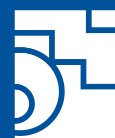
Special consultation by the
HE Employers' Pensions Forum

Pension provision in the higher education sector: initial report



Universities UK
Celebrating 90 years
1918–2008

About the author

Peter Thompson is an actuary with 30 years' pensions experience. He is a director of the independent trustee company BESTrustees plc, which he joined in April 2005 after having worked at the consultants Mercer for nearly 25 years.

Peter has been much involved with the National Association of Pension Funds (NAPF), being a member of Council from 1994 to 2005 and Chairman of the NAPF from 2001 to 2003. From August 2005 to March 2006 he was interim chief executive of the corporate governance company RREV. He was a member of the Railway Pensions Commission which was set up to review all aspects of pension provision in the railway industry and which published its final report in January 2008.

Peter is a regular speaker and chairman at conferences and seminars. He has also contributed on pensions issues to both print and broadcast media, including appearances on news programmes on the BBC, ITV and Channel Four, as well as *Money Box* and the *Today* programme. He is a member of the Council of the Pensions Policy Institute, and is a CEDR accredited mediator.

Peter's Trustee clients at BESTrustees include J Sainsbury, Scottish Power and Jacob's Bakery. He is also a member-elected pensioner trustee of his own scheme, the £3 billion MMC UK Pension Fund.

Pension provision in the higher education sector: initial report

This report has been prepared for the HE Employers' Pensions Forum by Peter W Thompson BSc FIA, Independent Actuary and Consultant.

Contents

2 Summary

1
3 Introduction

2
4 Background

3
5 Recent changes

4
6 The Hewitt report

5
7 Public sector or private sector?

6
8 Pension scheme models

7
10 Which design model for the higher education sector?

8
12 Scheme mergers

9
15 Universities Superannuation Scheme issues

10
16 A possible long-term solution

11
17 Conclusion

18 Glossary

19 Notes

Summary

- This report has been written at the request of the Universities and Colleges Employers Association (UCEA), Universities UK and GuildHE in the light of increasing concern among their members about the rising cost of pension provision. Rising costs are partly caused by generic factors such as improving mortality, and partly also by a number of factors specific to the higher education sector.
- Initially the major pension schemes operating in the sector – the Universities Superannuation Scheme (USS), the Teachers' Pensions Scheme (TPS), the Self-Administered Trusts (SATs) and the Local Government Pension Scheme (LGPS) – are reviewed, and recent changes made to the public sector schemes TPS and LGPS are noted. Key conclusions from the Hewitt report (2007)[1] are listed and it is noted that some of these give clear pointers towards possible solutions.
- The position of the higher education sector at the boundary of public sector and private sector is interesting and has some consequences for possible pension scheme models in the future. The major pension scheme models are reviewed and their advantages and disadvantages explained. Designing a pension arrangement which rewards or encourages particular behaviour is described.
- In looking at possible design models for the higher education sector, widespread adoption of money purchase provision is ruled out as there appears to be little employer appetite for such a large-scale transfer of risk to the members. However, the option of having a "menu" of pension options is worth further discussion although there are substantial practical difficulties with such an approach.
- The widely expressed desire to achieve greater economies of scale is addressed from the point of view of reducing the number of pension schemes in the higher education sector. Moving towards a single scheme for each institution is ruled out, as is the option of adopting the TPS as the single scheme for academic staff. However, the possibility of USS developing in this way is worth further examination, which would have to include consulting the relevant government departments.
- The position of non-academic staff, especially those in pre-1992 institutions, is considered and it is suggested that merging the smaller SATs, either with each other or into a larger existing scheme such as USS or the Superannuation Arrangements of the University of London (SAUL), is a practical proposition. Some institutions have already done this and others are understood to be considering this approach.
- The structure of USS, and in particular the role of its Joint Negotiating Committee (JNC), are examined and it is concluded that more work needs to be done, probably outside the USS framework, to establish an agreed route forward with the University and College Union (UCU) that would enable final salary pension provision to be sustained in its present form.
- Finally, a possible pensions model for the future is outlined together with a proposal that more work needs to be done to refine such a model, and in particular how it would adapt to future changes such as continuing improvements in mortality rates.

1 Introduction

1.1 This report has been prepared at the request of UCEA, Universities UK and GuildHE in the light of increasing concern about the sustainability and rising cost of the pension arrangements operated by their member institutions. Most of these arrangements are of the "final salary" type, where pensions are based on length of service and salary at or near retirement.

1.2 The background to the present request stems partly from factors which are generic to all pension arrangements – particularly cost issues caused by improving mortality and difficult investment markets – and partly from factors specific to the sector. The sector-specific factors include:

- the structure of USS;
- the extent of any influence which the sector's employers have over USS, LGPS and TPS;
- concern over rapidly increasing costs of some of the smaller schemes; and
- whether some of the schemes within the sector should be merged.

1.3 This initial report looks at the background and considers possible approaches at a high level. Following consideration of this report, it is hoped that a small number of options can be identified for more detailed consideration and costing over the coming months.

1.4 This report is intended for the use of UCEA, Universities UK and GuildHE only, and responsibility is not accepted towards any other parties for any of the contents of this report.

2.1 Most pension provision for employees in the higher education sector is made through one of four pension schemes or groups of schemes, which are described briefly below.

2.2 The **Universities Superannuation Scheme (USS)** provides pensions for academic and "academic-related" (i.e. senior non-academic) staff, primarily in pre-1992 institutions (the "old" universities). USS is a funded final salary pension scheme and indeed is one of the largest such schemes in the UK. It has a number of unusual features in its rules, one of which is the "exclusivity clause", which requires that an institution participating in USS must not offer another pension scheme to an employee who is eligible for USS membership.

2.3 The **Teachers' Pension Scheme (TPS)** provides pensions for academic staff in post-1992 institutions (the "new" universities, many of which were formerly polytechnics). It also of course provides pensions for schoolteachers in England and Wales. TPS is "notionally funded" – that is, contributions are assessed on a quasi-actuarial basis, but in reality no funds are built up and the liability for future pensions is ultimately borne by the taxpayer.

2.4 Non-academic staff in pre-1992 institutions, other than academic-related staff, are generally provided with pensions by means of schemes set up by the individual institution. These are known in the sector as **SATs (self-administered trusts)**, although it should be noted that this terminology would not be recognised outside the sector. The largest of these by some distance is SAUL (Superannuation Arrangements of the University of London), with assets of some £1.3 billion. Many of the others are much smaller, which in some cases has given rise to concerns about their viability. In general these are also final salary arrangements, although there are examples of both career average and money purchase SAT schemes.

2.5 Non-academic staff in post-1992 institutions, including academic-related staff, are mostly members of the **Local Government Pension Scheme (LGPS)**, operated by the local authority responsible for the area where the institution is located. This reflects the origins of these institutions as polytechnics when they operated under the aegis of local authorities. The LGPS is a final salary pension scheme whose benefits and member contributions are centrally determined, although each local scheme has separate funding, administrative and employer contribution arrangements. It should also be noted that those institutions which participate in the LGPS cannot in general withdraw from it (under the LGPS regulations on "scheduled bodies"), and employees have a right to join.

2.6 This summary describes the main features of pension provision in the sector only. There are many additions and exceptions, such as:

- Academic staff in post-1992 institutions in Scotland are generally members of the Scottish Teachers' Superannuation Scheme (STSS);
- Some staff in medical schools are members of the National Health Service Pension Scheme (NHSPS);
- The membership of USS includes some academics in post-1992 institutions if they had previously been members of USS whilst being at a pre-1992 institution;
- USS is in practice open to all employees at institutions, including non-academic staff. Some have taken advantage of this, including the Open University, and others are in negotiation.

2.7 These exceptions do not of themselves affect the general conclusions of this report.

3.1 The LGPS and the TPS have both been the subject of changes in recent years, which have involved negotiation with various stakeholders including participating employers, members and their recognised trade unions, and the relevant government departments. Details can be found on the respective websites but they can be summarised as follows.

Teachers' Pension Scheme

3.2 The changes to the TPS were introduced with effect from 1 January 2007. The most important changes are that, for new entrants (only), the pension age will be 65 rather than 60; and pensions will be based on an accrual rate of 1/60, with the option to take a tax-free cash sum, rather than on an accrual rate of 1/80 with an automatic lump sum of 3/80.

3.3 Benefits for those who were members before 1 January 2007 are essentially unchanged although there are some modest improvements.

3.4 It is proposed that future increases in cost will be shared equally between employers and employees and that there will be a maximum employer's contribution of 14 per cent following the outcome of the next actuarial valuation, although the exact mechanism by which this will happen is still to be determined.[2]

Local Government Pension Scheme

3.5 The changes to the LGPS were introduced with effect from 1 April 2008 and apply to the future service of existing members as well as to new entrants. Future pensions will, as in the TPS, be based on an accrual rate of 1/60, with the option to take a tax-free cash sum, rather than on an accrual rate of 1/80 with an automatic lump sum of 3/80. Member contributions will vary from 5.5 per cent to 7.5 per cent according to pay levels.

3.6 The normal pension age will continue to be 65. Early retirement rules in the LGPS are complex and changes were made to these with effect from 30 September 2006 because the existing "rule of 85" was deemed to be age-discriminatory.

3.7 As in the TPS it is proposed that employers and employees will share future increases in the cost of pension provision. The LGPS is currently conducting a public consultation as to how this proposal should be implemented, and whether there should be a maximum employer rate of contribution in the future.[3]

Comments

3.8 Higher education employees only form a small part of the membership both of the TPS and the LGPS, and there is some concern about the limited influence that the sector has on the operation of these schemes. However, it is important in the context of pension strategy for the higher education sector to note that both of these schemes have retained the final salary concept for existing and new members. The move to age 65 for new entrants to the TPS, and restrictions on the availability of early retirement in the LGPS, reflect broader government policy to encourage longer working lives in the light of improving mortality.

3.9 It is also interesting to note that both the TPS and the LGPS have moved towards a structure based on a 1/60 accrual rate, rather than the "1/80 plus cash" approach which has been traditional in the public sector (and which still applies in USS and SAUL, amongst others).

4
The Hewitt report

4.1 In the second half of 2007, Hewitt, a pensions adviser, was commissioned by Universities UK, GuildHE and UCEA to produce a report on pensions strategy for the higher education sector. Its report was essentially an attitude survey which asked over 160 higher education institutions about their attitudes towards pension provision for their employees, putting forward twenty questions each with a "point" and a "counterpoint" view. There was an overall response rate of 53 per cent. Each set of responses was rated, both for the average answers within the range 1 to 10 and for the dispersion of those answers.

4.2 As one would expect, some of the responses were more helpful than others. Some showed evidence of a wide variety of views within the sector with no consensus of opinion. Some, on the other hand, provided evidence of strongly held views across the sector, which are helpful in indicating possible ways forward and in ruling out some other possibilities.

4.3 Those responses which indicated the strongest views, starting with the strongest (using a fairly basic methodology to combine both the absolute values of the answers and their dispersion) are as follows:

- The sector should work together for administrative economies of scale (question 6);
- Risk should be shared between the institution and the employees (question 14);
- Pension benefits should be comparable to those provided in the public sector (Question 20);
- The cost of early retirement should be met by each institution (question 18);
- Members' contributions should vary to reflect the true cost of their benefits (question 13);
- The higher education sector should negotiate on pension issues as a single group (question 5).

4.4 Some of these responses give clear pointers as to the type of pension benefits that might be found acceptable (or not) in the higher education sector, whereas others are more indicative of the process that the sector might use to reach a generally acceptable conclusion.

4.5 A few other sets of responses are notable, not because of a particular strength of view but because of a lack of support for a particular view. For example, although the question on the degree of change (question 15) indicates that some change is widely expected, it shows little appetite for radical change. This view is supported by the response to other questions, for example question 19 on employment models.

4.6 Finally, the responses to questions 16 and 17 indicated a general belief that the present arrangements are only partially understood and that members did not fully appreciate the value of a pension. It is clear that there is work which could be done to improve both these aspects of pension provision within the higher education sector.

Public sector or private sector?

5.1 The higher education sector is in some respects curiously positioned at the boundaries of the public and private sectors. It is still dependent for much of its activities on government funding, but receives an increasing proportion of its income from tuition fees, research grants and other sources (such as alumni and vacation courses). The post-1992 institutions were public sector in origin as polytechnics run by local authorities. Nevertheless, it has become increasingly clear in recent years that financial disciplines imported from the private sector are an essential part of governance in the higher education sector.

5.2 Pension arrangements in the sector tend to reflect this background. USS is, and has always been, very clear that it is a private sector scheme and not a public sector scheme; it carries no government guarantee and pays a levy to the Pension Protection Fund like other private sector schemes. The same applies to SAUL and the SATs.

5.3 LGPS and TPS, on the other hand, are clearly public sector pension schemes and the latter is unfunded. The LGPS is funded although it is not subject to the normal funding rules (under the Pensions Act 2004) and political as well as actuarial considerations have sometimes played a part in setting employer contribution rates. Most employers in LGPS have a tax-raising power and there is no realistic prospect that a local government pension scheme would be allowed to become insolvent.

5.4 In recent years, as is well known, most private sector employers have moved away from final salary pension provision, at least for new employees and sometimes also for existing members. Final salary schemes have been replaced by money purchase or, in some cases, career average schemes. These have different risk characteristics which are explored later in this paper. It is fair to say that smaller employers in particular have moved towards money purchase provision.

5.5 Public sector pension schemes have themselves been the subject of revision in recent years, including but not limited to the LGPS and the TPS as mentioned above. However, they have in general continued with a defined benefit model, rather than the more radical shift to money purchase which has characterised much of the private sector.

5.6 Against this background it is interesting to note the strength of feeling expressed by respondents to the Hewitt report that pension benefits in the higher education sector should be comparable with the public rather than the private sector. This seems to indicate that the sector as a whole does not have the appetite for risk transfer which would be inherent in a large-scale move to money purchase; the answer to question 14 in the survey bears this out in that there was very clearly no appetite whatever amongst the respondents for a solution in which the employees would bear all the risk.

6.1 In this section the key characteristics of the main pension scheme models are considered. It is important to realise that these are not the only possible designs of pension scheme that could be made available; they do however cover the main options, and most others can be characterised as being similar to, or a combination of, the models described below.

Final salary (final pay)

6.2 In a final salary pension scheme, the member's pension at retirement is determined by reference to length of service and pay at or shortly before retirement (or leaving service). Member contributions are normally a fixed proportion of pay with the employer paying the balance of cost. The concept underlying a final salary scheme is that the member's standard of living in retirement should be related to that which they enjoyed shortly before retirement, as measured by their regular earnings in the last few years of their working life.

6.3 In this type of arrangement, the employer takes nearly all the risk: investment, mortality, pay growth and inflation risks may all affect the cost of benefits and the member simply pays a fixed proportion of pay. The member's only material risk is that of insolvency of the employer, although the introduction of the Pension Protection Fund has largely mitigated this risk.

6.4 Final salary schemes are most suitable for:

- long-serving employees;
- employees whose pay rises in real terms, especially where such rises continue throughout their career; and
- employers who are able to take financial risk.

Career average

6.5 In a career average pension scheme, each year's pay is revalued to retirement using a pre-determined index (for example, the Retail Prices Index (RPI) or national average earnings), and the total is then multiplied by the accrual rate. Again, member contributions are normally a fixed proportion of pay with the employer paying the balance of cost.

6.6 The employer's exposure to risk is less, in that pay growth (especially late in career) does not affect past service liabilities. However, the employer is still exposed to the financial consequences of mortality and investment risks.

6.7 The distribution of member outcomes within a career average scheme depends crucially on the accrual rate and the rate at which a member's pre-retirement earnings are revalued. In general, for a given overall cost:

- members with long service are likely to receive less from a career average scheme than from a final salary scheme, while members with shorter service are likely to do somewhat better;
- the higher the rate of pre-retirement revaluation, the more weight will be given to earnings earlier in the working lifetime, rather than later, and vice versa. In other words, the lower the rate of pre-retirement revaluation, the less will be the change from benefits calculated on a final pay basis.

6.8 The exact outcome for any individual or group of individuals does of course depend largely on their actual pay progression, both in absolute terms and in relation to the rate of pre-retirement revaluation assumed, and models can be constructed to demonstrate a wide range of possible outcomes. Nevertheless, the general points made above still apply; they show that a career average pension scheme can be used, if desired, as a means to distribute pension benefits in a way different from that which would be achieved under a final salary structure.

Money purchase (defined contribution)

6.9 In a money purchase pension scheme, employer and members pay a pre-determined rate of contribution into the scheme; this is invested and the outcome for the member is whatever the accumulated "pot" will purchase at the point of retirement. The rate of contribution may be fixed as a percentage of salary; it may be related to the member's seniority; or the member may be able to choose a rate, within limits, with the employer paying a corresponding rate which typically varies according to the member's chosen rate to give a "thrift plan" effect.

6.10 Whichever pattern is used, the employer's liability is restricted to the agreed rate of contribution and the employer has no liability beyond this. The member takes the investment risk as well as the longevity risk. It is widely believed that a large proportion of the money purchase schemes set up in the last decade will produce pensions at retirement which will be inadequate for the member to live on, although many such schemes are in their relative infancy. It is also worth noting that members cannot accurately assess their likely pension from a money purchase scheme until shortly before retirement.

6.11 Money purchase schemes are best suited to those cases where the employer has no appetite

for, or ability to take on, financial risk; in some such cases, members may actually be better off in a money purchase arrangement since their pension should be unaffected in the event that the employer fails.

Other designs

6.12 Other designs, such as cash balance plans (where the scheme funds an amount of cash at retirement rather than a pension) and combinations of final salary and money purchase, have met with limited success both in the UK and in the United States. These generally work by sharing risk, for example, investment and mortality risk, between the parties in various ways. They can be complex to communicate and administer, although this should not be an insurmountable obstacle to such a solution if this is thought to be the most appropriate in the circumstances.

General

6.13 It is important to realise and accept that there is no one pension scheme model which is always "good" and one which is always "bad", even though various commentators have tried to present this as being the case. There are good and bad final salary schemes, just as there are good and bad money purchase schemes. The key determinant of the generosity of a pension scheme is the level of contributions (employer and members combined) made to the scheme. For the same total contributions, any pension scheme will produce broadly the same level of overall benefits. What the choice of design does is to influence how this overall outcome is distributed between the beneficiaries, for example:

- long-stayers versus early leavers;
- high-flyers versus plodders;
- those who live to a ripe old age versus those who die early;
- members versus their dependants;
- those who are successful, or lucky, in their investment decisions versus those who are not.

6.14 It follows that, if an employer or a group of employers can determine which behaviours they wish to encourage and reward amongst the members of their workforces, they can design a pension scheme to reflect the desired behaviours. The same is, of course, true of the remuneration package more generally, but that is beyond the scope of this report.

7.1 As described above, pension provision within a given cost framework can be used to reward behaviours which are determined to be beneficial. Employers in the higher education sector clearly feel that they should negotiate on pension issues as a single group. This will therefore require a consensus on what these behaviours should be; whether they are the same for all institutions; and whether they are the same for all staff within each institution. Employment models have changed in many sectors in recent decades and there is some evidence from the Hewitt report that the same is happening in the higher education sector. So, for example, institutions may, or may not, wish to reward and encourage:

- long service;
- flexibility and innovation;
- loyalty to a particular institution, or to the sector as a whole;
- staff moving within the higher education sector, or outside it;
- staff staying on beyond age 60, or even 65, provided they are fit and healthy.

7.2 There may be other behaviours which the sector wishes to encourage or discourage as well as those listed. Any of these can give useful pointers as to possible pension scheme designs for the future. There is also the question of risk, and the extent to which institutions in the sector are able and willing to accommodate pension risk within their overall operations (especially given the very high proportion which payroll costs represent within the total costs of operating a higher education institution).

7.3 There is also the output from the Hewitt survey mentioned above (on page 6). The following two answers give the strongest pointers for this discussion:

- Risk should be shared between the institution and the employees (question14)
- Pension benefits should be comparable to those provided in the public sector (question 20)

7.4 The view on risk being shared (as opposed to all the risk being borne by one party or the other) was very clear, and as already pointed out there was no appetite at all for a solution which involved employees bearing all the risk.

7.5 The combination of these two answers leads inexorably to a conclusion that there is little appetite in the higher education sector for a widespread adoption of money purchase pension provision as the way forward. Further consideration of a solution based on money purchase provision is therefore ruled out.

7.6 After discussion of the behaviours to be rewarded, the next consideration is the cost parameters within which the sector feels it can afford to operate. As described above, whether a particular pension scheme can overall be described as "good" or "bad" depends less on its particular design than on the level of contributions which can be afforded by the participants. In this area the input of those operating within the higher education sector is indispensable. However, it is worth noting that the question in the Hewitt survey on the cost of pension arrangements (question 12) elicited a wide spread of responses with an average close to the mid-point of the range, which does not indicate a general view that current costs are too high.

A "menu" of pension options

7.7 One option canvassed in the Hewitt report, which received a generally positive response (although not as positive as the six responses listed in section 4.3), was the possibility of employers having a "menu" of possible pension options to offer their staff. The counter proposal, under which each employer would individually decide the pension arrangements to offer its employees, received relatively little support.

7.8 Under the "menu" approach, employers would be able to select, from a limited pre-determined list, what pension arrangements to offer their employees. There is clearly a large number of options that could be included, but those listed in the Hewitt report were:

- 1/60 final salary from age 60
- 1/50 career average scheme from age 65
- 6 per cent defined contribution (money purchase) plan.

7.9 Each option would have different rates of employee and employer contributions associated with it.

7.10 On the face of it, this seems like an attractive approach, allowing institutions a degree of flexibility but restricting the choice sufficiently so that the sector could still benefit from those economies of scale which were so clearly desired by survey respondents (question 6). The same would certainly not apply if each institution were to be able to choose its own pension provision.

7.11 There are, however, many practical issues in terms of the implementation and administration of a "menu" approach, and some of these will be material. Examples are:

- who chooses which pension arrangement to offer, and whether it should be the same for all employees of an institution;
- whether the overall pay package would be adjusted in some way if a cheaper pension arrangement were offered;
- whether the chosen arrangement would be offered to existing employees (in place of their current pension scheme), or just to new employees;
- if existing employees were to be included, how past service would be handled;
- what would happen if an employee were to move to another institution which participated in the same scheme but offered a different menu option;
- whether the "menu" would be offered under the aegis of one of the existing schemes (USS, for example) or as a new arrangement;
- if the latter, how the USS "exclusivity clause" and the right of non-academics at post-1992 institutions to join the LGPS would be addressed;
- how funding, sectionalisation and cross-subsidy issues would be handled;
- the consequences for existing arrangements, whether USS, TPS, LGPS or SATs.

7.12 These issues can all be expanded upon if desired, and they are not necessarily insuperable, but it must be clearly understood that the implementation of a "menu" approach would be far from straightforward. If this approach is to be examined further, the issues of scheme design discussed in section 6 must be considered so that participants in the sector can be satisfied that this approach would achieve the desired outcome.

8.1 One way of achieving the economies of scale so clearly desired by the participants in the sector would be to reduce the number of pension arrangements on offer. There are several possible approaches, and the following are considered further in this section:

- One scheme for each institution
- One scheme for all academic staff
- One scheme for all non-academic staff
- One scheme for the sector

One scheme for each institution

8.2 Under this approach, each institution would have one pension arrangement for all of its own staff, academic and non-academic. The concept could be extended so that smaller institutions could perhaps join in a grouped scheme with other institutions in their area or region. In effect, academic staff would join the SAT operated by the particular institution where they were working.

8.3 It is not clear that this approach offers any advantages, and indeed there would be considerable disadvantages in splitting (for example) USS into many component parts. Further, academic and non-academic staff do not necessarily have the same needs or the same career paths. In addition, the history and experience of the higher education sector suggests that "larger is better" whereas splitting USS and the other large schemes would have the reverse effect.

8.4 Consequently, this option is not considered further.

One scheme for all academic staff

8.5 At present, academic staff are generally members either of USS (in pre-1992 institutions) or TPS (in post-1992 institutions). Contribution rates are as follows:

	USS	TPS
Member	6.35%	6.4%
Institution	14%	14.1%

8.6 This approach suggests that all academic staff would become members either of USS or of TPS, and therefore that the other one would cease to have members in the higher education sector. Either approach (USS members into TPS, or TPS members into USS) has disadvantages and the issue therefore is whether these are too great to outweigh any perceived gains from having a single scheme for all academic staff.

8.7 It is worth exploring what these perceived gains might be. As shown in the table above, contributions to USS and TPS are virtually identical, although there is of course no guarantee that this will continue in the future. New entrants to TPS are already joining with a pension age of 65 and, other things being equal, this would suggest that the contribution rates to TPS will, over time, be lower than they would otherwise have been. The TPS is of course an unfunded public sector scheme, so it carries a Government guarantee of its benefits, which members may perceive as an advantage; on the other hand, the higher education sector has little influence over the TPS, which is primarily intended for teachers in state schools.

8.8 Economies of scale are not likely to be a major issue here: both USS and TPS are very large schemes and already benefit as far as possible from the scale of their operations. It appears that the main benefit of having a single scheme for all academic staff is one of perception rather than control or economies of scale.

8.9 Moving USS members to TPS would have major and serious consequences both for USS, and for the institutions which currently have members in USS. These arise from the fact that a move to TPS would in effect close USS, at least to new members and possibly also to future accrual (if existing members were also to join TPS). This would probably cause USS to re-examine its investment strategy with a move away from the current high level of equity investment. Also, if institutions were to cease membership of USS altogether, it is probable that a "Section 75" debt would arise which would be likely to impose an intolerable financial burden on such institutions. It seems unlikely that any actual or perceived gains would be worth this kind of financial risk.

8.10 From the members' point of view, new entrants to TPS do of course join with a normal pension age of 65, which may itself prove an insuperable obstacle to a transfer of existing members from USS to TPS. The position of academic-related staff would have to be considered; currently these are in USS if in pre-1992 institutions, or in LGPS if in post-1992 institutions. It is not clear whether they could join TPS and the alternative would be for them to seek admission to the relevant LGPS.

8.11 Ultimately it seems that the obstacles to positioning TPS as the single scheme for academics are probably insuperable and this option is not therefore pursued further.

8.12 The alternative would be for USS to become the single scheme for academic staff, either for new entrants to the sector only, or including all

existing TPS members. At present, this would have little immediate financial impact on institutions because the contribution rates to both schemes are very similar.

8.13 However, the result if new recruits only were to be admitted to USS would be an influx of younger members to USS, which ought to reduce the overall rates payable to USS. The remaining higher education population in TPS would gradually age, and the contribution rate to TPS ought to increase gradually; however, as TPS is an unfunded scheme and the proportion of its members in higher education institutions is small, the extent to which this would actually happen in practice is not clear.

8.14 The consequences for TPS would also have to be thought through, not least because such a move would have implications for the financial position of the TPS as a whole. As the TPS is an unfunded scheme, any change which materially affects its flow of new entrants could disturb its cashflow pattern with consequent implications for other contributors. This would be an area where the input of HM Treasury and DIUS would have to be sought and a convincing business case for such a move would have to be constructed. At this stage it is not clear that such a business case exists.

8.15 A final consideration is whether, even if a business case could be constructed, post-1992 higher education sector institutions do actually wish to withdraw from TPS. From the viewpoint of members (and presumably their trade union representatives), it is difficult to see why they would wish to withdraw voluntarily from a scheme whose benefits are backed by the Government.

8.16 The case for USS becoming the single scheme for academics is not therefore straightforward although it has fewer obvious drawbacks than the TPS option. This may therefore be worthy of further examination, including at least initial discussions with relevant government departments, to see if the option deserves detailed analysis.

One scheme for all non-academic staff

8.17 At present, non-academic staff in pre-1992 institutions, other than academic-related staff, are generally in a pension scheme operated by the institution (a SAT), except in the London area, where the centralised scheme SAUL covers these staff. SAUL is a large scheme with assets of around £1.3 billion, whereas other such schemes are much smaller, with average assets of £68 million as at 31 July 2005.[4] Non-academic staff in post-1992 institutions, including academic-related staff, are in the LGPS covering the area where the institution is located.

8.18 Because academic and academic-related staff are excluded from SATs, the average salary of members of these schemes is low. The average salary of SAUL members at 31 March 2005 (the last actuarial valuation) was £20,149[5] whereas that for USS at the same date was £33,281.[6] Less than 0.5 per cent of SAUL's active members earn in excess of £50,000 a year.

8.19 Contributions to these schemes vary widely. The employer contributions to SAUL are 13 per cent of payroll, whereas contributions to SATs tend to be higher with half reporting employer contributions in excess of 17.5 per cent.[7] LGPS contributions are lower than SATs, with over half being below 15 per cent.

8.20 The average size of SATs indicates that some must be small, of the order of £20 or £30 million, which leads to the conclusion that some economies of scale must be obtainable if these could somehow be merged together or absorbed within a larger scheme. Both SAUL and USS have made it clear that they are happy to absorb other schemes by merger; some such mergers have already taken place (the Open University, for example, has undergone a full merger of its scheme with USS) and others are being actively considered.

8.21 So one option for many SATs would be for them to join USS or SAUL, subject to the legal and funding requirements set out by those schemes and by pensions legislation more generally. Joining could be for future new entrants only; for all active members for their future service; for all active members including their past service; or a full merger including a transfer of deferred members and pensioners. Any funding deficit transferred would have to be paid off over an agreed period, typically not exceeding ten years, calculated on funding assumptions set by the receiving scheme. This may appear onerous, and certainly some institutions have commented on the perceived "cost" of joining USS. However, any institution not transferring its past service liabilities would need to consider carefully its funding plan for such liabilities, and whether the long-term intention is to secure the liabilities in some way, either by the traditional means of annuity purchase or through one of the newer vehicles operating in this market. The institution would have to be careful to avoid a large residual liability falling on the institution a decade or more hence.

8.22 An alternative to a full merger with SAUL or USS might be for institutions operating SATs to come together in regional groupings in order to take advantage of some at least of the economies of scale that are available to larger schemes. This feels rather like a "halfway house", and in addition there would be other practical difficulties, one of which would be determining the receiving scheme for this purpose. This could be a new vehicle set up specifically as a receiving scheme (which has been done in other sectors, such as the Co-Op), although this would tend to reduce the cost savings which might otherwise be achievable; or one of the existing SATs, depending on legal advice, could be chosen as the recipient scheme.

8.23 None of this addresses the issues facing post-1992 institutions which have members in the LGPS. As mentioned earlier, these institutions generally cannot withdraw from the LGPS without changes to regulations, and consultation with members or their trade unions would also probably be necessary. The regulatory issues, and the lower employer contribution rates to the LGPS, mean that further consideration of the position of non-academic staff in post-1992 institutions should be deferred.

One scheme for the higher education sector

8.24 This is really just an extension of the various possibilities outlined in the preceding paragraphs. However, it is not obvious that the economies of scale to be obtained from such a large pension scheme would be significant enough to justify some of the practical challenges, including the sheer scale of the merged operation (which would probably be the largest funded pension scheme in the UK), governance issues, the workload on trustees, and so on. Given the issues around the public sector schemes discussed earlier, a more realistic option may be to move gradually towards one scheme for the pre-1992 higher education sector.

8.25 If some of the suggestions proposed in this section were to be adopted, the number of schemes in the pre-1992 sector would be expected to reduce materially. If in due course it were to appear that further economies of scale could realistically be achieved by a second round of mergers, then this is an issue which could be addressed at that time.

Universities Superannuation Scheme issues

9.1 Although USS is a very large (around £30 billion), and generally well governed, funded pension scheme, some difficulties and anomalies have arisen, partly from its legal structure, and partly from the relationships built up within the sector over the years.

9.2 USS was set up in 1975 as a successor to the Federated Superannuation System for Universities (FSSU), and its legal structure reflects the political and industrial relations environment prevailing in the 1970s. In particular, USS has a "Joint Negotiating Committee" (JNC), whose purpose (*inter alia*) is "to approve amendments to the rules proposed by the trustee company".[8] This in effect gives the JNC a veto over any changes to the rules of USS.

9.3 The membership of the JNC comprises five members appointed by Universities UK, five appointed by UCU, and an independent chairman. In default of agreement, the chairman has a casting vote, and if the chairman is not prepared to use that vote then a "built-in deadlock" ensues. This has led recently to a situation where proposed changes to USS rules, in particular bringing in a later normal pension age, have not been able to proceed.

9.4 This is a difficult situation which will require careful and delicate handling, probably over a long period, to resolve. Changing the structure of USS to reduce or remove the "blocking power" of the JNC would itself require the consent of the JNC, which in the circumstances is unlikely to be forthcoming. There seems little doubt that changes will be required to USS if the present final salary pension model is to be sustained in the higher education sector over the coming years, and all parties will need to understand that these changes are essential rather than merely desirable.

9.5 The second set of issues involving USS is the relationship between USS and the employers in the higher education sector. This seems to be more an issue of communication and style rather than substance. Both parties seem to wish to improve the relationship and this will be best done by more frequent meetings and genuine attempts to understand the other's point of view and constraints.

10
A possible long-term solution

10.1 Pension provision in the higher education sector is, at present, mostly on a final salary basis, for good reasons connected with pay and employment patterns in the sector. Most of these reasons remain valid, and it is clear that many of those operating in the sector regard final salary provision as an important part of the remuneration package, particularly for academic and academic-related staff.

10.2 The key issue for the sector is how final salary pension provision can remain affordable and sustainable at a time when life expectancy is continuing to increase, to an extent that many people who retire at age 60 can expect to spend nearly as long in retirement as at work. Many pension schemes in both the public and private sectors have moved away from a retirement age of 60 to one of 65, with retirement before 65 being on a cost-neutral basis. Some have made provision for retirement ages to continue to increase in the future if life expectancy continues to improve.

10.3 A sustainable pension scheme, in any sector, must be affordable to both the employer and the members; must be fair as between different categories of member; and must provide a reasonable pension for the long-serving retiree. If any of these criteria are not satisfied, then either the employers or the members (or both) will lose faith in the scheme and it will eventually lose credibility.

10.4 A possible approach for the future could include some of the following features:

- Normal pension age 65
- Early retirement (in normal health) on a cost-neutral basis
- Future improvements in life expectancy dealt with by:
  - automatic raising of normal pension age; *or*
  - sharing of future cost increases; *or*
  - adjusting pension benefits to reflect the longer period of payment; *or*
  - some combination of these things.

10.5 There are numerous possible combinations of the above factors – raising normal pension age, sharing future cost increases, and adjusting pension benefits, in the light of improving life expectancy (generally described as "calibration") – which could be explored with a view to improving the sustainability of defined benefit provision in the higher education sector. This is an area where more work should be done, incorporating proper costings and consideration of alternatives.

11
Conclusion

11.1 This report is a high-level overview which attempts to define the main pension problems facing employers in the higher education sector and to offer some options to be explored further in the coming months.

11.2 The following areas are specifically recommended for further investigation:

- Discussion of the employee behaviours which should be rewarded and encouraged through pension scheme design
- The advantages and disadvantages of a "menu" approach
- The possibility of one scheme for all academic staff, based on USS
- Scheme mergers for non-academic staff
- Governance issues within USS
- Options for a long-term solution based on final salary benefits with calibration.

Glossary

Career average A type of *defined benefit* pension scheme in which pension is based on earnings in each year of membership, revalued in line with an index

Defined benefit A pension scheme in which pension is based on pay, service, or other values fixed in advance

Defined contribution A pension scheme in which pension is based on the contributions made and the investment return which these have produced

DIUS The Department for Innovation, Universities and Skills

Final salary/final pay A type of defined benefit pension scheme in which pension is based on length of service and pay at, or shortly before, retirement or leaving service

FSSU The Federated Superannuation System for Universities, set up in 1913 and the forerunner of USS

Guild HE Representative organisation for higher education colleges, specialist institutions and some universities.

HE higher education

JNC The Joint Negotiating Committee of USS

LGPS The Local Government Pension Scheme

Money purchase Same as *Defined Contribution*

NHSPS National Health Service Pension Scheme

RPI Retail Prices Index

SAT Self-Administered Trust: used in this context to mean a pension scheme operated by a higher education institution for its own non-academic staff

SAUL Superannuation Arrangements of the University of London

STSS Scottish Teachers' Superannuation Scheme

TPS Teachers' Pension Scheme

UCEA Universities and Colleges Employers' Association

UCU University and College Union

USS Universities Superannuation Scheme

UUK Universities UK

Websites

LGPS: http://www.lgps.org.uk

SAUL: http://www.saul.org.uk

TPS: http://www.teachernet.gov.uk and http://www.teacherspensions.co.uk

USS: http://www.usshq.co.uk

Notes

1 Hewitt (2007) *Strategic enquiry into the pension arrangements for the higher education sector*

2 Details of the new TPS contribution structure can be found at www.teachernet.gov.uk

3 Communities and Local Government (2008) *Sustaining the local government pension scheme in England and Wales*. www.xoq83.dialpipex.com

4 Derived from data in BUFDG (2006) *Twenty questions about pension provision in higher education*

5 Actuarial valuation as at 31 March 2005, SAUL website

6 Actuarial Valuation Report as at 31 March 2005, USS website

7 BUFDG (2007) *SAT and LGPS pensions schemes in UK higher education: 2005–06 data*

8 USS (2007) *Report and Accounts for the year ended 31 March 2007*

About Universities UK

This publication has been produced by Universities UK, which is the representative body for the executive heads of UK universities and is recognised as the umbrella group for the university sector. It works to advance the interests of universities and to spread good practice throughout the higher education sector.

Universities UK
Woburn House
20 Tavistock Square
London
WC1H 9HQ

telephone
+44 (0)20 7419 4111

fax
+44 (0)20 7388 8649

email
info@UniversitiesUK.ac.uk

web
www.UniversitiesUK.ac.uk

© Universities UK

ISBN 1 84036 178 6
May 2008

UCEA

Universities UK
Celebrating 90 years
1918–2008