Introduction

This document has been prepared by us, acting on instructions received in a video conference on Thursday 10 September with Jo Grady, Nick Hardy and Paul Bridge. We were asked to provide debating points to support branch officers in their discussion of pensions with their employers, in order to assist their employers in preparing their response to the USS's "A consultation for the 2020 valuation" which was published on 7 September 2020, although dated 28 August 2020.

Our input is grouped under the 8 topics for consultation listed on page 34 of the consultation document.

Consultation issue 1. The inputs and assumptions

Moving the goal posts

The USS has proposed to "move the goal posts" substantially to a more expensive funding target.

Evidence

See page 28 Table 9.1, single equivalent discount rate. The discount rate is the return assumed to be earned on the assets. The USS proposes to assume a return of CPI+0%, i.e no return on the assets, in real terms. This is extremely low and results in a very high demand for contributions. Realistically, a positive real return can be expected from suitable assets.

In contrast, the 2017 valuation assumed CPI+0.7% for the discount rate, and the 2018 valuation assumed CPI+0.9%.

Unnecessarily low discount rate

The USS has presented a range of options for the assumptions all of which are more expensive than needs be for an open, industry wide scheme operating in research and education.

Evidence

On page 75, chart F1, USS prints a chart prepared by The Pensions Regulator of the distribution of discount rates used by schemes in the 12 years since the current funding regulations came into effect.

The USS is an open industry wide scheme, operating in an industry which foreseeably has a permanent future. In the universe of pension schemes, most are closed to new members or to closed to benefit accrual entirely. These are likely to be funded more cautiously. Most schemes are funded by a single employer or a single group of employers. Generally speaking, these do not have the strength of employers' covenant which derives from an industry wide scheme operating in an industry which has a foreseeably permanent future.

The USS is probably in the top 5th percentile of schemes for durability of its employers' covenant and therefore this is where USS's discount rate should be. Looking at chart F1, USS's average discount rate should be at least "gilt yield + 2.19%", whereas all of the "single equivalent discount rates" in table 9.1 are below this.

Consultation issue 2. The methodology (this was the primary focus of the March discussion document)

The Valuation Methodology Discussion Forum sat from February to July 2020. Why has the March discussion document not been updated to July to reflect the outcome of the VMDF?

Is the USS wilfully not listening to and incorporating the views of its stakeholders: the employers and the members?

On page 4, USS said "These proposals are largely in line with the Joint Expert Panel's recommendations". We provide a very brief review relative to highlights drawn from the executive summary of the second report of the JEP.

JEP 2nd report recommendation	**USS response**	
An agreed valuation and associated contributions schedule completed within the statutory timescale without recourse to industrial action	The USS's proposals do not seem designed to be acceptable to either the employers or the active members.	✘
Joint modelling of the valuation assumptions (while recognising that it is the trustee's legal duty to determine the assumptions) which would help establish buy-in to the eventual outcome	The USS knows from the input to the Valuation Methodology Discussion Forum from UCU and UUK that there is no buy in to the USS's assumptions.	✘
The current valuation approach is overly restrictive and … denies the Trustee flexibilities in its choice of investment strategy.	The USS continues to deny itself flexibilities in its choice of investment strategy. It continues to insist that the funding method drives the asset allocation, which it does not.	✘
… coalesce around a new way of thinking about rewarded risk …	The USS continues to regard low risk, unrewarding investments as their benchmark driving their decisions (At the time of writing, the real return on UK Government index linked bonds is *minus* 2.5% a year. Such a return does not remove the risk of a down side investment outcome, it is a downside investment outcome.)	✘
Risk appetite of members needs to be reflected within the valuation process	The risk appetite of members was not satisfactorily explored by the VMDF	✘

Introduce a dual discount rate approach	The dual discount rate is a helpful means to an end, and USS has adopted it That said, the dual discount rate is not an end in itself. Adopting it alone does not bring a solution to the valuation. Also, it does not drive the investment strategy, in contradiction to the USS's approach.	✓ ✗
The cost of contributions was a major concern for younger members and non- members. Opt out levels for USS stand at 15% - considerably higher than the national average	The USS seems to wash its hands of this problem (see the paragraph at the top of page 40)	✗
Mutuality is a strength of the scheme	It is disappointing that USS is proposing contributions at an emergency level even though one employer chose to leave the scheme	✗

Apart from the adoption of dual discount rate, the USS has not adequately responded to the JEP's recommendations.

The Association of Pension Lawyers

The Association of Pension Lawyers (APL) made a submission to The Pension Regulator's consultation on the future of scheme funding. Their submission has been published here https://henrytapper.com/2020/09/15/association-of-pension-lawyers-dubious-about-tprs-db-funding-code/

There is much in this letter from the APL which is relevant to the way USS is approaching its funding strategy:

- Funding is "expressly intended to be scheme specific". TPR's focus on "fast track" (self-sufficiency funding) "has no statutory footing".
- "It cannot be realistically seen as the duty of trustees to remove risk from the funding of pension schemes"
- "nothing in the legislation suggests that a move to minimise dependence on the employer's covenant will always be appropriate or that trustees should be pushed in that direction"
- "it [the consultation document] does not seem to take sufficient account of the fact that there may be advantages … to keep schemes open to new joiners … as an employee recruitment and retention mechanism"
- "we do not believe that it is necessarily appropriate to assume that covenant lessens beyond visibility. It is not the legal duty of pension trustees to ensure that there is no reliance placed on the employer covenant beyond what can be easily confirmed …"

- “an under reliance on the employer covenant may be capital inefficient and result in the funding of the pension scheme being substantially more than necessary, which may not be consistent with the duty of trustees to have regard to the interests of all parties involved with the scheme …”
- “It is a well established point of trust law that the trustees of a pension scheme should take into account the interests of all beneficiaries, but do not need to treat all beneficiaries exactly the same. The trustees may therefore take a decision which favours the security of deferred members over the accrual for active members, but they can also legitimately do the opposite.”
- “we do not believe it is correct to assert as a general proposition of law that the provision of future accrual should only be in circumstances where the security of accrued benefits can be shown not to be compromised …”

It seems very clear from the APL’s outlining of the law that the USS’s approach as detailed in its consultation document is unbalanced. In particular, a theme in the consultation document that the USS is required by law to take the position it has appears to be unfounded.

Consultation issue 3. The risk management framework

Rejecting “risk taking” results in higher contributions

Employers need to be very careful how they describe their attitude to risk. An opinion that “we do not like risk” will be interpreted as not liking investment risk, resulting in more investment in assets which lose money in real terms and higher contribution rates.

Rather, to provide benefits efficiently, investment risk needs to be embraced and managed. Rewarded investment risk results in a higher investment return and lower need for contributions. An open scheme likes USS incurs lower investment risk than a scheme closed to benefit accrual (an open scheme has better cash flow, no disinvestment risk, a longer investment time horizon).

Increased costs from closure

Employers are highly likely to find their pension budget under **greater** pressure were the USS to be closed to benefit accrual:

- Investment risk increases in a closed scheme: net cash flow is worse, assets have to be sold to pay benefits, the investment time horizon is shorter and shortening all the time.
- USS is likely to invest more cautiously, and seek a higher funding level more quickly, all of which will **increase deficit contributions**
- Providing active members with a decent benefit in a DC scheme is expensive
- The benefit to employers of the present policy of sharing contribution increases with active members is lost.
- By closing, the USS becomes like any other closed scheme. Closing removes a justification for different treatment.

- For example, as The Pensions Regulator would have it, the eventual funding target for a closed scheme would use a discount rate such as “gilt yield + 0.5%” or “CPI – 0.9%”. Assuming the investments lose money in real terms is extremely expensive for employers.

Closing to accrual is the wrong reaction to the proposed increase in contributions. Although recent external events (the covid crisis and associated financial market reactions) have gone against the scheme, a material part of the contributions increase stems from the USS deciding to demand more.

Consultation issue 4. The figures for the technical provisions

“Technical provisions” is the capital value placed on pensions earned on service up to the date of the valuation. It is an over-estimate of the amount needed to pay the pensions as they fall due. USS is seeking to increase the over-estimate.

The consultation is rendered meaningless by its narrow scope

On page 30, the USS says, “At this stage we are not consulting on the future service costs or on the structure of the Recovery Plan and the resulting deficit recovery contributions.”

USS should be consulting on the total contributions. This is what the employers are interested in, and the active members too, for as long as any contribution increase is shared with the active members. Further, active members are put at risk of low or no pay rises, reduced job security and increased risk of redundancy if the employers’ pension contributions are too high.

High technical provisions could be acceptable if the contribution rate is no higher. This can be achieved if the recovery plan is longer, the assets continue to be invested productively and the recovery plan allows for more of the return expected on the assets. High technical provisions then becomes an expression of the USS’s ambition for the long run funding of the scheme.

The USS’s approach hurts active members

It is a theme of the consultation document that deferred and pensioner members are a high priority for the USS. The USS needs to recognise that its extremely high contribution demand has strong negative effects on active members. The USS is prioritising deferreds and pensioners over actives and must stop doing so.

The USS’s position pays insufficient attention to intergenerational inequity and to the reasonable needs of the employers. The high contribution demand is both inequitable on active members and unaccommodating of the reasonable needs for stability of contributions from the employers. The USS discusses intergenerational equity briefly on pages 39 and 40 of its consultation document. Summarising the paragraph at the top of page 40, their conclusion appears to be “this is not our problem”, which is unacceptable because part of the problem originates in the USS’s extreme contribution demand.

There is not a funding crisis requiring contributions at the emergency levels proposed by USS

A “best estimate” is an unbiased estimate of the amount needed to pay the pensions as they fall due i.e. it is roughly equally likely to be too much or too little. A “best estimate” value has not been provided in the 2020 valuation consultation, although it was in the 2017 and 2018 valuations. This is an important omission: the prudence in funding plans is judged against the best estimate value. Without it, there is a lack of transparency. We suggest that employers ask the USS for a statement of best estimate assumptions and a calculation of the best estimate liabilities and cost of benefit accrual.

In 2017 and 2018, the USS had a surplus on its best estimate basis. In other words, the USS is seeking to raise the funding from “more than enough” (the present position) to “much more than enough”. This does not represent a funding crisis requiring extraordinarily high contributions. The current contribution rate is already sufficient to raise the funding level given time.

We have grouped together consultation issues 5 to 8. We make some general comments in relation to these but the detail is for the employers to think about.

5. Whether the employers are willing to agree to debt monitoring and pari passu arrangements and the long term rule change required to support a strong covenant. (We anticipate that UUK will be issuing a separate consultation to employers on the rule change.)

6. Whether employers have any further feedback on the possibility of additional contingent support.

7. The level of financial support employers are collectively able to give the Scheme (see section 5) and their affordable risk capacity (and risk appetite, if different), specifically:

a) the percentage of payroll available (we assume 10%)

b) the length of time over which that is available (we assume 20 years under a tending-to-strong covenant, and 30 years under a strong covenant)

c) the cost of future pension provision to employers acceptable to the sector in an adverse scenario (we assume 15% of payroll. This is on top of the 10% of payroll available for deficit recovery contributions. This gives a total employer rate of employer contributions of 25% of payroll)

d) the growth of the sector payroll over the longer term (We have used CPI+2% before, but we have shown alternatives)

8. How should we determine the employers’ collective risk appetite, and any alternatives if you don’t think the approach based on affordable risk capacity is reasonable

Members' confidence in existing benefit security

A continuing pension scheme must pay all its members' benefits in full. The only circumstance in which members' benefits can be reduced is after all of the employers have terminated their membership of the USS. If a scheme has no employers left, it is wound up and the benefits are insured.

An employer terminating its membership voluntarily must pay in sufficient money for the USS to be able to afford to insure their employees' benefits (this is what Trinity College Cambridge did). Only if the last employer(s) to leave USS were insolvent would there be benefit reductions, because the USS would not then have sufficient money to insure the benefits in full.

It is clear that members' benefits are very secure. The security is provided not only by the assets already in the USS, but also by the existence of the employers. Benefit reductions are only possible after there are no employers left, some or many of them having left while insolvent. Before then, the employers are liable for contributions, and the USS has sole power to set the contributions.

For these reasons, members can have confidence that their USS pensions will be delivered, even at the present funding level. While the USS is keen to raise the funding level, there is not an emergency need to do so and time can be taken to achieve this. There is not a need for USS to demand extremely high contributions in the names of the members.

Availability of financial support from employers

There is not a funding crisis requiring contributions at the emergency levels proposed by USS. Identification of the scope for contributions in item 7 does not mean those contributions need to be paid now to prove their availability.

Collective responsibility

A pension scheme, to be a success, must last a lifetime. Members expect their employers to maintain their collective responsibility for sponsoring the USS. There are (or should be) strong benefits for employers to participate in a very large efficient pension scheme (see section 10 of the second JEP report). The collective covenant of employers in an industry wide scheme is greater than the sum of the parts.

Members also expect the Trustee to take more fully into account the views of their member and employer stakeholders and to find a more appropriate solution to the investment and funding strategies of the USS than the extreme one proposed in the consultation document.

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15 September 2020

Actuarial standards

Technical Actuarial Standards TAS 100: Principles for Technical Actuarial Work and TAS 300: Pensions apply to this work. We confirm we have complied with their requirements.