USS — the need for reform

Introduction

1. The employers have proposed changes to USS based on a move to age 65 retirement for new entrants and existing members under the age of 55 and the introduction of a CARE scheme for new entrants only.

2. This paper explains the financial reasons why these changes are necessary. It explains why universities will not be able to meet those costs as public funding for higher education is subject to further substantial cuts in the spending review in the autumn. It also discusses why the costs of USS will inevitably continue to rise unless changes are made.

The employers' funding problem

3. The cost of the scheme is already very substantial. In 2009 universities were contributing £750 million a year to the scheme. This figure does not include the effect of last year's 2% increase in employer contributions arising from the 2008 valuation. This amounts to a further £120 million a year.

4. The funding of universities is now under severe pressure and future increases in employer pension costs are unaffordable as well as being politically unacceptable; they can only be met by further reductions in staff numbers with a consequent impact on university services. The changing political context in which decisions about the future funding of higher education will occur has been highlighted in two recent ministerial speeches. In his speech to Oxford Brookes University, 10 June 2010, David Willetts made the following statement;

> *...when Labour implemented changes in 2004, they failed to demand enough of the sector in return for the massive financial infusion. They did not push universities sufficiently to make tangible improvements to the student experience as a quid pro quo for the students' own contribution. They didn't press universities to hold down their costs. For example, it's very hard asking students to pay higher fees in order to prop up final salary pension schemes for universities when their own parents have lost theirs.*

5. This was followed by a speech delivered by Nick Clegg on 15 June in which he said that final salary pension schemes were not just unfair, but also not affordable. *'As*

we face up to living within our means, we cannot ignore a spending area which will more than double within five years.' The reform of the public sector schemes is now inevitable and the newly established pensions commission has been asked to report on a short timescale underlining the political pressure for change. In these circumstances it is difficult to believe that the current USS scheme can be sustained by a sector which is still largely publicly funded.

6. In the emergency budget on 22 June the Chancellor announced that the coalition government intended to accelerate the previous government's plan to reduce the deficit and (excluding net public investment) would seek to remove it entirely by 2015/16. This represents a fiscal squeeze of £213 billion, which is unprecedented. He also announced that the expenditure of non-protected departments would be cut by 25% over the lifetime of the government in the autumn spending review. As defence and education spending would be given some priority in this exercise, it is possible that higher education could be facing a reduction of more than 25% over the period. The announcement that VAT is to increase to 20% from next January will also have a significant effect on university costs.

7. These future cuts are additional to the reductions that have already been announced by the government and its predecessor. Following the general election the Treasury announced that an additional £200 million saving was required from higher education in England in 2010/11, as part of the governments £6.3 billion in year' cuts. The £200 million cut is additional to those previously announced. The HEFCE funding letter of 1 February 2010 informed the sector that 'there is a £449 million reduction in funding for the 2010-11 financial year compared with the previously announced plans for that year." The effect of these existing cuts will not be limited to 2010/11. Taking account of the additional £200 million reduction, HEFCE will see its budget reduced by £1.13 billion over the next three financial years. The consequences of the changes already announced will be a significant reduction in public funding per student — reversing some of the increases over the past few years — a further fall in the already small surpluses that universities generate for reinvestment.

8. The combined effect of these reductions — together with the sharp fall in the number of 18 year olds over the next decade — will result in unprecedented changes in the scale of university activities and will require radical action to reduce costs. In this rapidly deteriorating context the employers believe that urgent action to reform USS is needed.

The increasing cost of USS

1. There is strong evidence to support the conclusion that the costs of USS are likely to rise in the short to medium term. For example, in a paper produced in March 2009, Mercers, the USS actuaries, assessed the level of possible future increases that the scheme may be facing as follows:

- A 2% increase in contribution rates (amounting to a total rate of 22.35% effective from 2009) which now been implemented and is being fully funded by the employers

- A 1.5% increase as a result of improvements in longevity — according to the latest briefing from the USS actuary this is now an estimated 1% increase to be applied in the 2011 valuation

- An increase to address any past service deficit that may arise at the 2011 valuation

- A possible increase in relation to salary growth

2. There will be additional cost pressures arising from two other factors:

- The first arises from USS's intention to move a significant proportion (20%) of its assets from equities to gilts or their equivalent with the aim of reducing future investment risks and volatility. This is an objective that the employers strongly support but it will inevitably have a significant impact on the future service contribution rate.

- Secondly, USS is likely to mature as a scheme more quickly than had previously been anticipated as a result of the changing funding position the higher education sector will be operating under in future. Currently USS benefit's from a positive cash flow position, where the contributions derived from active members (supported by the increasing number of new joiners entering employment in the sector, and thus the scheme) has covered the growth in the number of USS members now drawing scheme benefits. However as public funding for higher education is cut, staffing numbers may shrink quite rapidly. The cash flow calculation in Appendix 1 indicates that USS may well cease to be cash flow positive sooner than anticipated, if you were to exclude the income derived from investments (mainly from UK and overseas equities). These figures are for illustration only, and it is acknowledged that investment income has been excluded. Having said that, they are based on the conservative assumption that there will be a 3% reduction in active members of USS during the period 2011-13, yet the

actual number may be significantly higher and the potential impact on the scheme will be even more severe.

There is expected to be a saving to the scheme arising from the Government's plan, announced in the emergency budget in June, to increase public sector pensions using the CPI rather than the RPI as from April 2011. Under the scheme rules this change, if approved by Parliament, will also apply to USS and the expected saving is of the order of 1.4% a year on the future service rate. Please note however that this is an estimated figure, and importantly depends upon such a change being able to be implemented within USS in a way that ensures the scheme continues to meet the statutory requirements for pensions increases and increases to benefits in deferment. The legal position is currently both complex and unclear, but it is possible that the actuality may be such that no or only limited lesser savings are in fact achievable.

Addressing the rising costs of USS

9. The employers' proposals for reform are designed to address rising costs and produce a sustainable scheme that is affordable in the face of the severe squeeze on university income which is likely to continue for many years.

10. Our proposals for change are based on the need to protect as far possible the position of existing members whilst delivering the changes necessary to ensure that USS remains affordable. The resulting two tier structure (with CARE for new entrants only) produces the following savings to the scheme in the short to medium term:

Normal Pension Age of age 65 for existing staff	1.30%
Caps on inflationary increases	1.40%
Increased employee contributions	1.15%
Introduction of CARE (initial period; see para 13)	0.00%
Total saving	**3.85%**

11. The initial savings of 3.85% are likely to be needed to address the rising costs outlined earlier in the paper, including an estimated 1% rise in the 2011 valuation to meet the costs of increasing longevity.

12. The other cost pressures on the scheme include:

- Addressing a possible past service deficit arising in March 2011
- the sharp change in USS's cash-flow position as a result of staffing cuts and a fall in USS member numbers
- The need to switch from equities to gilts, which might arise if the scheme's positive cashflow position becomes diminished
- The closure of the final salary section of USS

The need for CARE

13. The introduction of a CARE scheme for new entrants will not produce any savings for the scheme at the outset. The savings will only flow in over time to balance the increasing costs of the final salary section. It is likely that it will be at least 40 years before the last members of the final salary section retire, and may even later depending on further changes to the retirement age, the use of the flexible retirement option, and new employment practices. If CARE were introduced in April 2011, as the employers propose, it is unlikely that there will be more than 50% of the membership in the new scheme until after 2020. CARE is an essential part of the strategy for controlling future costs but its benefits will take a considerable time fully to realize.

14. In the long term it is possible that the employers' proposed changes will produce savings that will enable the employers' contribution rate to be reduced to a more realistic level during the extended period when university finances are likely be severely constrained. It is impossible to indicate what the likely long term employer contribution rate might be although we believe that ideally it should be closer to 10% - as envisaged at the time USS was first established - although this will take many years to achieve because of the relatively slow transition to the new CARE scheme.

The move from being a cashflow positive scheme to one which requires investments to fund benefits in payment will happen within the next three years (2011 to 2013)

			USS			
Year	Contributions	Costs	Active Members	Deferreds	Pensioners	Fund Value (£Bn)
2002	755.7	672.0	95700	49500	35100	19.8
2003	816.2	695.7	98400	51400	37000	15.6
2004	844.0	737.7	103100	56,700	39,200	19.4
2005	1046.0	809.1	110000	62,700	42,200	21.7
2006	1013.8	839.6	115,600	66,100	44,700	28.3
2007	1113.6	953.8	121,200	70,700	47,200	30.1
2008	1242.9	1040.9	126,400	76,400	49,900	28.8
2009	1356.5	1119.5	133,400	78,700	52,000	21.4

Projecting Forward - Assuming a 10% reduction in Actives over a 3 year period							Transition from casflow positive to negative
Year	Total Funding	Benefits Paid Out	Active Members	Deferreds	Pensioners	Year	
2011	**1,316**	**1186.7**	129,398	85,783	55,120	**2011**	**129.1**
2012	**1275.1**	**1257.9**	125,516	93,503	58,427	**2012**	**17.2**
2013	**1234.4**	**1333.3**	121,751	101,919	61,933	**2013**	**-98.9**

Change over the period 2002 - 2013					
	Total Funding	Benefits Paid Out	Active Members	Deferreds	Pensioners
	63.3%	98.4%	27.2%	105.9%	76.4%
	Assumes 3.3% reduction per year over 3 years	Assumes 6% increase per annum	Assumes 3.3% reduction per year over 3 years	Assumes 9% increase per annum	Assumes 6% increase per annum