UNIVERSITIES & COLLEGES EMPLOYERS ASSOCIATION

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The Rt Hon E Truss MP
Chief Secretary to the Treasury
1 Horse Guards Road
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By email

28 September 2018

Dear Ms Truss

PUBLIC SERVICE PENSION SCHEME VALUATIONS 2016 – DRAFT AMENDING DIRECTIONS

You will probably not remember, but I had the pleasure of interacting with you when I carried out the A Level content review in 2013 when you were at the DfE. However I am now writing to you as Chair of the Universities and Colleges Employers' Association (UCEA) in response to the Treasury's draft valuation directions, published on 6 September 2018, to explain the extremely serious impact of the consequent large and wholly unexpected increases in employer contributions. I have copied this letter to colleagues at Universities UK and GuildHE and I can advise I have their full support on this issue.

UCEA represents 172 Higher Education (HE) employers across the UK many of which, particularly those that are post-92 universities, have exposure to the public service pension schemes, mainly the Teachers' Pension Scheme, Local Government Pension Scheme and the NHS Pension Scheme.

The scale of this proposed 44 per cent increase in Teachers' Pension Scheme employer costs and an expected similar increase in NHS Pension Scheme costs resulting from the implementation of the assumptions set out in the draft directions, together with the requirement to increase member benefits under the cost cap process, is unprecedented. We have estimated that the increase in contributions to the Teachers' Pension Scheme alone will represent an additional cost of c.£130 million per year in England and Wales falling across some 70 universities, with a similar impact for the modern universities in Scotland and Northern Ireland. The short timeframe over which institutions would need to find this additional and ongoing funding will mean this is an exceptional challenge which our institutions advise could not be achieved without damaging consequences on the student experience.

We are therefore pressing for an immediate pause to the 2016 valuation to allow for GAD to do a full review of the valuation process and the implementation of the cost cap. Your written answer of 6 September conveyed doubt that the valuations are operating "in line with the original policy intentions [of the government in 2015]" when the rules were last set (para. 4). We believe that is absolutely the case.

We go on here to provide some further information on impact and the reasoning behind our call for an immediate pause to the current process.

Impact of the proposed contribution changes on Higher Education

The proposed employer contribution increases will without doubt have a detrimental impact on universities, their staff and their students at a time of great uncertainty and we would urge the Treasury to reconsider.
The results of the 2016 unfunded public service scheme valuations have been awaited for some time and the 70 university institutions required to offer these schemes to their academic staff were aware, from the announcement in the 2016 Budget of a reduction in the discount rate, that an increase in employer contributions was likely in 2018. HE employers are committed to funding the benefits that have accrued for their staff in the public service schemes and UCEA suggested the need to budget for an increase in employer contributions in the region of 2% likely to be effected in 2018-19. This was already a significant increase in their cost base coming on top of, for many, a series of increases in the required employer contributions to LGPS, which is the scheme most modern universities are required to offer their non-academic staff. Such pension costs also have had to be provided for alongside other increases in employment costs over the past 2 years including,

- the increase to National Insurance as a result of changes to the State pension,
- the apprenticeship levy, and
- the immigration skills charge.

The scale of a 44 per cent increase in employer costs is unprecedented. We know from the extensive work commissioned in the last year by the Universities Superannuation Scheme on employer covenant, which examined the research-intensive universities in the UK, that the conclusions were that increases of a similar order of magnitude even in this part of the university sector "would put pressure on some" and that an "increase would be much easier with two to four years notice".

We have estimated that **the increase in contributions to the Teachers' Pension Scheme alone will represent an additional cost of c.£130 million per year** falling mainly across some 70 post-92 or 'modern' universities in England and Wales, with a similar impact for the equivalent universities in Scotland and Northern Ireland. The short timeframe over which institutions need to find this additional and ongoing funding will mean this is an exceptional challenge which is being received with shock and dismay.

Universities are knowledge-based industries and as such a high proportion of their expenditure necessarily goes on staff. Of the £34.5 billion spent by HEIs in 2016-17, 55% was invested in the remuneration of staff. As students and taxpayers make a significant investment in higher education, the sector must ensure that it uses its resources efficiently and effectively and universities have for a number of years been focused on this task while also enhancing the quality of the student experience. One demonstration of this is that the proportion of income spent on staff has been maintained for the past five years while at the same time sector employment has risen by 9.6% from 383,045 to 419,710 (excluding atypical employment) including an 11.4% increase in academic staff. Expenditure on staff over this period has increased by 22.5% from £15.5 billion in 2012-13 to £18.9 billion in 2016-17, with average investment per employee increasing by 11.8% from £40,225 to £44,963.

While it is recognised that sustainable investment in staff is fundamental to the ongoing success of the HE sector it is the unfortunate case that **a large and unplanned for cost increase such as the contemplated 7.2% increase in employer pension contributions to TPS from next September, can for many institutions only be met by reducing other expenditure on staff, with inevitable impact on what can be delivered to students.**

We illustrate these concerns in the Annex to this letter with some immediate feedback gathered from universities on hearing of the 7.2% increase being modelled for TPS.
HEFCE's last report on the financial health of the sector published on 20 March 2018 found that there is a 'trend of reducing surpluses and cash levels, and a rise in borrowing' and that this 'signals a general weakening of financial performance and a trajectory that is not sustainable in the long term'. HEFCE's review of forecasts for England showed that the sector is experiencing deteriorating liquidity with forecasts suggesting net liquidity will fall from 135 days' expenditure to just 81 days between 2015-16 and 2019-20. The same report noted that cash flow as a percentage of total income is expected to fall from10.2% in 2015-16 to 9.1% in 2019-20 with a range of from -6.7% to 28.6%. Therefore **finding significant cash sums to divert towards pension contributions will be extremely challenging.**

Furthermore HEFCE commented that:

"The growing uncertainties faced by the sector will inevitably lead to a greater focus from investors on the underlying financial strength of individual HEIs. Consequently, any fall in confidence levels could restrict the availability of finance in the sector and put significant elements of the investment programme at risk. Falling confidence levels are also likely to lead to a rise in the costs of borrowing."

TPS as a pension scheme is one that is more extensively used in the post-92 or modern universities and these are institutions that have a high dependency on tuition fee income. Such universities are often also a major economic actor in their city or region and at the forefront of widening participation. The freezing of the upper cap for tuition fees in England for 2018/19 and 2019/20 means that the greater proportion of university income cannot increase to meet these externally driven cost pressures. **For many post-92 universities these proposed employer contribution increases will push them into deficit at a time when surpluses are vital.** Universities are required to maintain minimum surpluses to manage short-term risks arising from fluctuations in demand from students, and to enable them to invest in teaching and research facilities. In addition, for many there is now an ongoing requirement regarding the servicing of borrowing. Transparent Approach to Costing (TRAC) data collected by the Office for Students show that there is still a sustainability gap in terms of the difference between the level of surplus achieved and the level required to cover the full economic costs of activity. In 2016-17, 64% of UK universities experienced a fall in their surplus (or increase in deficit) with the median surplus falling from 3.9% to 2.9%. We estimate that the number of post-92 universities in deficit will double as a result of the implementation of these pension contribution increases.

The universities we represent also have concerns over the rising costs of LGPS, already an issue and with the directions now likely to impact on LGPS costs at its next valuation.

Comments on the discount rate and other assumptions

UCEA would urge the Treasury to reconsider making these changes, particularly the reduction to the discount rate. When the SCAPE discount rate was initially introduced, HM Treasury confirmed that they would undertake a review in 5 years' time, which it duly did in 2016 and this led to an announcement of a reduction in the discount rate as part of the 2016 Budget. Employers had no reason to anticipate a further review before another 5 years had passed or to expect that the discount rate would be so unstable particularly since this one assumption has such a profound impact on the cost of the public service schemes. Indeed the technical annex attached to the directions itself refers to "the need for certainty and finality in relation to valuation results calculations" and we would posit that a review of the discount rate at such short intervals does not provide for this to be the case.

We would recommend that a further review of the discount rate only be undertaken after a further 5 year period, as part of the process surrounding the 2020 valuations and the wider GAD review of the cost management process (as referred to in your letter to the TUC of 6 September 2018). **The statutory 2016 valuation process should be paused and the status quo maintained in the meantime with no changes to contributions or benefits.** We believe this is possible as a similar position was reached after the 2008 valuations when the process was delayed by the then Chief Secretary to the Treasury to allow for a review of the discount rate which took place in 2010.

We would also draw attention to the fact that HE falls outside the public sector and has not been subject to the same policy on pay restraint. The short and long term pay assumptions for HE employers are not the same as that for the wider public sector. We have provided data to DfE to demonstrate this. Therefore the proposed changes to these assumptions would not be appropriate for HE scheme members and indeed the impact of salary assumptions on individuals will vary given the differing proportions of final salary and career average benefits.

<u>Comments on the proposal to increase members' benefits</u>

While HE employers appreciate that the benefit offering to members needs to remain attractive, the UK public sector schemes are already generous in their benefit design and an increase in member benefits at this time is not felt to be appropriate.

For a number of reasons, **we believe it would be preferable that the value of benefits be maintained through reductions in member contributions rather than increases in headline benefits as currently being 'required' in the Treasury policy position. We believe this view would be shared by staff** and while we appreciate that this could potentially reduce the yield to the Treasury we believe this would be mitigated by:

- a reduction in members opting out due to affordability issues, as seen particularly in London and other areas with high housing costs,
- a reduction in members opting out for pensions tax reasons who will be those on the highest salaries and paying the highest tier of contributions,
- reducing the cost impact on employers which will prevent their having to take actions which could reduce the scheme membership base, and
- the removal of the need for departments to provide additional funding to meet these costs in 2019/20.

We believe the argument that a reduction in member contributions will create concerns about contribution volatility for members as it would lead them to anticipate future contribution increases is weak given that member contributions are reviewed each year and have been adjusted before. Also members see increases in their contributions as they move up the salary tiers (or indeed a decrease if their pay falls relative to the contribution tiers). In addition, the last round of member contribution increases took place between 2012 and 2015 so will have been experienced by many of the current members. Finally it is our strong view that a short term reduction in member contributions would be far preferable when balanced against the potential long term funding risk to employers and ultimately the Treasury of a permanent increase in benefits.

An associated issue is that **academic staff at post-92 universities that are USS members due to previous employment (usually a small number of people) are able to exercise their**

statutory right to move to TPS. Once the last USS member leaves the scheme the cessation debt may be triggered for that employer which could require the university to fund their share of the scheme deficit (calculated on the basis of securing benefits with an insurance company) – **likely to be a bill of several million pounds for such a post-92 universities.** This is an issue that many institutions are watching carefully.

In addition, scheme members in HE tend to be at the higher end of the salary spectrum and as such an increase in benefits could compound the current impact of the Lifetime and Annual Allowances already disproportionately affecting higher education staff in TPS and NHSPS. This could lead to further opt outs or additional early retirements with the commensurate loss of senior skilled staff in disciplines which are already struggling, for example in the recruitment of clinical academics by medical schools, and a further negative impact on the contribution yield.

Funding arrangements in university medical schools differ, with varying arrangements in place to share funding between the NHS and the respective university. **It is not clear whether any of the additional NHS funding granted as part of the recent funding plan is earmarked for clinical academic funding or can be directed to universities, but it should be noted that in many cases the university funds 100% of the salary and pension costs for their clinical academic employees.** Five new medical schools have opened recently as a result of the increased funding made available for medical school places. In each case the university will have taken into account NHS pension costs when assessing the viability of setting up the new venture and a sudden significant increase in those costs with no commensurate increase in funding could put pressure on the ability of universities to maintain the new provision. The DHSC needs universities to significantly expand their provision due to the shortage in doctors and they are already struggling to recruit, retain and reward clinical academics within the envelope provided.

Process for additional funding

We would welcome clarity on statements from the Department for Education (DfE) and Department of Health and Social Care (DHSC) on how assistance in meeting the proposed additional pension costs will be provided for the 2019/20 financial year across all areas of provision. In both cases **the route by which any funding could be provided to universities is not obvious and we would like to understand how any additional funds will be distributed fairly across the range of employers** and to see assurances of how such large cost increases will be addressed for Education and Health in the next Spending Review.

Summary comments

In summary, we have set out here the compelling reasons for our writing to press for the following changes to the stated Treasury policy:

1. That the 2016 valuation process be paused to allow for GAD to do a full review of the valuation process and the implementation of the cost cap.
2. That the Scheme Advisory Boards be allowed to negotiate any potential changes to member benefits or contributions without constraint, without the possibility of a deduction being made from departmental budgets.
3. That the position regarding additional funding be clarified before the results of the valuations are finalised, including confirmation that HE will be eligible from additional funding from both DfE and DHSC and that the additional pension costs now being planned

will be taken into account when setting these departmental budgets as part of the next Spending Review.

We ask for an urgent meeting with you/and or your officials to discuss this matter.

Yours sincerely,

Professor Mark E. Smith

Vice-Chancellor, Lancaster University and Chair of the UCEA Board

Cc Mr Sam Gyimah MP (by email)
Ms Nicola Dandridge CBE, CE Office for Students (by email)
Mr John Swinney MSP (by email)
Ms Kirsty Williams AM (by email)
Mr John Kemp, Interim CE Scottish Funding Council (by email)
Dr David Blaney, CE HEFCW (by email)
Professor Dame Janet Beer DBE, President Universities UK (by email)
Mr Alastair Jarvis, CE Universities UK (by email)
Professor Joy Carter, Chair GuildHE (by email)
Mr Gordon McKenzie, CE GuildHE (by email)

Annex to this letter with some immediate feedback gathered in recent days from universities on hearing of the employer contribution increases being modelled

"We have recently undertaken a number of exercises across the University to ensure that our resource levels are optimised and we are as efficient as possible with regards to both our teaching delivery and also all of our professional, technical and support services. Given the depth of these previous optimisation reviews we are of the firm belief that in order to accommodate these additional costs we will have no option other than to reduce the spend per student on direct teaching activities."

"We envisage a necessary reduction in the region of 5% of teaching workforce alongside reductions in spend on facilities and resources available for students to support their learning."
"An increase of over 7% in one go is disproportionate to the ability to absorb such an increase and will impact on staffing …have already had to face substantial downsizing in the last few years. Implementation of an increase in TPS as proposed would add over £2.5m to the annual pay cost of the University. This is within the context of inflationary pressure on the university budget due to flat fees."

"We are forecasting significant shortfalls in surplus prior to this bombshell. All part of a strategic decision to maintain entry requirements relative to the local competition and this is a strategy I do not see us swaying from. As student numbers continue to fall over the next few years so too will staff numbers and this issue will only magnify that."

"C.£3.5m additional contributions per year. Along with other pension scheme increases which might follow, probably £5.5m additional costs over and above existing forecasts. That's £25-30m over the 5-year forecast period. It will slow investment in our strategy, and likely speed changes we have already modelled in response to a negative outcome from the post-18 funding review. That has implications for things like widening participation, as well as non-core activities such as sport etc. More widely I think this is a very real risk to Universities with tight margins, low operating cashflows, and/or who have under-recruited."

"The University estimates that the TPS increase will be £1.3m pa, representing an overall increase on the pay bill of circa 2%. This comes at a time when UGT fee rates are flat, and we are experiencing a contraction in new student enrolments, therefore our income is falling. The University has no option but to implement a sizeable savings programme, and expect that we may need to shed around 120 staff. It is impossible to envisage a situation where these cuts will not impact adversely on the student experience."

"A quick back-of-an-envelope calculation suggests a cost of over £600k for [the university], in addition to the £100k+ hit we would take on USS. We already know that our LGPS cost will increase by around £100k per year (cumulatively) for the next three years, so overall an increase of around £1 million in pension costs on a pay bill of £22 million, so just under 5%. We have around 30 staff in USS, so will monitor whether there is a move to leave the scheme."

"The university in its medical school employs around 370 clinician academics who are members in the NHSPS and we calculate the cost of moving from the current employer contribution will be an additional £1.2m"

"An increase of 7.2% on the current 14.38% employers pension rate from Sept 2019 would add approximately £820k to the University's pay bill, only 11% of which might be reclaimable from research sponsors."

“The other known unknown here relates to the proposed change to the LGPS valuation cycle. Again, modern universities tend to have their professional staff predominantly in the LGPS pension scheme. Whilst there is a triennial cycle for local fund valuations, it is unclear what the impact of the national scheme valuation will be. The LGPS pension funding deficit provided for within the accounts is already at a high level and raises questions on institutional performance as it is now reflected in the Statement of Comprehensive Income (SOCI) under FRS102 accounting rules, as well as the balance sheet. TPS does not of course have this arrangement as it is an unfunded scheme but the expenditure and liquidity implications are immediately felt in the institution’s accounts and therefore the SOCI, cashflow and balance sheet.”