Consultations

USS Trustees: An integrated approach to scheme funding

UUK: USS Funding and benefits

Response by University of Oxford

Thank you for the opportunity to comment on both these documents. In our response we set out a number of areas where we have concerns or questions, but we have also tried to suggest constructive alternatives to both process and proposals. We do accept the serious situation of the scheme, and we are committed to working constructively with all relevant parties to find the most equitable and stable solution we can for our staff. We hope that our response can help with finding that best solution, and we would of course be very happy to discuss it further.

This response reflects the views of a working party specially set up by University Council to reply to you. There has been no opportunity for Council to express its views, but we have had the benefit of a limited amount of feedback from some active members in the scheme. Though there was limited college representation on our working party, this response should please be read as coming from the University: we cannot speak for individual Colleges who are independent employers. Given that so many of our academic staff hold dual University and College contracts, we would have liked to have been able to consult formally with the Colleges, but that has not been possible over the summer. We shall share this response with both Council and Colleges, and subject to their permission, with our staff and unions, and we are likely to receive further feedback when we do so.

Our comments are based on the information we currently have. Before we take a considered view, we would need to review more information and to consult on this with our professional advisers and our scheme members. We have set out below a number of areas where we should like to see more information.

Summary

i. We have considerable concerns about the timetable and process of this consultation, and we very seriously advise UUK and USS to reconsider the speed of these discussions. We are concerned that some good options may not have been fully considered and others may yet emerge from consultation. Much more data and information are needed if we are to build trust and have a constructive dialogue with our staff and our Union representatives.

ii. We agree that prudence and reduction of risk in the scheme are essential. We shall need to convince our staff that this valuation and associated benefit changes truly reflect the long-term financial situation of the scheme. We would therefore be grateful for more information on valuation assumptions, especially the potential for gilt-yield reversion, and on alternative valuation approaches.

iii. We support in principle the idea of the guiding principles and technical tests of the sort proposed to manage risk in the scheme. We feel that it is premature to give these specific tests our endorsement until we see how they would work in practice to eliminate proposals that might be put forward. In particular, we need to understand how sensitive the tests are to the values built into them (e.g the affordability limits).

iv. We should like to understand better what alternatives UUK has considered and the reasons why they were not taken further. Before we can support any one proposal for reform, we need to see the alternative solutions that were considered (including approaches proposed by the UCU) and understand the views of UUK and the USS Trustees on these alternatives.

v. Closure of the FS scheme is a very significant step and we should like to explore further the ways in which this could be managed fairly and without creating undue hardship: we ask for more information on several points including how pensionable salary will be determined at the changeover, how the value of the past accrual can most appropriately be protected and the additional costs that might imply, the cost of keeping the final salary link as an interim measure for those close to retirement, and how added years AVC contracts will be honoured.

vi. Setting the level of the salary cap in the proposed hybrid scheme is a key issue. There is no assumption by Oxford that the scheme should protect one group of staff more than another. However, we do think that the scheme needs to take due account of the typical academic career: as designed at present, the hybrid scheme significantly limits the DB element of pension for almost all academic staff. We should like to explore ways to move the cap towards a figure that is likely to capture more of a career academic's salary.

vii. Our own data also suggest that staff paid below £40k are more likely to leave the HE sector. If it is true in the scheme nationally, we suggest this should be reflected in the scheme design. We believe it is important to explore further at this stage the option of offering a good, highly portable DC nursery scheme for the first few years of membership of the scheme. Although it adds complexity, it could offer a more appropriate way of saving for a pension for those who are less likely to stay in the scheme, and allow a smaller reduction to the benefits available to those who stay for the long term.

viii. We have reviewed the worked examples supplied so far and we have made some requests for better information, including examples that recognise the likely promotion during a typical academic career.

ix. We ask that USS and UUK consider the possibility of a hybrid scheme in which all salaries are divided in a fixed proportion between the DB and DC sections (a 'vertical' split). This would address the very uneven pattern of winners and losers created across staff groups by the present 'horizontal' split at £40k. Not only would this approach be more equitable between different employees, it would avoid the uneven effects on contribution rates between universities with different proportions of their salaries above £40k. In the vertical split model, a cap could still be applied if needed to limit risks, but it should affect only a relatively small group of high earners.

x. We would like to understand more about the management of the DC scheme and whether staff will have the choice of DC providers other than USS. We believe that care will be needed to avoid cross-subsidies between the DB and DC schemes: this may result in different overall costs for different universities. It might help to establish a clear split of employers' contributions between cost of future accrual for each section of the scheme and cost of paying down the scheme deficit.

xi. We would like to understand the future level of death in service and ill-health benefits above the salary cap.

xii. We expect there to be appetite for a core provision with some flexibility on both contribution rates and accrual rates for those members who want to vary their investment in their pension at different life stages.

xiii. We note that, under the present hybrid proposals, it seems possible that our overall contribution costs might go down. We should like to explore ways in which we can keep our contribution at the same level, and preserve the best possible benefits for Oxford staff without subsidising the scheme as a whole while the deficit is being paid down.

The context of the present consultation

Our response is based on the following understanding of the context of the consultation.

The USS will produce the triennial scheme valuation in November, and it is bound to show a substantial and increased deficit. The Trustees are responsible for deciding on the investment policy and the acceptable levels of risk; and the employers are responsible for considering how much they will pay in contributions and any consequential changes to benefits. The USS Trustees have made some suggestions about benefit design because of the unusually difficult position that the scheme is in. There is a limited time for the Trustees and the Pensions Regulator to agree how the deficit should be tackled. This valuation exercise must be repeated every three years, and so there is a wish to find a stable solution that will not need further radical amendments at future valuations.

We understand that the Trustees are convinced of the need to reduce the overall risk borne by the scheme and that they are minded to reduce the investment risk in the scheme over 20 years by rebalancing the investment policy away from equities and towards gilts. This new investment policy is forecast to produce lower returns, and so the liabilities must also be reduced or the cost of contributions will be raised unacceptably.

Employers currently pay 16% on salary for USS benefits: in the final salary section, around 12% is paid towards future accrual of benefits, and the remaining 4% is used to reduce the deficit over an agreed period (currently 10 years, but probably to rise to 15). Based on a survey carried out by UUK last year, it appears that many employers are unwilling to pay more than 18% in total (possibly rising for short periods in extreme conditions to 21%). This is partly because all employers will, from 2016, have to pay around another 2.5% on salaries in increased National Insurance when contracting out from the State Pension Scheme ends. UUK and the Trustees are therefore proposing that the scheme liabilities should be limited by capping the salary to which defined benefits apply. This in itself reduces the risk in the scheme, and so a smaller change to the investment policy is needed, which in turn keeps contributions lower.

Not all employers stated that they were unwilling to pay above 18%. After this current exercise has taken place, we understand that USS intends to carry out a second review, of mutuality and of the scope for greater flexibility for employers. We note this could bring possibilities for some tailoring of the scheme for individual universities.

If in the future, the investment returns are better than expected, we understand that the Trustees would not wish to improve the DB section of the scheme, but might agree to improve the DC section.

We have the following comments on the proposals, each referring to a section of our Summary:

1. The timetable and process proposed by UUK/USS

The present consultation seeks comments from employers by 22 September 2014 for consideration at USS board meetings in October and November, alongside the final valuation. We understand that staff would then be formally consulted on final proposals in January 2015 as part of the statutory consultation process.

We recognise that the Pensions Regulator will have expectations of the timetable, and also that action to address the deficit must be taken in good time to secure the scheme against further deterioration. However, we believe that the current timetable and consultation process is unwise.

As employers, we do not consider that we have been given enough data for us to take an informed view of the proposals. We have a number of early concerns, which we outline below, based on what we know so far; but we also have significant requests for further information. In particular, we have not been able to review the valuation assumptions, the alternative proposals that were not taken further, or the effects on representative members.

We are also concerned to be able to manage a constructive and transparent dialogue with our staff and our Unions. This is particularly important given the potential for the current proposals to precipitate an industrial dispute. Some time is needed for local staff and Unions to consider options and comment on them. We would like to give them enough time and data for them to ask questions and raise alternatives for serious consideration, before we move to the formal staff consultation on a final proposal. We are not currently in a position to answer their very reasonable questions. We consider that important issues of trust are involved in this process.

We would like USS/UUK to consider extending the timetable to allow for a better informed appraisal of the proposals by employers and a more informed and constructive debate with active members. We suggest that reducing the opportunity for informed comment will lead to longer delays in implementation. Any delay may incur costs, but we ask USS/UUK to review whether a better balance could be struck through some relaxation to the timetable.

2. The current valuation

We know that this valuation is taking place at an exceptional time in the market and that the gilt rate, being at a historic low, has had a material influence. We understand that the Trustees do not think it will be possible to agree with the Pensions Regulator some adjustment to take account of this exceptional state of the gilt market. We accept that prudence is extremely important and that, unwelcome though the effects may be, managing the level of risk in the scheme is essential.

The limited consultation we have so far had suggests that our staff feel strongly that a major reform of benefits should not be based on what they fear may be exceptional market conditions. They have asked whether the Trustees would support reinstatement of DB benefits at their former level if market conditions change again, and we note that this is not the current plan. We shall therefore need to be able to address our employees' concerns on whether this valuation and associated benefit changes truly reflect the long-term financial situation of the scheme.

To do this, we would like to be able to give them reassurance that USS has fully explored the opportunity for including some allowance for gilt-yield reversion in the valuation assumptions. We should like to know how broadly equivalent schemes have approached the issue of gilt-yield reversion and whether a similar approach could be taken in USS.

We would also need to be in a position to explain the alternative valuation approaches that have been considered and the basis of the choice amongst them made by the Trustees. We understand that the UCU has made proposals for an alternative approach to valuation, but we have no knowledge of the details and so cannot make any comment. Any information on this point that can be made available would be welcome.

Overall, we need to be able to articulate where the deficit has arisen, on the basis of what assumptions, and explain the interplay between past investment performance, future benefits accrual, and current market conditions.

3. USS funding principles and the Trustees' technical tests

We support in principle the idea of the guiding principles and technical tests of the sort proposed to manage risk in the scheme. The principles and tests proposed are, however, very powerful in their effect. The way in which they constrain options depends on the values used for parameters such as affordable contribution rates and the acceptable risks of certain rates being exceeded.

Setting these values has to be a matter of judgment for the USS Trustees, and guidance has reasonably been taken from UUK's survey of employers. However, we understand that that survey produced a range of values, and we have no sense of the sensitivity of the tests to the precise values that have been chosen. We also do not yet understand the sensitivity of the tests to the details of the various benefits options which might come under consideration.

Before accepting the principles as stated, we should like to see examples of the outcome of their application to a range of benefits options that have been tested. In particular, we wish to understand how changes in the values used in the tests might affect the outcome for any given option, and, conversely, by how much it is necessary to change the contributions and benefits in any particular option to reverse the outcome of applying a standardised test.

Our concern is that we would not wish the principles and tests to be used inflexibly to rule out options which, with some acceptable changes either to the tests or the options, might provide valid solutions as alternatives to the proposals currently put forward. We therefore think it is premature to give the tests our endorsement at this stage.

4. The selection of the proposal under consideration

We should like to understand better what alternatives UUK has considered and the reasons why they were not taken further. Before we can support any one proposal for reform, we would need to see the alternative solutions that were considered, including the approaches proposed by the UCU, and understand the views of UUK and the USS Trustees on these alternatives.

It would be a tremendous help to see some of the alternative options that have been considered, costed so as to make them potentially acceptable to the Trustees and illustrated to show the implications for a typical member. Consideration has already been given to what employers can afford both routinely and in the extreme, but we are now being offered just one hybrid scheme - might there be alternatives which employees would see as attractive and for which they would be willing to pay higher contributions?

We note that there is no proposal for complete closure of the DB section. It is possible that such a closure would change the Trustees' view on the scale of the de-risking required, and open the possibility for a much more generously funded and ambitious DC scheme. Although we do not expect this option to be acceptable to our staff, we should like to see some modelling of what could be achieved, for the purposes of comparison.

5. Closure of the Final Salary (*FS*) Section

The core of the present proposals is to close the FS section completely, breaking the link of past service to final salary, and to provide a hybrid scheme, partly DB and partly DC, for all members.

The link of all past service to the final salary has undoubtedly resulted in some very generous benefits for those who receive significant promotion at the end of their career, and this has been exacerbated by the salary inflation that has been seen at the top end of the pay scale in the past decade. The cost of providing this benefit to everyone is well above what staff have paid to secure these benefits; and we accept that all the reasonable estimates that we have seen establish that the cost of continuing with the present system unchanged is prohibitive.

We are however concerned that there is a large group of staff who are not expecting significant pay rises, and who nonetheless value the certainty of DB benefits linked to their normal salary progression in their career. It seems excessive to break the link entirely. We should like to see consideration of alternatives to this, for instance retaining FS link for past service up to a salary cap. We should also like to review the costs of keeping the full FS link for those in the final few years of employment, as these staff have less time to change their plans. It is becoming apparent there is a pressing need to offer this group as much reassurance as is reasonably possible.

We would appreciate clarity on how pensionable salary will be determined at the time of closure of the final salary section. Taking the salary applying at the time of closure could be seen as unfair where staff have recently relinquished additional responsibilities, believing in good faith that they had established an increased pensionable salary under the present rules. Oxford would not support any proposal to use rules other than those presently applying.

We should also like to understand the proposals for present added years AVC contributors. What is the legal advice relating to potential changes to the scheme and their impact on these AVC contracts?

After closure of the final salary section, it is proposed to index the benefit due to previous years' service by CPI. We believe that salaries have historically increased by CPI plus 1-2%, and we should like to see some modelling of the costs of using this instead, with the additional cost falling appropriately on those who benefit from it.

6. The hybrid scheme: impact of the salary cap proposal on different staff groups

The current proposal is to offer a hybrid scheme with DB benefits on salary up to a cap, currently set at £40k. Above that, all benefits would be accrued on a DC basis. This approach is intended to reduce overall risk in the scheme and so reduce the need for de-risking the investment portfolio. We agree that it merits careful consideration: however, a key issue is setting the level of the salary cap.

We note that the intention in setting the salary cap is to maximise the number of scheme members who fall below the threshold while having due regard to managing the risk in the scheme. The approach aims also to concentrate DB on providing certainty of retirement income to those on lower incomes. We believe that the design of the hybrid scheme needs further thought in the light of the different career paths of the staff who will be affected.

As requested, we have looked at our staff distribution to see which staff groups fall above and below a salary of £40k. At Oxford, junior administrators and fixed term contract research staff will largely fall below a £40k threshold. Almost all permanent academic staff, clinical research staff and senior administrators will fall above it: of the 4,345 USS members who fall at or below a £40k cap, only 30 are full-time permanent academic staff. For those permanent academic staff whose salary falls above the £40k threshold, on average 44% of their salary would fall above it, and 56% below. At Oxford, therefore, it is not the case that there are large numbers of staff who only just go over the cap: the effect will be significant on substantially all permanent academic staff.

This is unlikely to be true only of Oxford: the national pay spine for academic staff has few points on it where someone would be paid below £40k for their entire career. There is no assumption by Oxford that the scheme should protect one group of staff more than another. However, we do think that the scheme needs to take due account of the typical academic career: as designed at present, the hybrid scheme significantly limits the DB element of pension for most academic staff.

We should like to explore ways to mitigate this by a move of the proposed salary cap towards a figure that is likely to capture more of a career academic's salary. The ideal point would be the top of the lecturers' scale, i.e. national scale point 51, £58k.

We should suggest that any salary cap should be linked to some specific point on the national pay scale and that in future years it should rise in accordance with that pay point, rather than by some other inflationary measure. This would be easier to understand for members and would reassure them that the extent of the DB element would not be eroded by inflation. We note that this was not the case in the examples given in the UUK webinar.

7. Length of service: potential for a nursery scheme

Protection of lower-paid staff is an important aim. However, there seems to be limited benefit in offering a DB scheme to staff who are more likely to leave USS and become deferred pensioners: these staff might derive more benefit from having a DC pot which could more readily be transferred to their new employment.

We believe that fixed-term contract research staff and junior administrators may on average be more likely to leave the HE sector than permanent academic staff. Our own data show a significant difference in length of service at Oxford between these staff groups and staff paid above £40k.

We should therefore like to see the USS national data on the (median and mode) average length of service in USS of leavers, deferred pensioners and retired staff, split by different salary bands. We are aware that other staff may also have short periods of USS service, for instance if they are senior academic staff recruited from overseas who then return to their previous jurisdiction.

If it is true nationally that those scheme members who earn below £40k are more likely to leave USS within a short time, then we suggest this should be reflected in the scheme design.

We believe it is important to explore further at this stage the option of providing a good, highly portable DC nursery scheme for the first few years (say, five) of membership of the scheme. Although it adds complexity, it could both offer a more appropriate way of saving for a pension for those who are less likely to stay in the scheme, and allow for a smaller reduction to the benefits available to those who stay for the long-term. We would emphasize that any nursery scheme should be fairly funded by the employer.

The consultation suggests that if market conditions worsen, a response could be to lower the salary cap in future valuations. This could further concentrate DB benefits away from long-term academic staff and towards staff who potentially are more likely to leave the sector. A nursery scheme might help to avoid this effect.

We would like to see what difference it would make to the proposals that could be afforded if all members in their first five years of service were DC only. We would in particular like to understand whether pursuing a nursery DC scheme for the early years of membership might create the scope to raise the salary cap towards a £58k threshold.

8. **Examples of typical effects on members**

We have reviewed the worked examples given by UUK in their webinar. We note that they have been done on the basis that salaries inflate by RPI while the salary cap inflates by CPI, leading on average to a 0.8% erosion of the real value of the salary cap every year. We note above that we think it would be better to link the cap to a specific point on the national pay spine, avoiding this erosion.

The examples compare future accrual under the proposed hybrid scheme with present FS and CRB section benefits. These comparisons are misleading because they assume no promotion or incremental salary increases over time, which are particularly relevant to comparisons with the FS section. We feel that we should show our staff examples based on a realistic and typical career, including the kind of promotion that they might reasonably expect. We note that this would show a much greater reduction of benefits to the average academic member of staff than is shown in the UUK webinar examples.

We note that the improvement in pension for the lower paid reflects that fact that their pay falls mostly below the cap and it is assumed that they will contribute two percentage points to the DC scheme above the DB-only contributions that they contribute at present.

We should like to see some more worked examples, showing the effect on typical staff, including those who will be most affected by the proposals. They should include typical promotions and within-grade increments, not just inflation. The national salary scales for academic staff offer a useful structure for providing such examples.

We should be grateful if these new examples, like the present ones, could show the change in future accrual over a range of periods. We should also like to see an aggregate pension figure including the deferred rights of final salary members with representative amounts of past service at the time of the change to the new scheme.

9. Request that USS and UUK consider a hybrid scheme with a 'vertical' salary split

We note that, as currently calculated, UUK's chosen illustrations reveal uneven effects, with increases of up to 30% in the pensions of lower paid staff, and significant reductions to typical academic staff, even before amending the examples as suggested above to reflect a realistic promotion path.

We think that consideration should be given to options that create a more even effect across all staff groups. One way to do this would be to split the salaries of all members between DC and DB according to a fixed proportion of individual salaries (a 'vertical' salary split). The same result could be achieved by changing the DB accrual rate, which would be simpler to administer, and which would also allow the Trustees to pass on any improvements in investment performance in the future to the DB side of the scheme, by moving the accrual rate in the future.

A hybrid scheme with a vertical salary split would have the advantage of treating members in way that is demonstrably equitable. It would also avoid the undesirable consequence of the proposed horizontal split which would have different impacts on universities with different fractions of their salaries above the cap.

We accept that, to limit risks to the scheme, there could still be a need for a horizontal cap above which all the pension has to be DC, but that cap might be much higher than £40k and so the benefits of the vertical split would for the most part be retained.

We do hope that this option is one that UUK and USS will wish to investigate.

10. The administration of the proposed DC scheme

We note that, under present proposals, the DC element of the pension will be highly significant for permanent senior academic staff. In common with other research-intensive Universities, we recruit many highly paid research staff from overseas. While pensions are not their prime consideration, they are certainly relevant to recruitment. If we are to manage the effect of this on our academic recruitment, we shall need to build confidence and trust in the DC element of their pension.

We expect our staff to have significant concerns about the DC element of the proposed hybrid scheme. We should like to understand whether it will be compulsory to use the USS DC scheme, or whether staff will be free to make arrangements with alternative providers if they wish. We should also like to be better informed on USS's proposals for running their DC scheme. We look forward to reviewing some examples of DC benefits and the effect on pensions of higher-paid staff in particular. We have some concerns that, in proposing the hybrid scheme, a good deal of weight has been given to the recent budget changes to the rules on the use of DC pension pots: these rules, like other aspects of the tax treatment of pensions, could be reversed by a future budget.

As mentioned above, different universities are likely to have a different mix of staff between DC and DB under the present hybrid scheme proposals. It follows that if all employers pay the same contribution rate, there will be some cross-subsidy between parts of the scheme and between employers. We shall be concerned to ensure that any DC scheme is entirely free from any obligation to pay towards the deficit on the DB scheme. At Oxford we have a specific problem because many of our staff are jointly employed with Colleges and we shall want to understand how the contribution cost will be split fairly.

We suggest a separate "deficit contribution" should be levied on qualifying salaries, with the costs of future DB accrual and DC contributions shown separately.

11. Death in service and ill-health benefits for the DC portion of the scheme

The restriction of death in service to 3x the salary cap would represent a significant reduction in this protection for members, who currently receive 3x annual salary under both FSS and CRB sections. Similar concerns would apply to the restriction of ill-heath payments to the salary cap. We should like to understand more of what is proposed for the element of salary above the salary cap. We expect our staff to be concerned to retain these benefits, and we would like to see some modelling for the effects of doing so.

12. Ability for staff to pay more for improved benefits

We note that UUK advises that their main concern is to limit future DB accrual and so contain the growth of future DB liabilities, and therefore a number of options for increasing the DB contribution rate to provide enhanced benefits have been ruled out. We would like to revisit this decision because we think that such options could be very important for staff.

We expect there to be appetite for a core provision with some flexibility on both rates and accrual for those members who wanted to vary their investment in their pension at different life stages.

Apart from the ability to pay additional DC contributions into the new scheme, what options could come under consideration to allow those who wish to pay higher rates to secure higher benefits? Would USS consider including the option for individuals to pay higher contributions to change the accrual rate, increase their salary cap for CRB accrual, or (if necessary) preserve death in service and ill-health benefits at existing levels?

13. Ability for the employer to pay more for improved benefits

We note that under the present proposals it seems possible that our overall contribution costs might go down, because we have significant numbers of senior academic and research staff who will be above the proposed salary cap. This is neither desirable nor politically possible, and we would like to explore ways in which we can keep our overall institutional contribution steady and preserve better benefits for our own members, and pay our fair share towards reducing the deficit, without providing a subsidy to the scheme as a whole.

We note that other universities with significant numbers of senior academic staff may be in a similar position. After this current exercise has taken place, we understand that USS intends to carry out a second review, of mutuality and of the scope for greater flexibility for employers. We note this could bring possibilities for some tailoring of the scheme for individual universities. However, we would like to understand what might be possible earlier than this, as part of considering the current proposals.