UCU counter-proposal

Executive summary

The purpose of this document is to introduce UCU's proposals for resolving the 2018 valuation without an unnecessary and damaging industrial dispute. We are calling for employers to cover all costs arising from the 2018 valuation apart from the default member rate of 8%. As we argue below, this outcome is both fair and affordable, and it would stem the flow of members already leaving the Scheme because of the 2017 contribution increases that have been imposed upon them.

We regret that employers have not joined us in pushing vigorously for USS to take the JEP report more seriously. Had employers supported UCU's calls for transparency and rigour in the valuation process, these proposals might not have been necessary. However, employers' behaviour since the JEP issued its first report has made it difficult to believe that they intend to reverse their longer-term trajectory of cutting and eventually closing the Defined Benefit element of the Scheme.

In what follows, we offer some detailed reflections on the employers' position, that members should share 35% of the costs over 26% that arise from this valuation. We believe that it is unjust and irrational. In brief:

- Employers can benefit from overpayment in one valuation cycle by underpaying in future ones, whereas members cannot.
- Employers have underpaid into the Scheme in the past.
- Employers can influence the contribution rate in various ways, whereas members cannot.
- Members have repeatedly suffered the impact of investment decisions they had no input into, in the form of benefit cuts and earlier contribution increases.

We further argue that employers can afford to cover the costs, on the following grounds:

- The independent covenant assessments commissioned by USS, along with other factors, indicate that they can.
- Employers are better placed to absorb the increases than individual members.
- Members' wages have been systematically suppressed for more than a decade.
- Sector staff costs have fallen in the last decade from 58% of total expenditure to 54% now, and implementing our proposals would raise this figure no higher than 56%.

Most importantly, we argue that requiring employers to cover all increases will have two further beneficial effects. First, the increased short-term cash commitment will strengthen the covenant in the eyes of the Regulator (although we maintain that employers could have made such a measure unnecessary by pressing USS to engage with TPR and demonstrate the prudence of a 26% contribution rate). Secondly, this commitment, and particularly the prospect of paying 26.7% from October 2021 under Option 3, will finally focus employers' minds on achieving a better outcome for the JEP.

Foreword

As UCU members of the USS Joint Negotiating Committee (JNC), we have tabled proposals for employers to cover all costs arising from the 2018 valuation, with the rate for members remaining at the standard level of 8% established under rule 5.1.

This is not our preferred outcome for this valuation cycle. Since the Joint Expert Panel issued its first report in September 2018, UCU has pressed for the implementation of all of the JEP's proposals. If applied to a 2018 valuation, these would result in a contribution rate no higher than 26% and no need for employers or members to pay more than they did before 2017. At the same time, we have pressed USS on other matters relating to the JEP's wide-ranging critique of its governance and valuation methodology. Standing at the end of this process, we continue to believe that USS's response to the JEP is not satisfactory.

It was clear that the JEP's initial proposals were a bare minimum, and a proper overhaul would need to follow in the wake of its second report. UCU negotiators and members recognised this, and worked to reinforce and develop the work of the JEP as holistically as possible. We have criticised The Pensions Regulator's problematic interventions in the valuation process. We have highlighted USS's questionable transparency and its tendency to lean inappropriately and selectively on certain statements by the Regulator, or on speculative claims about what the Regulator may or may not permit USS to do. We have asked USS to answer the Regulator's repeated invitations to provide further evidence about the strength of the employer covenant and a fuller analysis of risk, to no avail. We have, moreover, noted that the rushed and haphazard employer consultation procedures criticised by the JEP have worsened significantly.

Most importantly, UCU has built considerably upon the JEP's criticisms of Test 1. We have shown that the de-risking which Test 1 serves to justify may not be necessary even by USS's own stated criteria. But when we demonstrated that USS could achieve the self-sufficiency target within its required timeframe without de-risking, USS moved the goalposts and presented a series of new arguments. Every time, we have exposed those arguments' flaws. First, USS argued that The Pensions Regulator's preference for benchmarking the technical provisions discount rate against gilts made it impossible to delay de-risking – falsely, as it turned out, with the Regulator itself having to correct USS's claims. Once the Regulator's rebuke became more widely known, USS added new arguments, based on the supposedly higher volatility of the surplus/deficit and higher downside risk in a return-seeking portfolio. Even USS agrees with our objections that it has not modelled these effects with the rigour or precision necessary to make informed decisions. We were therefore shocked when the Trustee's **most recent statement** on de-risking invoked no reasons other than that it 'introduces less volatility in the funding plan and reduces the risk that – in significantly adverse outcomes – USS will make unsustainable calls on the sector in order to pay members' benefits'[i]. In other words, inadequately modelled volatility and downside risk are all USS currently has to say for itself in defence of the most controversial and destructive aspect of the valuation.

UCU's concerns intensified when it became clear that many of the questions posed by the JEP had also been asked by one of USS's own Trustee Board members, both before and after the Panel began its work. Professor Jane Hutton claims to have been denied access to key information pertaining to the 2017 and 2018 valuations by the USS Trustee Chair, David Eastwood, and Chief Executive, Bill Galvin. In one case there is already very clear proof of this, which USS has not denied: after receiving the aforementioned email from the Regulator rebuking USS's claims, Eastwood withheld it from the rest of the Board, even after Professor Hutton asked about it directly.

In pursuing all these questions, UCU and Professor Hutton have been acting with no agenda other than protecting the interests of Scheme members, although the extensive coverage of the crisis in USS by the Financial Times, the BBC and other outlets shows that the matter is also of public interest.

Employers have taken a different approach. Universities UK responded to the JEP with a narrowly framed consultation, asking employers only whether they accepted the JEP's proposals. Although a majority of employers did accept them, the opportunity for wider reflection on the report was missed. UCU responded to the JEP not only by accepting the proposals but also by reaffirming its conviction that USS is viable in the long term with the same level of benefits and contributions as members and employers enjoyed before 2017. Employers, by contrast, did not entertain that question. Their silence has understandably led UCU members to conclude that they are simply biding their time before returning to their original plans to cut and ultimately close the Defined Benefit element of the Scheme.

By concentrating exclusively on the JEP's formal proposals, employers committed what could charitably be described as a grave tactical error. They allowed USS to treat the proposals as an upper limit: a basis for negotiation downwards, not upwards. Whenever UCU raised the questions we have outlined above, employers did not adequately support us. They did nothing in response to our criticisms of Test 1, and did not join us in asking for up-to-date modelling until it was too late to have any impact on this valuation cycle. Most frustratingly, Universities UK received a copy of the crucial email from the Regulator correcting USS, and failed to divulge it to employers or to UCU. They do not share UCU's view that the Trustee Chair and Chief Executive have failed in their duties to stakeholders.

Perhaps employers think that it would be counterproductive to work with us on these issues, on the grounds that USS would respond poorly to a more robust approach, or that the Regulator might regard a more fractious employer-Scheme relationship as a token of a weakening covenant. If so, they are wrong. Employers' more conservative bargaining tactics have failed to get what stakeholders wanted. As for the covenant, we are equally unconvinced. Employers have gone so far as to threaten legal action against USS in the past without any tangible impact on the covenant. In any case, there are plenty of ways to strengthen the covenant while remaining critical of USS, as we shall argue in what follows.

Despite their initial endorsement of the JEP's proposals, we do not feel that employers have shared our commitment to honouring the agenda for reform laid out by the JEP, and we do not believe that they are committed to sponsoring the USS benefit package in the long term. UCU currently finds it difficult to believe that they will operate any differently when the Panel issues its second report.

Rationale for UCU proposals

The failure to implement the JEP report's recommendations represents an immediate threat to USS members, not just a long-term one. Employers have not shown the necessary commitment to preserving the Scheme in the face of resistance from the USS Trustee and Executive. They have already declared their intention to impose some of the costs of the 2018 valuation on members, even in the case of their preferred 'Option 3'. They have given no assurances that they would continue to do this beyond the 2020 valuation, when the rate is scheduled to rise from 30.7% to 34.7%. Some university managers have already indicated that they will seek to 'reform' benefits if the rate does not drop at that point.[ii] Meanwhile, employers have not signalled that they will be any more assertive in their interactions with USS once the JEP has published its second report. If a cautious approach failed to achieve the outcomes to which both employers and UCU signed up, UCU has to ask why we should expect it to succeed in the future – especially given that the next report's proposals are likely to be more ambitious, and there will be relatively little time to implement them prior to a 2020 valuation.

UCU members have spent more than a year since the strike hoping that the JEP, and the resulting negotiations, would be enough on their own to secure an acceptable outcome. We made considerable sacrifices by agreeing to suspend strike action to establish the JEP. We allowed employers to keep millions of pounds in docked pay from members who took strike action – equivalent to a one-off transfer of 4% of salary. We agreed not to pursue many other grievances that had arisen in relation to the dispute, such as Universities UK's obvious and disastrous manipulation of the September 2017 employer consultation. We left the negotiating table with no material concessions from employers. We abandoned any means of preventing USS from imposing Rule 76.8 contribution increases on us on the back of the 2017 valuation – a situation that arose because employers spent months refusing to enter serious negotiations with us, and were only moved to do so by extended industrial action. At the time, many UCU members argued that we should stay on strike until employers committed to covering a larger share of future contribution increases, so that they would have a stronger incentive to make the JEP work. Instead, the majority of members chose simply to trust that employers would do everything in their power to honour the outcome of the JEP. We now feel that they have betrayed our trust.

UCU's position is that, absent an adequate response to the JEP report, the only fair outcome for this valuation cycle is an arrangement whereby USS members pay the standard rate of 8% and employers cover everything else. Given that the employers' preference is for Option 3, in practice this will mean that they pay a rate of 22.7% until October 2021, and 26.7% after that.

Such an arrangement is fair, whether considered in general terms or in the particular context of this dispute. It is written into the Scheme rules that members pay 8% and employers pay whatever else is necessary because it is employers, not members, who stand to benefit from any overpayment. If paying 30.7% serves to stabilise the Scheme such that rates can drop below 26% in the future, members who overpaid will not be compensated. Many, if not all of them will have retired. Only one side benefits properly from sliding contribution rates. Only one side should pay.

Equally, only one side in this arrangement can have an influence on those contribution rates. Employers may not control the valuation, but their expressions of risk appetite, their record of financial commitment to the Scheme, and their other business activities all have a bearing on the covenant and the methods and assumptions adopted by USS, and thus on the final contribution rate. It is not fair that members should foot any of the bill when employers' behaviour weakens the covenant.

This bears on the larger question of how risk is shared in the scheme and who should underwrite it. In USS, the members cannot decide how much risk the Scheme should take, but they have suffered almost all of the impact of its investment decisions. Members have no input into the level of risk in the valuation, even though they can be required to pay the high premium associated with sub-optimal investment strategies via forced Rule 76.8 cost-sharing. That was the outcome of the 2017 valuation, which also saw a benefit cut in the form of the removal of the employer 'match'. At the previous two valuations in 2011 and 2014, members absorbed almost all of the burden of USS's investment decisions, by accepting the end of Final Salary along with other very significant cuts to their benefits and increased contributions. It is members, not employers, who have tended to bear the direct consequences of USS's investment strategy and other decisions, in the form of benefit cuts. This was despite the fact that employers had spent several valuations paying less than the actuarially determined rate into the Scheme, a behaviour that not only contributed to underfunding but also most likely weakened the covenant in the eyes of the Regulator. This underpayment would not in itself be problematic if USS continued to invest on the assumption that the Scheme would remain open and underwritten by a strong covenant. But it has become unjust in the context of USS's subsequent decision, which employers still support, to move towards a self-sufficient, liability-matched portfolio, and employers' accompanying insistence that members should share the costs of that move.

The Joint Expert Panel rightly identified the injustice of these arrangements. If members are to be expected to pay a share of contribution increases, they too should be consulted on their risk appetite, or they should be allowed to feed in to employers' consultation responses. The **JEP report** stated that the absence of such a member consultation 'seems to be a weak point' in a scheme like USS, where members 'share the consequences of decisions made in the valuation', and that this weak point 'should be addressed for future valuations'[iii]. When the JEP said this, it was not envisaging a situation in which USS rejected a large part of its recommendations and left members facing a share of a contribution rate well over 29.2%. Since the costs of this valuation are higher than the JEP envisaged and there are further costs which employers are trying to force on members via future valuations, employers should address the continuing absence of member input by agreeing to cover costs up to 34.7% until a longer-term means of accounting for members' risk appetite can be found.

Employers will claim that they cannot afford the extra costs we are asking them to cover. When considering this question we should put the second phase of Option 3, where the rate rises to 34.7% after 2020, to one side. We do not believe employers will agree to cover even a 65% share of that rate, and will undoubtedly seek to cut or close the Defined Benefit element instead. We do believe that they could afford to pay 100%, given the time which Option 3 gives them to adjust their business models, the improved revenue streams which they are forecasting after 2020, and the fact that an 8.7% increase is not extravagantly higher than the 6.2% increase which USS has already scheduled for employers on the basis of the 2017 valuation (not to mention the 6.9% increase initially proposed, prior to the DRC consultation). Nevertheless, we expect that employers will refuse to pay. Whatever the JNC decides regarding the 2018 schedule of contributions, that schedule is unlikely to stay in place from 2020.

The 1.6% extra which employers would need to pay until October 2021, by contrast, is unquestionably affordable and should not give rise to any objections or countermeasures on their part. If employers were to pay 22.7%, their total contributions would hardly differ from the 22.5% middle step of the 2017 contribution increases that have already been scheduled. We know of no assessment of the covenant by USS or its advisers that finds such a rate to be seriously problematic for employers. For members, by contrast, all the evidence suggests that even 9.6% would be too much to ask. Employers have vigorously suppressed our wages since the financial crisis, with cut after cut leaving them around 20% lower in real RPI terms than they would be if they had kept up with inflation. Spending on staff across the sector has dropped as a proportion of overall expenditure, from 58.1% in 2006-7 to 54% in 2017-18, and been replaced by costs relating to capital expenditure, much of which is discretionary. If employers paid the 4.7% extra needed to cover the first phase of Option 3, we have determined that the proportion of expenditure on staff would rise no higher than 55%; and if they covered the second phase of Option 3, no higher than 55.8%. The cost of preserving USS, in other words, would not even go halfway towards restoring the balance that prevailed before the financial crisis.

Again, staff have accepted all these sacrifices with only very minimal, occasional resistance in the form of industrial action. Members are already dropping out of the scheme in significant numbers while citing the unaffordability of the 2017 contribution increases as their reason for leaving (JNC 166-2.7, Annex B). Other leading reasons for dropping out include the difficulty of staying in the Scheme while on a fixed-term, part-time, or variable-hours contract. Given that female staff are more likely to be on such contracts and lower down the pay scale (see the **data** provided by the Higher Education Statistics agency),[iv] the similar percentages of women leavers in USS's latest figures almost certainly translate into higher overall numbers of women being forced out of the Scheme; the same is likely to be true of disabled and BAME staff. If employers were enacting their proposed contributions split within their own institutions rather than through a private pension scheme, they would be expected to complete a detailed Equalities Impact Assessment before proceeding. Younger members, who in most cases have never known anything other than drastically suppressed wages and an inferior CARE benefit package, are similarly at risk. USS's failure to retain younger members destabilises the Scheme.

We are speaking of a body of precarious staff that cannot absorb financial shocks in the same way as a massive non-profit organisation. And yet the Chair of the Employers' Pensions Forum, Adam Tickell, has already, on several occasions, threatened mass redundancies throughout the sector if employers are required to increase their contributions above the level they are proposing.[v] In every debate about universities' financial position, there seems to be an underlying assumption that employers' ambitions and activities must never suffer, whatever the cost to members. Employers should never have to cut capital expenditure. They should never have to reshape their business models. They should never have to draw on their ample unrestricted reserves, even in case of emergency. And yet what clearer emergency could there be than a highly controversial, delayed valuation of a pension scheme that is under investigation by regulators? And who is more responsible for that emergency – the members or the employers? Employers cannot keep insisting, no matter the circumstances, that members should give up their current income or their retirement income for the sake of institutions' balance sheets.

Besides being the fairest solution other than full implementation of the JEP's first report, our proposals also represent the most pragmatic, forward-looking outcome. We believe that making employers cover the full cost of the 2018 valuation will have positive effects. First of all, it will repair any damage done to the covenant in the eyes of the Regulator, and smooth the path towards appropriately favourable valuation outcomes in the future. We share the JEP's doubts about the Regulator's pessimistic assessment of the covenant, but a renewed financial commitment by employers will allay the Regulator's concerns, however misguided they may be. Secondly, and more importantly, it will focus employers' minds on securing a positive reception for the JEP's second report. Employers are likely to take a more assertive approach if they have more riding on the outcome, and there will be less risk that criticism of USS will weaken the covenant if employers have proactively agreed to pay higher contributions. Members have pressed USS with levels of ingenuity and energy that belie their relatively meagre resources, precisely because there has been more at stake for them. It is time to level the playing field.

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[i] 'Note from Sir David Eastwood, Chair of the USS Trustee Board, to heads of participating institutions', 12 June 2019. **https://www.uss.co.uk/how-uss-is-run/2018-valuation/2018-valuation-updates/12-june-2019-hoi**

[ii] See, for instance, the University of Birmingham's response to the initial 2018 technical provisions consultation: **https://intranet.birmingham.ac.uk/finance/documents/public/UUK-March-19-submission.docx**

[iii] 'Report of the Joint Expert Panel', p. 32. **http://www.ussjep.org.uk/files/2018/09/report-of-the-joint-expert-panel.pdf#page=32**

[iv] 'Higher Education Staff Data'. **https://www.hesa.ac.uk/data-and-analysis/staff**

[v] See, for instance, 'Pensions demands put jobs at risk, say universities', *Financial Times*, 11 July 2019. **https://www.ft.com/content/c9be3a58-a31a-11e9-974c-ad1c6ab5efd1**