

## **USS funding and benefits – consultation by Universities UK**

### **Introduction**

1. This consultation paper provides an update on USS developments following the Universities UK consultation on the scheme's future funding which concluded in March 2014. It outlines the options for benefit reform and invites USS member institutions to comment.
2. Universities UK is the formal representative of all USS participating employers on funding and investment issues under the scheme rules and we would encourage all employers to respond to this consultation so that their views are taken into account as the employers' position on benefit reform is developed further.
3. Replies to this consultation – together with comments on the enclosed USS discussion paper which is referred to in paragraph 12 below - should be sent to Tony Bruce at [pensions@universitiesuk.ac.uk](mailto:pensions@universitiesuk.ac.uk) by **5 pm on Monday 15 September 2014 or earlier if possible**.

### **Timetable**

4. Following the completion of this consultation - and the associated consultation on the USS paper on integrated scheme funding (discussed below) – meetings with the University and College Union (the UCU) will continue in order to discuss the detail of any benefit reforms. Following the completion of the consultation, Universities UK will provide an update of its findings to the USS Trustees' meeting on 24 September 2014 when the initial outcomes for the 2014 valuation will be considered.
5. The USS Joint Negotiating Committee (the JNC) will meet in October to consider whether there is a need for contribution increases and/or benefit reforms in the light of the emerging valuation outcome and it is expected that discussions will be sufficiently advanced for decisions to be taken on any reforms in November 2014. If it is determined that reforms are required, a statutory consultation undertaken by employers with affected scheme employees will follow early in 2015 which will include a reaffirmation of the case for making the proposed changes which is outlined in this document (and which will be more fully communicated in the JNC discussions and separately with UCU). The statutory consultation period must be not be less than 60 days. The USS Trustees will then consider the responses and along with the JNC make final decisions on any benefit/contribution changes that are to be implemented.

### **Background**

6. Universities UK's response to the previous consultation on behalf of the USS employers, which was submitted to USS in March 2014, concluded with an acknowledgement of the following:

- the need for increased employer contributions, but with a clear indication that contributions should remain within the 16 to 18 per cent range in order to ensure that they are maintained at an affordable level, particularly in view of the additional increase in National Insurance due in April 2016;
  - the need for benefit reform (based on redefining the final salary link for past service and career average benefit for all for the future);
  - the need for some investment de-risking, principally to respond to the increasing reliance which the scheme will otherwise place on the sector over time, and to help in reducing funding (and contribution) volatility;
  - deficit contributions being required over a 15–20 year period; and
  - a longer-term review of mutuality and the need for greater institutional flexibility in USS pensions provision.
7. Following the consultation, Universities UK commissioned the actuarial consultancy AonHewitt to advise the USS Group of the Employers Pensions Forum (the EPF) on potential benefit reform options. These options are considered central to maintaining employer contributions within the range of 16 to 18 per cent alongside the need to eliminate the USS deficit and to manage investment de-risking effectively.
  8. AonHewitt identified a number of potential benefit packages, taking account of the outcome of the previous consultation with employers, and set out the estimated costs of each option when combined with one of four different levels of investment de-risking and either a 15 or 20 year recovery period.
  9. The outcome of the USS Group's work was presented to the Board of Universities UK on 27 June 2014. This considered the benefits provided by the scheme, and the risks they pose for both employees and employers alike, in the light of the financial position of the scheme as at March 2013, when there was a deficit of £11.5 billion, based on the March 2011 valuation assumptions. (The deficit had eased to an estimated value of £7 billion as at 30 September 2013, based on the March 2011 assumptions updated for market conditions.) The Universities UK Board shared the USS Trustees' concerns about the potential for employer contributions to increase further given the continuing level of investment risk borne by the scheme, and the need to reduce the likelihood of significant increases in employer contributions being required in the long term, in the context of maintaining USS's reliance on the covenant of the scheme's participating employers at current levels.
  10. It was recognised that the Pensions Regulator is of a similar view to that expressed by the Trustees in terms of the need to reduce risk in the scheme and avoiding any increase

in the scheme's reliance on the covenant. Universities UK has held two meetings with the Regulator in recent months in order to provide information on its response to the current funding position of USS and our proposals for benefit reform. In view of the size of USS and the scale of its deficit the Regulator has been monitoring the valuation process closely and has asked to be kept updated as our proposals for reform develop.

11. The Universities UK Board considered the sustainability of current USS pension provision in this context and concluded that the employers should be aiming for a longer term solution which substantially reduced the risk of further employer contribution increases above the 16 to 18 per cent range, but still offered the opportunity to implement an attractive and flexible benefit package as well as allowing for an element of investment de-risking. The USS trustee company has indicated that a strategy which substantially reduced the deficit through redefining the final salary link for past service and capped future benefit accrual, in conjunction with the introduction of an element of benefit flexibility on a defined contribution basis, should under the USS Trustees' risk parameters lead to lower cost impacts than the investment de-risking in their original proposals.
12. The USS Trustees' approach to scheme funding is discussed in *An integrated approach to scheme funding* (July 2014), which Universities UK is circulating for comment at the same time as this consultation paper. The attached USS Trustees' paper considers the interaction between the covenant, investment strategy and funding and discusses three guiding principles on which the Trustees' management of scheme finances are based. It then describes a series of specific tests which the USS Trustees will consider in ensuring that USS's funding arrangements continue to satisfy those principles. The USS trustee company has applied these tests to the options discussed in this paper and Universities UK believes that the illustrative hybrid option as described below will fit within the guiding principles outlined in the USS Trustees' paper. This includes the underlying principle – which Universities UK supports - that the scheme's exposure to the employer covenant should not increase over the next 20 years.

### **Proposed benefit reform options**

13. The Universities UK Board reviewed the main options for benefit reform relating to future service including the extension of the existing Career Revalued Benefit (CRB) scale for all members, a hybrid model incorporating career average and defined contribution (DC) elements, and a single DC scheme. The Board agreed that a hybrid CRB option for future service which incorporated an element of DC in the approach should be recommended as the basis for consultation with USS employers. For the reasons given below, the Board believes that the principal alternatives are unlikely to address the funding position of USS and/or provide suitable pension provision for the participating employers, but institutions are also invited to submit their views on these options.

14. In the Universities UK Board's view, a hybrid design outlined in broad terms below would provide a sustainable benefit structure that balances the needs of scheme members and employers, would be consistent with the principles established by the Trustees and also more generally meet the Regulator's expectations:

- **Past service:** The final salary section will be closed to all future benefit accrual for existing members from a specified date (this has been assumed for modelling purposes to be April 2016). Benefits for past service (i.e. up to the date of change) for existing final salary members would be calculated based on their salary at the date of the change and from then on would be revalued annually in line with the consumer price index (CPI) (in the same way as CPI indexation applies to existing benefits accruing in the CRB section). This would mean that past service final salary benefits would no longer be linked to final salary at retirement.
- **Core Defined Benefits up to a salary threshold:** Future benefits from the date of implementation would be on the existing CRB scale, subject to an upper salary limit qualifying for defined benefits (the Salary Threshold). Our aim is to maximise the number of scheme members who fall under this Salary Threshold. We expect to be able to implement a Salary Threshold of no less than £40,000 per annum and have been modelling benefits on this basis. The final level of the Salary Threshold will depend on the need to ensure affordability while maintaining the attractiveness of the scheme. We will also need to consider how this Salary Threshold is revalued in future years.
- **Member contributions:** In the CRB section, scheme members currently contribute 6.5 per cent of pay in order to qualify for CRB benefits. Under the existing cost sharing arrangements of broadly 2/3rds employer and 1/3rd employee, this contribution rate may need to rise for future CRB benefits provided up to the Salary Threshold (at the same accrual rate of 1/80ths pension and 3/80ths lump sum as now) if scheme risks are to be contained. Scheme members could pay additional contributions to qualify for the flexible DC pot as described below.
- **Additional flexible DC pot:** This added benefit will mean that scheme members could elect to pay additional contributions in respect of their pay up to the Salary Threshold (as defined above). Additional member contributions of up to 2 per cent on pay up to the Salary Threshold would be matched pound for pound by employers up to a maximum percentage of 2 per cent of pay. Hence if a member earning up to the Salary Threshold made an additional contribution of 2 per cent of pay then they would then have a total contribution to their flexible DC pot of 4 per cent of pay. Members would also be permitted to pay further, additional DC contributions into their pot but any amount above 2 per cent would not be matched by the employer.
- **DC benefits above the Salary Threshold:** For pay above the Salary Threshold (as defined above), it is proposed that scheme members would receive a contribution

from their employer of 12 per cent of pay, in excess of the Salary Threshold, into their flexible DC pot. Scheme members would be required to make a minimum contribution of 6.5 per cent to their flexible DC pot in respect of salary above the Salary Threshold.

- **Death in service and ill health:** Benefits on death in service and on ill health will be provided in a similar form as under the existing CRB arrangements for salary up to the Salary Threshold. For salary in excess of the Salary Threshold, it is intended that part of the 12 per cent employer contribution will be used to provide further death in service and ill health benefits in respect of salary benefits above the Salary Threshold, although this will need to be considered in further detail.

### **Commentary on other benefit reform options**

15. The option of moving to a DC scale for all future accruals was also considered. This provision has become commonplace in the private sector and is now found (for new entrants) in a number of Self Administered Trusts and auto enrolment schemes in the higher education sector. While there was a significant minority of institutions which supported a full move to DC in the earlier Universities UK consultation, there was a strong sense from the majority of employers that it would be appropriate to maintain a core element of defined benefit (DB) in order to retain an attractive scheme, help with retirement planning, and to maintain a feature which is valued by many scheme members. However, the concept of a hybrid scheme with core CRB to a Salary Threshold, coupled with DC provision on salary above the Salary Threshold, received broad employer support. This type of scheme can be implemented such that the overall growth of the guaranteed DB liabilities would over time be limited, giving the USS Trustees and the Regulator confidence that these benefits would remain affordable in relation to the financial strength of the sector over the long term, and the growth of DB liabilities would remain proportionate to the employers' covenant.
16. The idea of a moving to a pure CRB scale for future service - with all future benefits remaining on a DB basis – was considered, but it would not produce sufficiently material changes to the level of risk associated with the scheme. As such, the Trustees would argue that they needed to continue with their investment de-risking as originally proposed, pushing up the cost of both funding the deficit and providing future service benefits. Without significant reductions to future benefits this would lead to a substantial increase in employer and employee contributions. There would be a higher probability of the need to revisit benefit structures at future valuations as the resulting structure would not be as future-proof as the proposed hybrid CRB scheme.
17. We have therefore endeavoured to propose a sustainable solution that mitigates the possibility of future employer contribution increases by reducing the risk borne by the scheme through benefit accrual in order to allow the USS Trustees to be comfortable implementing less investment de-risking. The proposed hybrid scheme will increase the

probability that employer contributions will remain within the 16 to 18 per cent range. The USS trustee company has estimated that with a pure CRB scheme (based on current accrual rates) there would be a 35 per cent probability of contributions exceeding 18 per cent in three years and a 25 per cent probability of them exceeding 21 per cent. The equivalent figures for the hybrid CRB option with a £40,000 salary cap would be a 16 per cent probability of them exceeding 18 per cent in three years and a 9 per cent probability of them exceeding 21 per cent.

18. We considered the possibility of an increase in the employee DB contribution rate in order to provide a higher level of future service benefits than is currently available in the CRB section. However, at this point the main concern is to limit future accrual in order to contain the growth of DB liabilities and an increase in the employee contribution rate in order to provide an improved CRB accrual rate has not therefore been included in the illustrative benefit design. However, as mentioned in paragraph 14, the current contribution rate of 6.5 per cent for the CRB section may need to rise in order to maintain the same CRB accrual rate as now if scheme risks are to be contained.
19. A further consideration relates to the impact of the 2014 Budget which fundamentally enhanced the attractiveness of DC pensions by removing restrictions on how an individual can access a DC pension pot. As a result, the option to take the entire fund as cash (subject to tax charges as appropriate) will become available from 2015. The shape and level of pension income derived from a DC pension pot could within certain limitations and subject to specific scheme rules be determined by the individual to reflect their own attitude to risk and their personal circumstances.
20. The adoption of a DC scale for earnings above the Salary Threshold offers another increase in flexibility in the scheme, which has hitherto provided a uniform scale of benefits for all scheme members, regardless of their personal circumstances. The facility to permit members to make additional DC contributions above the required minimum may encourage those who value pensions saving the most to invest more.
21. The concept of core CRB to a Salary Threshold ensures that the DB is targeted on scheme members with lower incomes, where certainty of retirement income is most important. Put another way, the intention would be that the DC element of the pension provision is greater among the higher paid scheme members, who generally speaking are more able to deal with the inherent variability associated with DC saving, and can probably make greatest use of the flexibility of the DC pot. The addition of the DC element is intended to offer an improvement to the current CRB section for many members and modelling is being undertaken by the USS trustee company which we believe will show the potential for this to be a valuable additional benefit.
22. Although the considerable DB benefits accrued to the date of implementation of reform leave open the possibility of further deficits arising in future, the proposed hybrid design will produce a significant reduction to the current deficit of the order of £6 billion through

re-defining the final salary link to past service (assuming that it is replaced with CPI indexation), and will limit the build-up of guaranteed DB risks in the future. If market conditions worsen at future valuations, then the hybrid structure could be modified (for example, by lowering the Salary Threshold, or the DC employer contribution rate above and/or below the cap) in order to keep contributions affordable. Likewise, if market conditions improve, an increase in the employer's DC contributions below the cap could be considered. This would need to be balanced against the need to reduce investment risk further, giving greater certainty around the cost of the scheme in the future.

23. The proposed changes would have a number of implications for the operation of the scheme which will need to be further discussed and resolved. They include, for example, participation in the public sector transfer club and the basis on which deficit contributions are calculated for participating employers, and these (and others) are currently being considered. We will consult institutions further on these issues in due course.

### **Issues for consultation**

24. Institutions' responses to this consultation will provide the basis for further discussion with the UCU in the autumn and the submission of a proposal to the USS Joint Negotiating Committee in November 2014. Institutions are invited to comment on this consultation paper and the specific issues raised below:

- Potential benefit reform that relies solely on career average benefits and re-defining the link between pension entitlement and final salary is unlikely to curtail risk in the scheme and be sustainable in the longer term. The employers should aim for a longer term solution which significantly reduces risk of further employer contribution increases above the 16-18 per cent range, whilst preserving an attractive and flexible benefit package;
- Benefit flexibility should be adopted so that the USS Trustees can, in line with their risk parameters, undertake less investment de-risking than originally proposed, thereby reducing the impact on future costs. To achieve a sustainable solution, benefit reform is likely to involve a hybrid career average option which incorporates elements of a defined contribution scheme, as described in paragraph 14 above;
- The Salary Threshold above which only defined contribution benefits would apply should be set so as to ensure that as many members as possible are below the Salary Threshold whilst still retaining an affordable model.

25. Replies to this consultation – together with comments on the USS discussion paper (referred to below) - should be sent to Tony Bruce at [pensions@universitiesuk.ac.uk](mailto:pensions@universitiesuk.ac.uk) by **5 pm on Monday 15 September 2014 or earlier if possible.**

17 July 2014