

## Public Sector Pensions Authority

### Frequently Asked Questions

These Frequently Asked Questions (FAQ's) have been compiled in response to questions asked by scheme members following the publication of the PSPA's report "Fairness and Sustainability of Public Sector Pension Schemes – Revised Proposals" and the Cabinet Office's report "Public Sector Pensions – Addressing the Legacy Funding Gap".

#### **1. If the Scheme's are to remain open, how would the proposed changes to the Scheme design, that would reduce my pension by 6%, impact on what I am expecting when I retire?**

The actual Scheme design within the new cost envelope has still to be agreed. However, the overall effect is to achieve a cost saving of 6% of your current benefits for future service (i.e. service after any change has been introduced). If all of the cost saving of 6% is applied to the future pension earned, this will mean that the older you are, the less impact there will be to your expected pension, as you will have less future service to accrue. Younger members, with longer to serve until retirement, will see a bigger reduction in their expected benefits at retirement age.

#### **Example 1**

To demonstrate how this may work, first of we need to show how the pension in the Unified Scheme is calculated using the following simple formula:

$$\text{Years and Days of Scheme Service} \times \text{Pay} \times \text{Growth Rate}$$

So, taking the example of a member in Section 2, retiring at age 60 with 40 year's service and pay of £40,000 the expected pension will currently be:

$$40 \times £40,000 \times 1.46\% = \underline{£23,360} \text{ a year}$$

With this pension, the member would have an option of exchanging it for a Maximum Lump Sum of £135,638.71 and reduced pension of £15,824 a year

It is proposed that the 6% reduction will only apply to the pension service built up *after* any changes are brought in. Using the example figures above the potential reduction is illustrated by way of two further examples as follows:

**Example 2 – Assume a member is aged 58** – with 40 years expected service to retirement age 60, of which 38 years were built up before the date of change and 2 years to be built up after the date of change. To illustrate the pension that equates to the 2 years service built up after the change date, we pro rata the pension expected at age 60 as follows:

$$£23,360 \times 2/40 = \underline{£1,168.00}$$

A 6% reduction in the pension for the 2 years service from the date the changes were implemented would result in a £70.08 (i.e. 6% of £1,168.00) reduction in the expected pension.

Therefore, the total benefits after the proposed 6% reduction when compared with **Example 1** would be:

- Pension of £23,289.92 a year  
OR
- Maximum Lump Sum of £135,231 and reduced pension of £15,777 a year.

**Example 3 – Assume Member Aged 30** – using the same pension as Example 1, but assuming the member is younger at the time of change, with only 10 years built up to the time of change plus an expected 30 years service to retirement age 60. To illustrate how the pension that equates to the 30 years service to be built up after the change date, we have pro rata the pension expected at age 60 as follows:

$$£23,360 \times 30/40 = \underline{£17,520}$$

A 6% reduction in the pension for the 30 years service from the date the changes were implemented would result in a £1,051.20 (i.e. 6% of £17,520) reduction in the expected pension.

Therefore, the total benefits after the proposed 6% reduction when compared with **Example 1** would be:

- Pension of £22,308 a year  
OR
- Maximum Lump Sum of £129,534 and reduced pension of £15,112 a year.

## **2. There was an undertaking given that GUS would not change until 2020, why is it changing now?**

That was the intention when the Council of Ministers gave a concession that no changes as a result of the new cost sharing mechanism being applied, that may lead to benefit and or contribution changes, would be introduced until 2020. However, a lot has changed that has impacted on the Island's finances since 2008, which was when the work on GUS first started, which has required changes in advance of cost sharing being introduced from 2020.

Understandably, a number of members have expressed their disappointment that changes are being proposed sooner than 2020.

However, there has been considerable change to what was deemed affordable since GUS was designed. When the actuary assessed the projected cost of the Scheme and this was added to the concessions granted when GUS was implemented (i.e. contributions increases via 1% transition from 2012-2018 and lower contribution rates for those within 7 years of retirement age) it impacted on the scheme's income. As a result the Working Group took the view that given the projected increasing costs, it was reasonable to ask members to contribute more outside of the original cost sharing date of 2020.

If no increases are applied sooner than 2020, then there is the risk that when the valuation takes place in 2020 and the costs are reviewed to keep the scheme affordability on track, it may be that whatever increases are applied could potentially be at a significantly higher rate than the proposed 2.5%, with no leeway to provide for transition – which could result in members being hit with an immediate increase they may find difficult to budget for.

The majority of the trade unions have accepted both the need for change sooner than 2020 in order to make the Scheme sustainable into the future and that the proposals are fair to members, particularly in comparison with the UK changes to public sector schemes introduced in 2015.

### **3. What reports will Tynwald be debating?**

There are two reports on public sector pensions that will be debated by Tynwald at its April 2016 sitting. The reports recommend that all Schemes are further reformed to make them more affordable and sustainable in the future, including:

- making recommendations to deal with the growing cost of public sector pensions in the future; and
- considering the Government's options for addressing the pension's debt or "legacy funding gap," that has built up over a prolonged period.

The first report entitled "Fairness and Sustainability of Public Sector Pension Schemes – Revised Proposals" is from the PSPA and makes further recommendations for reforming the Isle of Man Government Unified Scheme 2011 (and other public sector schemes) for the future, following on from discussions held during the last year with staff representatives, the Treasury and Government Employers.

The second report entitled "Public Sector Pensions – Addressing the Legacy Funding Gap" was commissioned by the Council of Minister's and prepared by the Cabinet Office. The report considers the options for funding current pensions expenditure until the long term cost of public sector pensions falls and income is sufficient to meet expenditure.

### **4. How much more will members be asked to pay?**

Proposals are that contributions will increase for a majority of public servants:

#### GUS:

New members will be paying over 50% more in the future compared with current members. Current members it is proposed should pay 2.5% more. This means average contribution will increase to 10% of pay, which is an average increase of 35% on current levels overall.

Contributions across the 7 GUS Sections will increase and will range from 7.5% and 13.50%

#### Police:

Still under discussion, but the focus is on savings for new members.

#### Teachers:

The focus is on achieving similar outcomes as is proposed for GUS – change will be shared amongst new and existing members.

#### Tynwald Members:

100% increase in contributions and lower benefits for new members.

300% increase in contributions for existing members who wish to protect current benefit expectations.

#### Judicial:

Reforms are in the early stages but the focus will be on reforming pensions for this group in line with those applied to other schemes.

### **5. How do the proposals seek to make public sector pensions more affordable?**

The proposals in the PSPA report seek to make public sector pensions more affordable from this point in time.

The projected long term cost of providing benefits under the Unified Scheme will fall from its current 28.6% of pay to 22.5% of pay and this should, in the long term, mean that contribution income from both members and employers will be sufficient to meet benefit payments.

There is still the legacy funding gap to consider, which is the difference between contribution income and benefit payments, which will continue to increase and which cannot be addressed by asking current members to pay more and receive less pension.

The reality is that affordability can only be addressed into the future and not historically. In addition to asking members to pay more and reducing the rate at which their pension benefits continue to build up, it is proposed that the overall cost of providing pension benefits will now be shared more equitably between the Government and scheme members.

In the future, these proposals will see scheme members paying a fairer share of the cost of their pension. Currently the overall cost of a pension is split 1:3 employee/employer, but these proposals introduce an equitable balance of 1:2. This is more in line with how other public sector schemes are funded in the UK and the Channel Islands.

Additionally, it is important to mention that in the future, all public sector schemes will be subject to tri-annual cost sharing reviews, which will ensure that scheme costs remain within an agreed level of future cost known as the "cost envelope".

### **6. Why is this sustainable?**

In the future, these proposals should mean that the contribution income is sufficient to meet the benefits payments and that future costs will remain within the agreed "cost envelope". If it appears that this is not going to be the case, the regular actuarial and cost sharing reviews undertaken by the PSPA in the future will highlight any differences such that they can be addressed at that time.

## **7. Why don't you just close the Schemes as I have heard happened in the private sector?**

That is an option that is covered in the Cabinet Office Report for Tynwald's consideration.

However, with the proposed changes, the expectation is that the schemes will become affordable and sustainable in the long term. This will lead to less reliance on funding from the tax payer. If all current schemes were closed and no member contributions were being paid there would be a loss of around £18 million per year of member contributions.

Therefore, the total cost of the existing pensions in payment and already built up would have to be met in full by the Government. The Government would still have to fund the pensions in payment, plus the benefits that have been built up for payment in the future. This would impact greatly on the Island's cash flow, potentially for the next 70+ years.

However, there are ways in which the Government could make arrangements to meet that cost and this is one area that is covered in the Cabinet Office report for further consideration by Tynwald.

Furthermore, if Government closed the Schemes it might wish to provide employees with an alternative pension scheme – such as a Money Purchase or Defined Contribution Scheme. This is a type of pension scheme that is popular with private sector employers, because it allows them to make a contribution towards their employee's pension, but unlike the current schemes, there is no financial risk or obligation on the employer to provide a guaranteed level of pension on retirement. That risk and obligation lies with the pension provider, usually a large pension provider such as Aviva or Prudential.

If the Government were to do this and also make a contribution towards its employee's money purchase pension that cost would also be in addition to the costs of closing the scheme.

## **8. What about taxing public sector lump sums?**

This is an option that Tynwald may consider in its debate. However, in the past this hasn't been well received by the scheme membership. It could also be considered discriminatory against public servants if it wasn't applied to all Island residents, be open to legal challenge and could also create a 2-tier tax regime between public and private sector workers. There would also be an issue with imposing a higher tax rate for those pensioners who live off island.

This would of course raise more revenue for Government but would not directly affect the pension scheme or the legacy funding gap. Currently a 1% rise in pension scheme contributions costs Treasury approximately £300,000 in (lost) tax because the increased contributions are not subject to income tax. In addition any change would need to be phased in as the effect on take home pay could cause issues for lower earners.

Given the above, the Cabinet Office report does not propose that any action should be taken in respect of a change in taxation, but if Tynwald do wish to consider this option further, then the Treasury will need to assess the financial effect of any changes.

## **9. Is capping the amount of pension paid an option?**

Yes, this would be one way of reducing the amount of pensions paid for the future and is an option that Tynwald may debate further. Capping pensions say to £30,000 a year, would still have a limited impact on current expenditure, as the average pension is well below that figure. In 2014-15 49 retirees out of 399 had a pension of over £30,000 a year.

However, the key consideration with any change is what is known as **"Accrued Rights"**.

Public Sector pensions are calculated based on scheme service (number of days in scheme membership) and final pensionable pay) and a growth rate or accrual rate (the rate at which pension builds up, for example 1/80<sup>th</sup> per year).

Every day a member is in the scheme, they are building up service that will be applied to their final pensionable pay and a growth rate at the date they retire.

Any change to any of these three elements can only be changed for future service as current legislation does not permit retrospective changes to current benefits built up. These are known as "Accrued Rights". Any change to Accrued Rights would therefore need to be very carefully considered in the context of the current legislation.

Therefore, current Accrued Rights protections means that only pensions pension accrued in the future could be capped. This would impact on pension costs in the long-term, but have no immediate impact on cash flow or reduce the current legacy funding gap.

## **10. What about reducing the maximum amount of lump sum members can take?**

This is another option that Tynwald may consider. The option would be to reduce the level of maximum lump sum that could be taken, particularly in GUS which permits members to take the maximum amount specified under the Island's Income Tax rules.

Currently, this is 30% of the value of a member's pension (calculated broadly as (annual pension x 5.8). Tynwald could decide to reduce this to say 25%, as in the UK.

Again, the general perception is that this leads to savings and will have an immediate impact on cash flow – which in the short-term it would, but as members would be "giving up" less pension future pension costs would increase as the payment of a lump sum usually represents a long term saving to the scheme. This is because the cost of paying a pension for life is usually greater than the amount paid out by way of a lump sum.

It is also acknowledged that any move to reduce the amount of lump sum that can be taken, might force those who have already made their financial retirement plans based on an expectation of taking a lump sum equivalent to 30% of the value of their pension, to retire earlier, just to ensure that they still benefit from the current lump sum rules. Given that around 16% the membership are over age 55 and could do this, the concern is there would be large numbers retiring earlier than planned, which would have a negative impact, not only on cash flow, but also on the Government's ability to provide key public services.

Another key factor would be the impact of Accrued Rights and the potential that any attempt to reduce the lump sum value of the pensions members have already accrued could be challenged. Therefore, this option may only be a viable option for future pension accrual.

### **11. What about reducing the commutation factor used for exchanging lump sum for pension?**

This is another option that would make a saving, by reducing the amount of pension members would receive in exchange for a lump sum. Currently, in GUS this is at a rate of £18 of lump sum for each £1 of pension given up.

It has no impact on the amount of lump sum paid.

Again, any changes would need to consider the impact of Accrued Rights and given this, the predicted impact on immediate cash-flow would be limited.

Given the Accrued Rights issues there may be scope for Tynwald to take the view that a combination of all three: reducing lump sums, reducing commutation factors and capping pensions, would lead to long term savings when applied to future service only.

### **12. How much is the "legacy funding gap"?**

It is expected to be £44.9m at year end 2016/17 and rising to £96.4m by 2034/35 in today's terms (i.e. after taking out the effect of future inflation). The "gap" is the amount which will have to be funded by Government after the payment of Employers' and Employees' pension contributions each year.

If the changes proposed in the PSPA report are implemented in April 2017, based on current actuarial assumptions and projections (which have been independently verified), it is predicted that this legacy funding gap will continue until 2054/55, which is when the amended schemes are predicted to be fully sustainable.

### **13. Why do we have this "legacy funding gap"?**

It has arisen due to how the Government historically decided to fund its employee's pension schemes.

All of the Island's schemes (excluding the 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 paid 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.

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 the benefit 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.

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 with larger benefits who are living longer. This has led to current and projected expenditure - v - income issues. There has been historic high wage growth, high benefits and growth in the public service and considerable improvements in longevity. When the schemes were introduced in the 1960's average life expectancy was 70 years, meaning pensions would be in payment for only about 10 years, assuming a retirement age of 60. Life expectancy is now 83 years meaning pensions will be in payment for about 23 years.

#### **14. Will any increase in my contributions go to fund this "legacy funding gap"?**

No. your contributions will go to fund the future cost of providing your benefits and not the legacy funding gap.

#### **15. What is the Public Sector Employees Pension Reserve (PSEPR)?**

The PSEPR is not a pension fund in the same way as a private sector pension fund operates to fully fund the pension scheme. Instead, its purpose was to:

1. accumulate the receipt of transfer values in respect of incoming employees; and
2. 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.

Since its inception in 1994, the PSEPR has increased substantially, benefiting 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 is anticipated that it will now be exhausted by 2020/21.

#### **16. Wouldn't a move to Career Average Scheme be cheaper?**

Whilst Tynwald may consider this as a viable option it was considered in the Cabinet Office report to be a less viable option for the following reasons:

- A switch from the current "final salary" to a "Career Average Revalued Earnings" (CARE) basis for new members may not lead to sustainability or lower costs, as generally it is the level of benefits provided (i.e. the accrual rate) which primarily determines the cost effectiveness of a scheme;



- CARE is likely to lead to cost and benefit increases whilst inflation is higher than wage growth;
- 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”;
- Finally, moving to a CARE system would have limited impact on the current cashflow position or legacy funding issues.

**17. Won't these further changes make public sector pensions in the Island less competitive than the equivalent UK arrangements for recruitment of new staff?**

No, they shouldn't do. In comparison with the UK, GUS has:

- Around the same level of member contributions and a similar split between what you pay and what the employer pays;
- Continuation of Average Salary benefits – the UK has gone to Career Average benefits for the majority of its members;
- A higher lump sum option – 30% of the value of your pension compared with 25% of the value in the UK;
- A better commutation factor – 18:1 in the IoM compared with 12:1 for most UK schemes;
- A better taxation position for, in particular, members with long service on higher benefits

**18. For those members who signed up to be in the Protected Sections of GUS, what has been protected and how long?**

Protection in GUS, at the time of implementation was that members would receive equal value of the pension and any automatic lump sum they would have expected to receive at the pension age of their former scheme. There was no time scale on the protection. If the recommended changes are introduced to reform the benefit design for future benefits the protection would change - the future benefits would have reduced by about 6% from what you would have expected under “protection” but these benefits will still remain higher than those in the non-Protected Standard section of GUS.

**19. Under these new proposals, can I still claim my benefit when I retire at age 55?**

The PSPA's report does not propose changing the earliest age at which members can claim the benefits that they have built up so far from age 55. However, there is a proposal to link the earliest age at which retirement can take place to the State Pension Age, less 10 years. The State Pension Age's (SPA) on the IOM differ depending on age and sex, so if introduced this change may impact those members with an expected SPA higher than age 65.

**20. Will the proposed changes apply to those members who are in a special membership category, such as those with Special Class status, Mental Health Officer status and Civil Servants able to retire after 40 years service?**

Yes. Whilst it is not proposed to remove the right to these special memberships the proposals for reform is expected to apply in the same way as they would for other membership groups.

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