1. INTRODUCTION:

Overview – what is cost sharing?

1.1 The PSPA manages and administers the unfunded public sector pension schemes (the "pension schemes") in the Isle of Man, including the Government Unified, Police, Teachers and Judicial pension schemes. As part of the ongoing programme of ensuring that the pension schemes remain sustainable into the future, the PSPA is establishing a cost sharing mechanism for all schemes. This is way of assessing on a regular basis how the costs of a scheme have changed over time. If costs have increased (or decreased), the cost sharing mechanism will then allow those cost increases (or decreases) to be shared between scheme members and the Employer.

1.2 The future sustainability of public sector pensions is improved by putting in place a long term plan to identify and then manage future cost changes to the pension schemes. Therefore any cost changes will be identified and action taken at regular intervals to address them in a way that has not previously been in place. In the future, both pension scheme members and Government will share the responsibility of ensuring the ongoing sustainability of schemes.

Does cost sharing exist at the moment?

1.3 There is already broad provision in the Government Unified Scheme rules for cost sharing to be applied but there is currently no detail as to how this will work in practise. The PSPA therefore intends to prepare legislation which provides the detail and clarification. Other pension schemes do not currently have cost sharing provisions within their rules but the PSPA will introduce similar rules across all pension schemes.

1.4 In the UK, unfunded public sector pension schemes have cost sharing provisions in order to improve sustainability and therefore the PSPA wishes to introduce similar provisions in the Isle of Man. The PSPA has always maintained that this would happen and cost sharing has formed part of the ongoing reform discussions with you and your union representatives. Therefore your union representatives in particular should be well aware that cost sharing is coming along and that it is required to ensure the ongoing sustainability of the current pension schemes.

Will cost sharing apply to me?

1.5 If you are a contributing member of the Government Unified, Police, Teachers or Judicial pension schemes then future cost sharing will apply to you under these schemes. Legislation covering all pension schemes will therefore be introduced over the next few months such that cost sharing will be in place from 2020. Government has always maintained that cost sharing will apply from 2020 and you may have already seen this date mentioned when other pension changes have been discussed.

How will cost sharing work?

1.6 The PSPA will work with its actuaries to assess on a regular basis (every three or six years – further details are provided later in this document) how the costs of pensions have changed. If costs have, or are projected to, increase then these increases will be shared between scheme members and Government. The effect on scheme members will either be that future benefits are reduced or contributions are increased to take account of cost sharing. Benefits earned to date will not be affected as the PSPA is only able to reduce **future benefits** if a cost increase is determined. Which of these options will be taken forward will be determined by consultation between the PSPA, Government and representative organisations at the appropriate time. Similarly, if a cost saving emerges, this will also be shared with scheme members either by a benefit improvement or a contribution decrease.

2. PROPOSALS

Summary

2.1 The PSPA is introducing cost sharing across all of the pension schemes it administers and manages. It therefore wishes to consult you on the principles of three possible cost sharing design options before selecting one which it will then introduce via amending legislation and which will cover all pension schemes. The three cost sharing options are as follows:

Cost Sharing Option 1 – The "2% of pay buffer option"

2.2 The option involves having a "buffer" or "band" of 2% of pay for cost sharing purposes:

- A cost sharing valuation will be undertaken by the PSPA's actuaries every **three** years;
- If cost variations are assessed by the actuary at each cost sharing valuation as falling **within** the 2% of pay buffer, no changes to your benefits or contributions will occur. Effectively this means that the Government will bear the cost of any increases (or savings) within the 2% buffer;
- If cost variations are shown to exceed the 2% of pay buffer (either as cost increases or savings), then the whole of the cost increase or saving will be borne by the scheme members;
- This means that small cost variations, whether cost increases or savings, are born entirely by the Government and it is only when the cost variations are higher or lower than 2% of pay that they will be passed onto members;

- **Examples**:

  Example 1 – a cost sharing valuation shows a cost increase of 1.6% of pay. Because this is within the 2% of pay buffer, the cost increase is absorbed entirely by Government and there are no changes to your future benefits or contributions;

In terms of what a 1.6% contribution increase would look like for employers if implemented, based upon the total pensionable payroll as at the 2016 valuation (around £258 million) this would amount to £4.1 million.

Example 2 – a cost sharing valuation shows a cost increase of 2.3% of pay. This now exceeds the 2% of pay buffer, therefore scheme members will bear the full 2.3% cost increase. This will take the form of a contribution increase equal to 2.3% of pay or, alternatively, a reduction to future benefits equivalent to the value of 2.3% of pay as calculated by the PSPA actuaries. Note that it could also be a combination of adjustments to contributions and future benefits.

Based upon an average salary of £36,000 per year, an employee contribution increase of 2.3% of pay would amount to £828 per year or £69 per month.

- The same principle applies to any **cost saving**, in that if this is within the 2% of pay buffer the cost saving is taken by Government and if above the 2% of pay buffer, members benefit from the full saving.
- For comparison purposes, a 1.6% contribution **saving** for employers if implemented based upon the above examples and a total pensionable payroll as at the 2016 valuation (around £258 million) would amount to £4.1 million and a 2.3% saving for employees based upon an average salary of £36,000 per year would amount to £828 per year or £69 per month.
- This is the broad principle upon which cost sharing works across the UK public sector pension schemes.
- No changes to your benefits or contributions as a result of a cost sharing valuation would be made without further consultation with you and your trade unions and then only after an Amending Scheme has been made, consulted upon by the PSPA and approved by Tynwald. Therefore there is no question of any changes arising as a result of cost sharing being made to your benefits or contributions without having been fully disclosed to you first.

2.3 The advantages of this option are that small cost changes will be absorbed by schemes and effectively Government would bear the costs (or savings) in full. However, any cost increases (or savings) above/below the 2% of pay buffer would in their entirety fall upon scheme members. Cost sharing valuations would be undertaken every three years and therefore any changes in costs would be assessed on a regular basis.

Cost Sharing Option 2 – The "75% and 25% split of costs" option

2.4 Currently there is allowance for cost sharing already within the rules of the Government Unified Scheme (GUS). Within this existing allowance, there is a provision that cost variations would be shared between members and Government on a 75/25 basis. Therefore building upon what is already in the GUS rules, under this option cost sharing would work across all schemes as follows:

- A cost sharing valuation will be undertaken by the PSPA's actuaries every **six** years;

- If costs are assessed by the actuary at each cost sharing valuation as having risen, the cost increases will be shared 75% by scheme members and 25% by Government. Similarly, any cost savings will be shared in the same 75%/25% proportion between members and Government;
- This effectively means that any cost increases or savings, no matter how small will be shared after each cost sharing valuation;
- Costs sharing will again mean either changes to your contribution rate or future benefits in line with your 75% share of the cost variation;
- No changes to your benefits or contributions as a result of a cost sharing valuation would be made without further consultation with you and your trade unions and then only after an Amending Scheme has been made, consulted upon by the PSPA and approved by Tynwald. This does therefore give the opportunity for Government to review whether, in the interests of pension benefit stability, any small cost changes should in fact be shared 75%/25% or will be deferred for the time being;

- **Examples**:

  Example 1 – a cost sharing valuation shows a cost increase of 1.6% of pay. This is shared 75% with scheme members and 25% with Government. This means that scheme members would bear a cost increase of 1.2% of pay and Government would bear a cost increase of 0.4% of pay. The cost increase born by scheme members would take the form of a contribution increase equal to 1.2% of pay or, alternatively, a reduction to future benefits equivalent to the value of 1.2% of pay as calculated by the PSPA actuaries. Note that it could also be a combination of adjustments to contributions and future benefits;

  Based upon an average salary of £36,000 per year, an employee contribution increase of 1.2% of pay would amount to £432 per year or £36 per month. If an employer contribution increase of 0.4% was applied to the total pensionable payroll as at the 2016 valuation (around £258 million) this would amount to just over £1 million.

  Example 2 - a cost sharing valuation shows a cost increase of 2.3% of pay. This is shared 75% with scheme members and 25% with Government. This means that scheme members would bear a cost increase of 1.72% of pay and Government would bear a cost increase of 0.58% of pay. The cost increase born by scheme members would take the form of a contribution increase equal to 1.72% of pay or, alternatively, a reduction to future benefits equivalent to the value of 1.72% of pay as calculated by the PSPA actuaries. Note that it could also be a combination of adjustments to contributions and future benefits.

  Based upon an average salary of £36,000 per year, an employee contribution increase of 1.72% of pay would amount to £619 per year or £51.60 per month. If an employer contribution increase of 0.58% was applied to the total pensionable payroll as at the 2016 valuation (around £258 million) this would amount to £1.5 million.

- The same principle applies to any **cost saving** revealed, in that these are also shared 75% with pension scheme members and 25% with Government.

The advantages of this option are that cost sharing valuations are only undertaken every six years to recognise that, without a buffer being present, changes to benefits and/or contributions are likely to be made more often which are costly to administer and difficult for members to absorb and plan for retirement.. Also, this option follows the principles for cost sharing already established in the Unified Scheme rules and approved already by Tynwald, therefore there is an argument to say that we should follow what has previously been agreed.

Cost Sharing Option 3 – The "75% and 25% split of costs including a small buffer" option

2.5 This option is based on Option 2 above but to guard against very small cost changes being shared 75% with scheme members and 25% with Government, a small buffer of 0.5% of pay would be introduced. Therefore any cost variation which fell within a 0.5% of pay buffer would be absorbed by Government. Outside of the 0.5% buffer, the other provisions of Option 2 would then apply.

Other features of cost sharing – The Recovery Period

What is the Recovery period?

2.6 When the actuaries perform a cost sharing valuation they will assess the cost of both future benefits and those already earned to date. The cost of benefits earned to date are measured by the past service benefit liability. Based upon actual experience between cost sharing valuations, there may be an increase or decrease in the past service benefit liability (called a past service deficit or surplus in actuarial terms). This may occur if, for example, pension scheme members are living longer than expected or if there have been less ill health retirements than expected. Any past service deficit which arises has to be recovered or "made good" over an agreed period by increasing **future** member contributions or reducing **future** benefits (members' accrued benefits are **not** changed). Similarly any past service surplus which arises also has to be addressed by reducing member contribution rates or increasing future benefits.

Why is the Recovery Period important?

2.7 The period over which any deficit or surplus is recovered is called the Recovery Period and this is expressed as a time period, usually a number of years. This is important as the length of the Recovery Period determines how quickly any deficit or surplus is recovered. A short Recovery Period generally means that the surplus or deficit is recovered more quickly which means that a greater change is required for member contributions or future benefits compared to a longer Recovery Period, where the surplus or deficit is recovered at a slower rate.

2.8 Furthermore, under the buffer option, the length of the Recovery Period will also affect how much cost variation is passed on to members. A shorter Recovery Period will result in more cost variations being passed to members, whereas a longer

Recovery Period will result in the Government underwriting more of the cost variation.

2.9 In order for cost sharing to work as envisaged, which is primarily to ensure the future sustainability of the pension schemes, the Recovery Period must be set at such a level that any significant deficits in particular are recovered relatively quickly and shared appropriately between Government and members. If this doesn't occur and deficits are spread over a long period such that Government continues to bear a significant proportion of cost variations, then the PSPA is concerned that the cost sharing mechanism will not work properly with the result that pension schemes will not be sustainable for the Government to provide.

What are the proposals for the Recovery Period?

2.10 The initial proposal put forward by the PSPA was for a Recovery Period of 3 years for past service deficits (or surpluses). In the UK public sector schemes the Recovery Period for their cost sharing mechanism is 15 years. In UK private sector schemes the Recovery Period is generally between 7 and 8 years. After discussions with your trade union representatives, the PSPA determined it wished to set a Recovery Period which would reflect the average future working lifetime of pension scheme members. This approach is so that anyone who had been in a scheme which had given rise to a deficit (or surplus), should be accountable for its recovery (or should be able to benefit if a surplus is revealed) whilst they are still contributing members of the scheme, and this should not be passed onto future scheme members.

2.11 A Recovery Period of 8 years reflects the average future working lifetime of pension scheme members and therefore the PSPA wishes to implement 8 years as its Recovery Period across all pension schemes. This is a significant improvement for pension scheme members from the original 3 years proposed but less than the UK Recovery Period of 15 years. The PSPA wishes to introduce a viable Cost Sharing mechanism and believes that an 8 year Recovery Period is appropriate for Isle of Man public sector pension schemes for both members and Government.

2.12 To try and illustrate the impact of the choice of deficit Recovery Period on a cost sharing exercise, two basic examples are set out below:

Example 1 – a cost sharing valuation of a pension scheme with a payroll of £250m shows a past service **deficit** of £25m. This is to be recovered over an 8 year period. The cost to recover the deficit over this period is equivalent to 1.3% of pay. This means the cost of the scheme would rise by 1.3% of pay. Alternatively, if the recovery period was:

- 3 years: the cost to recover the deficit would be 3.4% of pay.
- 15 years: the cost to recover the deficit would be 0.7% of pay.

Example 2 – a cost sharing valuation of a pension scheme with a payroll of £250m shows a past service **surplus** of £40m. This is to be distributed over an 8 year period. The cost to distribute the surplus over this period is equivalent to 2.0% of pay. This means the cost of the scheme would fall by 2.0% of pay. Alternatively, if the recovery period was

- 3 years: the cost to distribute the surplus would be 5.4% of pay.

- 15 years: the cost to distribute the surplus would be 1.1% of pay.
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2.13 The above examples are sensitive not only to the Recovery Period but also to the size of any deficit/surplus and the total pension scheme payroll. The payroll used in these examples is close to the pension scheme's total payroll at the 2016 formal valuation. To help put the example deficit/surplus figures into context, the past service liabilities in respect of active members of the pension schemes at the 2016 formal valuation were equal to around £1,100m.