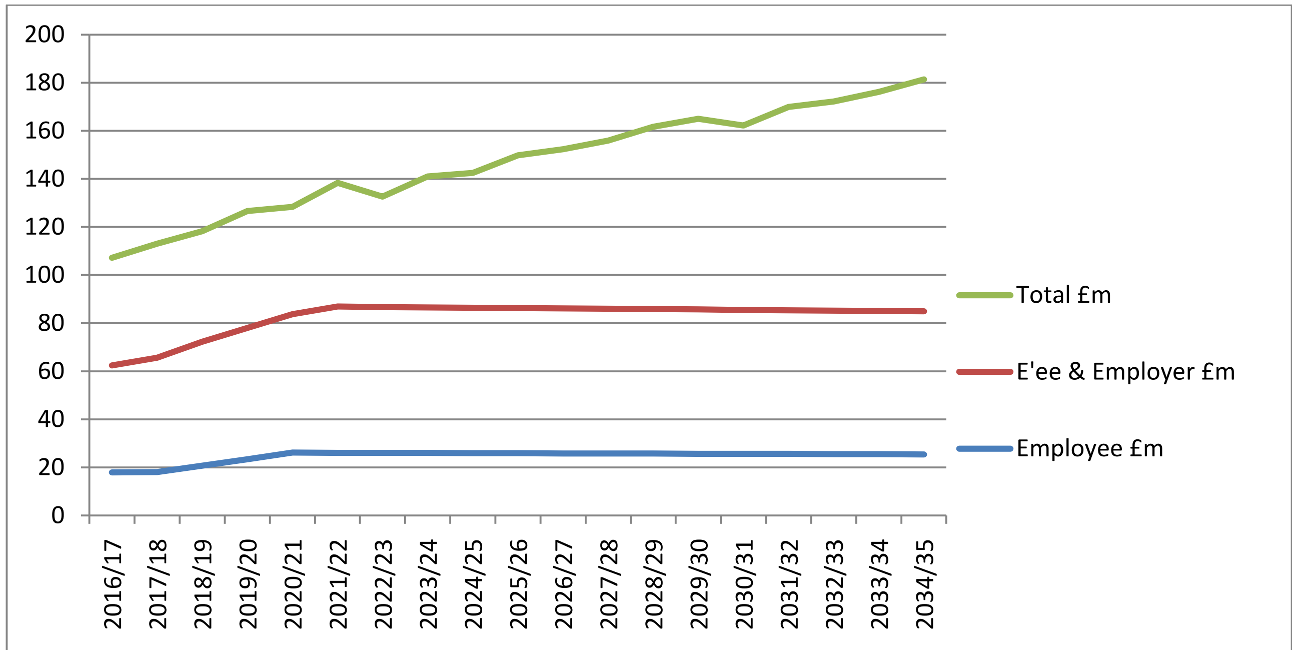
APPENDIX 1

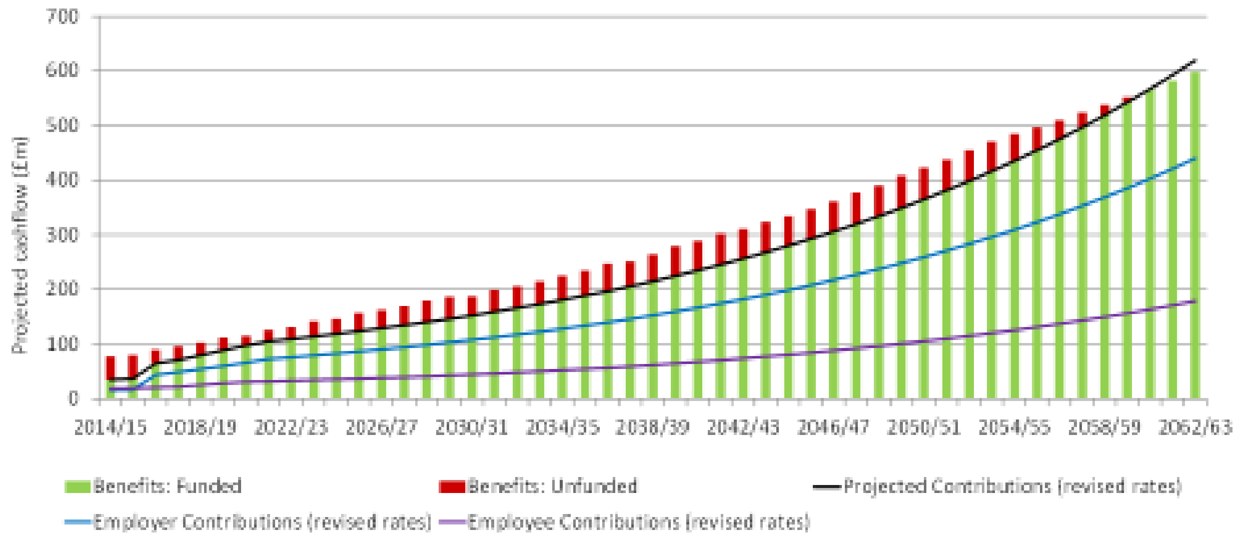
Year	Employee	Employer	Funding Gap	TOTAL	Govt Funding	Reserve drawdown	Revenue Funded
	£m	£m	£m	£m	£m	£m	£m
2016/17	17.94	44.43	44.86	107.23	89.29	44.89	44.40
2017/18	18.1	47.46	47.48	113.04	94.94	42	52.94
2018/19	20.73	51.52	45.94	118.19	97.46	33	64.46
2019/20	23.4	54.55	48.66	126.61	103.21	25	78.21
2020/21	26.13	57.61	44.58	128.32	102.19	15	87.19
2021/22	26.08	60.79	51.47	138.34	112.26	20	92.26
2022/23	26.03	60.69	45.92	132.64	106.61	6	100.61
2023/24	25.98	60.59	54.43	141.00	115.02		115.02
2024/25	25.93	60.49	56.00	142.42	116.49		116.49
2025/26	25.88	60.39	63.49	149.76	123.88		123.88
2026/27	25.83	60.29	66.15	152.27	126.44		126.44
2027/28	25.78	60.19	69.98	155.95	130.17		130.17
2028/29	25.73	60.09	75.90	161.72	135.99		135.99
2029/30	25.68	59.99	79.37	165.04	139.36		139.36
2030/31	25.63	59.89	76.71	162.23	136.60		136.60
2031/32	25.58	59.79	84.53	169.90	144.32		144.32
2032/33	25.53	59.69	86.93	172.15	146.62		146.62
2033/34	25.48	59.59	91.05	176.12	150.64		150.64
2034/35	25.43	59.49	96.45	181.37	155.94		155.94

Assumptions

1. Figures are inflation adjusted, to show growth at current prices and are the total expenditure figures based on the figures provided by Hymans Robertson.
2. The inflation element included in Hymans Robertson figures has been reduced by 2% per annum. From 2022/23 a further 0.5% reduction has been applied.
3. The figures are adjusted to reflect current forecast expenditure based on experience to 2015/16, whereas Hymans Robertson figures are based on the 2013 Valuation. It is for this reason that the figures for total expenditure in 2016/17, are higher in this table compared to the charts at Appendices 3 and 4 below.
4. The total expenditure for 2034/35 is lower in this table compared to Appendices 3 and 4 because, the latter charts include inflation and this table has inflation removed.

Short Term Cashflow Modelling – Income/Expenditure Forecasts

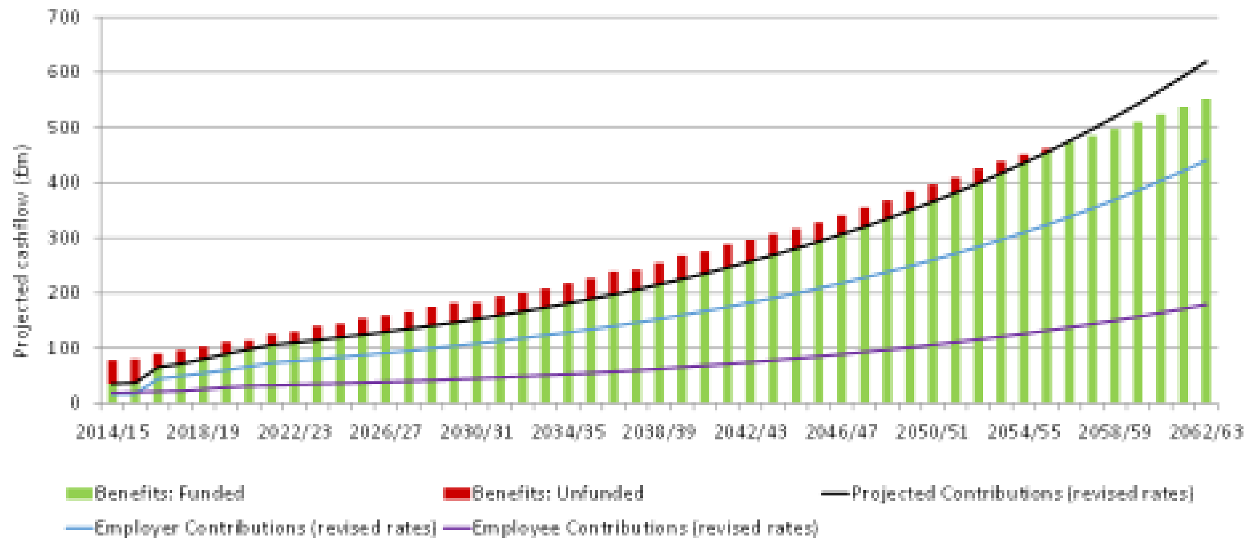



HYMANS ROBERTSON
Monetary projection (50 years)
Current rates
Projected benefits and contributions (combined PSPA schemes)
Projected cashflow (£m)
700
600
500
400
300
200
100
0
2014/15
2018/19
2022/23
2026/27
2030/31
2034/35
2038/39
2042/43
2046/47
2050/51
2054/55
2058/59
2062/63
Benefits: Funded
Benefits: Unfunded
Projected Contributions (revised rates)
Employer Contributions (revised rates)
Employee Contributions (revised rates)
Prior to allowing for proposed benefit
and contribution reforms

6

HYMANS ROBERTSON

Monetary projection (50 years) Post proposed reforms



Allowing for proposed reforms to benefits and contributions

ASSUMPTIONS BY HYMANS ROBERTSON

Reliances and Limitations

The results presented here and in the cashflow modelling report dated 22 September 2014 are dependent on the quality of the data provided to us by the PSPA for the actuarial valuations as at 31 March 2013. The data provided is suitable for the purposes of this exercise and is summarised in the 2013 valuation report dated 3 September 2014.

The assumptions underlying the projected benefit outgo and current contribution projections are set out in the cashflow modelling report dated 22 September 2014, with the following exception;
Future pensioners are assumed to elect to exchange pension for additional tax-free cash up to 100% of the maximum amount permitted (previously 50%).

The 'revised rates' assume that contribution rates for all GUS members (current and future members) will increase by 1% of pay in April 2018 and April 2019 then 0.5% in April 2020. This results in all GUS members paying 2.5% of pay per annum more from April 2020 than they are currently paying. Contributions from Non GUS members are unchanged.

The revised contributions for all employers (GUS and Non GUS) are assumed to increase to 15% of per annum from April 2016 then increasing at each April thereafter by 1% of pay. Increases continue until April 2021 at which point all employers are paying 20% of pay per annum.

The revised cashflows for all GUS benefits accruing after 1 October 16 have been reduced by 9% (this reflects future service rate change from 28.6% to 26.0%). Cashflows resulting from benefits accrued prior to 1 October 16 are unchanged. Cashflows from Non GUS members are unchanged.

Long Term Cashflow Projections

The longer the future projection of benefit outgo and contribution income, the less reliable these projections become. It is extremely unlikely that the long term cashflow position will be the same as the projections provided.
The long term projections shown in slide 4 and 5 have been prepared on an approximate basis using the same data and assumptions as the previous projections (see slide 6).

The demographic profile of future new entrants is highly uncertain. It is assumed that every leaver (due to retirement, withdrawal etc.) is replaced by a new entrant such that the payroll remains constant in 'real' terms. The long-term cashflow projections are sensitive to this assumption and it is unlikely that the actual new entrant experience will be in line with what has been assumed.

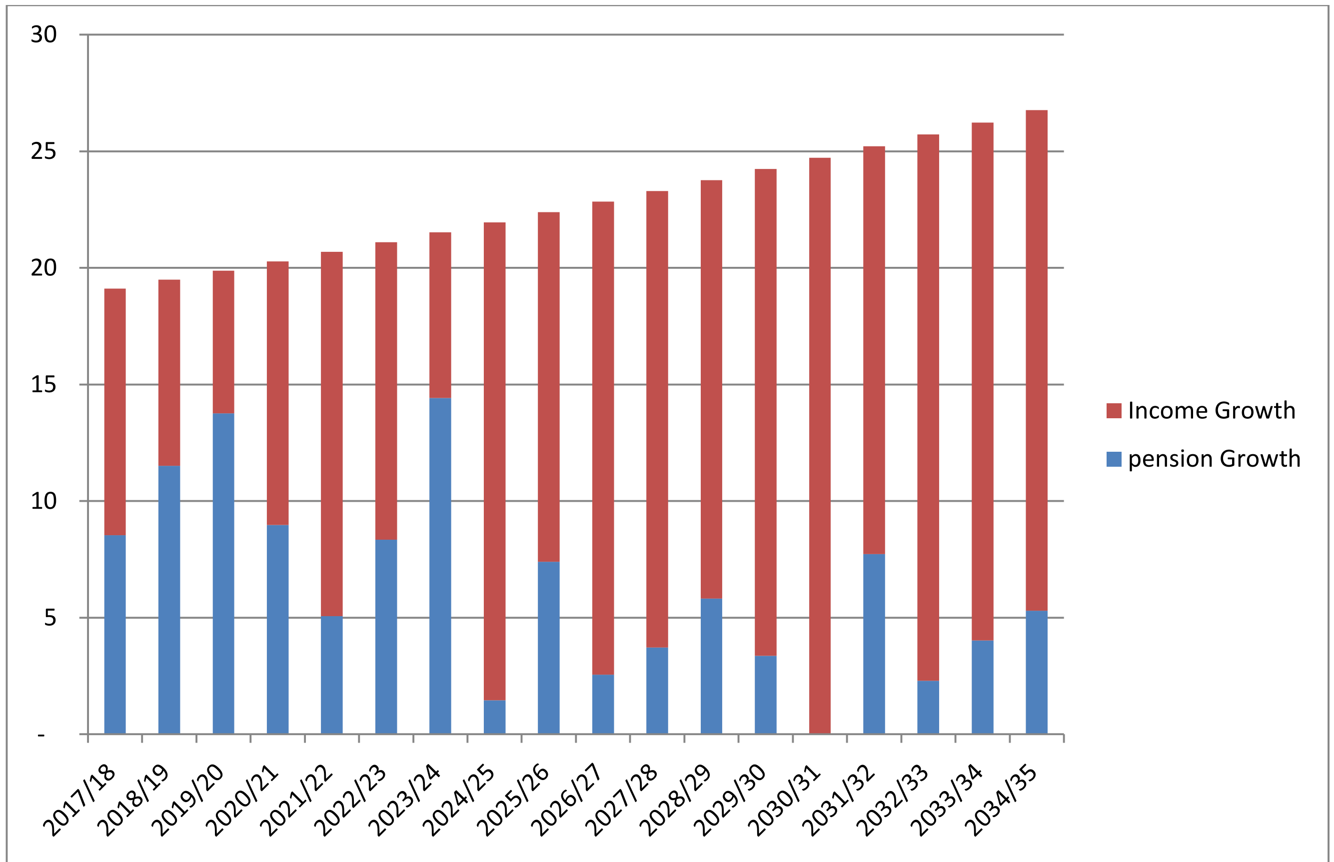
We understand that new entrant experience since the 2013 valuation has not been in line with the assumption made at the 2013 valuation. This will have an impact on the cashflow projections, which has not been factored into this analysis.

We expect to provide updated cashflow projections following the 2016 valuation. These are likely to be different to those provided here.

APPENDIX 5

Pension Growth as a Proportion of Income Growth

(£millions)



APPENDIX 6

Revised Pink Book Tables (Pages 24 & 8)

Pension Table Page 24	**16/17**	**17/18**	**18/19**	**19/20**	**20/21**	**21/22**
	£m	£m	£m	£m	£m	£m
Gross Cost	107.26	113.04	118.19	126.61	128.32	138.34
Employee	17.94	18.1	20.73	23.4	26.13	26.08
Employer	44.43	47.46	51.52	54.55	57.61	60.79
PSEPR drawdown	44.89	42	33	25	15	20
Revenue Gap		5.48	12.94	23.66	29.58	31.47
Per pink book gap	0	0.00	9.00	6.00	50.00	63.00
Additional to revenue		**5.48**	**3.94**	**17.66**	**-20.42**	**-31.53**
PSEPR Balance	180	140.11	102.11	72.11	49.11	35.11
Investment Income	5	4	3	2	1	
Fund Drawdown	44.89	42	33	25	15	20
PSEPR Balance	140.11	102.11	72.11	49.11	35.11	15.11
MTFS Figures Page 8						
		17/18	**18/19**	**19/20**	**20/21**	**21/22**
		£m	£m	£m	£m	£m
Surplus		15,708	24,171	41,751	13,205	14,506
Revenue Gap 17/18		5,479				
additional gap 18/19			3,936			
additional gap 19/20				17,664		
additional revenue 20/21					-20,420	
additional revenue 21/22						-31,535
		10,229	**20,235**	**24,087**	**33,625**	**46,041**