Self-Administered Trusts Strategy Project Report

Employers Pensions Forum for Higher Education
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1 Introduction

This is a report into the current status of Self-Administered Trusts (SATs) prepared on behalf of the Employers Pension Forum (EPF)\(^1\). A SAT is an independently administered pension scheme for support staff primarily in use at pre-92 Higher Education Institutions (HEIs). Currently there are 36 HEIs that offer a SAT scheme to support staff employed at their institution.

This report on Self-Administered Trusts (SATs) builds upon previous work undertaken for the EPF, in particular the following two studies:

a. [Pension provision in the higher education (HE) sector](#) undertaken by the actuary Peter Thompson and published in 2008; and

b. [Self-Administered Trusts: some options for institutions](#) prepared by Dr Tony Bruce in 2010 from an original report by KPMG.

The principal objectives of this current SATs project can be briefly summarised as:

- To set out the current status of SATs pension provision and outline potential ways for Higher Education Institutions (HEIs) to manage the risks associated with their SAT and achieve greater financial stability, for example, through use of shared services, greater governance collaboration with other SATs or consideration of a merger.
- To analyse and summarise the methodologies and results of any individual reviews by HEIs into the operation and management of their SAT.
- To provide relevant case studies, disseminating good practice and achieving cost reduction within the sector over the short, medium and long term, plus achieving some convergence of provision, if possible.

1.1 Project work plan

The project was divided into four main stages as follows:

- Stage 1: an online survey of SATs.
- Stage 2: detailed analysis of a sample of respondents’ survey responses.
- Stage 3: preparation of case studies for dissemination to all SATs.
- Stage 4: identification of options for cost savings and process improvements.

The project has been undertaken on behalf of the EPF with support from HEFCE. As part of the project, the New Joint Negotiating Committee for Higher Education Staff (JNCHES) Pensions Group\(^2\) which includes employer and union representatives was consulted on the project methodology. The background research was undertaken by Tony Knapp, former Director of Finance at the University of Surrey and the report was drafted with the assistance of UCEA staff and support from UUK.

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\(^1\) The Employers Pensions Forum was established by GuildHE, the Universities and Colleges Employers Association and Universities UK in 2007 as a broad-based forum for HEIs to discuss current and longer term pensions issues and to develop a strategy that will enable the HE sector to continue to offer staff access to high quality, affordable and sustainable pensions schemes as an important part of the total remuneration package.

\(^2\) The New JNCHES Pensions Group was established in 2009 in order to exchange views on pensions provision across the sector, to discuss the impact of all issues that affect pension schemes in HE, as well as the impact of government regulation on pensions provision; and to promote pensions as a valuable and attractive part of remuneration to attract and retain high quality staff in the sector.
2 Executive summary & overview of recommendations

The purpose of this report is to review the current status of pension provision for support staff working in the higher education sector and in particular pre-92 Higher Education Institutions (HEIs). The report provides an analysis and evaluation of 36 SATs using annual report and accounts and the results of our survey. The report builds upon the data and recommendations from the two previous reports into SATs and draws on the results of studies undertaken by Mercer and Barnett Waddingham3.

The major findings in the report indicate that HEIs have implemented a variety of changes to the structure of their SAT aimed at addressing on-going pension costs and associated risks. In addition to these changes, HEIs have taken steps to try to reduce ever increasing past service deficits by agreeing recovery plans and making lump sum deficit reduction payments into their SAT.

The report outlines possible ways HEIs could further reduce the on-going costs and associated risks relating to their SAT which range from reviewing third party service providers and strengthening scheme governance arrangements through to merging with either USS, SAUL or other SATs, or implementation of a de-risking strategy.

Finally, the report summarises the results of our financial analysis and survey and sets out three recommendations based on our findings.

2.1 Summary of financial analysis and survey results

Benefit structure

- 72 per cent of HEIs that have closed their final salary scheme to future service still retain a final salary link for the past service of existing members.
- 22 per cent of SATs continue to provide final salary benefits to both new and existing support staff.
- 28 per cent of SATs have moved to a Defined Contribution (DC) benefit basis for new support staff.
- 31 per cent of SATs have moved to a Career Average Revalued Earnings (CARE) benefit basis for new support staff.
- 2 HEIs offer hybrid arrangements.
- 5 HEIs offer membership of the USS to new support staff.
- 36 per cent of SATs are offered alongside an alternative scheme used for auto enrolment, particularly for casual staff.

Funding levels & recovery plans

- Based on FRS17 data, the total accumulated fund deficits as at 31 July 2012 amount to £1.48 billion - a 23 per cent increase on figures provided by Mercer for the previous year (2010/11) and equivalent to a 76.9 per cent average funding level on a technical provisions basis.
- Nearly all SATs have increased their employer contribution rates in order to reduce past service deficits.
- The average length of the recovery periods agreed by HEIs as at 31 July 2013 is just over 15 years (with a maximum of greater than 25 years).
- The majority of institutions are not currently looking to use contingent assets as a way to manage their SAT deficit.

Employer and employer contribution rates
- The average employer future service contribution rate (i.e. excluding past service deficit contributions) is 15.6 per cent of pensionable salaries.
- The average employee contribution rate is 6.9 per cent of pensionable salary.
- HEIs expect to increase their deficit reduction payments within the next three years.

De-risking
- There is little appetite for purchasing annuities through a buy-out or buy-in under current market conditions.
- Most HEIs are not considering offering enhanced transfer values or pension increase exchanges to try to reduce liabilities.

Governance
- HEIs are unwilling to consider changes in governance arrangements if this leads to a perceived loss of control.
- HEIs would be willing to consider collaborating in support of some governance functions, such as collective trustee training.

Mergers
- HEIs would be willing to consider a merger with USS or the Superannuation Arrangements of the University of London (SAUL) if their policies were relaxed.
- 36 per cent of HEIs would be willing to work closely with other HEIs to see if a merger of a group of institutions’ SATs could reduce costs and risk.

Auto enrolment
- HEIs understand the financial and administrative implications of auto enrolment.
- HEIs are willing to collaborate on auto enrolment, case studies and benchmarking of data.

Information & collaboration
- HEIs would value anonymous information relating to benefit changes implemented within the HE sector.
- HEIs would welcome collaboration in developing an approach to communications with the regulator and other national bodies, for example, the Pensions Protection Fund.

2.2 Summary of recommendations

Recommendation 1 – Benchmarking

Monitor and benchmark a range of SATs data that would be of particular interest to HEIs. This would include information relating to the benefit structure and type of scheme offered to support staff including employee and employer contribution rates, accrual rates and normal retirement ages.

Most of this information could be collated from each SAT’s annual trustee report and accounts and triennial valuation. This would mean that institutions would need only to supply these documents for analysis.

Information such as advisor fees, fee structures could be gathered through a bi-annual survey, the results of which could be assessed by HEIs and used as a basis to negotiate contracts with third party service providers. In addition scheme opt out rates could be monitored to assist employers in addressing issues relating to the reasons why staff are opting out of pension saving. HEIs may also find sector-wide data relating to the assumptions agreed in SAT actuarial valuations useful, for example, longevity assumptions based on the experiences within the HE sector.
It is envisaged that the benchmarking exercise could be undertaken by UUK who have experience on similar benchmarking exercises and also have the resources and experience available to progress this work.

**Recommendation 2 – SATs conference**

Establish an annual SATs conference as a forum for employers and trustees to share information and case studies, for example, relating to auto enrolment and scheme change, as well as aspects of the governance of SATs. The conference would also represent an opportunity for groups of HEIs to discuss working more closely with the potential of taking steps to merge a group of SATs in order to benefit from reduced running costs and a reduction in associated risks. The conference could incorporate some HE sector specific training aimed at independent trustees who sit on SAT trustee boards but do not have knowledge of the HE sector. Subject to a positive response from institutions an annual SATs conference would be organised by UCEA.

**Recommendation 3 – Case studies**

Prepare a further set of case studies to assist HEIs and trustee boards of SATs that are contemplating implementing changes to their scheme with the aim of both managing costs and associated risks. The requirement for these changes may arise inter alia, as a result of additional pension legislation. HEIs have indicated that they wish to share information and learn from the experiences of others in the HE sector.

Examples of the areas the case studies might cover include:

a) Implementing (further) changes to the benefit structure of a SAT.

b) Undertaking a de-risking exercise, e.g. a pension increase exchange.

c) Assessing a SATs service provider(s).

d) A merger with SAUL or USS.

e) Auto enrolment.

These case studies would draw upon the experiences of HEIs that have undertaken any of the example projects outlined above and could be used as a reference point by institutions wishing to implement similar changes to their SAT.

*We would welcome feedback on the recommendations outlined in this report and envisage that the proposed SATs conference presents a useful opportunity to discuss these recommendations in greater detail with a view to agreeing a way to take any further work forwards.*
3 Analysis of data from the on-line survey and final published accounts

3.1 The current status of Self-Administered Trusts

During the period since our previous SATs report was published in May 2010, the prevailing economic conditions have had a profoundly negative effect on the financial position of most defined benefit pension schemes. Any positive investment returns have only partially offset the increases in scheme liabilities for a large proportion of SATs and this has placed significant financial burdens on HEIs. This has led to an increasing number of HEIs undertaking a detailed review of the on-going financial viability of their SAT.

The results of these reviews have in turn resulted in a range of measures being implemented to help HEIs reduce their institution’s risk exposure in a bid to achieve greater financial stability for the pension provision of their support staff.

The changes that have been implemented to SATs have included:

- further closures of final salary SATs to new and existing members;
- reducing pension accrual rates for future service;
- the setting up of Career Revalued Average Earnings (CARE), Defined Contribution (DC) or hybrid schemes;
- capping of pension increases;
- significant one-off lump sum payments by HEIs to reduce past service benefit deficits;
- regular deficit reduction contributions; and
- implementation of recovery plans, some of which are longer than 10 years.

The chart below sets out the types of pension scheme currently available to new support staff:
We have analysed the annual reports and accounts for the years ending 31 July 2011 and 31 July 2012 for 36 HEIs that still currently operate a defined benefit scheme which is either open or closed to future accrual.

- 69 per cent of SATs FRS17 funding levels decreased between 2011 and 2012
- 17 per cent of SATs FRS17 funding levels improved slightly between 2011 and 2012
- 14 per cent of SATs FRS17 funding levels remained the same between 2011 and 2012
- The average funding level on an FRS17 basis as at 31 July 2011 was 80.1 per cent
- The average funding level on an FRS17 basis as at 31 July 2012 was 76.8 per cent.

There are a number of factors that have contributed to the increases in SATs’ deficits between July 2011 and July 2012. These factors include: lower than expected investments returns (although the market has improved recently); increased operational costs; and adverse changes in mortality assumptions. A further factor that has contributed to pension fund deficits has been the fall in bond yields to unprecedented low levels.

Government bond (gilt) yields have been steadily falling since the UK Government commenced its Quantitative Easing (QE) programme in 2009. Under the QE policy, the UK Government, via the Bank of England undertakes asset purchases, mainly buying back long-dated gilts. These gilt purchases have the effect of pushing up the value of gilts which have an inverse relationship with yields: when gilt prices rise, yields fall. The Bank of England has suggested that as a result of QE gilt yields have fallen by 100 basis points or 1 per cent. The National Association of Pension Funds (NAPF) has estimated that when gilt yields fell by 1 per cent pension scheme deficits increased by 20 per cent.

Gilt yields fell to record low levels during the European sovereign debt crisis towards the end of 2011 and through to 2012 as investors increased their demand for UK “safe-haven” government bonds. Since gilt yields are used as the measure for discounting future pension liabilities to their present day value, the lower yields fall the higher the present value of the liabilities becomes. This increases the amount of assets required to be able to pay projected pension benefits in the future and causes
pension scheme deficits to grow. It is during this period of falling gilt yields that SATs’ deficits increased significantly and this is evidenced in our analysis. It should be noted that by mid-2013 bond yields were beginning to rise in response to anticipated policy changes in the US and UK.

3.2 SAT recovery plans

We have reviewed the most up to date actuarial valuation that was available for 30 HEI SATs. The average scheme funding level was 78.4 per cent on a technical provisions basis. As a consequence of SATs not meeting their statutory funding objective, recovery plans have had to be put in place setting out how the funding objective would be met and over what time period.

Recovery plans to reduce projected scheme deficits place a significant financial burden on HEIs because cash is moved away from the core academic business into the institution’s SAT and it is only in exceptional circumstances that the trustees are able to refund excess contributions back to the employer. In the past the Pensions Regulator has encouraged a ceiling of 10 years within which scheme deficits should be addressed through a recovery plan agreed by the trustees and the employer. This resulted in recovery plans in excess of 10 years normally being a trigger for increased scrutiny of the scheme and the strength of the employer covenant by the Regulator. However despite a preferred recovery plan length of 10 years, flexibilities did exist which meant that schemes were able to put in place recovery plans that range in length from 1 year to 20 years.

In putting in place a recovery plan for their particular SAT, HEIs and trustee boards will have been required to provide a clear justification to the Pensions Regulator for the proposed length of the recovery plan, as well as setting out a long-term strategy for how they are going to manage the risks to which they will be exposed. The Regulator’s guidance relating to recovery plans is based on a principle that any shortfall in pension scheme funding should be eliminated as quickly as the sponsoring employer can reasonably afford. The length of the recovery period would therefore be based upon the assessment of the strength of the employer covenant and the cash or assets available that the employer can use to reduce the schemes deficit. Where a recovery plan has been put in place covering a period in excess of 10 years, the Pensions Regulator would have taken a much closer look at the circumstances of the scheme, recognising that members’ pensions should not be put at risk by the terms of the agreed recovery plan.

In 2009, when the full effects of the recession were being felt, the average length of a defined benefit scheme recovery plan was 11 years. This figure fell to 8 years by 2011. However research by PricewaterhouseCoopers (PwC) in 2012 predicted that, against a backdrop of depressed gilt yields and continuing economic uncertainty, the average length of defined benefit pension scheme recovery plans would increase back up to 11 years.

As part of our financial analysis of the SATs that were surveyed we reviewed the recovery plans that have been put in place. While we were unable to access the recovery plans for all the SATs, we have found information relating to the recovery periods for addressing the deficits in 28 cases. The list below illustrates the length of time remaining for schemes to pay down their deficit on 31 July 2012 as set out in the version of their recovery plan in force at that date.

- 68 per cent (19) of SATs have agreed a recovery plan covering a period greater than 10 years.
- 32 per cent (9) of SATs have recovery plans covering a period of 10 years or less.
- Recovery plans ranged in duration from 5 years to 25 years.
- Average length of the 28 recovery plans reviewed is 15.1 years.

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• Despite the length of the recovery plans agreed, 72 per cent of HEIs surveyed stated that they expected their deficit reduction contributions to increase during the next three years.

The length of the recovery periods as at 31 July 2012, over which SATs have agreed to address their deficit, indicates that while HEI covenants may be strong, HEIs do not have funds immediately available to plough significant amounts of money into their SAT to pay down the deficit quickly or where HEIs do have available cash, this is being kept in reserve rather than being tied up in their SAT.

One factor to consider when analysing the length of SAT recovery plans is the move towards a more risky funding environment facing HEIs in general. Grants and external funding are reducing and there is a greater need to build up surpluses to support institutional sustainability and to finance investment from more volatile non-governmental sources. HEIs are now spending more of their own resources on maintaining the quality of their infrastructure in order to maintain a high level of student experience. HEIs are also aware that any surplus cash allocated to their SAT will not be able to be returned to the institution at a future date (except in very limited circumstances).

The Universities UK submission to the 2013 Spending Review evidences the increasing use of HEIs’ internal cash to finance capital expenditure. The report states that in 2009–10 around 11 per cent of capital expenditure was financed from HEIs internal cash: this is projected to rise to around 73 per cent by 2014–15. Furthermore, now that central funding has been reduced, internal cash is increasingly being put towards new capital projects.

While the length of SAT recovery plans has been increasing during a period of depressed bond yields and rising deficits, recovery plans can be reviewed and adjusted in the future should economic conditions improve. Where triennial valuations indicate that a scheme deficit has reduced as a result of the payment of deficit contributions and increased investment returns, it is possible to reduce the length of a recovery plan accordingly. However, research by auditors Baker Tilly found that only 12 per cent of employers they surveyed had sought to renegotiate their recovery plan outside of the triennial valuation discussions.

In April 2013 the pension plan of a large education company negotiated a three-year reduction in its recovery plan, after its latest valuation revealed that the employer deficit contributions paid and an equity market recovery had helped to narrow its scheme deficit. The company also agreed to pay higher cash flow-linked contributions which were double those calculated at the last valuation and, in return, the scheme agreed not to increase the guaranteed annual deficit payment.

Recently the Pensions Regulator has reiterated that there is no upper limit to the length of the recovery plan for underfunded DB pension schemes and that each scheme’s individual circumstances will determine what is appropriate in the context of other demands upon the sponsoring employer’s resources. Furthermore there will be occasions where it is appropriate for the sponsoring employer to invest in the growth of the employer’s business rather than making higher pension contributions. The Regulator has also reiterated that there are a number of flexibilities within the current funding regime, including flexible recovery plan lengths, allowing post-valuation experience to be taken into account in setting recovery plans, back-end loading of recovery plans, and including contingent assets in recovery plans. All these points reinforce the long term nature of pension liabilities and the need to make reasonable adjustments over an extended period.

The Regulator has confirmed that it will move away from fixed triggers in relation to scheme funding. Instead the use of a range of triggers to determine the circumstances in which the Regulator undertakes increased levels of involvement in a schemes funding position which will introduced.

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5 http://www.universitiesuk.ac.uk/highereducation/Documents/2013/UUKsubmissionToThe2013SpendingRound.pdf
6 http://www.bakertilly.co.uk/publications/Pages/pension-scheme-trustee-confidence-survey-2012.aspx
The new triggers include:

- whether recovery plan contributions and the amount of investment risk appropriately reflect the relative strength of the employer and affordability of contributions;
- the shape of recovery plans including initial low levels of contributions;
- the investment performance assumed over the life of the recovery plan;
- any specific issues and concerns relating to deterioration in sponsor covenant strength or possible avoidance; and
- any significant issues with previous valuation submissions.

The Regulator is encouraging schemes to adopt an integrated approach to covenant, investment and funding risks, with the aim that trustees can incorporate the ‘ability of employers to support the scheme in their overall risk management approach and allow for an appropriate level of risk to be taken that is neither overly prudent nor overly optimistic’.

The Regulator makes clear that a key area of focus when it engages with schemes will be the link between the strength of the covenant, the scheme's investment strategy, and the prudence in the discount rates compared to expected investment returns. The lengths of the recovery plans we have analysed suggests that SATs have previously been able to demonstrate to the Regulator the strength of the HEI’s covenant and its ability to continue to fund the scheme and pay down the deficit. As HEIs move into a period of significant change in relation to how they are funded there will be a need to maximise the existing flexibilities set out above to address SAT deficits.

The Regulator’s most recent annual DB funding statement issued in May 2013 seems to herald a new era of greater flexibility for sponsoring employers with DB pension schemes which are in deficit. This comes after the Government’s announcement earlier in 2013 that the Regulator will be given a new statutory objective to consider the long-term affordability of scheme sponsors. While the wording of the new objective still needs to be finalised, it is clear that the Regulator will afford employers even greater flexibility in agreeing the length of a recovery plan in the future. However it is still anticipated that employers will need to be prepared to enter into robust negotiations with the Trustee Board and the Pensions Regulator in order to ensure that the full benefit of the new flexibility is available to them.

### 3.3 Recovery plans in the wider economy

The Pensions Regulator has recently released data relating to recovery plans associated with triennial valuations with effective dates between September 2010 and September 2011. The due dates for the completion of the recovery plans resulting from the above triennial valuations were between December 2011 and December 2012. This data can be compared with that released for the schemes with valuation dates between September 2007 and September 2008 as well as between September 2009 and September 2010.

By January 2012 the Pensions Regulator had received 1,733 recovery plans for valuations that took place between September 2009 and September 2010. A breakdown of the data analysed by the Pensions Regulator based on the recovery plans received shows that:

- 83 per cent of schemes were closed to new entrants.
- More than 50 per cent of the schemes had technical provisions of between £5m - £99m.
- 66 per cent of schemes had fewer than 500 members.
- Average funding status on the technical provisions was 78.8 per cent (compared to SATs at 82.1 per cent)*.
- The average length of a recovery plan was 8.1 years (compared to SATs with 15.1 years).

*Based on SATs valuations between September 2009 and September 2010.
A survey undertaken by the auditors, Baker Tilly⁷, in 2012 found that 34 per cent of the pension schemes they surveyed had agreed a recovery plan covering a period in excess of 10 years, with one third of those schemes having a recovery plan greater than 16 years. The schemes with recovery plans exceeding 10 years had risen 22 per cent from the previous year.

The Regulator’s most recent data for schemes with valuation dates between September 2010 and September 2011 showed that by March 2013 the Pensions Regulator had received just over 1,500 recovery plans. (A further 400 had reported a surplus and therefore did not need to put in place a recovery plan.) A breakdown of this data analysed by the Pensions Regulator shows that:

- 83 per cent of the schemes that submitted a recovery plan had also done so during their last valuation cycle i.e. the deficit had persisted for at least 3 years.
- More than 80 per cent of the schemes had technical provisions of less than £100m.
- 70 per cent of schemes had fewer than 500 members.
- For schemes in deficit, the average funding ratio was 83%.
- The average recovery plan length was 7.5 years, compared to 8.4 years 3 years ago. This implies that schemes have recovery plans which end on average approximately two years later than their original plans set at the last valuation.
- The proportion of schemes with more than 60% of their asset portfolio held in equities has fallen from 35% to 24% over the last 3 years.
- 19% of schemes in deficit hold at least one contingent asset reported in respect of funding and/or in support of the Pension Protection Fund’s levy calculation

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4 Issues facing HEIs and their Self-Administered Trusts

As well as the economic and financial pressures indicated by the survey results, legislative and regulatory changes such as the requirement to auto enrol staff into a work-based pension scheme and the proposed abolition of defined benefit contracting-out, place even greater cost pressures on HEIs and trustee boards. Below is a sample of some of the other key issues facing institutions in relation to their SAT.

4.1 Auto enrolment

In October 2012 regulations came into force which require all workers, who meet certain eligibility criteria, to be auto enrolled into a work-based pension scheme. The largest HEIs were required to auto enrol staff from March 2013 and it is anticipated that the majority of HE providers will be required to comply with auto enrolment by early 2014.

Where an HEI is planning to use their SAT to auto enrol support staff it will need to ensure that the SAT meets the criteria as a qualifying auto enrolment scheme. If the SAT does not comply with the auto enrolment regulations, changes to the scheme rules will need to be made in order for the SAT to become a qualifying scheme. For example, areas that may need to be assessed are:

- Eligibility and the joining process.
- How to deal with re-enrolment.
- Whether the contributions and/or benefit structure meet the minimum requirements.
- Definition of pensionable earnings.
- Impact on cost of any insured benefits.
- Scheme normal retirement age (NRA) versus increases in state pension age (SPA).

HEIs using a SAT as an auto enrolment scheme should consider whether any changes to HR and payroll processes are required as well as assessing the extra costs associated with increases in scheme membership and the communication requirements under the auto enrolment regulations. Employers can visit the UCEA website for more information on auto enrolment: [http://www.ucea.ac.uk/en/empres/pensions/guidance/auto/index.cfm](http://www.ucea.ac.uk/en/empres/pensions/guidance/auto/index.cfm)

Our survey of SAT scheme documents has indicated that a number of HEIs have chosen to implement a new DC auto enrolment scheme, such as NEST, NOW Pensions or The Peoples Pension, alongside their SAT. This is often for support staff who have already chosen not to join the SAT or for casual staff. It is also the case that some HEIs are using a DC scheme to provide a vehicle for auto enrolment while introducing a waiting period or other eligibility criteria which must be met before the employee is entitled to join the defined benefit SAT. This implies that auto enrolment is influencing HEIs’ decisions regarding the future pension provision made available for support staff.

One area where further work may be required is regarding potential longer term impacts on the SAT due to any changes in the potential pool of membership. For some SATs, offering an alternative auto enrolment scheme may potentially reduce or change the profile of the active membership, leading to cash flow or funding issues in the longer term.

4.2 Abolition of defined benefit contracting-out

The Government has announced that, as the earnings-related elements of the State pension (S2P, previously known as SERPS) are to be removed and a new flat rate pension introduced from April

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2016, contracting-out for DB pension schemes will be abolished. This will affect employers and employees in final salary and career average SATs which are still open to future benefit accrual on a contracted-out basis, due to the removal of the contracting-out rebate. If a scheme is contracted out this currently means that employer National Insurance Contributions (NICs) on band earnings (between approx. £5,600 and £40,000) are reduced by 3.4 per cent. If a scheme ceases to contract out employers will therefore pay NICs at the full rate. A broad estimate of the cost impact of this change is that the removal of the contracting-out rebate will add approximately 2 per cent to the average cost of pensionable payroll.

The Government has recognised that paying higher NI contributions will put additional strain on the finances of sponsoring employers with an open contracted-out DB pension scheme. In order to mitigate this the draft Pensions Bill 2013 includes a statutory power enabling sponsoring employers to make changes to the structure of their scheme without trustee consent, for example, adjusting members’ future pension accruals or changing the rate of contributions to take into account the loss of the contracting-out rebate.

An actuary will be required to certify that the proposed amendments meet certain statutory requirements and, although this amendment power may be used more than once, it will only be available for a limited period of five years. Employers are still required to consult with those members who would be adversely affected by any changes to the structure of their scheme and which would result in a reduction to their level of benefits. (It should be noted that although the USS may be covered by the legislation granting new powers of amendment, it has not yet been clarified by the Government how these powers would apply in a multi-employer scheme. There may also be complications relating to how this power could be applied in the context of the decision making powers that sit with the JNC.)

It is possible that the abolition of contracting-out will accelerate the closure of the remaining DB SATs. Of the SATs we have analysed, the majority (91 per cent) still provide a DB benefit to some or all of their support staff. The HEIs operating these DB schemes will need to consider how they propose to absorb the additional NI contributions required to be paid from April 2016 and such analysis will require significant planning as well as member consultation. It is therefore expected that HEIs operating DB SATs will be putting plans in place in the near future to address the issues arising from the abolition of contracting-out.

We are already seeing that HEIs have taken the increased NI contributions and the changes to the State Pension into account when assessing future benefits and contributions. For example, some SAT reforms have already included a move to being contracted in as it was anticipated that the members would pay higher NICs but would build up greater state benefits to supplement those from the SAT. Now that the Pensions Bill has been drafted it is recommended that employers review this when looking at any future reforms.

However, employers should be aware that due to the transitional period between the current system and the new flat rate pension it will still be difficult to accurately include the potential State Pension when assessing the estimated future income available to SAT pensioners. The assumption that all future pensioners will receive the flat rate pension may not be reliable as the new benefit will not result in all pensioners being better off in retirement; as with many changes made to State benefits it is designed to be cost neutral so there will be winners and losers.

In addition, HEIs may want to take into account the fact that employees in these schemes will also pay higher NI contributions of an extra 1.4 per cent of band earnings. This may further influence the affordability of the pension scheme and could lead to employees choosing to opt out, with the corresponding loss of employee contributions. This may in turn accelerate the maturity of the SAT reducing cash flow flexibility and may drive up long-term costs. In order to ensure that affordability
is less of an issue, some SATs have phased employee contribution increases over a number of years to smooth the impact on take home pay or even reduced employee contributions.

The impact of the changes on a particular scheme will depend on the specific scheme rules. Trustees and employers will need to check their rules carefully and should take advice on the effect of any references to the state pension or National Insurance system. It is likely that many DB schemes will have active members with accrued guaranteed minimum pensions (GMPs) built up in respect of pre-1997 service. Once DB contracting out ceases these schemes will have a number of administrative considerations including:

- Whether the scheme’s benefits are integrated with those provided by the state. Examples include: definitions of "pensionable salary" as basic pay less the lower earnings limit, or bridging pensions payable to members below state pension age of an amount linked to the basic state pension. For such integrated schemes, the abolition of contracting-out and the introduction of the flat rate State Pension may well impact on benefits that have already accrued or are in payment.
- The end of DB contracting out is likely to trigger the requirement for schemes currently contracting out to reconcile GMPs. The large number of schemes all attempting to reconcile GMPs simultaneously is likely to cause difficulties for HMRC. This issue was acknowledged in the White Paper on state pensions and HMRC will be liaising with the pensions industry to try and make the process easier.
- Schemes will need to communicate any changes to benefits and/or contributions to members. Schemes should also check references to state pensions in scheme communications such as member booklets or standard letters and update them accordingly.
- Currently, contracted-out schemes automatically count as ‘qualifying schemes’ for auto enrolment purposes. Once contracting out is abolished, employers will need to carry out further checks (and possibly introduce rule amendments) to ensure that their scheme meets the qualifying requirements.
- Schemes contracted out on a DB basis are required to meet the Reference Scheme Test (essentially a minimum quality standard). Depending on how scheme rules are drafted, this underpin may or may not continue to apply. Schemes wishing to remove this requirement after April 2016 will need to review their rules.
- Unless legislative changes are introduced anti-franking provisions will be required for the GMPs of members who cease to be contracted out but continue in active service
- The Government intends to bring in legislation next year confirming that schemes need to equalise for the effect of GMPs so trustees may wish to start the GMP conversion process.

4.3 Solvency II

In May 2013 the European Commission (EC) announced that it had temporarily dropped plans to introduce Solvency II type funding requirements for DB pension schemes with the proposal being reviewed again when the next EU commission is appointed in November 2014.

If the Solvency II requirements for insurers are extended to pension schemes it could make the funding requirement for defined benefit SATs even more stringent. Solvency II sets up the quantitative and qualitative requirements that insurers must adhere to in order to reduce their risk of insolvency. In particular, the regulation focuses on:

- the quantitative capital requirement that insurers must hold to reduce the risk of insolvency;
- the requirements for the governance and risk management of insurers, as well as for the effective supervision of insurers; and
- disclosure and transparency requirements.
The Solvency II type proposals for pensions would mean that DB schemes would be subject to onerous funding requirements, potentially increasing DB funding deficits to at least £450 billion according to analysis from the European Insurance and Occupational Pensions Authority (EIOPA). It is understood that new disclosure and transparency requirements will still be applied.

4.4 Increased focus on employer covenant

The assessment of the employer covenant is a fundamental step in agreeing a recovery period that is affordable to the sponsoring employer but at the same time protects the interests of the members of the scheme. The assessment of the employer covenant in relation to SATs will need to take into consideration the range of pension schemes offered to staff at each particular HEI. For example, the sponsors of all 36 of the SATs we analysed also offer membership of USS. USS currently provides final salary or career average pension accrual and has a significant deficit which will need to be addressed. The level of employer contributions will have to be considered as part of the financial management plan that will be agreed with the Pensions Regulator in order to manage the deficit in that scheme. Should the USS employer contribution be increased this could potentially mean that HEIs will have less cash at their disposal to address the deficit in their SAT. This could in turn weaken the employer covenant and affect the length of any recovery periods agreed to address SAT deficits. The impact could also be felt in reverse because if an HEI commits substantial assets or funds to their SAT this may have a detrimental impact on the assessment of their covenant strength for USS purposes.

Section 9 of this report refers to the use of contingent assets which can be utilised to strengthen the employer covenant and provide additional security to a pension scheme. Where an HEI is considering the use of contingent assets it will need to decide whether the asset should be applied to their institution’s SAT or whether they wish to consider assigning the asset to another scheme, for example USS. In this instance, the employer covenant in relation to only one of the pension schemes offered by an HEI will be strengthened by use of a contingent asset leaving the other scheme with a potentially weaker employer covenant. The Pensions Regulator’s increased focus on individual employer covenant, rather than the covenant provided by the HE sector as a whole, means that the decisions made regarding how each HEI distributes its finite resources between the different pension schemes they operate will come under greater scrutiny.

4.5 Introduction of FRS 102 accounting standards

One further consideration is the introduction of the accounting standard FRS 102 for the accounting years commencing on or after 1 January 2015. Where an employer is unable to identify its share of the assets and liabilities in a multi-employer DB pension scheme (such is the case for those HEIs that participate in USS or SAUL) but an agreement has been made to fund any scheme deficit, FRS 102 requires the recognition of a liability in relation to the payments due under the recovery plan. This liability will represent the present value of the deficit reduction contributions over the total recovery period that has been agreed between the trustees and the employer. For example, the proportion of USS employer contribution that represents deficit reduction contributions is currently 3.4 per cent of the 16 per cent employer rate, payable over 10 years. As the deficit contributions paid by HEIs that offer a multi-employer scheme at their institution have not been calculated and expressed in such a way before, this new requirement has the potential to affect the asset and liability values expressed in an HEIs annual report and accounts.

HEIs should ensure that the impact of this new disclosure requirement is fully understood as early as possible so that it can be communicated to relevant parties. This may help to prevent any potential weakening of an HEIs credit rating so avoiding an impact on the ability of the HEI to borrow money which if not successful could in turn have a negative effect on the strength of an HEIs covenant.
5 Mergers

In response to the issues set out in the previous chapters, HEIs are investigating the options open to them to manage the costs and risks associated with their SAT. One solution that is often considered is to merge with another HE sector pension scheme.

The possible advantages of a SAT merging with either USS or SAUL, or alternatively a group of SATs merging with each other have been investigated in a previous report prepared by Dr Bruce and referenced in Appendix 3. Since that report we are aware that a small number of HEIs have made initial enquiries in relation to a merger with USS, however no mergers have taken place to date. In this section of the report we also discuss potential mergers with USS and SAUL and a group of SATs merging together. Our survey indicated willingness from some HEIs to consider the possibility of mergers with other SATs. Further information on the merger policies of USS and SAUL is provided in Appendix 2.

5.1 Merger with USS

The situation is as outlined in our 2010 report. A full merger could provide significant savings over the medium to long term. However the popularity of this option is mostly dependent upon the terms of USS merger policy conditions. Full details of USS’s merger policy can be found at: http://www.uss.co.uk/HowUssIsRun/employers/Pages/Mergers.aspx

A number of initial applications have been made to and accepted by the USS Board. However the basis for the merger calculations has been set as gilts plus 1 per cent as most applications have been in relation to very small mergers. The current low gilt yield environment, coupled with the 1 per cent basis, has meant that applications have proceeded no further than the initial stage.

A further significant factor is the perceived loss of control coupled with a recent history of major disputes within the USS governance structure between the employers’ and trade union sides. Taking all this into account, plus the fact that recent experience shows no SAT having gone ahead with a USS merger, we believe this is unlikely to be currently regarded as a favoured option. However, as demonstrated through the results of the SATs document review, several HEIs have chosen to use the USS CRB section for new employees or to provide future service for all support staff while continuing to manage past service deficits through their SAT. So it is clear that the benefit structure provided by the USS CRB scheme is attractive to a number of HE employers.

5.2 Merger with SAUL

This is perceived to be a slightly more favourable option because of SAUL’s less stringent merger conditions. However the loss of control aspect is still a potential concern. One university is currently considering merging their SAT with SAUL and some HEIs have looked at the option of closing their SAT with future service benefits provided through SAUL.

5.3 Mergers with other university SATs

HEIs could consider a merger with a group of SATs to try to achieve greater efficiencies by working closer together. Economies of scale could be achieved through lower fees and greater efficiency from combining administrative and actuarial operations. However unless a significant number of SATs decide to work together this option would be unlikely to deliver much in terms of cost savings and/or economies of scale.
5.4 Alternative options other than full scheme merger: combining SATs investments

SATs could achieve savings in administrative costs and potentially enhanced returns by pooling investments. Similar developments are taking place in some local government pension schemes, which are discussed below.

5.4.1 Local Government Pension Scheme (LGPS) case study

A recent study into the potential merger of a group of LGPS funds has been undertaken and one of the findings of the study was that significant cost savings could be achieved by merging London LGPS funds into a collective investment fund. To this end London Pensions Fund Authority is investigating the possibility of merging London’s local authority pension funds into a pan-London fund, pooling the assets of 32 boroughs with those of Transport for London. In addition, Oxfordshire, Buckinghamshire and Berkshire are in preliminary talks about merging their funds.

There is currently a lot of debate among stakeholders in the LGPS about how greater efficiencies can be driven as a result of schemes working together and the form that collaboration could take. There are a range of options being discussed from more joint working through to full mergers of individual funds. Other options being considered include:

- Collective Investment Funds, which would establish a central entity having the expertise to procure, monitor and replace the best investment managers in each asset class, leaving individual local authority funds to decide asset allocations between those managers; and
- Framework Funds, which would go further by creating a single legal framework for a group of local authority funds, handling many operational matters on a collective basis. Administering Authorities would still choose asset allocations and negotiate individual contribution rates.

The Society of London Treasurers (SLT) recently considered a report from PwC regarding increased co-operation across the London Boroughs on pensions and, in particular, on pensions investments. The PwC report sets out a proposed structure whereby each of the participating boroughs would retain autonomy in asset allocation and funding strategy. There would be a central entity, or “Oversight Agent”, working within new governance arrangements, that establishes a choice of funds within each asset class, selects fund managers and negotiates and monitors fee and service levels. The participating boroughs would set their asset allocation, choosing between wide ranges of Investment Funds offered by the fund. The establishment of a Collective Investment Vehicle (CIV) is considered to be one possible way forward that could reduce investment fee costs and potentially increase performance.

5.4.2 Collective Investment Vehicle

The key advantages of Collective Investment Funds as identified by SLT are as follows:-

- It preserves individual boroughs’ decisions on funding strategy and asset allocation.
- It enables the boroughs with lower performance (generally those with the smaller funds) to access better performing fund managers.
- It provides an investment platform where the boroughs can aggregate investment options making it more attractive for fund managers, hopefully increasing efficiency from combined administrative operations and therefore reducing fees.
- It provides a range of not only asset classes but also different styles of managers to meet requirements of boroughs.
- It would demonstrate that Funds are capable of working together.
SLT have also identified some possible downsides:

- it requires a number of Funds to be prepared to join, ideally the better performers; and
- there will be the normal cost of changing fund managers, but hopefully less than a number of boroughs changing individually.

London Councils commissioned SLT to undertake a survey to gauge interest in establishing a collective investment vehicle. The survey results indicate that there is significant interest in the creation of such a vehicle to enable collaborative working and achieve both lower investment administration costs and greater investment performance without the loss of operational independence in terms of asset allocation policy. The management of the CIV would be fulfilled with a lead authority carrying out the role, which could be either London Councils itself or a lead borough. Funding for the lead authority would initially come from participating boroughs, but once the CIV were established, would be more than paid for from reduced fees. The lead authority would procure an investment advisor followed by a transition manager and investment funds/fund managers within each asset class, including alternatives like infrastructure.

The CIV would operate by maintaining a “best of breed” selection of funds/managers for each asset class. These would be well defined, generally segregated mandates, with the CIV using its buying power to secure lower investment manager fees. The CIV would be responsible for day-to-day governance in relation to each selected manager, including, in conjunction with the appointed investment advisor, performing necessary due diligence for the chosen managers. This would include quarterly meetings with managers, providing quarterly reports for borough Pensions Committees that summarise performance and any other pertinent due diligence.

Boroughs would be free to choose which, if any, manager to use from the CIV. Boroughs would not be compelled to use any CIV manager, but clearly, best-in-breed managers at the lowest cost obtainable should make the selection of managers desirable. One of the first asset classes to be investigated would be infrastructure.

Boroughs would retain their own custodians, control over asset allocation, and accounting responsibilities, although manager related information would be supplied by the CIV. In time, the CIV could also be used to provide any other officer-related investment duties that boroughs voluntarily wished to delegate, for instance if key staff left a particular borough – this could extend to preparing draft reports for all investment related matters for the local pensions committee, using a common custodian, preparation of accounts, etc.

If and when appropriate, funds/managers would be deselected and recommendations for change would be made. Boroughs would be free to focus their investment governance budget on the asset allocation – the key driver of investment performance.

The costs of setting up a CIV would be largely recoverable from participating boroughs, although there is a risk of some initial set up costs including legal and other professional costs being non-recoverable. These could be as much as £50,000 (although in practice are expected to be significantly less than this). The Wandsworth Council Pension Fund has since indicated that it is interested in leading a London-wide collective investment vehicle.

5.4.3 Potential for application in HE

The main advantage thought to result from scheme mergers is the cost saving that could be realised through economies of scale. Further advantages would come from pooling governance arrangements. Mergers would also have implications for the advisers used by pension schemes, adviser fees, asset management and investment strategy. However full scheme mergers are
complicated projects and can take a long time to finalise and HE employers also indicated that they would not want to undertake any scheme changes that led to a perceived loss of control of their local scheme.

A merger of the assets held by a group of SATs into a pooled SATs investment fund could provide shared access to expertise in procuring, monitoring and replacing investment managers in each asset class with the responsibility for selecting the asset allocations remaining with each individual SAT. A centrally-operated body could be set up with its own governance structure, consisting of representatives from each of the SATs who have merged their assets into the pooled investment fund. This body could have responsibility for the selection and maintenance of the range of investment funds within each asset type, as well as responsibility for assessing and measuring investment manager performance, and negotiating fees which could be secured at a lower rate.

By pooling SATs assets into a collective investment fund HEIs could have access to a greater range of investments, including emerging and specialised asset classes as well as more sophisticated investment techniques for example inflation and interest rate swaps.

Each SAT would be still be able to retain a separately identified funding level and contribution rates for each SAT would remain calculated at an individual institution level, reflecting the performance of each individual SAT’s selected asset allocations. The asset information required for actuarial valuations and annual accounting purposes could be gathered by the selected investment managers and produced in a more efficient and standardised manner. This could lead to greater efficiencies and further potential cost savings including lower total actuarial costs and less duplication of actuarial advice. Funding levels could be calculated on a common set of financial assumptions for each fund, however individual circumstances, for examples, longevity experience, could still be applied. Recovery plans would also be negotiated at institution level.

A collective SATs’ pooled investment fund would be relatively straightforward to set up with legal issues readily addressed. One of the main factors to consider would be that in order to gain from the advantages of scale and achieve a reduction in investment costs there would need to be buy-in to the merger proposal at an early stage by a group of HEIs. Our survey suggested that a third of HEIs would be willing to explore options for merging with other SATs. There are currently 10 SATs with assets greater than £150m. The average asset value of the SATs we have analysed is £127m. It would therefore only require upwards of eight or nine of the larger SATs to agree on a merger to result in a collective investment fund of assets of £1bn.

A further potential benefit of a group of HEIs collaborating in order to pool their SATs’ assets into a collective investment fund is that by building relationships and sharing expertise these HEIs may consider working more closely with each other to achieve further cost efficiencies that are not specifically related to the pension provision at their institution. There is no reason why this type of arrangement could not be used for other investments. This could remove further risk from an institution, whilst also maintaining a high standard of service.

Alternatively SATs could work together to approach fund managers who they already work with to see if they could negotiate better terms on the basis of the total funds under management.
6 Making changes to an existing scheme structure

Legislation protects benefits that have already been accrued and as such changes (without member consent) cannot typically be made retrospectively. However there are a number of changes that could be implemented to an existing scheme with the aim of reducing liabilities and the institutions own cost and risk exposure while still allowing future service to accrue and new entrants to join the scheme. Many of the following are examples of the changes that have been implemented by SATs.

NOTE: any HEI that has committed to applying the auto enrolment transitional period to delay auto enrolling staff into their SAT will have to be very careful that changes made to scheme benefits before the end of the transitional period (October 2017) do not lead to the employer being required to backdate benefits in a DC auto enrolment qualifying scheme.

6.1 Increasing employee contribution rates

Implementing such a change may depend on the employer’s assessment of the willingness of members to pay more into the scheme, which may be particularly difficult at a time of pay restraint. The abolition of contracting-out in 2016 already means that employees will be paying increased NI and this may make it particularly difficult to raise pension contribution rates any further.

An HEI could consider introducing a tiered employee contribution structure similar to those that have already been introduced in the TPS and the LGPS. A tiered contribution structure could protect the lowest paid from any increases in their employee contribution rate while the contribution rate payable by the remaining higher paid support staff could be increased gradually based on their earnings. While there is little evidence that tiered contribution rates have led to a discernible increase in opt outs in the TPS to date, it remains to be seen whether opt outs rise as the employee contribution rates continue to increase in the public service pension schemes in 2014/15 at the same time as benefits are reduced and against a backdrop of increases in contributions that will be payable as a result of the abolition of contracting-out.

There is the danger that members might choose to opt out of their institution’s SAT if the increased contribution rates were seen as unfair or unaffordable for relatively lower paid support staff. This could reduce cash flow into the scheme and adversely impact the sustainability of the scheme over the medium to long term.

6.2 Reducing the accrual rate for future service

It is not uncommon for DB schemes to change their accrual rates from 1/60ths to 1/80ths or lower in order to reduce future service liabilities. We are aware of a number of SATs that have done this. In some cases contribution rates have been linked to accrual rates i.e. members pay a higher employee contribution in order to access a higher accrual rate. This is an option currently being consulted on in relation to the TPS.

6.3 Capping inflation uplifts

Employers may be considering implementing this change at the present time because, although in the recent medium term inflation has been relatively benign compared with the mid to late 20th century, it still has consistently been above the Bank of England’s 2 per cent target. Given the level of unemployment and stagnation, or at best low growth in the economy, the Government may give the Bank of England a broader remit to include minimum levels of economic growth which could result in higher levels of inflation. Higher inflation also has the “advantage” that it deflates the real
value of existing debt so it is tempting for any government holding a large debt portfolio to pursue such an inflationary policy. However the downside of this is that unless wages keep pace with inflation there will be a real fall in living standards – a scenario that has occurred in the UK during the period since after the credit crisis of 2008.

USS has adopted a form of inflation capping and a further example is provided in the “Mercia” Case Study (Appendix 1b).

It should also be noted that there are statutory minimum requirements on DB schemes to increase pensions in payment in line with inflation, capped at 5 per cent for benefits accruing from service between April 1997 and April 2005, and at 2.5 per cent for benefits accruing from April 2005. There are also statutory minimum revaluation rates that apply to deferred pensions. These require pensions that accrued between January 1991 and April 2009 to be increased in line with inflation capped at 5 per cent, and at 2.5 per cent for rights accrued on or after 6 April 2009.

It should also be noted that from 6 April 2011 the statutory requirements were no longer based on the increase in RPI but on CPI. It is anticipated that CPI will consistently remain lower than RPI; a 2011 report by the Office for Budget Responsibility estimated that over the long term RPI would be between 1.3 and 1.5 per cent higher than CPI. For those schemes where the change from RPI to CPI was automatic under the rules this resulted a substantial saving, but schemes where increases were specifically linked to RPI can still change their rules to use CPI for future service benefits (subject to consultation requirements). This would realise part of the saving from the change in Government policy but as it would apply for future service only, would have no impact on any scheme deficit.

6.4 Changing the definition of pensionable pay

This could be a relatively minor change such as ceasing to pension bonuses or overtime, or could be a more fundamental change such as to limit annual increases in pensionable pay. The basic premise with the second option to decouple the link between an employee's salary and the pension they are accumulating. This can be achieved by limiting futures increases in pensionable pay to a set percentage, usually between zero and 2 per cent to 2.5 per cent. Alternatively pensionable pay could be capped at a fixed amount or an amount that increases by a specified percentage each year. If the amount or cap is fixed then more members will be caught each year as their salary increases. HEIs who might be considering this option should refer to their SATs’ trust deed and rules and seek legal advice to ensure that they are complying with pension legislation.

6.5 Increasing normal retirement age

This has usually involved linking normal retirement age (NRA) to state pension age (SPA) (which the Government is linking to future increases in longevity). Rule amendments can be put in place which will continue to increase NRA automatically in line with future SPA increases announced by Government. USS and the new public service pension schemes offered to HE sector staff all link their schemes’ NPA to the SPA.

6.6 Reviewing actuarial factors

In particular early and late retirement factors to ensure they are (and continue to be) cost neutral, but also commutation and transfer factors could have an impact.
6.7 “Future Proofing” scheme changes

There are a number of measures that can be introduced which can help to ensure that future increases in employer pension costs are managed more effectively. These measures include:

6.7.1 Cost sharing

Provisions are put in place whereby any future increases in the cost of benefits above a certain level will be shared between employees and the employer or in some cases met solely through employee contribution increases.

6.7.2 Automatic benefit adjustment triggers

Rules can be introduced whereby an increase in total cost of the scheme above a certain level can be mitigated through automatic benefit adjustments rather than an increase in contribution rates. For example, by reducing the accrual rate or increasing the scheme retirement age. It is also possible to set out how benefits would be improved in this way should the cost of the scheme fall, in order to maintain a level future service rate. This process is currently being designed for use by the public sector schemes to manage employer and Treasury costs going forward.

6.8 Cost and risk reduction without scheme benefit changes

6.8.1 Discretionary benefits

Employers can alter their policy so that no discretionary benefits over and above those set out in the rules are granted. An example is the provision of an enhanced pension on redundancy. The employer may wish to amend their redundancy policy to remove this provision. Employers should check scheme member booklets and other communications to ensure that the ability for the employer to choose not to exercise their discretion in certain circumstances was communicated. Legal advice may be needed in these circumstances to ensure there is no “custom and practice” argument that suggests members were entitled to expect that a discretion would be exercised in a certain way.

It is also possible to implement scheme changes which include an element of employer discretion in terms of benefit provision, usually as an alternative to removing a benefit altogether. The granting of discretionary benefits can be automatically linked to scheme investment performance or total cost, or fully within the employers gift. The type of discretionary benefits are most often additional revaluation or pension increases granted above the statutory minimum but could take a number of other forms such as adjustments to the annual accrual rate, particularly in a CARE scheme context, improved early retirement terms, or pensioning salary above a scheme cap.

6.8.2 Flexible retirement

This option could be offered to staff, and set up to have no net cost to a scheme. The opportunity could be taken to include this benefit at the same time as any other pension scheme reforms are introduced.
6.8.3  Salary Sacrifice

The setting up of a salary sacrifice arrangement can lead to cost savings which benefit both HEIs and scheme members. Many HEIs have already put such schemes in place. Salary sacrifice involves employees giving up part of their salary in return for a compensating benefit. For example, a member of a pension scheme is deemed to have reduced his or her pensionable salary by an amount equivalent to their normal employee pension contribution. At the same time the deduction from salary for their employee pension contribution is reduced to nil and the employer increases its contribution by the exact same amount as the employee’s contribution.

The benefit is in the saving the employer achieves in NICs. The employer pays NICs on the employees' salaries but not on pension contributions. The higher the salary, the more the employer has to pay in NICs. Reducing the employees' salaries would therefore allow the employer to pay less in NICs. Collectively, across a large workforce, an employer can achieve a substantial saving in NICs. In addition the costs of setting up a salary sacrifice arrangement are generally minimal and can allow employers to offer improved benefit packages to employees.

The employee gets the same overall benefit as the reduction in salary is the same as the pension contribution that would have been deducted but with a further advantage that the employees should also pay less in NICs. Like the employer, the employees pay NICs based on salary, so the lower their salary the lower their NICs will be.

If an HEI is considering setting up a salary sacrifice arrangement it should ensure that the following requirements are met:

- Revision of the terms and conditions of employment between the employee and employer.
- The revised contract must state that the employee is entitled to a lower cash remuneration or benefit as a result of salary sacrifice.
- Although HMRC does not require salary sacrifice to be reported, it is prudent for employers to keep copies of the revised contract in case it is required.
- Specialist advice on the implementation of salary sacrifice schemes is available from a number of accounting and HR consultancies.
- HEIs should be aware that salary sacrifice is not appropriate for all employees, particularly those on lower salaries. A salary sacrifice arrangement cannot take an employee’s pay below the level of the minimum wage and certain statutory benefits are based on salary, such as statutory sick pay, so some employees may be worse off by accepting a salary sacrifice arrangement.
- Entering into a salary sacrifice arrangement cannot be compulsory and joining the pension scheme cannot be reliant on the employee agreeing to the salary sacrifice as this is against the auto enrolment requirements.

The majority of SATs in the sector have chosen to use salary sacrifice for employee pension contributions but only a few have extended this to AVCs. It may be possible to extend the facility, particularly for Added Years AVCs contracts where employee contributions are fixed over a defined period. Money Purchase AVCs are usually less suitable for salary sacrifice as the amounts paid and timing of payments can be changed at any time at the member’s request and HMRC usually require the reduction in salary to be “permanent” (usually defined as for at least 12 months).

6.8.4  Use of contingent assets

A contingent asset is one that can be assigned to the Trustees of a pension scheme in the extreme event that an HEI is unable to continue to meet its pension scheme obligations. The contingent asset represents additional resources available to the Trustees to ensure that all accrued benefits are
secured in full should the scheme have to wind up following an insolvency event. Until such time as the asset is formally assigned to the Trustees it can revert back to the employer, so the employer retains control and ownership of the contingent asset.

The use of contingent assets can provide an HEI and scheme trustees with an alternative way of addressing their pension scheme deficit without increasing immediate cash payments. A contingent asset can also provide flexibility to the recovery plan and help to reduce the Pensions Protection Fund (PPF) levy. The Pensions Regulator regards the existence of a contingent asset as a major step towards reducing the risk that a scheme would require support from the PPF.

We are aware of at least one HEI that has agreed the use of a contingent asset. The contingent asset takes the form of a floating charge on certain of the university’s assets specified in a reserve set up in the university’s accounts. The reserve comprises a list of property and cash, which is valued and certified annually.

Our survey indicated that 24 per cent of HEIs had implemented or were considering implementing the use of contingent assets.

A recent update from the Pensions Regulator on triennial valuations and recovery plans indicated that 21 per cent (358) of schemes with effective dates for valuations between September 2009 and September 2010 reported having some form of contingent asset, the majority of which (265) are recognised by the PPF in relation to the levy calculation. 90 per cent of those schemes reporting a PPF recognised contingent asset held Type A assets (guarantees provided by the parent/group companies to fund the scheme) where the trustees receive a guarantee that covers a pre-arranged percentage of liabilities.

6.8.5 Managing the costs of ill-health benefits

Many occupational pension schemes pay ill-health pensions when a scheme member finds they can no longer work for health reasons. Benefits will vary depending on the rules of the particular scheme. Some schemes will provide different levels of benefits depending on the seriousness of a worker’s illness and what work, if any, they may be capable of undertaking in the future.

Schemes often pay individuals the full value of their pension and do not reduce it even though it is being paid before the worker reaches their normal retirement age. Some companies provide their ill-health benefits through an insurance company rather than through the pension scheme. These are known as Permanent Health Insurance Schemes. In this circumstance it is the insurance company that decides what benefits (if any) a person is entitled to according to their health issues and ability to work in the future.

There are a number of ways of calculating ill-health pensions. Employers should ensure that they understand what benefits their pension schemes provide and how much the different options may cost. The pension scheme rules will state when a person will qualify for ill-health benefits, and what those benefits will be although these rules may be complex and require careful interpretation.

Trustees must know the process for dealing with ill-health cases. In some schemes the employer must consent to the payment, and in others the trustees have the discretion to agree to the pension. Sometimes both employer and trustees will be involved. Trustees need to gather facts and evidence to properly evaluate an application for ill-health benefits. This may include investigating the demands of an applicant’s job.

Trustees should also seek advice from a registered medical practitioner. It is also important that the medical practitioner understands what advice is needed. For example, the trustees may need a
medical opinion about the member's fitness for work or about whether the illness is likely to be permanent.

HM Revenue & Customs allow an ill-health pension to be paid as a single lump sum if an applicant is not expected to live more than a year. It is important that employer and trustees have a process in place that allows them to react quickly to applications if the circumstances warrant it.

Pension scheme rules often allow trustees to review ill-health pensions at a later date. Trustees must explain to applicants that the pension can be reduced, or even suspended, if the applicant's health improves. Trustees should have an agreed policy in place for dealing with ill health early retirement reviews.

### 6.9 Other options

These include relatively minor scheme changes: commute trivial pension entitlements; undertake a data/benefit audit; provide more at retirement options; write to all deferred members to remind them of early retirement options or review and benchmark advisor costs.
7 Changing to a new benefit structure

Some employers are finding that the costs and risks associated with traditional final salary schemes make them no longer sustainable. Some HEIs have considered that the types of benefit change set out in chapter 6 are not sufficient to make their SAT viable over the longer term and have looked to more fundamental changes to the scheme structure to reduce the cost of providing future service benefits. Other employers have decided to close their schemes to new entrants but to allow existing members to continue to accrue benefits, perhaps on a reduced scale, or to introduce other forms of defined benefit arrangements that share risk between the employer and employees. In HE these changes have mostly been implemented for new entrants only but in some cases have applied to all members for future service.

Our survey indicates that 25 per cent of the SATs we surveyed expect to make changes to their pension scheme for new entrants within the next two years.

Possible changes to the benefit structure of SATs

- Closing a final salary element of a SAT to all members for future accrual.
- Closing the final salary scheme to new members only.
- Removing a final salary link to past service.
- Increasing contribution rates for both HEI and/or employees.
- Reducing the rates of future accrual.
- Capping pension increases.
- Setting up a career average (CARE) or defined contribution (DC) scheme for all members or new support staff.
- Increasing normal retirement age.

Before any changes are implemented, it is important to consider the drivers behind the employer’s decision, so as to ensure that the changes implemented are the most appropriate and address the employer’s concerns and objectives. The main reasons typically seen for requiring scheme reforms include the cost of future accrual, the discrepancy in this cost across different employees and the potential for additional contributions if a deficit persists or increases. In addition other reasons include the need to manage the liability disclosed on the balance sheet, to minimise the impact this can have on the finances of the employer.

7.1 Consideration for HEIs when implementing scheme benefit changes

In making plans to implement changes to the structure of a SAT there are a number of issues to take into account. These apply for most of the changes that SATs have made recently or are looking at making in the near future. This list sets out the typical key stages and points to consider associated with a closure to accrual or major benefit redesign process:

- What powers are available under the Trust Deed and Rules of the scheme? If there is a power of amendment, who is able to exercise this power? This may be the employer or the trustees. Sometimes the scheme rules allow for closure to future accrual by giving notice to members. In other cases, schemes can be closed by rule amendment. Often, such amendments will require the consent of the trustees as well as the employer. Both sides need to be aware of the formalities which must be observed when exercising the power, for example is actuarial advice or a deed required in order to ensure the change is valid? The precise wording of the rule must be followed.
While the power to amend the pension scheme may be contained in the scheme’s trust deed and rules, employers should also check the terms of the members’ employment contracts, the scheme booklet and member announcements to make sure there are no obstacles. It is recommended that a scheme documentation audit is undertaken to ensure that all parties are fully aware of the specifics of the SAT before any changes are considered.

Employers should review the members’ contracts of employment to ensure that they do not legally prevent the closure of the scheme to future accrual or the employer changing the terms of future accrual. If the proposed changes to the SAT do constitute a variation of employees’ contractual terms the HEI will need to vary the terms of the contract by either seeking their employees’ express agreement to the new terms (this can be on an individual or collective basis); unilaterally imposing the change and relying on the employees’ conduct to establish implied agreement to the change; or terminating the employees’ employment and re-engaging them on the new terms. In this case consultation under the Trade Union and Labour Relations (Consultation) Act 1992 may be needed. Depending on the number of employees potentially affected, the consultation period is either 30 days or 90 days. The employer must consider the responses to the consultation however they are under no obligation to alter the proposed changes to the scheme as a result of the consultation.

Section 67 of the Pensions Act 1995 places restrictions on the ability to change members’ existing rights or to reduce pensions in payment. Failure to comply would render any change void. Most schemes’ rules also contain a similar restriction. There are exceptions, whereby certain changes can be made; ‘regulated modifications’ can be made with the member’s consent or an actuarial equivalence test, but ‘protected modifications’ are only possible with the member’s consent. Clear communication with the scheme’s members is essential, as they must be able to give their fully informed consent for the changes to be enforceable. The consultation could take the form of face to face meetings, written communications, presentations and question and answer sessions. Where employees are being asked to make a decision about various options, it may even be appropriate to offer independent financial advice and offer a member hotline or email line service. Overall this means that the scope for HEIs to reduce members’ accrued benefits is very limited.

There is a statutory duty under s259 of the Pensions Act 2004 to consult ‘affected members’ before making certain changes to a pension scheme. Such changes include closing a scheme to new members; reducing future service benefits; ceasing future accrual; and increasing members’ contributions. The minimum consultation period is 60 days and the Regulator has said that it expects employers to “carry it out in good faith, taking all responses into account”.

Under the Information and Consultation of Employees Regulations 2004 there is a requirement to consult with employees and trade unions in relation to pension changes. Discussions with unions will need to be carefully managed in order to mitigate the risk of potential industrial action.

### 7.2 Process considerations

Usually the employer puts a proposal to the trustee board which includes:

- how the changes will be implemented;
- whether the Trustees’ consent is needed;
- whether the employees’ agreement will be sought;
- why the employer is proposing the change;
- what alternatives were considered;
- comments on the potential impact on scheme funding.
Employers may wish to consider meeting the Trustees costs in connection with the proposal. HEIs will need to demonstrate to the trustees and members that there is a sound financial reason for implementing any proposed changes to the benefit structure of a SAT. The scheme's trustees, who must act to safeguard the interest of beneficiaries, are obliged to examine the reasons for the reforms and may want to explore alternatives to benefit change with the employer. However employers should note that the employer may also be a potential beneficiary of the scheme in law. The trustees will also need information about the employer covenant and to be assured that the pension obligations will be met in the long term and that the relevant actuarial, investment and legal advice has been sought.

As the scheme reform process progresses there are a number of practical considerations:

- Appropriate information must be given to scheme members to meet the statutory requirements under the Disclosure of Information Regulations. It is important that communication to both the trustees and the employees is clear and appropriate to the audience.
- The scheme administrator should be given advance notice of the proposed changes so the administration system and records can be updated.
- It is vital that any scheme changes are fully reflected in the scheme's trust deed and rules; failure to do this could result in the change being void.
- The Pensions Regulator will also need to be notified of certain changes.
- The trustees may wish to review the scheme’s funding arrangements following the changes. For example, would it be appropriate to carry out an updated actuarial valuation and/or review the current schedule of contributions? The trustees may also review the scheme’s investment strategy and update the statement of investment principles.

7.3 Considerations when closing a DB scheme

Closing a DB scheme to future accrual is a significant step, but one that many employers have made in recent times. It will ensure that there is no further increase in pension liabilities and is usually the first step in containing, managing and sometimes ultimately buying out past service liabilities.

If an employer wishes to close their DB scheme completely, i.e. all future accrual ceases for existing members and no new members can join, there are a number of issues which need to be considered, in addition to those listed above.

Checking the scheme's rules to ensure that the entitlements of members are fully understood is extremely important. Even though a scheme has been closed to future accrual, in some cases members may still retain a link to final salary. This means that although they do not build up future benefits in the scheme, the pension they will eventually receive will be based on their salary at the date they leave employment with the employer rather than their salary at the date the scheme closes.

Once the process through which the scheme can be closed is clarified, legal advice should be obtained to ensure there are no unintended consequences of the closure. In some cases, ceasing accrual may trigger the winding-up of the scheme. If this happens the employer will become responsible for its share of any deficit in the scheme under section 75 of the Pensions Act 1995. This requires the employer to pay the cost of fully funding the purchase of annuities with an insurance company for all members. This will usually be a significantly higher cost than funding the deficit on a technical provisions basis. The trustees will need to consider the period over which they wish the employer to fund the deficit and the scheme actuary may recommend a higher employer contribution should they feel that any funding deficit should be made good over a shorter period than had previously been agreed. One potential way to avoid triggering the debt could be to set up a
new section of the same scheme which all members move to rather than closing the DB scheme and moving to a completely new scheme.

As the cost of purchasing annuities is very much higher than the cost of satisfying the technical provisions basis, and due to the risk of creating a debt on the employer, the employer may wish to continue the scheme on a closed basis. Whether this is possible will depend in on both the terms of the trust deed and rules and the wind up regulations. In some cases any proposal to run the scheme on a closed basis may necessitate a negotiation with the trustees and possible some enhancement of members’ rights and a consideration for trustees agreeing to a change in the deed and rules or a postponement of the winding up.

It is good practice for the trustees to review the scheme’s existing investment strategy if future accrual is to cease. Less risky investments may be more appropriate for a closed scheme where there are no more member contributions coming in and no new members joining and the trustees may wish to move towards matching assets to liabilities. They may also wish to take a more prudent view of the actuarial assumptions and this is likely to lead to a lower discount rate being proposed by the trustees for the scheme’s valuation, which would serve to increase the scheme’s technical provisions. This may, however, be at least partially offset by the fact that future deferred revaluation is usually expected to be lower than the lost future salary growth. Finally they will need to consider how to set a strategy for disinvesting assets over time in order to pay benefits, paying particular attention to how they monitor and manage investment management and advisory fees.

The trustees should consult with the employer before implementing any changes to the investment strategy. In particular, any proposed material change in strategy will need a revised Statement of Funding Principles to be put in place, and the employer should be consulted on the new draft.

The employer may want to take actuarial advice about any funding implications of ceasing future accrual. It is common now for employers to appoint their own independent actuarial and legal advisors to support them during these types of discussions, rather than relying on the trustee’s advisers.

As more and more SATs close to future DB accrual and move to a DC structure HEIs will be faced with how they deal with their legacy SAT and its associated liabilities. For example a closed DB scheme is often more concerned with managing cashflow as no new employee contributions are being paid into the scheme. In addition once future liabilities have been capped, many employers seek to reduce the size of the past service liabilities using liability reduction exercises, such as those set out earlier in this report.

One option HEIs and SAT trustees may wish to explore is how to define and agree an exit strategy which identifies the time period over which the employer wishes to manage the SATs assets and liabilities so that they are gradually matched leading to the eventual purchase of annuities with an insurance company and the wind up of the scheme. This would generally lead to the scheme reaching a point of holding zero assets and liabilities and then winding up and is a process which can be outsourced in its entirety to a third party.

7.4 Moving to a CARE scheme

CARE (career average revalued earnings) is a different type of defined benefit scheme. Our analysis of SATs pension provision indicates that 31 per cent of HEIs now offer a CARE scheme to new support staff. In this type of scheme members pay an agreed rate of contribution and, in the same way as a final salary scheme, the SAT provides a benefit which is calculated using a pre-defined formula. The HEI still bears the longevity and investment risks that are associated with running a DB scheme; however the risks, and the overall pension costs, tend to be lower in a CARE scheme than in
a final salary scheme, particularly in relation to higher earning employees with late career promotions. A large pay rise represents a double cost for the sponsoring employer of a final salary scheme as there is a large one-off increase in the member’s past service liability, together with a smaller on-going increase in current pensionable salary (and associated employer contributions and pension obligations). The risks and costs associated with members who receive large pay rises late in their careers are largely removed by moving to a CARE scheme (particularly if the final salary link to past service is also removed).

Since under a CARE scheme a big pay rise does not result in an increase of past service liabilities this can also be beneficial to members who may be in danger of breaching the Annual Allowance. In a final salary scheme as any pensionable salary increase applies across the whole of their past service the increase in the capital value of their pension fund can be substantial, especially if they have long service. This can cause the member to exceed the Annual Allowance. However under a CARE scheme it is only the current year’s accrual which would be affected by their salary increase as any past service revaluation is ignored for the purposes of the Annual Allowance calculation. Therefore it is much less likely that the member will exceed the Annual Allowance in a CARE scheme and where high earners do exceed the Annual Allowance the tax charge would be expected to be much lower than that incurred in a final salary scheme.

In addition, the argument is often made that CARE schemes are fairer to members, mostly because the large benefit payments made to “high flyers” whose salary has increased significantly, often as the member approaches retirement, are reduced. These employees generally pay much less in contributions compared to the benefit they receive on retirement. On this basis a CARE scheme is therefore fairer to the majority of staff that remain in steady employment throughout their career and who would otherwise be subsidising the pensions of higher earners. This is particularly true in periods of pay restraint where earnings are rising slower than inflation. In addition CARE tends to be better for employees who have a reduction in pay or fluctuating pay throughout their career or those who earn more in their early career, for example manual workers or those that suffer from ill health and are unable to continue to work at the same level. CARE schemes are also generally more compatible with today’s flexible working patterns. CARE schemes penalise members less for taking time out to have children, working part time, having a career break etc., whereas in a final salary scheme these choices can have a significant impact on the benefit payable at retirement.

The use of a career average benefit structure also offers the flexibility to change the revaluation rate and the definition of pensionable pay, without creating the administrative problem of tranches of past service that are created in a final salary scheme. In this way the scheme is easier to “future proof”.

CARE schemes are generally attractive to HEIs that are exploring ways to reduce their pension risk and associated costs as they still provide a generous level of pension entitlement to members, but the financial burden and associated risks are less than in a final salary scheme.

The investment considerations for a CARE scheme are similar to those in a final salary scheme and so an investment strategy to fund the future costs of providing career average pension benefits must still be put in place. CARE schemes can still experience funding deficits if investments underperform or longevity assumptions are too optimistic which means that HEIs offering CARE schemes may be required to meet any shortfalls in the assets by paying increased contributions and even deficit reduction contributions.

Applying a CARE scheme can often be more complex than a final salary scheme as accurate and detailed membership data relating to accrued benefits and earnings histories need to be recorded over an extended period and reconciled as and when the benefits accrue rather than waiting until retirement. A key consideration for HEIs, if they are considering opening a CARE scheme, is whether the current administrator has the systems, procedures and experience in place to administer such a
scheme to the required standards. In addition to robust recordkeeping, detailed and regular communications should be issued to all CARE scheme members.

One further point to note is that the sector wide schemes on offer to both academic and support staff at HEIs have already either changed to a career average benefit structure or will so do in the near future. This includes both SAUL and LGPS (the latter is usually available to support staff in post-92 institutions but also some pre-92s that have chosen to become admitted bodies), as well as the USS and TPS which are offered to academic staff. It is thought that the move to CARE by the sector wide schemes has, at least in part, driven the move to CARE in the SATs as it allows employers to manage the costs and risks associated with their scheme while maintaining parity of benefits between academic and support staff.

A case study in Appendix 1b details the benefit changes implemented by one HEI in relation to the pension provided to their support staff.

7.5 Moving to a DC scheme

There are currently 10 HEIs that have opened a DC scheme to new support staff. In a DC scheme the longevity and investment risks are shifted away from the employer and onto the individual member. As there is no pre-defined benefit in a DC scheme, an HEI is only required to pay a set level of contribution on behalf of each member. The member uses their individual fund, comprising the employer and employee contributions and any investment returns over the course of their membership in the scheme, to secure a pension at retirement. This is usually by purchasing an annuity.

DC schemes do not provide members with the guarantees offered by a DB scheme but can have a number of possible advantages over DB schemes for certain members:

- They provide more choice to members and members are responsible for their own decisions;
- They provide more flexibility for members in terms of the level of contributions they wish to make, how they should be invested and the level and structure of benefits that are purchased at retirement;
- They can potentially be financially advantageous for young members with short periods of service;
- There is more transparency and it is easier for high earners to monitor themselves against the Annual Allowance in a given year.

However there are also some disadvantages for members compared to DB schemes:

- It is difficult for members to determine accurately in advance what their retirement pension will be. The value of their individual savings pot will fluctuate depending on the assets in which the funds are invested and the pension that is put into payment will depend on the annuity rates at the chosen date of retirement.
- Lack of member understanding of the investment risks associated with a DC scheme can mean that members have unrealistic expectations about their retirement income. This in turn can lead to members making inappropriate contribution, investment and benefit choices which can result in their receiving a much lower pension than expected.
- Members may not understand the annuity market and may not get the best value out of their fund at retirement. There are potential implications for HEIs if they are deemed not to have provided the appropriate guidance or the required standard of communication to members.
7.5.1 Employer considerations

A key choice that HEIs will have to make if they are considering offering a DC scheme is whether the scheme should be contract based or trust based. There are some significant differences in the way that the schemes are established, managed and regulated and each HEI would need to assess which type of scheme meets their requirements, as well as those of their employees.

7.5.1.1 Trust-based schemes

These can be either self-administered (either in-house or by a third party administrator) or insured (where an insurance company provides some or all services within the terms of a group policy). They will have to be set up under a trust deed and have a trustee board which operates in a similar way to a DB scheme. Some providers have established Master Trusts, which companies can join to benefit from economies of scale as the provider covers all the administration and compliance issues.

7.5.1.2 Contract-based schemes

There are a number of varieties of contract-based pension arrangements although all are established by a contract between the individual and the provider. Even where there is a group arrangement sponsored by an employer, the scheme exists as a series of individual contracts. This category of scheme includes personal pensions, group pension plans, self-invested personal pensions and stakeholder pensions. The administration is usually outsourced by the employer to a third party provider, who will manage all aspects of the scheme.

Where a contract based DC scheme is set up consideration would need to be given to whether a governance body or group should be established by the employer to exercise oversight of the scheme as well as to review the operation of the scheme with the chosen provider. By setting up a governance body, a formal structure can be put in place to manage the contract, ensuring that the scheme’s investment options and administration are performing to standard. Member communications can also be reviewed to ensure that they are clear and helpful as possible.

7.5.2 Contribution rates

One of the most important design aspects of a DC scheme is the level of employer and employee contributions required. Employers need to consider not only what is affordable, but also the level of retirement income that they feel is appropriate. The auto enrolment minimum is widely believed to be inadequate for many employees when considering what a reasonable income in retirement might be. This is even more of an issue if contributions are phased in. Many employers are therefore considering an employer contribution rate which is higher that the statutory minimum, often between 5 to 10 per cent of salary. There is no requirement for employees to contribute at all but employers generally set a minimum contribution requirement. The employee contribution rates need to be affordable and many schemes set a minimum rate but allow the employee to make higher contributions should they wish to. Some employers are using matching contributions as a way to encourage membership, for example, if the employee pays 2% then the employer pays 4%.

7.5.3 Investment choices

Alongside the contribution rates, scheme investment strategy is the other most important scheme design feature. Together these two decisions will have the greatest influence on the size of the member’s pot and therefore their income in retirement.
It is generally believed to be good practice that a DC scheme should offer a range of investment funds that meets the needs of the memberships’ differing circumstances and attitudes to risk. In order to minimise the risk of poor investment decisions being made DC schemes should offer an appropriate default fund. The Mercer DC Pension and Workplace Saving Survey 2012 found that 79 per cent of DC funds had over 75 per cent of their membership in the default fund. The Pensions Regulators draft DC code of practice, discussed in more detail below, recommends that investment choices offered to DC scheme members should be reviewed on a regular basis to ensure that they continue to be appropriate in terms of their investment performance and risk profile. Default investment options should be reviewed annually as part of the governance arrangements of the scheme. There are a number of sophisticated DC investment strategies on the market including lifestyling and target date funds. Employers should ensure that they have considered which default investment strategy is the one that will most suit their employees.

7.5.4 Communications

An effective communications strategy is a crucial part of running a DC scheme. HEIs who are considering offering a DC scheme may wish to supplement regular mailings to members with web based communications, road shows and the use of financial modellers to get members to engage in the important decisions they need to make. It may also be beneficial to obtain feedback from employees to ensure the most appropriate communication strategy is in place. This includes all communications to members during their time with the scheme - from joining through to making decisions about converting their pension pot into a retirement income, including promotion of the Open Market Option. There may also be issues in terms of lack of parity of benefits between academic and support staff and perceived inequalities between different staff groups based on the view that DC benefits are automatically worse than DB. In reality much depends on the design of the scheme. It is just as easy to set up a very poor DB scheme as it is to set up a very good DC scheme. How will communications be managed - in house by the employer or through the provider? Will the target employees be able to access online information or will you need paper/telephone based options? Will you require in house presentations to staff?

7.5.5 Other employer considerations

- The provision of ancillary benefits, in particular death benefits, ill health pensions and redundancy/severance benefits. These are often linked to the provision of a pension but they are not automatically provided through a DC scheme and will usually come at an additional employer cost.
- Whether access to an independent financial adviser will be offered at employer cost
- Whether an independent open market option annuity provider will be included
- How will the scheme be branded – will it be the provider, the HEI or jointly?
- If engagement with the relevant employees and trade unions on the issue of pensions and auto enrolment has not already started, how can you best include them in the setting up of the new DC scheme?

7.5.6 DC governance

With the introduction of auto enrolment from October 2012 it is estimated that between five and eight million people will enter pension saving for the first time, with the vast majority joining a workplace DC pension scheme. With this in mind, earlier in 2013 the Pensions Regulator published a consultation paper on the approach to regulating occupational DC pension schemes. The paper sets
out new standards for DC pension schemes with the aim of increasing the chances that DC scheme-members receive healthy returns from their pension savings.

The Regulator’s view is that to achieve this they must ensure that “schemes are governed in members’ best interest; that capable and not conflicted to oversee the key decisions and functions that determine outcomes for members. It means that we have had to reassess the way in which we regulate DC provision.” One of the Regulator’s key objectives in the coming three years is to ensure that employers are selecting high quality DC schemes that are compliant with the six principles and quality features detailed above.

The Regulator is also placing a greater emphasis on the governance arrangements of DC schemes and so any HEI considering offering a DC scheme to support staff will be required to adhere to the Regulator’s requirements. Therefore employers should not assume that by moving to DC that they will automatically reduce the management oversight and governance responsibilities that they were required to comply with in relation to their DB scheme.

The Pensions Regulator has started by outlining their six fundamental principles of good DC scheme governance:

1. **Schemes are designed to be durable, fair and deliver good outcomes for members.**
   This principle will cover the features necessary in a scheme to deliver good outcomes for members, including the provision of a suitable default fund, transparent costs and charges, protected assets and sufficient protection for members against loss of their savings.

2. **A comprehensive scheme governance framework is established at set-up, with clear accountabilities and responsibilities agreed and made transparent.**
   This includes identifying key activities which need to be carried out, and ensuring each of the activities has an ‘owner’ who has the necessary resources to carry out the activity.

3. **Those who are accountable for scheme decisions and activity understand their duties and are fit and proper to carry them out.**
   This principle will ensure that those who are given accountability or responsibility for a key governance task are able to carry this out. The principle will cover definitions of fitness and propriety for accountable parties and also conflicts of interest that may arise.

4. **Schemes benefit from effective governance and monitoring through their full lifecycle.**
   This principle looks at the on-going governance and running of the scheme, including the internal controls and monitoring needed to ensure that the scheme continues to meet its objectives, and continues to be run with the best interests of its membership in mind.

5. **Schemes are well-administered with timely, accurate and comprehensive processes and records.**
   This principle will be informed by our previous work on record keeping, looking specifically at the administration processes required in a DC scheme.

6. **Communication to members is designed and delivered to ensure members are able to make informed decisions about their retirement savings.**

**7.5.7 The Pensions Quality Mark**

Employers with a DC scheme may wish to consider applying for the Pension Quality Mark (PQM). The PQM is a standard that recognises high quality occupational and private DC pension schemes which meet three basic criteria - contributions, governance and communications. It is designed to
raise confidence in workplace pensions, help employers demonstrate the value of their scheme to current and future employees, and help employees recognise that their scheme is of a good quality. The PQM is available for all types of DC pension schemes, whether occupational, GPP, or stakeholder, which meet the PQM standards. More information can be found here: http://www.pensionqualitymark.org.uk

The PQM has two standards, the PQM and the PQM plus. In order to qualify for the PQM the total scheme contribution rate must be at least 10 per cent with the employer contributing a minimum of 6 per cent. For the PQM Plus the total contribution rate must be 15 per cent with the employer contributing a minimum of 10 per cent. These contribution rates are designed to reflect the variation in the design of DC pension schemes taking into account such factors as fixed or matching contribution structures, job and category related schemes and salary sacrifice.

The contribution rates are also designed to encourage saving at a level above the new minimum set out in the Government’s auto enrolment regulations which stipulate that by 2018 the minimum total contributions rate in an auto entitlement compliant scheme will be 8 per cent. The PQM does not seek to guarantee a given level of pension income an employee will receive at retirement. Rather, it seeks to identify reasonable and good base pension provision.

There are currently approximately 170 defined contribution schemes that have attained either the PQM or PQM plus, none of which come from the HE sector.

7.6 Moving to cash balance or other hybrid scheme

In November 2012 the Government released a paper entitled Reinvigorating Work Based Pensions. The paper covered the concept of “Defined Ambition” (DA) pension schemes. The basic aim of a DA scheme is to create greater certainty for members about the final value of a pension pot than is provided by a pure DC pension and also seek to ensure less cost volatility for employers than pure DB pensions.

In terms of the level of risk being borne by the employer or the employee, a DA scheme would sit somewhere in the middle of a DB scheme and a DC scheme as the employer and employee would share a similar amount of pension risk. There are three possible DA scheme models:

- A cash balance scheme (see appendix 1).
- An employer pays a guaranteed pension income but the date on which it is paid can change if life expectancy rises again. This means that staff could end up working longer than they anticipated.
- An employer gives younger workers an estimate of what their pension will be, based on a wide range, but that range is narrowed down as they approach retirement to give more certainty about the income they will receive.

The Government has come under increasing pressure from the pensions industry to publish further guidance on its plans for DA schemes in advance of 2016 when DB contracting-out will be abolished.

Appendix 1 provides a case study relating to one HEI that has opened a cash balance scheme for new support staff. A cash balance scheme is a form of DB pension arrangement under which the benefit that is promised to the member is not a defined amount of pension at retirement but a defined lump sum which is used to purchase an income in retirement. The lump sum target is usually expressed as a percentage of final (or average) salary and depends on service.

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For example, the benefit promise might be 20 per cent of final salary for each year of service. Like traditional final salary schemes the employee will pay a fixed contribution, however the HEI will pay the balance of cost which means that the employer bears the investment risks (and perhaps the salary growth risk) in the period up until retirement.

The HEI’s obligation is limited to providing the promised pot of money at retirement. At this point the interest rate and mortality risks pass onto the individual member who will need to purchase a pension with at least part of that pot. Members are entitled to take 25 per cent of their pension pot as tax-free cash lump sum and are then required to purchase an annuity with the balance. Therefore the member bears the annuity rate risk and the related longevity risk and inflation risk of the pension payable in retirement.

Other ways for employers to share the risk between themselves and the employees are by creating a hybrid scheme. This type of scheme has part of the benefit payable through DB and part through a DC scheme. Often by providing a core DB pension on a capped pensionable salary and then providing in addition a DC element on pensionable salary above the cap. Therefore the employer bears the investment risk on the DB section and the employee on the DC section.
8 Further options to consider

In addition to changes in the benefit structure of their institutions’ SAT, HEIs may also wish to consider a range of options to try to reduce the cost of funding past and future service liabilities, as well as reducing the on-going costs of running their SAT and its associated risks.

8.1 De-risking liabilities

A number of HE employers are currently considering de-risking options for their scheme liabilities. This generally involves working with the trustees to put in place investment strategies that are properly aligned to the level of risk faced.

Before considering securing liabilities externally with, for example, an insurer, there are a number of administrative considerations which if dealt with in advance can ensure that when the decision is to be implemented it can be done so swiftly and at the anticipated cost:

- Benefit specification – a benefit audit should be undertaken to ensure that legacy benefits are specified correctly and fully understood and to ensure the benefits that have been paid out are consistent with scheme documentation.
- Accurate pension history recorded – there have been many legislative changes which have led to pension record keeping getting increasingly complicated. The splits between different pension elements should be checked to ensure that they are correct and therefore increases are being applied correctly.
- Member and dependent information – trustees may wish members to confirm all the personal data held on them including marriage certificates, spouse dates of birth, child dates of birth etc to ensure correct valuation of dependents benefits. Otherwise insurers have to make assumptions and will add a premium to account for the level of uncertainty around member data.
- Addresses and postcodes – to assist with accurate longevity analysis and ensure members get all the relevant scheme communications.
- Member tracing and mortality checks – tracing deferred members can be particularly difficult but there are a number of tracing services available and checking member mortality to ensure no pensions are being overpaid is also good practice.
- Contracted out records – reconciling records with HMRC is essential if a scheme is closed and can take a long time. A level of tolerance should also be agreed to avoid spending time trying to reconcile figures to the penny.
- Benefit reconciliation – member files should be reconciled with the pension administration database to ensure that no pension entitlements are retained for members who received a refund of contributions or a transfer out. Also checks need to be undertaken to ensure that any existing AVCs are fully accounted for and have been allocated to individual members.
- Communications – a plan should be prepared to manage member needs throughout the process to prevent queries and complaints later on in the process. A helpline or FAQs can also be useful to members.
- Project management – a project manager should be appointed to manage the whole process to ensure that the process moves as quickly as possible.
- Fees – should be transparent and fixed if possible. Certainty of fees is important as the aim is to maximise the benefits payable to members while managing additional contributions required from the employer.

There are a number of options that an HEI might consider if it has a very large past service deficit and wished to reduce past service liabilities and the associated risks in order to maintain financial viability. Liability de-risking options include:
Enhanced Transfer Values (ETV).
- Pension increase exchanges (PIE).
- Pensioner buy-in or full buy-out of past service liabilities.

8.1.1 Enhanced Transfer Values

A deferred member of a pension scheme has a statutory right to request a Cash Equivalent Transfer Value (CETV) at any time (up to 12 months before Normal Retirement Age). An ETV is a CETV that has been uplifted or enhanced. Employers can offer ETVs but cannot impose these on members. Offering an ETV may be beneficial to deferred members in periods of high inflation whereby there is a cap on the rate at which their preserved pension is revalued so that their benefit is reducing over time in real terms. The benefit for the employer in offering a member an ETV is that although the payment to the member will be higher than the CETV would have been it is likely to be less than the cost of providing the pension at retirement. If ETVs are offered on a bulk basis the employer may be able to reduce its pension liabilities. However, offering ETVs can come at a substantial cost to the employer. If HEIs are considering undertaking an ETV exercise there are a set of questions that they should consider in advance:

- What is the likely cost going to be?
- What is the estimated benefit to the scheme from this expenditure?
- How do we maximise take up?
- What are the risks associated with the ETV exercise?
- What are the tax implications?
- What level of third party advice will the employer require and be required to facilitate?
- What are the communication requirements?

8.1.2 Pension Increase Exchange exercises

A Pension Increase Exchange (PIE) involves current and/or future scheme pensioners giving up their rights to non-statutory increases (see “capping inflation uplifts” on page 29) to their pension in return for a higher initial pension or pension and tax free cash. PIE exercises may help to reduce the inflation risk for an HEI.

We are aware of at least one HEI that has implemented a PIE exercise where 300 pensioners were offered the opportunity to exchange their pre-1997 pension increases for a higher pension. 97 pensioners took up the offer.

Another example is the British Telecom (BT) Pension Scheme. As part of the agreement reached between BT and the unions in relation to the future of the BT Pension Scheme it was agreed that from 1 April 2009 pensioners reaching their normal retirement date would be provide with a PIE option. BT has recently announced that it will now extend this to 120,000 pensioners who retired before April 2009 to allow them the same flexibility. The benefit for the trustees is that by reducing the need to value all pensions based on potential future inflation they have a better estimate of how much money they will need to meet the scheme’s liabilities. This helps to provide greater certainty in relation to the funding of the scheme and reduced some of the longevity risk relating to pensioners living longer.

HEIs considering a PIE exercise might wish to consider similar questions as set out above in relation to offering ETVs. One further consideration is that PIE exercises involve correspondence with older scheme members who may not have the ability to fully understand the offer and the implications of
exchanging pension increases[10]. HEIs may wish to limit such exercises to younger pensioners or set a minimum pension amount that must be in payment before the option can be offered. Members should be advised to take independent financial advice and the employer may wish to assist this process by setting up a helpline or funding IFA visits.

8.1.3 Employer considerations with ETVs and PIEs

The Government has expressed concerns on the use of incentive exercises such as ETVs and PIEs as these were seen as not providing value for money to DB scheme members. A code of conduct on incentive exercises was published by an industry working group, set up by the Government, setting out seven principles to be followed in such incentive exercises:

- Not providing cash conditional on the acceptance of the offer.
- Providing advice to members who are offered such exercises.
- Maintaining clear communications with members.
- Keeping good records.
- Allowing enough time for members to make their decisions.
- Observing a vulnerable client policy.
- Ensuring all parties involved act in good faith.

While this is not a statutory code, the Pensions Ombudsman and the Financial Ombudsman Service will have regard to the Code, where appropriate, when dealing with any complaint involving an incentive exercise. In addition, the Pensions Regulator has updated its guidance relating to incentive exercises and set out a list of five principles that any ETV exercise should follow:

- Be clear, fair and not misleading.
- Be open and transparent.
- Manage conflicts of interest.
- Involve consultation with trustees.
- Provide independent financial advice to members.

The draft Pensions Bill 2013 contains regulations which would prohibit the offering of a financial/similar incentive to an individual to induce them to transfer their benefits out of a salary-related occupational pension scheme. This power will be repealed seven years after it comes into force if it has not been exercised.

There are other options in addition to exchanging pension increases, for example, in some private sector schemes the option is available for a member to accept a lower pension at retirement in exchange for a higher spouse pension to be payable on the member’s death.

ETV and PIE exercises may be beneficial for members of DB schemes who have an impaired life expectancy or have alternative pension savings which will provide an income in retirement but, in general, these exercises are unlikely to be favourable options for a significant proportion of the members of SAT pension schemes.

8.1.4 Pensioner buy-in or full buy-out

In a pensioner buy-in exercise an insurance policy is purchased which covers the payment of benefits for a subset of scheme members. The policy remains as an asset of the scheme and perfectly

matches the liabilities for that particular subset of members. The insurer makes a monthly payment to the scheme to cover the benefit payments of the members covered by the policy. At a later stage benefits for further tranches of pensioners and the deferred members can be secured, often with the same insurance company.

In a full buy-out scenario the scheme’s assets and liabilities are transferred in their entirety to the chosen insurance company and the employer and trustee obligations to the scheme are discharged. Individual policies are written in members’ own names, and the insurance company pay benefits to the pensioners and deferred members when they reach their retirement age.

Our survey of SATs found that HEIs had little appetite for considering either a pensioner buy-in or full scheme buy-out. While 76 per cent of HEIs surveyed said that they understood the positives and negatives, including the financial implications of purchasing annuities either through a pensioner buy-in or full buy-out, only 12 per cent of HEIs agreed that they were interested in undertaking such an exercise.

8.1.4.1 Employer considerations

There are likely to be a number of reasons why HEIs are not currently exploring either of these options, mainly around the affordability of achieving such a transaction coupled with the significant amount of planning and work that need to be undertaken to achieve such a goal. In order to be able to secure benefits with an insurance provider scheme data needs to be cleansed and the benefits payable to members agreed. In addition a suitable asset allocation needs to be put in place.

Once these steps have been completed the prevailing economic conditions need to be favourable in order for the scheme to be able to afford to transact. This whole process can often take months or even years without a scheme ever being in a position to secure member benefits with an insurance company.

A recent survey of trustees of private sector DB schemes conducted by Pensions Age magazine indicated that the top three obstacles preventing sponsors and trustees from de-risking their scheme were: the overall funding position of the scheme; insufficient sponsoring employer resource to assist with a de-risking exercise; and, depending on the size of the scheme, a lack of available de-risking options. Other reasons to barriers for de-risking included a lack of knowledge of the available options and current investment conditions being unsuitable.

The survey also suggested larger numbers of schemes were considering a return to riskier investment assets and strategies rather than de-risking exercises, in particular during the current period of strengthening performance in the equity markets which have had a positive impact on pension fund deficits.

One reason HEIs might be unwilling to action a pensioner buy-in or full buy-out now will be a reluctance to de-risk while their SAT is still in deficit thereby locking into a poor funding position. SATs may wish to maintain or increase their allocations in higher return-seeking assets in order to try to achieve greater investment growth thereby addressing their schemes deficit, rather than transact with an insurer so limiting their scope for manoeuvre. Where an HEI is looking to de-risk, investing in returning-seeking assets can offer the opportunity to create a de-risking budget whereby significant equity gains over and above those assumed in the schemes funding valuation can be consolidated and used to transact with an insurance company.

Since 2011, favourable market conditions have existed for schemes wishing to action a pensioner buy-in as the record value of gilts has often exceeded the buy-in price meaning that pension schemes with a significant proportion of their assets held in gilts have been able to use their gilt
holding to fund the buy-in policy with their chosen insurer. In addition, a full buy-out could be more suitable for a smaller SAT where the HEI is willing and able to pay a premium of between 10 and 30 per cent above the schemes funding target in order to remove the risks and on-going costs the scheme poses. During 2012 65 schemes secured benefits with Legal & General with an average premium of £16m paid to the insurer and a further 20 schemes transacted with Pension Insurance Corporation with the average transaction value being £73m. These transactions are likely to have been made by schemes which are of a similar size to the SATs we have analysed.

While current economic conditions mean that the affordability challenge of a pensioner buy-in still remains for schemes wishing to transact with an insurance company, there is the risk that poor UK growth coupled with further credit downgrades could push gilt yields up meaning that it becomes less affordable for schemes to secure a pensioner buy-in in the future. Furthermore, the Regulator has imposed various requirements on pension schemes to cleanse their data and maintain accurate records. These requirements regarding pension scheme data need to be fulfilled as part of the journey towards securing benefits with an insurance company and are generally included as part of that process.

8.1.4.2 Medically underwritten bulk annuities

The medically underwritten bulk annuity market is continuing to develop and 2013 has seen a growing number of pension schemes start to secure medically underwritten bulk annuities for their pensioner population. A recent report\(^\text{11}\) by the Pensions Institute at Cass Business School has set out the processes involved in a medically underwritten bulk annuity transaction.

The individual enhanced annuity market is well established with individuals who have a poor medical history being able to secure a higher annuity compared with standard terms, due to their expected shorter life expectancy.

Recently two of the established insurers within the individual enhanced annuity market have become the first to offer medically underwritten bulk annuities to defined benefit pension schemes. Two of the UK’s largest insurers Legal & General and Aviva have also entered the medically underwritten bulk annuity market.

It is suggested by the Pensions Institute that medical underwriting could significantly alter the way in which bulk annuity deals are carried out in the future. While the market is solely focussed on smaller schemes there is the potential that as the market develops larger schemes with a cohort of members that account for a disproportionate level of liabilities will in the future be able to secure medically underwritten bulk annuities. This therefore represents an opportunity for HEIs and trustees of SATs to secure annuities for members that would otherwise be unaffordable under normal circumstances.

When considering medically underwritten annuities there are a number of key issues to consider. These include:

- Put in place procedures for requesting and managing members medical records.
- Undertake modelling and obtain preliminary quotes as once a scheme has entered into purchasing medically underwritten annuities it is not possible to secure conventional annuities because trustees are required to declare when they have data on their membership.
- It can take longer to secure medically underwritten annuities compared to conventional annuities due to the data requirements of such an exercise.

\(^\text{11}\) http://www.pensions-institute.org/reports/HealthierWayToDeRisk.pdf
• Increase potential risk of missing investment opportunities in volatile markets due to length of overall process.
• Medically underwritten annuities only cover pensioner members.
• Medically underwritten buy-out exercises are currently only suitable for smaller schemes with 250-300 pensioners.
9 Moving to a new pension administration provider

HE employers realise that offering a workplace pension scheme is important for the recruitment and retention of staff. Equally employees are increasingly recognising that membership of a good quality occupational pension scheme is a vital element of their overall remuneration package.

A pension scheme’s trustees are in law primarily responsible to beneficiaries for keeping proper records, providing information and paying benefits. However, the great majority of trustees will use someone else to provide some or all of those services. Administering occupational pension schemes has become increasingly complex and costly to employers as a result of the pension regulatory regime in the UK. Recent new regulations include the requirement to auto enrol staff into a work-based pension scheme, as well as amendments to tax law and reductions in the lifetime and annual allowances.

The added complexity of administering a pension scheme can increase costs and place even greater financial pressures on HEIs. With increased complexity come the added risks that: benefits are calculated incorrectly, which may lead to member complaints; increased work to rectify errors, and possible effects on actuarial valuations by under or overstating funding levels and contributions. While it is good practice for pension scheme trustees to review the administration of their pension scheme a number of employers including HEIs, have decided to move the administration of a workplace pension scheme from an in-house administration team to a Third Party Administrator (TPA) to try to address some of these problems.

The pension outsourcing market has grown considerably during the past 10 years. This is partly as a result of sponsoring employers looking for ways to reduce exposure to their company pension scheme. This has been coupled with many TPAs investing large sums of money on new software and technology which has led to improvements in overall service delivery standards with greater cost efficiencies being achieved. The choice of TPA is wide and varied with groups of TPAs targeting different types of scheme mainly based on the size of membership and scheme assets.

9.1 Types of service outsourced to a TPA

Below are examples of the administrative functions that would typically be outsourced to a TPA:

- Managing member records and data input.
- Production and distribution of annual benefit statements.
- Production of standard reports, standard letters and forms.
- Undertaking the annual renewal.
- Transfer in and out calculations and quotations.
- Retirement, early retirement and leaver calculations.
- Maintaining the pension fund bank account.
- Monitoring cash flows and undertaking disinvestments.
- Providing the pension scheme annual report and accounts.
- Attending trustee meetings.
- Providing and maintaining Pensions payroll.
- Producing the members' handbook.
- Dealing with communications to members plus on-site presentations.

9.2 Advantages of outsourcing pensions administration

There are a number of advantages to be gained by HEIs working with their SAT’s trustee board to outsource the administration of their SAT. These include the transfer of risk away from the HEI,
access to best practice, the ability to handle business or pension changes, removal of the need to reinvest in enhancements to systems and processes plus reduced internal overheads.

The additional benefits to HEIs and trustee boards who are considering outsourcing the administration of their SAT may include:

- Access to state of the art technology without capital investment.
- Experienced qualified staff and on-going commitments to training.
- Data cleansing to ensure that errors are identified and rectification work is undertaken.
- Document audit and process mapping to ensure benefits are calculated in line with the scheme rules and relevant pensions legislation.
- Personal bespoke service.
- Standards and information flow can be required as part of the tender process with penalties for below par performance.
- Robust internal controls.
- Workflow controls and reporting.
- Automated calculation processes.
- Electronic document handling and storage.
- Record keeping and document archiving.
- Straight through processing.
- Business continuity and disaster recovery plans in place.

One of the most important advantages in outsourcing the administration of a pension scheme to a TPA is that it allows the scheme access to state of art technology without capital investment. As members are increasingly required to make choices about their benefits, it is essential to ensure that accurate information is available in multiple forms. Web technology and electronic communication has now become standard in the delivery of pension administration. The introduction of web technology allows individuals to manage their scheme membership online. This can provide them with immediate access to their pension records, scheme documentation such as annual report and accounts, funding statements and benefit illustrations. However written communications are still important, in particular where groups of members do not have access to computers or the internet.

The use of web technology can also provide members with the ability to model benefits themselves, increasing their knowledge and choice. The ability for an employer to communicate electronically with its membership provides scope for increasing efficiency, improving the quality of service and reducing costs when disseminating and receiving information.

9.3 Disadvantages of outsourcing pensions administration

There are a number of perceived disadvantages that HEIs working alongside their SATs trustee board will need to consider when looking to outsource their pensions administration. These include:

- Selecting the right provider for your scheme via a rigorous tender process which may need specialist procurement support
- Perceived loss of control.
- Opportunity for conflict of interest.
- Possible loss of the personal touch.
- Potential unforeseen expenditure.
- Reduced integration of pension scheme administration with other parts of HR and/or Finance.
- Potential for poor knowledge transfer and loss of “corporate memory”.
- Employer confidentiality may be weakened.
• Difficulty in managing service quality and member experience
• Need to obtain additional support to the trustee board in relation to contract management.

These perceived issues should be assessed by the HEI and the trustee board before considering outsourcing. Often the issues relating to such a change can be successfully managed through discussions with the proposed new TPA on the services and performance standards to be provided to the scheme.

9.4 Managing the outsourcing process

The quality and accuracy of scheme data is an important factor for any HEI and trustee board to consider as part of the outsourcing the pensions administration of their SAT to a TPA. The quality of the on-going administration of the scheme is heavily dependent on the quality of the data conversion, audit and cleansing work identified at the start of the implementation process. Scheme data that is incomplete or inconsistent is not easy to reconcile and could lead to additional transition costs. It may therefore be appropriate to put in place an action plan to identify gaps in data and to undertake a data cleansing exercise either before approaching a TPA or include the data cleansing work as part of the transition of the administration to the new TPA. The Trustees may also wish to undertake work to map out processes and procedures and ensure all the scheme documentation is present and correct, for example, ensuring that the terms for applying any employer discretions are fully documented.

Where a decision has been made by an HEI and trustee board in relation to outsourcing, a tender and selection process will need to be undertaken to select a new TPA. These exercises tend to be time consuming and can tie up significant amounts of resources for all parties. As a result the project is often delegated to a sub-committee of the board. However, as these exercises are unlikely to be required on a frequent basis, the time and costs involved should not be material and committing resource up front to enable a robust due diligence process to be undertaken, for example, through making site visits to TPA offices and following up client references, will hopefully ensure that the right provider is appointed.

There are a number of issues that HEIs should consider when planning to tender for a new TPA or any other third party service provider to the SAT:

• Set a realistic timetable for the tendering process.
• Agree how the tenders will be assessed and who will undertake the assessment.
• Agree what is to be achieved in terms of both quality of service and costs.
• Prepare a tender document which specifies the desired content of the proposals including performance standards and information flow to monitor these.
• Select a list of candidates to tender based on key criteria, for example, reputation, knowledge of the HE sector, ability to provide a high quality service.
• Decide whether the EU procurement process applies and how this will be followed.

Once the tender documentation has been assessed candidates should be selected to attend a presentation. Issues to consider in the selection process for the new TPA include:

• Compiling a list of questions which should be addressed in the presentation.
• Designing a methodology for scoring and assessing each presentation.
• Seeking references, preferably from schemes of a similar size and membership profile.
• A site visit of the proposed administration office should be undertaken by the trustees and/or employer.
The following factors should be considered in making the final decision on which TPA to appoint:

- Reputation and proven track record in providing a first class administration service to scheme of a similar size and nature.
- Feedback from references and site visit.
- Experience and knowledge of key staff.
- Depth of administration teams expertise.
- Evidence of robust internal controls and procedures.
- Value for money.
- Number of clients taken on recently and ability of the TPA to cope with the additional work.

9.5 Transferring from one TPA to another

Where HEIs and trustee boards are switching the administration of their SAT from one TPA to another they will need to refer to their SATs administration contract to find out the notice period that is required for any change of administrator and they will also need to understand whether it is the administrator or the trustee that owns the SAT’s documentation. Other issues to consider include whether there are any fees due for ending an administration contract before an agreed term and ensuring that paper and electronic records are backed up. Common problems associated with switching TPA can include delays in the provision of scheme data and information, disputes around the ownership of scheme data and the withholding of data.

9.6 Useful documents

- The University of Sussex Case Study (Appendix 1a) provides an example of such an exercise to switch from one external provider to another, including tender documentation.

- The Pensions Management Institute has also prepared example administration agreements which can be found here:


These documents were last updated in 2007 and so will not have taken into account any legislative changes since then but provide a reasonable starting point for discussion in terms of the services required. The Model Administration Agreement is designed to give trustees and their administrators (third party or in-house) the basis on which to establish the service standards required and the role and responsibilities of both parties.

**Please note:** The standard terms and conditions have been drafted by the Pensions Management Institute to be used as an example core administration agreement, with all details (parties, services, fees etc.) and all agreed modifications to the clauses being set out in schedules to the administration agreement. This has the advantage for trustees of highlighting for particular review any variations to the standard terms and conditions. Trustees and administrators should rely on advice from their own lawyers when formulating an agreement based on the standard terms and conditions and on their rights and duties from time to time under such an agreement. This applies particularly where the agreement is to be governed by the law of Scotland or Northern Ireland as the standard terms and conditions have not yet been conformed for Scottish or Northern Irish legal requirements.
10. Shared procurement

There are a number of common services that are required by pension schemes across the HE sector. This offers the opportunity to consider whether savings could be made through utilising the buying power of the SATs through the existing HE sector procurement frameworks. This could include scheme advisers, administration, communications, printing, trustee services, investments, medical advice and any number of other pensions related function.

There are a number of HE procurement bodies who may be able to take on the procurement of pension scheme related services. These include the Advanced Procurement for Universities and Colleges (APUC) in Scotland, the Higher Education Purchasing Consortium Wales (HEPCW) and in England the four regional purchasing consortia, in London, the North East, the North West and the South. Together they represent the majority of UK universities plus associated FE colleges and affiliated public organisations.

In addition, chairs and heads of the four English procurement groups, along with other specialist purchasing bodies, make up English National Procurement (ENP), the sector representative for collaborative procurement. Universities UK has established the Efficiency and Modernisation Task Group, which was chaired by Professor Sir Ian Diamond, Principal and Vice-Chancellor of the University of Aberdeen.

The groups work led to the publication of the 2011 Universities UK report, Efficiency and Effectiveness in Higher Education, which made several key recommendations, among them the need for the sector to think and act more strategically on procurement. Universities UK also put together Procurement UK to provide strategic leadership on the development of collaborative and more effective procurement to meet the objectives set out in the Diamond report. As HEIs have a target of using collaborative procurement for 30 per cent of non-pay spends we believe that SAT functions could play a role in HEIs achieving this target.

An example of this in practice is the way in which the LGPS funds have been working together to deliver efficiencies is through the National Procurement Framework, part of an HM Treasury and Cabinet Office efficiency programme. These frameworks provide pre-approved panels of service providers for specific fund services such as administration, actuarial advice and investment consultancy. The aim is to enable individual funds to replace service providers without the time, energy and cost involved in running an individual procurement exercise. The first framework, for actuarial and benefit consultancy services, was launched in July 2012 and the latest, on investment consultancy, in May 2013. Other areas which HEIs may consider for joint procurement could include services such as trustee liability insurance.

15.1 Shared services

In addition to shared procurement, it is also possible to go a step further and opt for shared services. SAUL and USS are good examples of this, where multiple employers come together to obtain benefits both in terms of cost and risk reduction from sharing access to pensions functions. This has also taken place in the LGPS, for example the LGSS set up by Cambridgeshire and Northamptonshire Pension Funds (http://pensions.northamptonshire.gov.uk/index.php/about-lgss-pensions/). This is not a merger of two LGPS funds simply a combined pensions administration service across both local councils.

The implementation of shared services has been made easier recently. HEFCE has published guidance on the benefits of shared services to universities and colleges following the introduction of the cost sharing groups (CSG) exemption from VAT. Found here: http://www.hefce.ac.uk/pubs/rerereports/year/2013/csgexemption/#d_en_83022. In July 2012, legislation was passed which allows HEIs to form CSGs that can provide services to members of the
group free of VAT. CSGs may be able to provide services more cost-effectively than individual HE institutions, and the exemption from VAT now means that substantial savings can be made. BUFDG has been working with HEFCE and others to make sure that the exemption is explained clearly and we are pleased that HEFCE has published this on-line guidance. The publication is hyperlinked so that the reader can find the areas which are of interest in their specific circumstances, and tailor their reading of the guidance for their own purposes.
11. Potential for collective benchmarking

The collective benchmarking of SATs data could provide HEIs with valuable sector wide information on pension provision for support staff. There is a wide range of SATs data that could be benchmarked including:

- SAT benefit structures.
- Employee contribution rates.
- Employer contribution rates.
- FRS17 solvency valuations and actuarial valuations.
- Mortality assumptions.
- Interest and inflation rate assumptions.
- Investment return assumptions
- Liability discount rates.
- Normal retirement ages.
- Length of recovery plans.

Benchmarking of SATs data could help HEIs plan modifications to the structure of their pension scheme in order more closely to match the changes that have already been implemented within the sector. This could also assist institutions achieve cost savings or a reduction in their exposure to risk. Conversely HEIs who have made the decision to commit to offering final salary benefits to new support staff in the future could use this as a recruitment tool when advertising support staff roles.

The benchmarking of data relating to funding valuations including salary increases, life expectancy, interest and inflation rates, discount rates and expected investment returns would enable HEIs to match their fund parameters to an agreed risk profile.

The benchmarking of SAT service providers could also provide HEIs with information relating to the fees charged by service providers, overall service delivery based on key performance indicators, and the perceived value for money of the service provided. This could enable HEIs to assess and monitor their service providers and renegotiate contracts with a more competitive fee structure. Our survey indicates that 68 per cent of HEIs surveyed would welcome the benchmarking of scheme advisor costs.

For HEIs offering a DC scheme, the benchmarking of employer contribution rates, investment manager fees, default funds and fund performance would be a valuable exercise.
12. Governance

Occupational pension schemes are subject to a significant amount of frequently changing regulation and statutory legislation. In many cases employers and trustees have cited the increasing burden of pension regulations as one of the drivers of the increase in scheme costs. The management of these schemes and the associated risks can have a fundamental effect on the HEI’s financial results, workforce productivity, reputation and industrial relations. These issues apply to the HE sector just as they do in any other sector in the UK. It is therefore necessary that HEIs and pension trustee boards work together to put in place a robust governance framework to manage the risks associated with running their pension scheme.

The decisions made by HEIs about their SAT can have a significant financial impact on other areas of their institution. HEIs need to determine their pension objectives and implement processes to achieve those objectives. Identifying risks at an early stage can avoid major problems later on. Understanding pension liabilities and their effect on an HEI’s overall finances can enable institutions to develop strategies to manage pension scheme shortfalls.

12.1 Assessing advisors and advisor costs

An important aspect of pension scheme governance is the on-going assessment of advisors. By assessing the advisors, considering issues around service delivery, reviewing quality of service and how the relationship is managed, the trustees will help determine if value for money is being achieved. This also allows HEIs and SAT trustees to identify issues in a timely manner in order to both improve the overall service as well as managing risks. A key part of this process is managing advisor costs.

A simple way of assessing an advisor is by using an annual questionnaire completed usually by the trustee board, the pension’s manager and the secretary to the trustee. Once the questionnaires have been completed a discussion can then take place to consider any significant issues that have been raised. As there is often room for improvement it may be helpful to focus on any areas of weakness or concern. The results of the assessment should then be played back to the advisor and their views should be sought on how improvements could be made. Discussions should then take place so that a plan for resolving the issues can be put in place. The tender process for advisor appointment should include a section on advisor performance and how it is intended to measure this. The advisor should also be tasked with providing regular reports including supporting data to enable performance to be measured and monitored over time.

12.2 Establishing a Corporate Trustee

If they have not done so already, HEIs could consider managing the SAT by a Corporate Trustee. A Corporate Trustee would be an independent company limited by guarantee. It would be the sole trustee of the scheme. The present individual Trustees would become Directors of the Corporate Trustee. The Directors’ terms of office and methods of appointment would be exactly the same as for the current Trustees.

The key advantage of a Corporate Trustee arrangement is that it provides greater protection to its Directors than individual Trustees are afforded. This makes it easier for individual members to stand for Director posts, knowing that their personal liability is limited by the Corporate Trustee’s articles of association. Both the USS and SAUL are managed by a trustee company.
13. Conclusions and recommendations

The on-line survey and financial analysis have provided valuable data on the current status of SATs pension provision provided to support staff. Our findings show that the majority of HEIs have taken steps to adjust the benefit structure of their SAT with the aim of reducing future service costs while at the same time paying increased contributions and lump sum payments into the scheme to address past service liabilities. The steps taken by HEIs are not unique to the HE sector but reflect the changes implemented by sponsoring employers in all sectors of industry that still offer defined benefit pension saving. Notwithstanding these changes, 72 per cent of the institutions we surveyed still offer access to a defined benefit pension scheme for either new and existing support staff or just existing support staff, with 69% of HEIs still retaining a final salary link for past service where the final salary section of their SAT has been closed to future accrual or new joiners.

Despite the changes implemented by HEIs to date, FRS17 deficits have continued to increase in recent years mainly as a result of unprecedented and challenging economic conditions coupled with continuing increases in longevity. This means that a growing number of the HEIs that have already made adjustments to the benefit structure of their SATs are either consulting or planning to consult with members in relation to further benefit changes. We are aware that some of the HEIs that still offer final salary pension accrual to new support staff are considering changes to their SAT which may include closure of the remaining final salary SATs to new, as well as existing support staff. Further changes being considered by HEIs also include the removal of existing final salary links to past service, moves from defined benefit to defined contribution pension saving, and pension increase exchange exercises.

This report has set out the range of measures that HEIs have implemented to reduce the costs and volatility relating to their SAT and has also outlined some of the options HEIs might wish to consider to further reduce on-going costs as well as to address past service liabilities. HEIs have indicated that they are willing to explore these options in order to be able to continue to offer support staff a retirement savings vehicle that continues to compare favourably with other local employers, remains a valued element of the benefit package offered to support staff, and is affordable and sustainable for each HEI. While the changes may often be portrayed as negative, there can be positives for the members concerned, in particular where they are offered greater flexibility at retirement or where employee contributions to the SAT become more affordable for lower paid support staff that may have previously opted out. This report also illustrates how the SAT’s operating costs can be managed in ways other than adjusting members’ benefits.

**Recommendation 1 - Benchmarking**

HEIs would find it beneficial to monitor and benchmark a range of SATs related data.

Our survey suggested that HEIs were interested in gaining a better understanding of the pension provision offered to support staff at other institutions. Our analysis indicates that a number of HEIs which have previously implemented changes to the structure of their SAT are now considering further modifications to their scheme. As greater numbers of HEIs are revisiting their SAT with a view to implementing further changes to address deficits and reduce future service costs, it is suggested that information relating to the benefit structure of each SAT, including the type of scheme offered to support staff, employee and employer contribution rates, accrual rates, normal retirement ages and the existence of a final salary link could be gathered. It would be possible to compile this information from each SAT’s annual trustee report and accounts and triennial valuation. This would mean that institutions would need only to supply these documents for analysis. Information such as advisor fees, fee structures and scheme opt out rates could be gathered through a bi-annual survey, the results of which could be assessed by HEIs and used as a basis to negotiate contracts with third party service providers to address issues relating to the reasons staff are opted out of pension saving. HEIs may also find sector-wide data relating to the assumptions agreed in SAT
actuarial valuations useful, for example, longevity assumptions based on the experiences within the HE sector.

It is envisaged that the benchmarking exercise could be undertaken by UUK who have experience on similar benchmarking exercises and also have the resources and experience available to progress this work.

**Recommendation 2 – SATs conference**

HEIs have indicated that they would be willing to work together if there was the potential to reduce running costs and associated risks.

A third of HEIs responding to our survey stated that they would be willing to work together on a potential merger of a group of SATs and there are many other areas where collaborative working could have a positive impact on scheme costs. Based on the responses from HEIs it is suggested that an annual SATs conference would provide a useful forum for employers, trustees and other SATs stakeholders to collaborate on these issues and take forward any further actions. The conference could also incorporate some HE sector specific training aimed at independent trustees who sit on SAT trustee boards but do not have knowledge of the HE sector. Subject to a positive response from institutions an annual SATs conference would be organised by UCEA.

**Recommendation 3 – Case studies**

There is a willingness to share information and case studies, in particular in relation to auto enrolment and scheme change, as well as aspects of the governance of SATs.

There are continuing significant changes being implemented to SATs in light of continuing economic uncertainty and ever evolving pension legislation. The requirement for these changes may arise inter alia, as a result of increasing costs and the need to reduce associated risks. HEIs have indicated that they wish to share information and learn from the experiences of others in the HE sector.

Examples of the areas the case studies might cover include:

- a) Implementing (further) changes to the benefit structure of a SAT.
- b) Undertaking a de-risking exercise, e.g. a pension increase exchange.
- c) Assessing a SATs service provider(s).
- d) A merger with SAUL or USS.
- e) Auto enrolment.

Case studies would draw upon the experiences of HEIs that have undertaken any of the example projects outlined above and could be used as a reference point by institutions wishing to implement similar changes to their SAT. This practical information could assist HEIs and trustee boards of SATs as and when they are considering implementing further changes to their pension scheme for support staff.

*We would welcome feedback on the recommendations outlined in this report and envisage that the proposed SATs conference presents a useful opportunity to discuss these recommendations in greater detail with a view to agreeing a way to take any further work forwards.*
Appendix 1 - Case Studies

a. The University of Sussex Pension Scheme

The University of Sussex Pension and Assurance Scheme (“USPAS”) was set up during the 1970s to provide final salary retirement benefits for the University’s non-academic and academic related staff. By 2007 it had become apparent that USPAS was not financially sustainable. Like many final salary pension schemes its deficit had increased sharply due to three factors common to almost all final salary schemes; increased life expectancy, lower long term investment returns and legislative changes giving rise to additional costs.

As part of a range of changes to the University’s pension provision for support staff a steps were taken to appoint a new service provider to administer the scheme.

Full details relating to appointment of a new administrator which includes an explanation of the tender and selection process and transitioning of the schemes administration records to the new administrator are available on the EPF website.

b. University of Mercia Pension

The Mercia Staff Pension Scheme (MSPS) was the University’s final salary pension scheme for support staff. An actuarial valuation undertaken in March 2010 indicated that the scheme deficit had increased to £82m. This was due to lower than expected investment returns and increases in life expectancy which were estimated to have added 3.5 to 4 per cent to the employer’s costs since the scheme was set up in 1992. Despite the University paying additional contributions to address the past service deficiency it was decided that the scheme in its current structure was no longer financially sustainable. The University was unwilling to increase the employer contribution rate further in order to underpin the current pension recovery plan, since it was already funding the past service deficiency over an extended period and in addition the University had already set aside contingent assets equivalent to £100m and was not willing to increase this amount further.

Full details of the changes implemented to the benefit structure of the Mercia Staff Pension Scheme, including the background to the options discussed, the process for implementing changes to the scheme can be found on the EPF website. In summary, in order to reduce the cost of future benefits and to reduce the recovery period, the University moved all scheme members to CARE with tiered contributions linked to different accrual rates; reduced the ‘insurance’ benefits such as death in service; linked pension age to the State Pension Age; and introduced a flexible retirement option.

c. University of Barchester Pension Scheme

The University of Barchester decided to implement changes to the pension provision offered to support staff, due to the scheme becoming financially unsustainable as a consequence of an ever increasing deficit. It was also agreed that a fundamental review of the scheme was required as only 25 per cent of support staff eligible to join the scheme had done so. This was due to the high employee contribution rates as well as the perceived complexities of the scheme.

Full details of the changes implemented to the pension scheme for offered to support staff at the University of Barchester, which includes the process undertaken to negotiate and implement a new cash balance scheme and the reaction of support staff to the new scheme can be found on the EPF website.
Appendix 2 - Comparison of USS and SAUL merger conditions

Introduction

We have reviewed both the USS and SAUL merger policies and set out below a comparison of the main merger terms.

USS takes a prescriptive approach to mergers with the parameters set out in detail from the outset to allow a degree of ‘self-service’ for candidate institutions.

USS has just revised its merger documentation and further details can be located here: USS merger documentation12.

SAUL adopts a slightly different approach to mergers whereby applications are considered on a case by case basis, but each will have to meet the criteria established by the SAUL Trustee.

SAUL has produced a merger summary document which is located at SAUL merger documentation13.

Comparison of USS and SAUL main merger terms

1. Standard discount rate
   
   **USS.** The basis upon which the candidate scheme’s liabilities are measured uses a discount rate of gilts +1 per cent. Any resulting deficit can be paid over a period of up to 20 years but only by agreement with the Trustee Company.
   
   **SAUL.** Does not specify an upfront discount rate but it will be related to the SAUL actuarial assumptions used for scheme valuation purposes.

2. Flexibility in discount rate
   
   **USS.** A less prudent discount rate of up to the scheme’s technical provision’s basis – currently gilts +1.7 per cent - can be agreed in cases where the merger would improve the employers’ covenant to the scheme. The discount rate will be confirmed by the board following consideration of the merger questionnaire and an in-house assessment of the sponsoring employer’s covenant. In the case of university SATs if the merger would significantly improve the overall employer covenant, or there are other special circumstances, then the Trustee Company can agree at its discretion an adjusted (i.e. less prudent) discount rate.
   
   **SAUL.** Does not have a similar provision but requires the sponsoring employer to have a strong covenant. All employers are treated on equal merit.

3. Funding level
   
   **USS.** The merging liabilities are required to be fully funded on the USS mergers basis – the Trustee cannot accept ‘level funding’ as the view is taken that that would increase the scale of the problem where there is a deficit. There is a minimum Technical Provisions Funding Requirement which means that the transferring fund’s technical provisions basis is at least as great as that of USS on the same date. See point five for further information on funding deficits upon merging.
   
   **SAUL.** The SAUL Trustee will require that the sponsoring employer of the candidate scheme meets the difference between the incoming scheme’s funding position and SAUL’s funding position plus a premium for risk. SAUL normally uses its secondary funding basis for valuing mergers.

12 http://www.uss.co.uk/HowUssIsRun/employers/Pages/Mergers.aspx
4. **Demographic assumptions**

**USS.** USS’s demographic assumptions, from the most recent actuarial valuation, will be used in all calculations, except where (in exceptional circumstances) to do so would lead to the liabilities being patently overvalued relative to the actual experience of the merging scheme.

**SAUL.** SAUL’s demographic assumptions, from the most recent actuarial valuation, will be used in all calculations, except where (in exceptional circumstances) to do so would lead to the liabilities being patently overvalued relative to the actual experience of the merging scheme.

5. **Funding of any deficit on transfer**

**USS.** In the event of the assets of the merging scheme being insufficient to cover the liabilities measured on the USS mergers basis, the Trustee Company will, at its absolute discretion, permit the institution to pay ‘merger deficit contributions’ to USS to cover the shortfall. The Trustee Company will also, at its absolute discretion allow deficit contributions to be paid over an extended period and at a commercial rate of interest. Where USS is in deficit on its technical provisions basis, no dilution of USS’s own technical provisions funding level will be allowed to protect the funding of benefits already accrued.

**SAUL.** The SAUL Trustee may consider allowing the sponsoring employer to spread all or some of the deficit over a period, subject to interest being payable in the interim on balances outstanding or alternatively while doing so, may require the provision of a contingent asset to cover any difference. Where SAUL is in deficit on its technical provisions basis, no diminution of that funding level will be allowed.

6. **Impact on existing recovery plan**

**USS.** The value of any merger deficit contributions paid will be taken into account as a credit in the event of the Trustee Company implementing a recovery plan which involves additional cash deficit contributions.

**SAUL.** Because SAUL requires funding up to its own technical provisions basis, in the event that a recovery plan to take a deficit funding position to a fully funded position resulted in additional contributions, the incoming employer would be required to contribute equally with the other employers.

7. **Duration of deficit funding contributions**

**USS.** The duration of the period over which the merger deficit contributions are able to be paid to fund any shortfall is to be decided by the Trustee Company and will crucially depend on the employer’s covenant and whether there can be any guarantees established, but in any case it will not exceed a period of 20 years.

**SAUL.** The duration of the period over which the merger deficit contributions are able to be paid to fund any shortfall is to be decided by the Trustee Company and will crucially depend on the employer covenant. It will also align to the Pensions Regulator’s guidelines.

8. **Membership requirements**

**USS.** The merging SAT’s demographic must include a substantial element of on-going active scheme members and also the employer must commit to continuing participation in USS for future newly hired staff who would have previously been pensioned in the merging SAT. The Trustee Company will accept a merger where there are no new actives if the institution has already consolidated on-going pension provision with USS prior to the merger.

**SAUL.** The incoming scheme should offer some diversification of demographics for SAUL and must have active members plus agreeing to continue to be open to new members.

9. **Transfer of assets**

**USS.** The general assets of the candidate scheme should be transferred to USS in cash form, unless entirely at the USS Trustee Company’s discretion, specific arrangements are made to accept assets “in specie” which latter will require a detailed review of the asset portfolio.

**SAUL.** Normally, assets will be transferred “in specie” with the Investment Management Agreement being novated into SAUL’s name.
10. **Administration charges**  
   **USS.** The Trustee Company makes a flat rate charge (currently £108,560) for merger costs plus a unit charge per pensioner and deferred pensioner to cover on-going administration costs. The charge only becomes payable once the merger agreement is signed.  
   **SAUL.** SAUL will recharge its external actuarial and legal costs plus any internal or other costs on an actual basis.

11. **Maturity check**  
   **USS.** A maturity check will be applied to all candidate schemes (which will be a condition of entry) in order to assess the impact the merger has on the maturity of USS’s liabilities. The check will form part of the Trustee Company’s consideration of the terms upon which the merger can proceed.  
   **SAUL.** A maturity check will be applied to all candidate schemes (which will be a condition of entry), in order to ensure that the merger has no materially adverse effect on the maturity of SAUL’s liabilities. In the event that it does the merger could still proceed if the employer were to agree to pay an on-going additional contribution to cover the increased liability.

12. **Future service benefits**  
   **USS.** Benefits post-merger can be on either a final salary or on a CARE basis.  
   **SAUL.** All benefits post-merger will be on a CARE basis. Past service will be converted to a SAUL service credit.

13. **Cost effectiveness**  
   **USS.** These parameters will apply to all scheme mergers, however there will also be criteria which will enable the Trustee Company to determine whether a merger is cost effective in terms of its administration (which will take into account factors such as the ease of transition of the candidate scheme benefits into the USS template, the overall asset size of the scheme etc.).  
   **SAUL.** As a general principle, the allowance for administration expenses included in the contributions received will be expected to cover the cost of administration of future benefits. However, SAUL reserves the right to ensure that all administrative costs are covered and to take these into account when agreeing a merger.
Appendix 3 - Recommendations from previous reports

As mentioned in the introduction, there were two preceding reports whose principal recommendations are summarised here:

**Pension provision in the higher education sector undertaken by Peter Thompson FIA and published in 2008**

The SATs and the Local Government Pension Scheme (LGPS) were considered and the major pension scheme models were reviewed and their advantages and disadvantages explained.

The main findings relevant to this study were:

- Widespread adoption of money purchase provision was ruled out as there appeared to be little employer appetite for such large-scale transfer of risk to scheme members.\(^{15}\)
- Having a “menu” of pension options was thought possible although there are substantial practical difficulties with such an approach.\(^{16}\)
- There was a widely expressed desire to achieve greater economies of scale.\(^{17}\)
- Economies of scale could be achieved by reducing the number of pension schemes in the HE sector, however moving towards a single scheme for each institution was ruled out.
- The option of adopting the Teachers’ Pension Scheme (TPS) as the single scheme for academic staff was ruled out.
- It was suggested that it would be worth examining whether USS could be developed as the single scheme for academic staff subject to consultation with the relevant government departments.
- Merging the smaller SATs, either with each other or into a larger existing scheme such as USS or SAUL, was thought to be a practical proposition. Some institutions had already done this and others were considering this approach.
- Further work was needed on refining a future pension model for the HE sector, in particular, how it would adapt to future changes such as continuing improvements in longevity.

**Self-Administered Trusts: some options for institutions prepared by Dr Tony Bruce in 2010 from an original report by KPMG**

The key benefit identified in this study was the merging of SATs in order to realise cost savings through administrative efficiencies, reductions in management overheads and savings in advisory fees. These savings could then be assessed against the one-off costs of a merger including the cost of implementation (management time, adviser fees and communication costs) and the costs incurred on asset transfer.

The report analysed the benefits that might be gained from merger with the USS. A discounted cash flow analysis of two case study universities suggested that savings would be achieved in the medium term and would be recurring thereafter. The cost of transition from existing asset portfolios had a major impact on the point at which savings would be achieved.

The report also considered the cost benefits to be gained from merger with SAUL. The analysis indicated that positive cumulative cost savings could also be achieved in the medium term that

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14 Pension provision in Higher Education sector
15 By 2012 28% of SATs now provide DC benefits to support staff
16 HEIs now offer members options such as higher contribution rate for a higher accrual rate,
17 Our latest survey suggests that a third of HEIs are willing to explore mergers with other SATs which could lead to savings from economies of scale
18 Self-Administered Trusts: some options for institutions
would be recurring.

There were other less tangible benefits which would be common to a merger with either scheme:

- Each individual merging scheme would be able to diversify its asset allocation within a larger fund reducing investment risk and potentially increasing investment returns.
- Each individual merging scheme would be able to diversify its asset allocation within a larger fund reducing investment risk and potentially increasing investment returns.
- A larger scheme would be able to pool the liability risks across a broader membership which would therefore result in risk diversification for each individual merging scheme.
- In addition to providing greater security for fund members, the diversified risk might also result in lower, more stable rates being charged to participating institutions.
- Merging with a larger scheme would release management time to focus on the core business of running the institution.

However, there were a number of constraints which SATs seeking to merge with a larger scheme would need to consider:

- A constraint which was common to joining USS and SAUL was the loss of control of funding and benefit policy following merger. For some universities this might rule out the option of merging, although others have expressed less concern. [This finding has to some extent been emphasised by feedback from the current study.] A mitigating factor here could be increased HEI influence in the governance of the merged fund.
- A constraint for merger into USS (although one that was addressed in the recent review of its policy on mergers) was the requirement for universities to disinvest from existing portfolios into cash prior to funds being reinvested in the USS portfolio. This represented a significant ‘up front’ cost to universities, particularly for larger universities as the disinvestment cost is proportionate to the funds invested. The analysis indicated that the time period for achieving recurring revenue savings was very sensitive to the disinvestment rate. This would be an area where negotiation with USS would be worthwhile so that its new merger policy allows for the transfer of assets in specie rather than as cash, thus minimising the asset transfer cost.
- The most significant constraint on merger was the impact on cash funding requirements. Typically on a merger pension schemes would need to align their funding levels which would crystallise the funding deficit that most SATs were currently experiencing. The analysis of the case study institutions showed that overall contributions would increase on merger into USS or SAUL even though the charge for future benefits is lower in both cases. It was important to note that cash payments to fund the deficit do not affect the real cost of the benefits, which are driven factors including how long members live. Instead it drives the pace of funding – greater contributions in the short term would mean lower contributions in the longer term, all other things being equal. However this would create a significant challenge for institutions and might prevent them from realising the real cash savings that were achievable through merger. Mitigation for this could be through assistance with short term funding, repayable over a number of years, or by negotiating with USS to relax its entry requirements (a process that is well underway, the details of which were included at Annex 1 of the original report).
- Another constraint for entry into USS was the maturity check carried out to assess whether universities meet a pre-defined profile in relation to the proportion of active to non-active membership and liabilities. The analysis indicated that only a very small minority of universities would currently meet the maturity criteria, and this would need careful negotiation with USS to secure workable terms in this area of policy. [Note that since the publication of this report there are no universities that have decided to merge fully with USS despite the relaxation of some of their merger conditions].

Other factors that were considered in assessing the relative merits of a merger with USS or
SAUL included the following:

- The benefits provided by USS were currently of lower expected value and hence cost less than those of SAUL (even though the assessed contribution charge is the other way round).
- USS is a much larger fund and should generate greater economies of scale.
- All SATs' sponsors already participated in USS for their academic and academic-related staff.

The report also considered other options for securing savings, including rationalising the use of advisers or using a single administrator, as well as changing the benefit structures of individual schemes. It provided examples (Annex 5 of the original report) of changes to individual SATs schemes that had been introduced by two universities in response to increased funding pressures.