Employers Pensions Forum for Higher Education

Universities UK

# UUK/EPF – IMPORTANT UPDATE ON USS FOR EMPLOYERS

## ANNEXE: DEVELOPMENT AND BACKGROUND TO UUK/EPF GUIDING PRINCIPLES

13 February 2017

## CONFIDENTIAL – FOR USS EMPLOYERS ONLY

# DEVELOPMENT AND BACKGROUND TO UUK/EPF GUIDING PRINCIPLES

## ENGAGEMENT WITH THE SECTOR

In order to engage with Universities Superannuation Scheme (USS) employers on their preferences for the future, a series of town hall events[1] took place in September 2016. During these events, USS, Universities UK (UUK) and Aon (in its role as UUK's actuarial advisors) delivered presentations to over 100 delegates at three venues. These delegates represented 89 different USS employers and covered over 83% of USS active membership.

Following these events, a survey of USS employers took place in October 2016. 115 USS employers responded, representing over 94% of USS active membership.

UUK and the Universities and Colleges Employers Association (UCEA) have also engaged with various sector bodies and representative groups[2] to invite further input to the pensions strategy project. The findings in this annexe are primarily derived from this engagement with the sector in 2016.

## DEVELOPMENT OF FIVE GUIDING PRINCIPLES

As a first step towards the development of a long-term strategy for USS, a set of guiding principles has been drawn up to describe the features that employers want from USS in the future. These have been developed through detailed consideration of the financial, competitive and workforce trends in the sector alongside the findings from the recent engagement with USS employers.

The five principles are:

1. Institutions should continue to offer pensions which are valued by employees
2. Pension provision should be sustainable in the long-term
3. Pension benefit design should be predictable and stable
4. Institutions should have more flexibility to adapt pension provision as appropriate to their needs and those of their employees
5. Employees should have more choice and control over their pension saving

When taken together, these principles emphasise the continuing wish of employers to provide good pensions, albeit with control and predictability as the key elements of any arrangement, within a structure which is adaptable to likely changes in future demands and behaviours. Employers will need to determine how to achieve the right balance between these principles. The evidence informing each principle is outlined in more detail in this annexe.

[1] The background paper provided to USS employers in advance of the town hall meetings can be found here and the mutuality paper provided in advance of the town hall meeting can be found here.
[2] Meetings have taken place with the Association of Heads of University Administration (AHUA), the British Universities Finance Directors Group (BUFDG), Universities Human Resources (UHR), Russell Group, University Alliance and Million +.

| Principle 1: Institutions should continue to offer pensions which are valued by employees |
|---|
| Pensions are an important and valued part of an institution's reward package. Institutions should continue to provide a quality pension to all employees, which meets their pension saving needs and helps institutions attract and retain talent. |

## Survey findings

In the survey 95% of respondents indicated that they strongly or somewhat agreed with the statement 'My institution highly values pensions as an important recruitment tool and benefit to employees' (see Figure 1). Such widespread agreement indicates that any approach towards pensions must continue to ensure a quality scheme remains available to the sector. In practice, this requires a clear understanding of what employees and employers most value.

*Figure 1: My institution highly values pensions as an important recruitment tool and benefit to employees*

| | **Total** | **Pre-92** | **Post-92** | **Oxbridge** | **Non-HEI** |
|---|---|---|---|---|---|
| #Responses | **115** | 60 | 22 | 16 | 17 |
| | | | | | |
| Strongly agree | **68%** | 73% | 73% | 63% | 47% |
| Somewhat agree | **27%** | 22% | 27% | 31% | 41% |
| Neither agree or disagree | **5%** | 5% | 0% | 6% | 12% |
| Somewhat disagree | **0%** | 0% | 0% | 0% | 0% |
| Strongly disagree | **0%** | 0% | 0% | 0% | 0% |

## Workforce trends

In recent years the UK higher education workforce has been required to adapt to fundamental shifts in funding and regulatory policies, as well as technological changes. There is increasing national and international competition for staff, particularly in respect of academic positions. There are also increasing numbers of part-time and older staff in the sector. These workforce trends impact pension provision put in place by employers.

*National and international competition for staff*

Institutions compete with the private sector and/or an international market. The former is most pertinent to recruitment and retention in professional and senior support roles and the latter more relevant to academic roles. HESA data indicates that over 28%[3] of UK academic staff are now from overseas. There is an ongoing need to attract and retain top talent in a global labour market while exercising constraint on staff costs. Following the result of the EU membership referendum there is even greater pressure on institutions to demonstrate that the UK is a welcoming destination for globally mobile staff, with attractive salary and pension packages. Pension packages need to be attractive to, and tailored to the needs of, both national and international staff.

[3] HESA Staff Record 2014–15

*Change in age profile of academic staff*

Between 2005–06 and 2014–15, the number of academic staff has increased in all age groups (except 25 and under). However, this increase is most pronounced among older staff. The number of academics aged 66 and over has more than doubled over the last decade. In 2014–15, there were 6,045 academics aged over 66, compared to 1960 in 2005–06. There has also been a relatively high increase in 61–65-year-olds. Over the same period, the number of full-time academics aged 61–65 rose by 48% and the number of part-time academics rose by 62%[4].

These changes affect the way in which pensions are accessed and drawn, with the link between retirement and age loosening. Staff are demanding greater discretion as to when they can access their pension savings, whether that be before or after they formally retire from employment.

| **Principle 2: Pension provision should be sustainable in the long-term** |
|---|
| The scheme must be sustainable in the long-term, where sustainability is about managing risk as well as cost. Pension costs must be predictable for both employers and employees. In terms of risk, the funding arrangements should not increase the pensions risk to which institutions are exposed, and similarly, strategies should be available to help employees to predict their pension outcomes. Sustainability also means giving importance to fairness and equity between generations of scheme members, balancing employer commitment to promises made in relation to past service with support for good future pension outcomes. |

## Survey findings

In the survey 97% of respondents either strongly or somewhat agreed that the risks associated with current defined benefit (DB) pension provision represent a significant financial uncertainty for their institution (see Figure 2).

*Figure 2: The risks associated with DB pension provision represent a significant financial uncertainty for my institution*

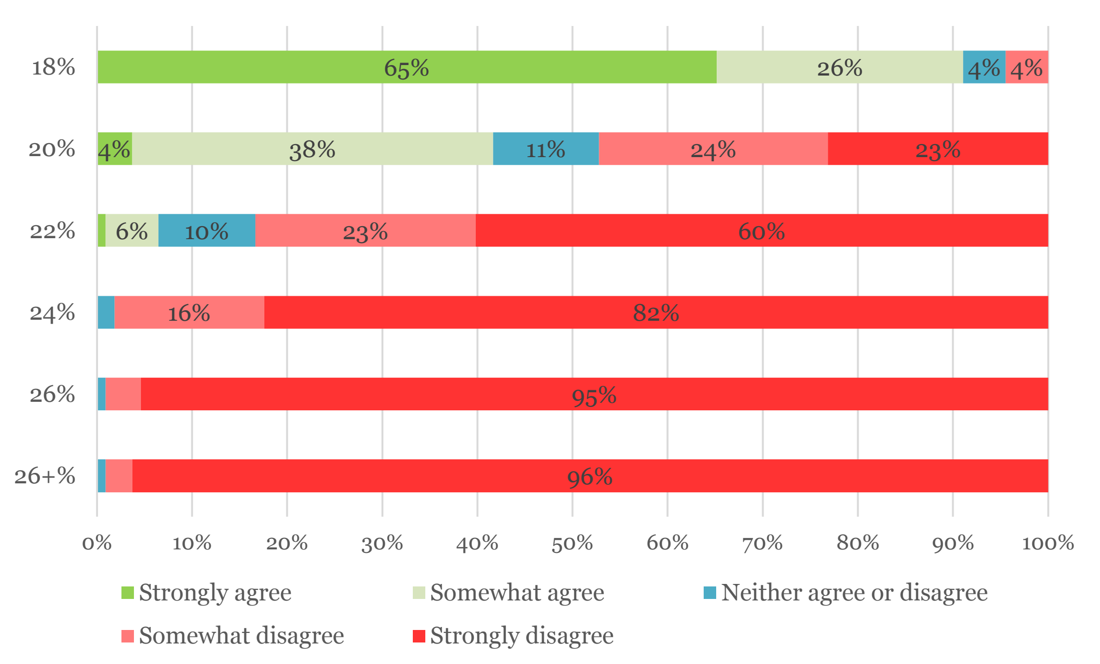
| | **Total** | Pre-92 | Post-92 | Oxbridge | Non-HEI |
|---|---|---|---|---|---|
| #Responses | **115** | 60 | 22 | 16 | 17 |
| | | | | | |
| Strongly agree | **80%** | 83% | 82% | 75% | 71% |
| Somewhat agree | **17%** | 15% | 18% | 25% | 18% |
| Neither agree or disagree | **2%** | 0% | 0% | 0% | 12% |
| Somewhat disagree | **1%** | 2% | 0% | 0% | 0% |
| Strongly disagree | **0%** | 0% | 0% | 0% | 0% |

The sector's views on the affordability of further employer pension contribution increases has not changed significantly from the position in 2014. Most survey respondents (91%) indicated that 18% was the limit of affordable contributions, a position which also closely aligns with comments made by delegates at the town hall

[4] HESA Staff Record 2014–15

meetings. Only a minority of employers felt any increase to employer contributions was affordable (see Figure 3).

*Figure 3: What is the maximum level of contributions that you could sustainably afford to pay, without causing material financial strain to your institution?*




It is important to draw a distinction between the ability to pay higher contributions and employers' willingness to do so. In the detailed comments employers included in their survey responses, many pointed out that while they had the financial capacity to pay higher contributions, any such change would need to recognise the need for an institution to be able to meet existing commitments as well as the reprioritisation (as required) to deal with short- and medium- term challenges facing the sector.

A number of employers commented on the level they felt was appropriate to pay towards employees' pensions, often citing the range of other financial commitments they have. This was also reflected strongly in institutions' responses to the recent covenant review consultation, where they observed that a key feature of being able to deal successfully with risks stems from their adaptability and ability to respond to various pressures to meet the needs of their institution. Many respondents highlighted the need to invest strategically to maintain their financial strength in the long-term, saying that any further increase in pension contributions would hinder this. Some employers also commented that any increase in expenditure towards staff reward should be targeted towards what employees value the most.

For many employers, the fact that current USS benefits cost more than is currently paid means more needs to be done to solve the problem sooner rather than making the funding position worse in the long-term. For some delegates at the town hall meetings, more formally separating the past service deficit from the future service cost is an option worth exploring to better portray the challenge of the 'legacy' funding issues, as distinct from the future benefits cost.

Many employers also expressed concerns regarding the ability and also the willingness, of employees to pay higher contributions. 73% of employers felt that employees would not be willing to pay higher employee contributions for reduced benefits (see Figure 4). Employers are also concerned that not all of their employees can afford the contributions required for the current level of benefits, with 43% of pre-92 institutions indicating agreement with that statement (see Figure 5). It is critical that the costs associated with the scheme are sustainable in the long-term for employers and employees alike.

*Figure 4: Do you think that employees would be willing to contribute more to their pension alongside employers if required?*

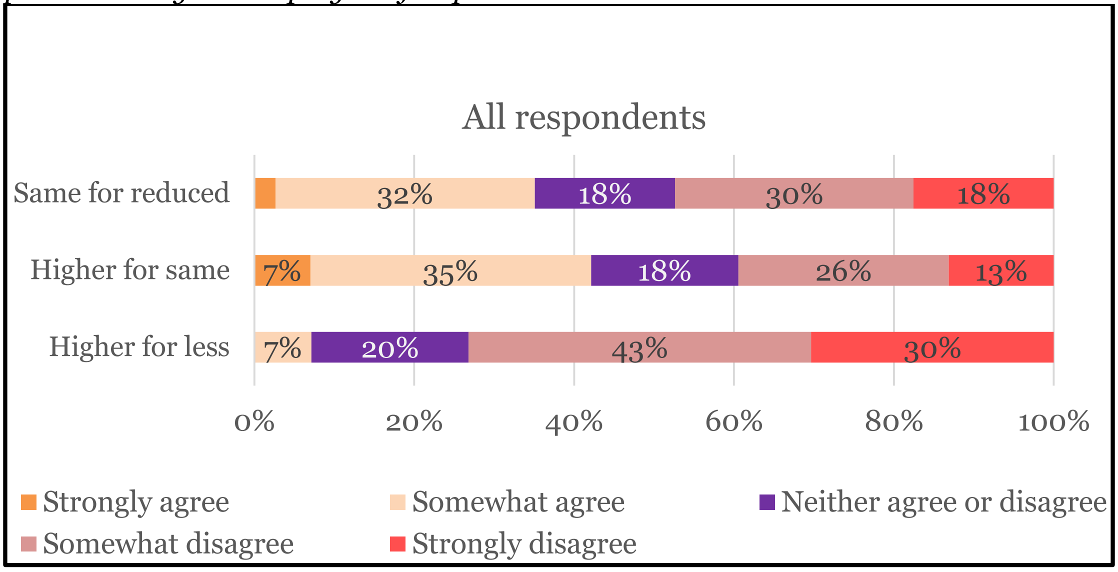
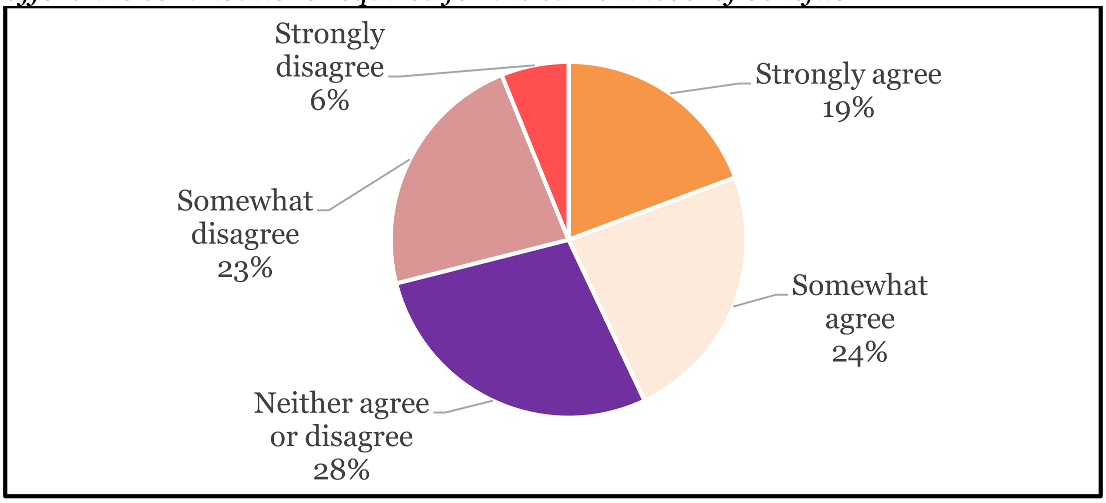



*Figure 5: Pre-92 institutions responses to statement – "not all my employees can afford the contributions required for the current level of benefits"*




It is clear that DB provision is hugely valued by the sector. However, it is also clear that the level of risk currently being carried to offer such provision is too high. Universities are now publishing their 2015–16 financial results – the first to be reported under FRS 102 as interpreted by the sector in the FEHE Statement of Recommended Practice (SORP). For the first time an institution's USS pension liability will now appear on its balance sheet. This has resulted in reduced reported annual surpluses in the latest accounts. This greater visibility of the USS pension scheme deficit is already starting to lead to a renewed focus on the organisational responsibility of each participating institution to USS. It is also creating a better understanding of the risk which now lies visibly on institutions' balance sheets.

Risks from pensions is a concern for all employers, with strong agreement from delegates at the town hall events that cost and the uncertainty around future costs is a significant concern. As a result, the need for options for control and stability in pensions risk, and in contributions, are a key part of a long-term strategic approach for the sector towards USS.

### Financial and competitive trends

Staff costs made up 55% of the sector's expenditure in 2014–15. In monetary terms, expenditure on staff has increased annually between 2005–06 and 2014–15, increasing by 28% in real terms from 2005–06 to 2014–15[5]. Staff costs as a proportion of total expenditure have remained relatively steady in recent years. However, this trend may not be sustained. Latest forecasts from the Higher Education Funding Council for England (HEFCE)[6] show that the sector expects staff costs to increase by 14.5%, from £14,783 million (equivalent to 51.1% of total income) in 2015–16, to £16,919 million in 2018–19.

| **Principle 3: Pension benefit design should be predictable and stable** |
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| Employers and employees have a desire for certainty in benefit design, as far as possible, so that they each can plan for the future. This means a stable benefit design in the long-term, which builds trust and which can be consistently communicated. |

### Survey findings

The last two USS valuations have necessitated changes to benefit design. These changes have had implications for both employees and employers. Employers are concerned that frequent changes will cause employees to undervalue their pension offer and feel unable to plan for the future. There is a serious risk of members opting out of pension schemes. 62% of pre-92 institutions indicated that they were concerned that future benefit reform may lead to staff opting out of pensions altogether (Figure 6). There are also implementation challenges as well as communications issues with ongoing benefit reform, which must be considered when determining a long-term approach to USS.

[5] HESA Staff Record 2014–15
[6] HEFCE Financial health of the higher education sector 2015–16 to 2018–19 forecasts

*Figure 6: If changes to USS benefits become necessary, to what extent are the following issues of concern to you?*

| | **Total** | **Pre-92** | **Post-92** | **Oxbridge** | **Non-HEI** |
|---|---|---|---|---|---|
| #Responses | **115** | 60 | 22 | 16 | 17 |
| **% strongly or somewhat agreeing** | | | | | |
| The possibility of staff opting out of pensions altogether | **58%** | 62% | 36% | 56% | 76% |

At the town hall events delegates noted a need to break the cycle of triennial reform. From the employers' perspective this would allow cost planning, and from the employees' perspective it would provide more certainty to ensure ongoing engagement and confidence in the overall benefit package. A number of delegates at the town hall events commented that institutional capacity to carry out further benefit reforms should be factored into decisions taken for the future of the scheme.

Employee engagement was discussed at all of the town hall events, with delegates emphasising the need for a pension scheme that is easy to understand. Having a clear approach to benefit design in the long-term should aid employee engagement, as there would be greater clarity for members.

### Trends impacting benefit design

Historically, pension schemes in the sector aligned their provision – often DB – with a similar accrual rate, lump sum and contribution rate, usually on a 'public sector' model. This is no longer the case. In addition, the exit from the public sector transfer club by USS following the most recent benefit reform means that schemes will no longer offer equal terms upon transfer, so employees moving between sector schemes will not receive equivalent credits.

Engaging and educating members to ensure their continued participation in sector schemes is a key challenge for schemes and employers. Furthermore, the introduction in the 2016 Budget of the new Lifetime ISA (LISA) may blur the lines between pensions and personal saving, in particular for those under the age of 40. This may impact membership figures and exacerbate funding issues.

In addition, recent reductions in the annual and lifetime allowances mean that more scheme members face additional tax charges on their pension savings, which may result in opt-outs. As a result, there is a need for the provision of alternative reward in lieu of pensions, and greater support for affected employees to ensure they make decisions that are appropriate for them.

There are further developments which could impact benefit design or member requirements from the scheme. These include:

- possible changes to tax policy and anticipated increases in the state pension age

- changes to the working lives of individuals, with more people working beyond their scheme retirement age (impact of State Pension changes)
- wider government policy, which has focussed on a drive towards defined contribution provision and increased flexibility and choice.

Finally, the government is expected to issue a green paper in the coming months detailing views on the future of defined benefit schemes. The content is as yet unknown, but the consultation is expected to seek views on indexation, scheme valuations, member protection and consolidation of small schemes. Developments in this wider policy context could impact on the pensions strategy work.

| **Principle 4: Institutions should have more flexibility to adapt pension provision as appropriate to their needs and those of their employees** |
| --- |
| The operating environment for institutions is evolving and with that the sector's workforce is becoming more diverse. Employers should have the flexibility to personalise and optimise their pension arrangements through flexible scheme architecture which enables configuration. That framework for flexibility should also be driven by the differing needs of groups of employees. |

**Survey findings**

From discussions at the town hall events and in the responses from the survey it is evident that a uniform pension solution for the sector is becoming difficult to align with an increasingly divergent sector. Different institutions have different strategic priorities and many want more flexibility in the pensions they can offer to help them provide a reward package most suited to their needs and the needs of their employees. This principle of flexibility aligns closely with the other guiding principles and should be considered closely alongside scheme sustainability, approach to risk, affordability considerations and the needs of employees.

The town hall events and surveys demonstrated the breadth of areas in which flexibility would be desirable. Institutions need to have the flexibility to rebalance reward packages and resources to meet the differing needs of staff. In particular, employers indicated a need for a more holistic approach to total reward with any discussion about future pension needs being considered alongside a more fundamental review of the overall reward package, including salary, reward, and performance. If institutions are to remain competitive, they need the tools of a flexible total reward package to meet their strategic needs.

The uniform contribution rate for both employers and employees offers little flexibility for employers or employees concerned about costs. Almost a quarter of respondents to the survey indicated that additional pension costs have been a barrier to their institutions' longer-term sustainable growth (see Figure 7).

*Figure 7: How has the rise in USS employer contributions from 16% to 18% in 2016 impacted your institution?*

| | Total | Pre-92 | Post-92 | Oxbridge | Non-HEI |
|---|---|---|---|---|---|
| #Responses | **115** | 60 | 22 | 16 | 17 |
| The increased expenditure on staff pensions was sufficiently offset by, for example, increased income or reserves | **29%** | 20% | 45% | 31% | 35% |
| The financial impact was considerable, but manageable through cost savings that will not impact significantly on the ambitions of my institution | **48%** | 53% | 36% | 44% | 47% |
| The additional pension costs are a barrier to my institution's longer term sustainable growth | **23%** | 27% | 18% | 25% | 18% |

A minority (32%) of employers believe that the ways in which contributions are set should be reviewed, or that there should be a legal separation of each institution's assets and liabilities (see Figure 8).

*Figure 8: What is your institution's view on the way current contributions are set and assets and liabilities are calculated?*

| | Total | Pre-92 | Post-92 | Oxbridge | Non-HEI |
|---|---|---|---|---|---|
| #Responses | **115** | 60 | 22 | 16 | 17 |
| **% somewhat or strongly agreeing** | | | | | |
| My institution would support taking financial control of its own liabilities both past and future | **32%** | 24% | 27% | 75% | 25% |
| My institution would support the legal separation of each institution's assets and liabilities and the negative effect this may have on mutuality | **26%** | 14% | 36% | 73% | 13% |

**Trends**

The financial position of the UK higher education sector is currently sound, but there will be increasing policy and funding challenges in the future. Further, a more competitive environment will result in pressure on universities to invest in capital, infrastructure and services, for instance to meet increasing student demand. This, according to Grant Thornton, is leading to considerable variation in both the financial strategies and performance of institutions[7]. This is consistent with HEFCE's review of the financial health of the English higher education sector[8]. HEFCE also note an increasingly wide gap between the lowest and highest performing institutions in England. When considering pensions, it appears that institutions will need greater flexibility in order to adapt pension provision to suit their needs.

| **Principle 5: Employees should have more choice and control over their pension contributions and benefits** |
|---|
| Employees should be able to save towards their pension in the way that suits their needs. They need choices which allow them to flex the amount they save, and which reflect their specific career plans and portability needs. Employee choices should also evolve, reflecting the development of contemporary retirement solutions. |

While employers would welcome more flexibility themselves, they also believe that employees should have more choice and control over their pension saving. In particular, many institutions would like to be able to offer a choice of alternative pension benefits to particular groups of employees. A number of employers commented that the exclusivity rule has prevented them from offering valued alternatives to staff for whom a USS pension is not a suitable option. Overall, an overwhelming majority of employers (75%) indicate that they would strongly agree or somewhat agree to greater flexibility in the pension options available to employees (see Figure 9).

*Figure 9: My institution wants greater flexibility in the pension options available to employees*

| | **Total** | **Pre-92** | **Post-92** | **Oxbridge** | **Non-HEI** |
|---|---|---|---|---|---|
| #Responses | **115** | 60 | 22 | 16 | 17 |
| | | | | | |
| Strongly agree | **31%** | 29% | 32% | 50% | 18% |
| Somewhat agree | **44%** | 47% | 50% | 13% | 53% |
| Neither agree or disagree | **16%** | 12% | 14% | 25% | 24% |
| Somewhat disagree | **8%** | 10% | 5% | 6% | 6% |
| Strongly disagree | **2%** | 2% | 0% | 6% | 0% |

Focusing on pre-92 employers who offer USS to academic and academic related staff, over three quarters of those 53 pre-92 employers (77%) indicated they would like to be in a position to offer alternative pension benefits to those with affordability concerns. Over half of respondents from pre-92 institutions also indicated a desire to be able to

7 Grant Thornton (2015) Thrive or survive? Financial health of the higher education sector in the UK: 2015

8 HEFCE (2016) Financial health of the HE sector: 2016–17 to 2018–19 forecasts

offer an alternative to internationally mobile staff (64%) and those on short/fixed term contracts (55%) see Figure 10.

*Figure 10: Number of survey respondents wanting to offer alternative benefits to particular groups of employees*