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Briefing note

University update - pension benefit design

These are uncertain times for universities sponsoring defined benefit (DB) pension provision, with ongoing negotiations on the benefits provided by the Universities Superannuation Scheme (USS), the abolition of contracting-out and ever-rising costs contributing heavily to the need to consider possible changes to their Self Administered Trusts (SATs). There are many potential options to consider and we have set out in this note some of the key factors along with our thoughts on the possibilities available.

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Changes to the USS…seeking consistency?

Following the move of the Local Government Pension Scheme (LGPS) and Teachers Pension Scheme (TPS) to Career Average Revalued Earnings (CARE) benefits, the latest proposals for the changes to the USS (entering consultation in spring 2015) include closing the final salary section entirely to move to CARE for benefits accrued on the first £55,000 of a member's salary, with benefits from any proportion of salary earned above that threshold being provided via a defined contribution (DC) section.

Those universities managing SATs that have historically benchmarked their benefit provision against the USS, LGPS and TPS may therefore be considering making similar changes in moving to CARE for future benefit accrual, if they have not already done so following the introduction of CARE for new joiners to the USS after 1 October 2011. This would mean that universities who provide benefits both through their own SAT and through wider schemes are able to maintain consistency amongst different groups of employees.

Under a CARE scheme, a member earns a pension equal to a percentage of their earnings each year and this is revalued in the period to retirement age, rather than the full benefit being based on the member's final salary at the time of leaving or retirement.

Moving to a DC arrangement for salaries above a specified threshold would add an extra level of complexity to SATs and this may not be desirable for all universities, or indeed necessary if the SAT is primarily used for lower earning employees. There are, however, a number of options for universities who wish to move away from final salary, but are willing to continue accepting some of the risks of defined benefit provision. CARE is one such example along with cash balance schemes, which are discussed further below.

The table below gives more information on which party bears some of the key risks under different benefit designs:

Risk	Final salary	CARE (revaluation in line with inflation)	Cash balance (linked to final salary)	Money purchase
Investment – pre retirement	University	University	University	Member
Inflation – pre retirement	University	University	University	Member
Salary increases	University	Member	University	Member
Investment – post retirement	University	University	Member	Member
Inflation – post retirement	University	University	Member	Member
Longevity	University	University	Member	Member

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Universities could combine the changes resulting from contracting out with other cost reduction measures

However, for those looking to take greater steps to reduce costs for the future, the proposed DC aspect of the USS changes may provoke serious thought about the form of benefit provision for the university sector into the future.

An additional aspect of the changes is that the USS will make it possible for members at all salary levels to voluntarily contribute an extra 1% of their salaries into the DC section and this may also prompt universities to review any existing AVC arrangements.

Abolition of contracting out…higher costs?

The abolition of contracting out in April 2016 also means that costs will rise for universities offering a contracted out DB scheme if they make no changes to their current benefits, because additional national insurance contributions (NICs) will be required from both universities and scheme members.

When abolishing contracting out for DB schemes, the Government expected that this would result in changes to scheme benefits, in that these can be reduced to allow for members receiving the new higher fixed state pension. There is therefore a statutory override that can be used by universities to reduce the value of member benefits or increase the member contribution rate to the extent of the additional liability caused by higher NICs, without consulting their scheme trustees.

However, it may be difficult to find a simple adjustment to scheme benefits that will leave all active members in a broadly comparable position allowing for the extra state benefits they might receive and the higher NICs that will be paid. For example, one method used to reduce the value of benefits could be to reduce the accrual rate, but this will impact different members in different ways. Another might be to increase member contributions, but this is likely to be unpopular given that employees will already be paying higher NICs themselves once their scheme is no longer contracted out. This may mean that universities combine the changes resulting from contracting out with other possible cost reduction measures and choose to consult with trustees and members rather than trying to use the statutory override.

Freedom and choice in pensions…all change?

In addition to the possible changes discussed above, the recent Government announcements regarding freedom and choice in pensions mean that scheme members may be seeking pension arrangements that will offer them more flexibility to take their benefits in the form that best suits them. In particular, they may wish to have the freedom to take a higher proportion of their benefits in the form of a cash sum, whilst still retaining a guaranteed pension income from the remainder and this could interact nicely with the possibility of providing part of the benefits through a DC section or providing more flexible AVC facilities.

As a further example, a cash balance arrangement may be attractive to such a member, as the university would fund a defined cash sum to be paid at retirement, but at that stage the member would be able to choose to use this cash sum to put in a drawdown arrangement or purchase benefits via an annuity or more bespoke arrangement, not to mention paying off debts or purchasing big items like a holiday or car.

The Budget announcements on freedom and choice may also offer universities an opportunity to consider liability management options more widely. One consideration could be to offer a pension increase exchange exercise at retirement, where member give up non-statutory pension increases in exchange for a higher flat-rate pension, which in turn would enable them to take a higher cash sum at retirement and increase the flexibility of their benefit, without losing the benefits of a guaranteed pension in payment.

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More standard exercises such as reviewing the basis used for transfer values and commutation factors may also be something to bring forward, to ensure that these options are being managed in the most cost-effective way possible.

Summary

In conclusion, the time to start considering possible changes to SATs is now, to avoid increased costs and coordinate member communications and consultation. The changes to the USS will be consulted upon during spring 2015 and are expected to come into effect from April 2016, which coincides with the abolition of contracting out.

Changes to design need not be structured to reduce expected costs – it could be a case of sharing the risk more evenly between the sponsor and the beneficiary so that the cost for the sponsor is less volatile. Members of such schemes are likely to place a high value on final salary benefits and could view any proposed changes with suspicion so it is important that the communication and consultation process is managed effectively.

Please contact your Barnett Waddingham consultant if you would like to discuss any of the above topics in more detail. Alternatively contact us via the following:

nick.griggs@barnett-waddingham.co.uk
020 7776 2200
www.barnett-waddingham.co.uk
