Employers Pensions Forum

for Higher Education

Paper 1: Employers Pensions Forum (EPF)[1] USS Town Hall Event
HE Pensions strategy: drivers and objectives

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Executive summary

The town hall meetings are intended to discuss the upcoming USS valuation, as well as also inviting employers to consider the longer-term, strategic direction of pension provision in the Higher Education sector. Since January, the Employers Pensions Forum (EPF) supported by Universities UK and UCEA has progressed research into a pension strategy for the sector. This paper sets out the drivers for the EPF's work, research conducted to date and next steps for the pensions strategy project.

Actions

There will be opportunities for discussion at the town hall events. Attendees should consider:

- If the objectives to which the EPF are working to (cost control, understanding reward and increased flexibility) align with the view of your institution?
- If the higher education sector wishes to think differently about pensions what should that new approach include to ensure the financial sustainability of the sector whilst providing adequate pension provision for staff?
- What are the critical areas that the pensions strategy work should focus on?

[1] The Employers Pensions Forum (EPF) and its subgroup, the USS Group, were established by UUK/UCEA/GuildHE in 2008. Both the EPF and the EPF USS Group are chaired by Professor Koen Lamberts. These groups sit outside the governance of USS but supports the UUK-appointed members of the JNC (who are all members of the EPF and the USS Group) and provides a forum for consideration of employers' interests in the scheme. The Local Government and Teachers Schemes Group for post-92 institutions was subsequently set up as a subgroup of the EPF and is chaired by Professor Nick Petford.

- If action is needed to reduce the USS deficit at the next valuation what should that action be?

Introduction

Over the last decade pension schemes across the UK have seen significant reform. Within the Higher Education (HE) sector those changes have resulted in increasing divergence in pension provision, however the core structure of the HE sector's main pension schemes remains defined benefit (DB) in nature. More widely across the UK, private sector employers have moved away from that model, preferring defined contribution (DC) provision.

In addition to reforms in the UK pensions environment, a decade of changes to funding and regulation, greater competition nationally and globally, and changing workforce patterns are all drivers behind changes to the operational environment of the HE sector. These drivers are important factors to consider when discussing the future of pension provision in the HE sector.

The EPF is working to assess whether these developments may have fundamentally altered the type of pension institutions wish to provide to employees and also what employees themselves want from their pension saving.

Background to the EPF pension strategy project

At a meeting held in January 2016, members of the EPF asked UUK and UCEA to conduct research to help employers form a position on the future of HE pension provision. It was thought that a wider strategy would help the HE sector develop a vision for the future, and assess how any significant reforms could be implemented. In particular, it was felt that a longer-term approach was needed as opposed to reactive and incremental reforms as part of each valuation cycle.

Following initial scoping and research, a presentation and discussion took place at UUK's members meeting in May 2016 to discuss the strategy with Vice Chancellors. The EPF received very positive feedback on plans for this project highlighting that pension issues are becoming an ever more important topic within the HE sector and highlighting that the development of a pensions strategy should include the view of employees on pension saving and retirement.

What do the EPF want to achieve?

The EPF is working to develop a pensions strategy that considers all schemes offered in the higher education sector, including in particular USS, LGPS and TPS. The four high level employer principles underpinning this strategy work are:

- To develop a proactive and long-term approach to pension provision in the sector in which that provision sits within a considered and balanced approach to employee rewards

- For that approach to be one which delivers stability and predictability of costs for institutions
- To underpin the development of that approach with an understanding of employers and employees approach towards reward more widely
- To deliver control (of both cost and pension provision offering) within an increasing divergent sector in which the pension provision itself is diverging from an originally similar base.

Considering the drivers for change

In order to consider the future of pension provision, there is a need to place it within the wider context of change within the sector. Over the last decade institutions across the UK have seen significant changes to their operational environments and have responded strategically to reductions in public funding, changing public policy and enhanced sector competition. Further policy changes will be progressed following the Higher Education Bill. In the meantime, the UK's vote to leave the EU is likely to continue to cause further uncertainty and influence change.

Over the last decade pension schemes across the UK have seen significant reform. As a result, there is now a greater divergence of pension provision within the HE sector. However, it is important to recognise that many commonalities continue to exist. In particular, many institutions and organisations in the higher education sector continue to provide defined benefit (DB) pensions.

The EPF in particular agreed that the long-term strategy must deliver:

- pensions that are valued by employees and for recruitment purposes locally, nationally and globally
- pensions that are financially sustainable in the long-term

The paper focuses on two key objectives identified by the EPF and UUK members as part of earlier discussions. These have formed the basis of UUK and UCEA work to date and set the structure of the remainder of this paper. The town hall meetings are intended to inform both wider strategy work and UUK's preparations for the 2017 USS valuations.

Pensions that are valued by employees and for recruitment purposes locally, nationally and globally

<u>Context</u>

A number of developments are likely to impact on employees' retirement plans and expectations. These include:

- changes to tax policy, reforms to the state pension and an anticipated increase in the state pension age
- changes to the working lives of individuals, with more people working beyond their retirement age

- wider government policy which has focussed on a drive towards DC provision and increased flexibility and choice
- changing landscape of long term savings, with the merging of wider savings vehicles with pensions savings (such as the expected introduction of the Lifetime ISA (LISA) from April 2017).

There are also important considerations to make with regards to trends in the sector's workforce. The number of academics employed in the sector aged over 65 has increased significantly in recent years. In 2008-09, employees over 65 made up 1.7% of the academic workforce in the UK, compared to 3.0% in 2014–15. The overall number of academics aged over 65 in the UK HE sector has almost doubled since 2008–09, to over 6,000 in 2014–15[2], with numbers rising faster than for any other age group. There has also been a noticeable increase in part-time staff and outsourced roles in the sector.

Another trend relates to the increased proportion of academics in the UK with a non-UK nationality. Institutions must be able to provide a reward package that enables them to recruit top academic talent in a global, competitive market. In 2014–15, over a quarter (28%) of the UK's academics had a non-UK nationality. The proportion of academics with a non-UK nationality has steadily risen in recent years, from 24% in 2008/09.

Diverging provision in the UK higher education sector

There has been a divergence of pension provision in the HE sector. Historically pension schemes in the sector aligned their provision, often DB, with a similar accrual rate, lump sum and contribution rate. This is no longer the case. There are now marked differences between USS, public sector pension schemes such as the LGPS, TPS and NHSPS alongside USS, a host of local Self-Administered Trusts (SATs) and the growth of NEST and other DC alternatives.

In addition, the exit from the public sector transfer club by USS following the most recent benefit reform means that not only divergence but portability of accrued benefits between sector schemes is also an issue as schemes will no longer offer equal terms upon transfer. Ever lowering pension taxation thresholds through the annual and lifetime allowance are also encroaching on more scheme members which can result in opt-outs from schemes and with that the need to consider whether to offer alternative reward provision in lieu of pensions.

In an increasingly complex pensions landscape, engaging with and educating members to aid their understanding of the sector's pension schemes is critically important. Regular changes to benefits amongst other reasons can impact on members' trust and engagement with schemes. For example, the 2016 USS Annual Report and Accounts shows a drop of 8,000 active members between 2015 and 2016. This drop follows years of increased participation following automatic enrolment, and its cause will need to be better understood.

[2] HESA Staff Record

From 2017, the new LISA may blur the lines between pensions and personal saving for those under age 40. This may impact on membership figures and exacerbate funding issues.

As part of the pensions strategy work the EPF are keen to determine what employees most value with respect to their reward package. We would welcome institutions views as to whether there is inflexibility built into current scheme design which is not meeting the requirements of groups of staff or where schemes could even be a barrier to recruiting and retaining staff. In addition, the EPF would welcome any insight employers could offer regarding work undertaken locally on the issue of reward and workforce preferences.

The EPF through UCEA will also engage with employees through a selection of institutions during October 2016. The aim of this engagement is to get a better understanding of what employees really value in terms of pensions and reward in general, feeding those views into the overall development of a pensions strategy for the sector.

<u>**Understanding the pensions offering across higher education globally**</u>

UUK is conducting research into the pension schemes offered by universities in other countries. This is valuable for the purpose of considering the global competitiveness of what UK universities can offer in this regard, and in order to learn from initiatives and developments overseas. As part of this research, UUK is considering pension offering in a wider context of academic salaries, living costs, non-salary reward, state pension provision and relevant pension policy.

Few countries have a pension scheme designed specifically for the higher education sector, though there are some examples, including UniSuper in Australia and Unisaver in New Zealand. Findings so far identify a range of different schemes in other countries, from full DC options to DC/DB hybrid schemes. While it is clear that offering a DB scheme is not uncommon in universities around the world, the schemes identified so far are often DC only or offer a choice between DB and DC. Findings from both research into the international competitiveness of the pension offers and the employee engagement will be reported to the sector early in 2017.

Ensuring long-term financial sustainability and affordability

<u>**Defined benefit funding challenges**</u>

The current funding environment for all DB pension schemes remains volatile and challenging. The funding issues facing schemes are further compounded by the UK's vote to leave the European Union, low interest rates, and further quantitative easing.

March 2016 and 2017 see the next cycle of valuations for all the main pension schemes in which institutions participate. It is widely anticipated that despite benefit reforms and significant increases in contributions rates, the deficits in these schemes will have grown in monetary terms, reflecting the increasing cost of scheme benefits.

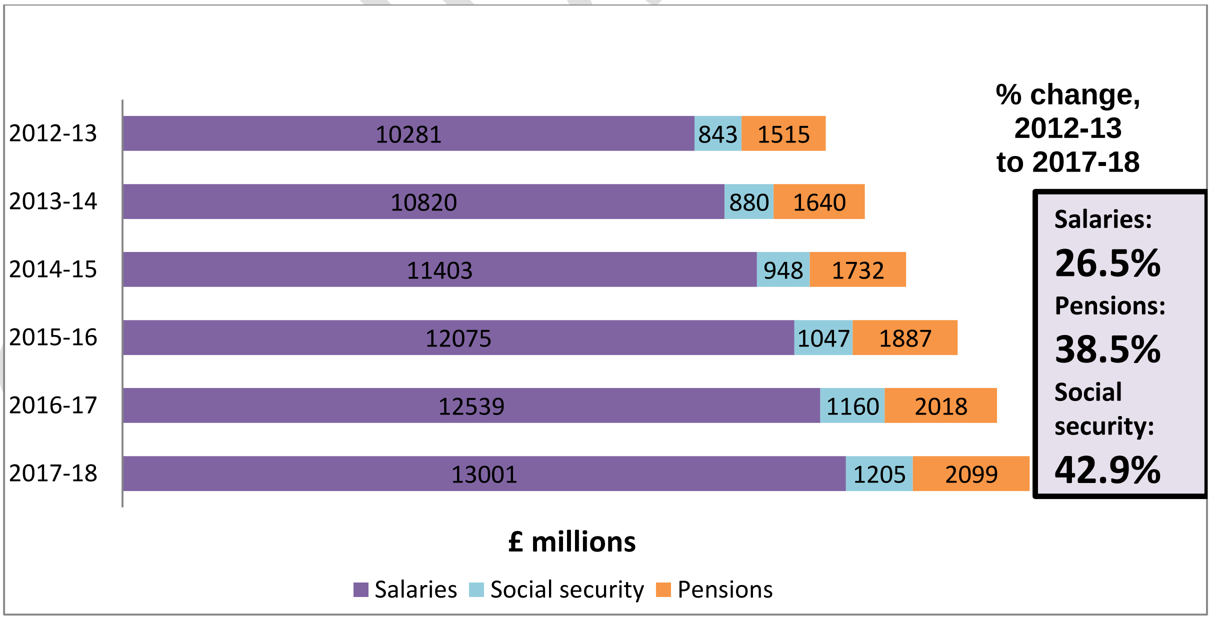
Employers participating in USS will likely have to return to discussions on how to manage the growing deficit. Increasing pressure on liabilities, caused by falling bond yields and low interest rates, mean that even with positive investment returns the scheme faces a sizeable deficit. The benefit reforms coming into effect from 2016 arguably went as far as could be expected within the negotiating constraints at that time when it was expected that the funding situation, whilst likely to have remained challenging, would not have been as difficult as has transpired over recent months.

Pension costs to institutions

Staff costs constituted over half (55%) of UK institution's expenditure in 2014–15. Over the last six years, staff costs increased by less than inflation. However, over the last three years' total staff costs rose in real terms with further increases expected[3].

As shown in figure 1 the highest forecast percentage rises in staff costs between 2012–13 and 2017–18 relate to pension and social security costs. In 2013–14, English institutions paid approximately £1.6 billion in employer pension costs and a further £880 million in social security costs.

Figure 1: Staff expenditure of English universities 2012–13 to 2017–18, actual and forecast



Source: HEFCE (2015)

The cost of pensions and social security for English institutions is expected to increase faster than other staff costs. This reflects rising employer contribution rates as well as the substantial amounts institutions are paying to manage scheme deficits.

[3] HEFCE (2015) "Financial Health of the Higher Education Sector"

Increases in employer National Insurance contributions since April 2016 represent a further significant increase in staff costs (estimated at around 2% of payroll).

USS costs

At March 2016, the USS deficit was estimated at £10 billion. During the town hall events USS colleagues will update delegates on the latest funding position following the EU referendum result and Bank of England quantitative easing initiatives will be discussed. As part of the valuation process for 2017, USS will also be considering its approach and inputs to the valuation process. This too will be set out in USS's presentation.

The current employer contribution of 18% of payroll comprises: funding for future pensioners in the USS Retirement Income Builder and USS Investment Builder, as well as a payment of 2.1% to reduce USS's funding deficit. USS employers will need to consider whether they are able and willing to increase payment towards the deficit if the funding situation requires. If total employer contributions remain fixed at 18%, but contributions towards the deficit are forced to increase above 2.1%, this will ultimately reduce the amount of funding available for future pensioners through the income and investment builders and thereby the level of benefits that can be offered.

In order to very roughly understand what various increases in contributions might mean in monetary terms, estimates can be taken based on 2014–15 data. Total employer contributions received by USS for the 2014–15[4] financial year add up to £1,139.9 million. At this time, employer contributions were 16%. It has been estimated that if, all things being equal, the scheme had a £10 billion deficit at 31 March 2017 with the current benefit structure, the required employer contribution rate at April 2019 would increase to circa 26%:

- Had the employer contribution rate been 21% in the year ending 31 March 2015, employer contributions to USS would have been £1,496.1 million, £358.2 million higher.
- Had they been 26% in the year ending 31 March 2015, employer contributions would have been £1,852.3 million, £712.4 million higher than the actual contribution made. Any movement in the required contribution rate based on the current tracked deficit will be shared by USS at the town hall event.
- £712.4 million equates to approximately 37% of the total operating surplus generated by the UK higher education sector in 2014–15 and is equal to 2.1% of total income to the sector in this year. However, it should be noted that 96% of the employer contribution rate applies to institutions the other 4% is from smaller employers participating in USS.

This provides some sense (and does not take into account affordability) of the cost of higher employer contributions on the sector as a whole. The extent of the

[4] 2014-15 data used to allow comparison with available operating surplus data. In 2016 USS employer contributions were £1,191m based on 16% employer contribution.

impact that increased contributions may have and the ability of institutions to absorb the additional cost will likely differ across the sector.

What potential options are available to control the cost of USS?

For the upcoming valuation, USS and employers will need to consider:

- What is affordable to the higher education sector?
- What is the ability of the sector to pay increased contributions?
- What is appropriate for a USS employer to pay within the context of other financial priorities?

While it is too soon to anticipate the scale of the USS deficit at March 2017, with USS revaluating its models and approach, options need to start being considered by employers. It is essential that sufficient time is allowed to establish a clear position that aligns with a longer-term vision of what the sector wishes its pension provision to look like in the future. Aside from higher employer and employee contributions, employers and representatives should consider:

- the flexibility needed by individual employers to control costs whilst providing an attractive benefit package (discussed in town hall paper 2)
- the actuarial inputs and assumptions made by the trustee and contributing to the views to be considered as part of USS's decision-making in this area
- altering the levers within the current benefit package
- seeking more fundamental benefit reform of USS pension provision
- employers considering the use of contingent assets

Each of these options will be set out in more detail by UUK's actuarial advisors Aon at the town hall meetings in order to help employers understand the opportunities and challenges they each present.

USS employers will subsequently be issued a web survey at the end of September (following the final town hall event) seeking institutions' views on options available, as well as longer term strategic views on pensions for the sector.

Broadly, the sector will need to decide whether to maintain current provision and structure, potentially agreeing a package of adjustments within the current USS framework to improve its funding position, or alternatively make more fundamental changes to the current framework.

Flexibility

From conversations with the sector to date the EPF acknowledges employers need for financial sustainability and control of costs alongside adequate pension provision that meets the needs of both employers and employees in the sector. Employers will need to determine what flexibility is required in order to achieve these key objectives. From a USS perspective a key consideration within that is the mutuality of the scheme.

A separate paper “USS Mutuality: Flexibility of pension cost and provision – an introduction” is provided to delegates to outline the nature of USS mutuality, looking in more detail at cross subsidies in USS and looking at what future room employers have to manoeuvre within the current mutual structure of the scheme.

Town Hall events and next steps

The town hall events[5] have been organised across the UK in September to consider and discuss both the strategic needs of the sector relating to USS, as well approaches in advance of the next valuation at 31 March 2017. The focus on USS is twofold: firstly, because the sector has a direct voice to influence change in that scheme and secondly because of the forthcoming valuation of USS.

These town hall events will include a presentation from the EPF on strategic longer term considerations detailing further the points highlighted in this paper. USS will provide an update on the scheme’s current funding situation and plans for the 2017 valuation. Aon as actuarial advisors will present to delegates on possible options available to USS employers in the future.

Following the town hall events an online survey will be issued to the all USS employers in the week commencing 26 September. The survey will set out questions relating to the longer term pension needs of USS institutions as well as specific questions regarding the affordability, benefits and structure of USS. Employer engagement with this survey will be essential to enable the EPF to understand institutions’ views on the issues presented, and in order to develop a viable long term position on pensions for the sector.

In October, the EPF will also engage with employees through a selection of institutions. The main objective of this engagement is to understand how employees view pensions as part of their overall reward package.

Simultaneously, the EPF secretariat will progress research to establish broadly how UK higher education pension provision compares to provision in other countries, as well as enhance understanding of developments in the UK’s private sector. A number of meetings with sector bodies and representatives[6] have also been scheduled to further inform the EPF.

In the Autumn the EPF will engage with institutions offering public sector schemes outlining the work being undertaken in relation to those schemes and the issues

[5] Edinburgh: 13 September 10:00 – 13:00
Liverpool: 20 September 14:00 – 17:00
London: 23 September 10:00 – 13:00
[6] Meetings with the EPF Secretariat and AHUA, BUFDG, GuildHE, UHR, CUC, Russell Group, University Alliance and Million + are taking place during August, September and October.

being considered. The EPF will also engage with LGPS and TPS Advisory Boards to ensure that views from the sector are heard. In addition, meetings will be held with relevant government departments to influence their thinking.

Views from the town hall events, data from the web survey and the results from UUK and UCEA's research and consultation will be discussed by the EPF in November, and subsequently collated into a report setting out recommendations in early 2017.

These recommendations will go on to form the employers position as we enter into valuation discussions with other stakeholders and the USS Trustees and Executive as part of the 2017 valuation process.

In addition, a timetable of USS activity for the 2017 valuation will be provided at the town hall events.

Questions to consider in advance of the Town Hall events

The events will offer an opportunity to get an update on the EPF's work to date, noting the key objectives which underpin that strategy. It will also offer the opportunity for discussion on the issues facing institutions regarding pension provision. The EPF would welcome institution's views on the points outlined in this paper and adequate time will be provided at the events to enable those discussions to take place. Institutions are asked to consider some exploratory questions including:

- Do the objectives to which the EPF are working to (cost control, understanding reward and increased flexibility) align with the view of your institution?
- If the higher education sector wishes to think differently about pensions what should that new approach include to ensure the financial sustainability of the sector whilst providing adequate pension provision for staff?
- What are the critical areas that the pensions strategy work should focus on?
- If action is needed to reduce the USS deficit at the next valuation what should that action be?