University and College Union
Higher Education

To HE Branch and local association secretaries

Topic 1) Challenging the USS approach to scheme funding;
2) USS Pension officers’ meeting

Action Branches will be aware that UCU continues to challenge the USS approach to scheme funding. Branches are asked to consider the attached briefing; raise the issue at branch general meetings (see model motion) and discuss with their employing institution.

Pre-92 branches are asked to send their UCU Pension officer to a meeting on 25 September 2015.

Summary This circular provides a UCU briefing on the need for the USS Board to change the approach to scheme funding and includes practical steps for members to take and asks TPS Pension officers to note meeting which will take place on 25 September.

Contact Geraldine Egan, National Pensions Official (pensions@ucu.org.uk)

Dear Colleagues

1) USS: Challenging the approach to scheme funding

Previous reports to branches have stressed the need for UCU to continue our challenge to the USS trustee board’s approach to funding methodology. At a national level we are raising the need for a full review prior to the 2017 valuation. Discussions with employer representatives are about to commence and we have made it clear that we expect this matter to be discussed formally within the USS negotiating structures.

Please find attached a briefing on the need for the USS Board to change the approach to scheme funding. It is essential that branches raise the need for a review with their institutional management. The briefing includes practical steps for branches to take. It is very important that branches keep head office informed of developments and a simple template has been provided to assist with report back.
2) USS Pension officers’ meeting

**Date:** 25 September 2015  
**Time:** 1100 to 1300  
**Venue:** Conference room, UCU, Carlow Street, London  
[http://www.ucu.org.uk/media/pdf/m/e/ucu_carlowstreetdirections.pdf](http://www.ucu.org.uk/media/pdf/m/e/ucu_carlowstreetdirections.pdf)

This meeting will enable Pension officers to discuss further the campaign to persuade employers into supporting our call for a change in the underlying assumptions applied by the USS Trustee Board. Please complete the registration form and return to [pensions@ucu.org.uk](mailto:pensions@ucu.org.uk) or post to:

UCU Pensions  
3rd floor Alpha Tower  
Suffolk Street Queensway  
Birmingham  
B1 1TT

Please note that branches are expected to pay the expenses for attendance at this meeting.

*Micahel MacNeil  
National Head of Bargaining and Negotiations*
Challenging the USS approach to scheme funding

A UCU briefing for branches

September 2015

This briefing outlines why branches should raise the need to change the USS Board's approach to scheme funding with their institutional management. It includes practical steps for branches to take. It is also important that branches keep head office informed of developments and a simple template has been provided to assist with report back.
Introduction:

UCU branches are aware that the recent radical changes to pension benefits were brought about by a triennial valuation which outlined that if there was no change to the scheme would have had a deficit of £12.4 billion based on the current funding methodology.

On advice from the USS Executive and actuary, the methodology adopted to produce this figure was agreed by the USS Trustee Board (hereafter referred to as the USS Board). The USS Board comprises four Directors nominated by UUK, three by UCU, and five ‘independents’ (mostly from City institutions).

The USS’s approach was challenged vigorously by UCU at every stage. We characterised the approach to valuation and de-risking as ‘recklessly prudent’. We were not alone in submitting a challenge; six HEIs also challenged the basis of the valuation. But, despite our best efforts, it was not possible to persuade the USS Board to agree a fundamentally different methodology for the 2014 valuation.

Gaining a change to the approach adopted by the USS Board in future valuations is possible if the UCU and UUK nominated Directors are in agreement. UCU believes such a change would be to the benefit of members, employing institutions and a more accurate reflection of the financial state of the scheme.

UCU policy is to continue to challenge the entire approach to funding methodology, not only because it is an incorrect approach; that it is wittingly or otherwise supporting an drive to make defined benefit schemes seem unsupportable by employers; but also because a more sensible approach would affect future valuations.

The next formal valuation will take a snapshot of the scheme’s financial health as at 31 March 2017.

UCU is pushing for discussion in an urgent review of the scheme’s approach to funding to start in the autumn of 2015. UUK have agreed to engage in such a review.

Key objectives:
Our core objective in this review is to win the argument and persuade the employers at national and local level that a change in valuation methodology is right for members, institutions and the scheme itself.

The UCU negotiators have already started discussion with the employer representatives at a UK level.

But a key objective for branches affected is to get their employer to question the current valuation methodology and eventually to persuade their nominees on the Board to adopt a different position.
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Section 1: Who is involved in shaping the USS scheme?

There are four key actors with a considerable influence on these negotiations:

- The USS Corporate Trustee (the USS Board)
- The Employers
- UCU
- The Pensions Regulator (tPR)

As previously stated, the USS Board comprises four Directors nominated by UUK, three by UCU, and five ‘independents’ (mostly from City institutions). Their primary duty is to ensure that the pension fund will have enough money to pay out the benefits that have already been accrued.

The Pension Regulator has statutory duties but, in short, they are concerned with protecting the accrued benefits of members and reducing the risk of situations arising which may lead to compensation being payable from the Pension Protection Fund (PPF). There are very few funded defined benefit schemes still open, which makes USS unusual. But because it is by far the biggest, with funds of over £40bn, it is the subject of intense scrutiny by the regulator. The regulator is highly cautious and conservative.
Section 2: USS funding

The funding position is derived by, at root, a simple concept: the projected cost of future benefits to members (liabilities) is set against the assets of the scheme and the expected contributions made by the employers and employees plus the financial benefits derived from investment. Of course, there is an entire industry surrounding the assumptions made in calculating what is likely to happen in the future to both sides of the calculation.

The rest of this section is a briefing prepared by First Actuarial, our actuarial advisers to explain USS’s approach to scheme funding.

Derisking and investment strategy

In December 2013, USS produced an engagement report entitled “Scheme funding within USS”. This report was intended to inform a number of discussions between the Trustee and institutions relating to the USS, including the assumptions to be used in the 2014 valuation.

According to the USS report, the key risk to the scheme is instability over time in the amount required from employers and employees to pay for the scheme. This amount is determined by the results of the valuation and also depends on how the scheme's assets are invested.

The USS report suggests that changes will be needed to ensure the scheme remains affordable in the future. It also argues that a degree of investment “de-risking” is appropriate to allow for potential long-term risks. Derisking means increasing USS’ holding in gilts and bonds, and reducing its exposure to growth assets such as equities and property. Growth assets carry more risk than assets such as gilts and bonds but this they generally also have higher return potential. So, de-risking the investments is likely to mean lower investment returns for the scheme in the future.

This would increase the cost of both past and future benefits in the scheme. (If investment returns are assumed to be lower, you need more ‘in the bank’ to pay for the benefits that have been promised or have lower projected benefits accruing in the future).

The current investment strategy of USS, as set out in their statement of investment principles, is shown in the adjacent chart.
Based on this strategy, the Trustee estimates that the assets will return approximately 2.75% pa above the yields on gilts.

The Trustee has proposed a long-term de-risking strategy which involves moving to an investment strategy which will produce a best estimate rate of return 1% pa lower than the current approach.

Comments on the derisking strategy
Whilst valuations are only snapshots of the position of the scheme, they are important as the deficit disclosed determines the deficit contributions institutions need to pay as well as setting the cost of ongoing benefits.

The current investment strategy combined with the current valuation methodology produces volatile valuation results. The volatility arises because the current methodology (termed the “gilts plus” approach) sets the value of the liabilities using gilt returns and compares this to the market value of the scheme’s assets. Because the return on gilts (which drives the liabilities) and the value of the assets are largely unconnected, the valuation results are volatile. If most of the assets are not in gilts, as is the case for USS, but the liabilities are calculated with reference to gilt yields, there is a fundamental mismatch between the value of the assets and the value placed on the liabilities.

The solution proposed by the Trustee is to invest more of the assets in gilts so the assets move in line with the liabilities assessed on a gilts basis. In other words, they are proposing that the valuation methodology should drive the investment strategy.

By allowing the valuation methodology to drive the investment strategy, the result is a cyclical process leading to increased costs and further benefit cuts, as shown in the diagram below. This is bad for members as it means lower benefits and/or higher contributions but also employers as it means the value they see in investing in an important area of staff remuneration is decreased.

This is particularly problematic now as gilt yields have fallen significantly over the past 6 years due to the effects of quantitative easing. On the other hand, asset markets have actually performed reasonably well compared to gilts.
Application of alternative approaches

Rather than setting the value of the liabilities using gilt returns, we believe a more appropriate method would be to value the scheme liabilities by taking into account the actual investments held by the scheme and the expected returns on these investments. By definition, the expected return on an asset is the rate of return which values the expected income on the asset at its market value. This is known as the “Internal Rate of Return”.

This alternative approach, which is used by many other schemes, would reduce the volatility in the valuation results as it would mean that the assets and liabilities move in line with one another. The stability of this alternative method is of particular relevance to the USS, as the key risk identified in the funding strategy report was the level of volatility in the contributions required to cover the costs of the scheme.

We recognise that the Trustee is required to take a prudent approach to the valuation and fully support this (as a way to ensure that members’ benefits are secure). But the assumptions being adopted by the Trustees are in our view overly cautious and lead to an inflation of the scheme deficit.

The graph above shows our approximate calculations which compare the historic funding position of the USS on a “gilts plus” approach with the “Internal Rate of Return” approach outlined above. The graph covers data from 2005 to 2014, and shows the volatility in the funding level from using the “gilts plus” method. Using a method that leads to more stability in funding level means that the risk that increased contributions will be required at future valuations is also reduced. The funding level under the “Internal Rate of Return” approach is far more stable over time than under the “gilts plus” method.

Rather than basing the USS funding assumptions on a “gilts plus” valuation approach, an alternative and more appropriate method would be to derive the discount rate used to value scheme liabilities by taking into account the actual investments held by the scheme and the expected returns on these investments. Given that the USS is invested predominantly in equities (50% as at 31 March 2013), it would be reasonable for the discount rate adopted in the valuation to allow for the expected return on equities, as well as the returns on the other asset classes held.

Ongoing and solvency valuations

In October 2014, USS issued the paper “2014 Actuarial Valuation: A consultation on the proposed assumptions for the schemes technical provisions and recovery plan”. It is clear
from this consultation paper that the Trustee’s focus is on a “self-sufficiency” valuation, which is a proxy for a buyout solvency valuation, and quite different to an “ongoing” valuation, as we explain below.

The characteristics of an ongoing valuation of a pension scheme are:
- It assumes that the scheme continues to exist.
- The principal purpose is to determine the contribution rate required to pay for accruing benefits and any funding shortfall.
- It is essential to estimate the expected return on the actual and intended investments of the scheme.

The characteristics of a solvency valuation are:
- It assumes that the scheme terminates.
- How the scheme is invested is irrelevant, it is assumed that the assets are sold and used to purchase annuities.

A solvency valuation is relevant when a scheme is wound up. A wind up may be triggered voluntarily, in which case the employer needs to ensure it can meet any solvency deficit before acting, or it may be triggered by the employer’s insolvency.

It seems clear from the October paper that the Trustee’s focus is on the self-sufficiency concept, seemingly to the exclusion of the ongoing concept. However, the value of the scheme’s liabilities as measured on a self-sufficiency basis only becomes relevant if the ability of employers to contribute is nil. For USS, the likelihood of this scenario is extremely small over any given time scale, and the 2014 covenant review carried out by Ernst and Young did not suggest any likelihood of this occurring in the next 20 years.

The most likely outcome, especially given the last person standing structure of the scheme (let’s say >99%) is that USS continues to exist as an ongoing scheme, collecting contributions from employers, and asset income from the scheme’s investments, and paying benefits to members – and in all likelihood remaining open to new members and collecting ongoing contributions. The least likely outcome (let’s say <1%) is that self-sufficiency becomes USS’s basis for operation. And yet the approach used by USS concentrates on the 1% scenario and not the 99% scenario. We discuss the “ongoing” context in further detail below.

The three tests

As part of its engagement with Universities UK (UUK), the USS trustee board published the paper “Integrated approach to scheme funding” in July 2014 which sets out three guiding principles for scheme funding, and addresses the interaction of employer covenant, investments, contributions and benefits. The ‘employer covenant’ is a broad term to describe the employers’ ability to stand behind the scheme – to pay the contributions required for ongoing benefits and deficit. The principles have been codified into three Tests that drive the degree of investment de-risking that the USS Trustee believes is appropriate.

Test 1 focuses on benefit security, and Test 2 is about the volatility of the employers’ contributions. Both tests rely on stochastic modelling of the future. Stochastic modelling involves running thousands of different combinations of future conditions then considering the outcome on those scenarios. The first test is to determine whether the Trustee is comfortable with a particular level of technical provision (based on the likely time to transition to a self-sufficiency position), the second to assess the likelihood of employer contributions exceeding certain pre-specified thresholds as set out in the Trustee’s paper “Scheme Funding within USS – an engagement with Universities UK”, December 2013.
The tests are designed to determine the level of investment de-risking the Trustee might adopt; de-risking will therefore influence the cost of the scheme, and the need for future changes to the benefit structure. However, there are some significant problems associated with using stochastic modelling to determine the need for changes to, or appropriate level of, future benefits. The output and results of stochastic models are highly dependent on the model itself, the assumptions chosen, and the level of correlation allowed for between the key variables and inputs.

These tests also rely on gilt yields for determining the value of the liabilities and are therefore likely to produce more volatile results than if the liabilities were calculated with reference to the return on the assets held by the scheme.

Test 3 focuses on the reliance on the employers’ covenant, and the Trustee’s principle that this level of reliance should not increase over time. In test 3, the level of reliance on the employer covenant is calculated by comparing the net asset value of all the institutions combined to the USS deficit (calculated on a “self-sufficiency” basis, using discount rates equal to the yields on gilts) and allowing for an amount required to meet a tail risk (calculated in probabilistic terms). As mentioned above, in the USS most of the assets are not invested in gilts. Basing the measure of the reliance on employer covenant on a deficit calculated with reference to the yield on gilts creates a fundamental mismatch – the deficit as measured using a gilts-based discount rate is irrelevant for a scheme where the majority of assets are not invested in gilts.

In addition, it is important to note there are two ways of measuring the level of reliance the Trustee has on the employer covenant. The first approach is to take a best estimate return on the asset portfolio and deduct an amount to allow for prudence. We might term this is “best estimate minus” approach to discount rates. Here the distance moved from right to left indicates the reliance on the employer covenant. Using this approach, we are answering the question “How much more are we saving than we think we need to give as a buffer against having to ask employers for more money in the future?”

The alternative approach, and the one favoured by the USS Trustee, is to set the starting point as the position USS would be in if it were to exist with no employer support (gilt discount rate) and to move away from this – a “gilts plus” approach. Here the distance moved from left to right indicates the reliance on the employer covenant. Here we are answering the question “How much less are we saving than the amount we need to buy the benefits out?”
The Trustee’s favoured approach is the second one. Note again the concentration on the 1% scenario (all the institutions become insolvent and the scheme winds up) rather than the 99% scenario (the employers continue for the long term future). Depending on the method used to set the discount rate for use in valuations of the USS, a change in market conditions will change the reliance on the employer covenant in different ways.

As an example, over the course of USS’ inter-valuation period, gilt yields have fallen significantly but the internal rate of return has fallen much less so the gap between a gilts basis and best estimate basis has widened. In other words, whilst in 2011 the gilts plus and best estimate minus approaches produced the same answer, there is now a significant gap between the two. This is shown in the chart below.

If the USS valuation methodology followed a “best estimate minus” approach, the change in basis from 2011 to 2014 would reflect the change in yield on the actual assets held by the scheme (such as the change in UK equity dividend yield, and other data considered relevant by the internal investment team) since the previous valuation. This would represent an unchanged margin of prudence relative to an ongoing best estimate value of the liabilities calculated using a best estimate minus approach, and therefore no change in reliance on the employers’ covenant in an ongoing scheme context. Using the “best estimate” approach rather than the gilts plus approach could have reduced the deficit in the 2014 valuation by around £8.6bn.

**Cashflow planning**

Given the >99% likely scenario of USS continuing as an open scheme sponsored by employers with a robust covenant, it is important to look at the scheme in an ongoing context. For an ongoing scheme, an important consideration is the scheme’s cashflow position - not just the liability outgo cash flows, but also the asset income. The net cash flow position gives an idea of the size of market value based risks the scheme is exposed to.
A defined benefit scheme which is open to new entrants and has matured to a steady state position may have broadly neutral net cash flow - benefits can be paid from the income without any need to sell assets. A prudently funded scheme in steady state could expect to have permanent positive cash flow if contributions are not reduced on account of surplus.

The chart below shows the (very approximately) modelled cash flow position of USS for the next 70 years, starting from the 2011 valuation. The figures are based on the current asset allocation and benefit levels and the undiscounted numbers on the chart increase with inflation. The figures do not allow for the proposed changes to USS from 2016.

The red bars show the difference between the projected incomes (contributions, income on assets) less benefit outgo – that is the net cashflow position, which is positive for a period of just over 20 years.

Given the change to benefits introduced in 2011, the chart shows an intermediate negative cashflow position. Here, the benefits being paid are mostly from the final salary section but the contributions in are lower given the reduction in the cost of accrual under the career revalued benefits (CRB) section. The scheme is then projected to return to a positive cashflow position in the very long-term, as would be expected, once it settles into a prudently funded steady state with benefits accruing in the CRB section.

While the net cash flow is positive, there is no need to sell any assets and therefore no disinvestment risk to the USS. While there is no requirement to sell assets, volatility from market value fluctuations is not a concern for the USS: the main concern is the volatility in asset income. Measures of risk and funding level which are market value sensitive, as opposed to asset income sensitive, are likely to be inappropriate in this context and should be given little attention.

UCU is proposing that future discussions on valuation methodologies should commence by looking at asset income and liability outgo.
Section 3: A model motion

It is recommended that branches adopt a formal position on the USS funding methodology at a general meeting. The model motion produced below may be of assistance.

This branch believes that the USS Board adopted a recklessly prudent approach to scheme funding in the lead-up to the 2014 triennial valuation and that this was been the driving force for increases to employer and employee contributions and cuts to members’ pension benefits.

This branch notes that UCU commissioned expert advice and used this to suggest an alternative approach to that adopted by the USS Board. Adopting UCU’s alternative approach could have reduced the deficit in the 2014 valuation by around £8.6bn. It is also noted that some universities also questioned the valuation methodology.

This branch calls on the branch committee to:

1. Raise the USS scheme funding approach through the relevant joint negotiating/consultative machinery, highlight the problems with the current approach; asking for the employer to agree that USS should adopt a reasonable interpretation of the available evidence when setting the approach to scheme funding;
2. Write to the VC/Rector/Principal asking for the University to join with UCU in reviewing the USS funding methodology;
3. Encourage members to raise the USS scheme funding approach at other institutional bodies (i.e. Senate, Assemblies, and Faculty meetings);
4. Keep the UCU’s head office informed of developments
Section 4:  Model letter to your institution

Branches may wish to use the following as a guide when writing to their head of institution.

Dear xxxx

**USS scheme funding**

You will be aware that UCU has maintained a consistent position that the USS Board had adopted an approach to the valuation method, technical assumptions, and risk management that was counter to the interests of both employers and scheme members.

A number of employers including Imperial, Warwick and Oxford broadly shared our view and had significant reservations about the approach of the Trustee. Part of the agreement to accepting the recent changes to benefits for members was that there would be an urgent review of the approach to USS funding methodology in advance of the next valuation of the scheme due on 31 March 2017.

Our branch general meeting on xx/xx/xx discussed the approach to scheme funding and I am writing to ask that this matter is raised at xxxx [insert appropriate fora] with a view to the university agreeing to persuading their representatives in the USS machinery to adopt a different and more reasonable interpretation of the available evidence when setting the approach to scheme funding for the 2017 triennial valuation.

I look forward to your response.

Yours,
Section 5: Raising the issue at institutional meetings

There are many ways that branches can raise the USS funding methodology within the institution.

Branches are strongly encouraged to place the issue on the agenda of the next JNC/JNCC or appropriate negotiating and consultation forum.

Branches should meet with any individual or body that is asked to respond on behalf of the VC/Principal/Registrar/Rector and encourage the institution to establish a working group of relevant academics to consider the issue in more detail.

If there is no positive respond then the branch should arrange for the issues to be raised at other appropriate institutional bodies, such as Senate, Assemblies and Faculty meeting or even University Council

It is worth remembering that other unions may have members in USS and that USS has agreed that staff who are promoted by their employer into USS are able to remain with their old scheme. Raise the issues at any joint union committees.

UCU would ask branch to encourage helpful responses to be directed to UUK representatives on USS Board asking them to seriously consider alternating the base of USS technical provision in advance of the next valuation.
Section 6: Keeping UCU Head office informed

It is important that the UCU at a UK level is able to keep track of which institutions are discussing the approach to the USS scheme funding.

It would be helpful if branches could pass on the following information, preferably using the checklist below:

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<tr>
<th>Issue</th>
<th>Yes</th>
<th>No</th>
<th>Comments/date</th>
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<tr>
<td>1. Has a branch general meeting adopted a formal position</td>
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<td>2. Has the branch written to the institution?</td>
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<td>3. Has a response been received?</td>
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<tr>
<td>4. Has the issue been raised at negotiating or consultation meetings?</td>
<td>If Y, please pass a copy to head office</td>
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<tr>
<td>5. Has the issue been raised at any other institutional bodies?</td>
<td>If Y, please indicate the date</td>
<td>If Y, please indicate in comments box the management response</td>
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<tr>
<td>6. Has a joint working group been established?</td>
<td>If Y, please use the comments box to provide further information.</td>
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<td>Any other comments</td>
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Send updates to: pensions@ucu.org.uk
Further advice is available from:

Geraldine Egan
National Pensions Official
Telephone: 0121 634 7387
REGISTRATION FORM

This form should be completed by branch/LA secretaries and regional committee secretaries to register delegates for the USS briefing. Please keep your treasurer advised of who will be making claims from them.

Each branch or Local Association is asked to send a member to this event.

The deadline for the registration of delegates is one week before the event but you are asked to book early. All registrations will be acknowledged.

To book or make further enquiries please contact Geraldine Egan UCU, Pensions,

By telephone: 0121 634 7387

By post:
UCU Birmingham Office,
2nd Floor Alpha Tower,
Suffolk Street Queensway,
Birmingham B1,

or email pensions@ucu.org.uk

1. Name of branch/local association

2. Branch Nomination (for expenses only)

Signature of branch/LA secretary, president or chair registering member to attend as a delegate for the branch/LA.

Date

3. Name and position held
4. Details of delegate

Name.................................................................................................................................

Membership number (if known)
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Mailing address..................................................................................................................
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Telephone
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Email
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5. Venue

UCU HQ London □ 25th September 2015

6. Additional requirements

Please give details of any access requirements/adjustments regarding any disability.

Mobility (eg wheelchair access)..........................................................................................

Visual assistance (including documents in Braille or large print)
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Hearing (including BSL)..................................................................................................

Any other access requirement (please give details).........................................................
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Please give details of any dietary requirements
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Secretary’s signature ........................................................................................................
Date ..........................

Please return at least one week prior to the briefing, send to pensions as stated.