Employers Pensions Forum

for Higher Education

Paper 2 – Employers Pensions Forum (EPF) USS Town Hall Event
USS Mutuality: Flexibility of pension cost and provision – an introduction

Contact/s	Territorial relevance	Paper number
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Introduction

From conversations with the sector to date the EPF acknowledges employers’ need for financial sustainability and control of costs alongside pension provision that meets the needs of both employers and employees. Employers will need to consider what actions may be required in order to achieve these key objectives. A key feature of the current arrangements when considering the shape of future pension provision is the mutuality of the scheme.

USS recently shared with the EPF Secretariat a paper prepared by the USS Executive for the Trustee entitled “USS Mutuality: Benefits and Cross Subsidies”[1]. The information below is a brief summary of that paper. It is provided to delegates attending the town hall events in order to identify some of the key facets of the mutual nature of the scheme, in particular, when considering what additional flexibility USS employers would like to consider.

The contents of this paper include the:

- Nature of USS mutuality
- Benefits as well as potential disadvantages of USS mutuality
- Consideration of cross subsidies in the scheme
- Potential changes to mutuality, and
- Achieving flexibility within the mutual structure of the scheme

[1] USS shared this paper in August 2016 to aid preparation for the EPF Town Hall events. The paper was prepared and delivered to the Trustee in September 2015.

The nature of USS mutuality

Due to mutuality employers share the liabilities, running costs, risks as well as the management and governance of USS. In practice, mutuality is multifaceted having several dimensions, many of which are interrelated:

- *Uniform employer contribution rate based on active members* – fixed percentage of payroll, currently 18%
- *Uniform member contribution rate* – fixed percentage of pay, currently 8%
- *Standard admission terms* - all institutions treated the same with the same contributions, benefits and restrictions
- *Exclusivity* – employers must admit qualifying staff to USS and not offer other arrangements[2]
- *Pooling of assets* – assets combined and managed collectively with both asset performance and investment risk shared across all institutions
- *A common investment strategy* – all institutions pursue same asset allocation with the same expected return and investment risk profile
- *Joint liability* – pooling of individual liabilities from all institutions into a single liability for which all institutions are collectively liable
- *Pooling of liability risk* – all risks associated with the liability are shared including for example risks associated with higher life expectancy (longevity risk), variation in the retirement age, uncertainties in the rates of withdrawal, etc.
- *Pooling of institutional credit risk* – As a result of the joint nature of the liability, all the sponsor credit is pooled, all institutions are responsible for meeting the obligations of a defaulting institution
- *"Last man standing"* – in the event of insolvency of one of more participating institution, and funding deficit is spread across the remaining institutions.

The benefits of USS mutuality

Mutuality has a number of clear economic benefits for all participants:

- **Risk pooling**, provides a form of insurance against concentration risk
- **Covenant strength**, trustee and the Pensions Regulator (tPR) view of mutual covenant is stronger
- **Advantages of scale**, such as reducing the cost of administration and investment, accessing large investment opportunities, and the ability to attract top in house expertise

[2] Exception for members at certain institutions who have individual option to join the Teachers' Pension scheme instead of USS

- **Better risk-adjusted investment strategy,** potentially higher investment returns due to the advantages noted above, and better risk management due more opportunities for diversification
- **Reduced Pension Protection Fund (PPF) Levy,** due to “last man standing” nature of the scheme.

While these economic advantages are not all quantifiable, it should be noted that the reduced PPF levy is estimated to save £28 million per annum (equivalent to 0.4% of total payroll) and administrative cost savings is estimated at £9 million per annum[3] (equivalent to 0.1% of total payroll).

There may also be a number of institutional benefits to mutuality, such as the scheme being generally perceived as fair by members, a lower burden for institutions in terms of management time, and easier movement for academics with standard benefits offered by all pre-92 institutions.

Cross subsidy

The mutuality of the scheme causes a certain degree of cross-subsidy across institutions. The most obvious of these derive from:

- The joint nature of the liability and the associated “last man standing” arrangement
- Employer contributions being based on payroll which reflects active membership of the scheme, whereas past service deficit relates to all classes of members (actives, deferreds and pensioners).

Cross subsidy is both a positive and a negative consequence of mutuality as the cost is higher for some and lower for others. Factors causing cross-subsidy may be on a member or an institutional level and are noted in table 1.

Table 1: Factors driving cross-subsidy between USS employers

Member-level factors	Past service deficit vs. accruals – relative to size
	Average age
	Proportion of actives
	Proportion of members with salaries above the cap
	Proportion of females
	Socio-economic profile
	Match take-up
	Spouse profile of members
	Proportion of ill-health retirements

[3] Calculated by USS based on the average per member cost of UK schemes of different sizes reported in IFF Research (2014) for the Pensions Regulator

Institutional level factors	Employer covenant strength
	Growth profile of institution
	Desire to enter/exit USS

The sections below summarise analysis undertaken by USS to estimate the level of cross-subsidy associated with the Scheme. The figures quoted were generated by USS to inform the internal and trustee understanding of mutuality. As such they reflect the aggregate position across the Scheme as a whole and may not be representative of the position of individual institutions.

Cross subsidy analysis
Below we present analyses of some of USS's most obvious cross subsidies from a principle point of view. Whilst cross subsidies will be different for each USS institution this level of detail is not explored in this paper and is not expected to be part of discussions at the town hall events. Instead the focus in on the principle points relating to cross subsidies in the scheme.

Contribution subsidy
Contribution rates are currently set as a fixed percentage of payroll for all USS employers. Due to mutuality employers with a relatively small number of actives compared to their past service deficit may be paying a smaller amount in current contributions to USS than is needed to account for their deficit. Conversely, employers with a high proportion of actives and low past service deficit will be paying higher contributions.

Analysis and estimates related to this form of cross-subsidy suggest that the total size of the contribution subsidies caused are estimated at £25 million, with an average size per institution of +/- £140,000 per annum.

In the eventuality of an institutional default
The joint liability feature of USS means that if a USS employer were to default, their share of the scheme's past service deficit would be funded by all the remaining institutions. USS calculations estimate that the impact of a default scenario (assuming that no debt owned could be recovered) on employer contribution rates is relatively low. For example:

- If the smallest 50 institutions (by payroll) default, the subsequent increase in contributions of other institutions (as a % of payroll per annum) is 0.001%
- If the largest institution defaults, the subsequent increase in contributions of other institutions (as a % of payroll per annum) is 0.1%
- If the median 10 institutions default, the subsequent increase in contributions of other institutions (as a % of payroll per annum) is 0.005%

Historical cross-subsidies under the old benefit structure
The final salary nature of the previous USS benefit structure generated higher levels of cross-subsidy than the new benefit structure. This has impacted cross-subsidy in two ways. First, a degree of cross-subsidy came from the variation in the mix of final salary and career-revalued benefits (CRB) members across institutions. Second, a degree of cross-subsidy may also have arisen as a result of institutions granting higher than average pay increases to final salary members.

Using data from 2011 to 2014, suggests that under the previous structure of the scheme the cross-subsidies described above had an estimated value of around £73 million per annum. Under the new scheme structure, the value of these cross-subsidies is estimated at £25 million, approximately 35% of the previous level.

Potential changes to mutuality

Employers will need to understand what changes to the current mutuality structure are possible and the EPF will need to consider this as part of the development of a pensions strategy. Any changes would need to consider two major challenges in terms of detailed design including:

- Dealing with the past – what to do about the past service liability at the time of the change and how this is funded
- Administering the future – how to balance complexity with transparency in the design of USS which has less or no mutuality.

Other considerations to changes to mutuality include legal constraints, duty to act in the members' best interests, economic coherence and political considerations.

If employers are seeking additional flexibility within the current structure of the scheme what options could be considered as part of the wider review of a pension strategy for the sector.

There are options for flexibility within the mutual structure of the scheme. A potential disadvantage of mutuality is that it may prevent individual institutions from managing elements of the scheme, such as benefit design, investment risk and accrued liabilities. In an increasingly competitive and diverse sector, this may now be more problematic. However, there are ways to address some concerns through scheme changes that still preserve the most beneficial elements of USS mutuality.

Adjusting the way contributions are determined
Rather than setting contribution rates as a fixed percentage of payroll, the Trustee could set institutional contributions on a customised basis without undermining mutuality. For example, it might be possible to calculate contribution rates individually

based on an institution’s share of the Scheme’s past service deficit and its service costs.

Supplementary benefit arrangements
There are ways within the mutual structure of the scheme and without causing additional cross-subsidies to allow institutions to offer supplementary benefits (either DB or DC) to employees over and above a core offering. For example, USS could comprise a “core” section that all USS employers offer, and a supplementary section that employers could offer in addition to the core.

Alternative benefit arrangements
In addition to supplementary benefits, it might be possible to enable employers to provide alternative benefits to a clearly targeted, well-defined category of members with strict admission criteria. This might relate, for example, to internationally mobile employees or long serving, senior staff.

Sectionalisation
Mutuality places some constraints on sectionalisation, but does not rule it out. In discussions with the EPF, USS indicated that sectionalisation could apply to both past and future service benefit accrual, but mutuality places a number of constraints on how the past can be dealt with. Two approaches to sectionalisation might be: (1) notational sectionalisation, whereby USS keep track of the assets and liabilities of individual institutions without changing the scheme, or (2) formal sectionalisation. Formal sectionalisation would involve the legal separation of each institution’s assets and liabilities. This would need to be structured to preserve joint liability in respect of past service benefits by way of cross-guarantees or another mechanism. Whilst it would be possible to maintain some of the advantages of mutualisation within a sectionalised arrangement there would be potential increases in costs in respect of administration and governance. The impact on the USS governance arrangements, and in particularly the JNC, would need to be considered carefully.

Next steps

The implications of mutuality and opportunities for flexibility within it will be discussed further by Aon during the town hall meetings. Views on the nature and level flexibility desired by employers will subsequently be sought as part of the web survey issued at the end of September. The output from both the town hall events and web survey on the subject of mutuality will be reviewed and considered as part of the pensions strategy work undertaken by the EPF.