# REPORT OF THE JOINT EXPERT PANEL

December 2019

The Joint Expert Panel on the Universities Superannuation Scheme Commissioned by the University and College Union and Universities UK

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## Figure 1: List of abbreviations

| | |
|---|---|
| ACAS | Advisory, Conciliation and Arbitration Service |
| AUM | Assets Under Management |
| CPI | Consumer Price Index |
| DB | Defined Benefit |
| DC | Defined Contribution |
| DRCs | Deficit Recovery Contributions |
| FSCs | Future Service Contributions |
| HE | Higher Education |
| HEI | Higher Education Institute |
| JEP | Joint Expert Panel (also the Panel) |
| LGPS | Local Government Pension Scheme |
| LTFT | Long-Term Funding Target |
| LTO | Long-Term Objective |
| JNC | Joint Negotiating Panel |
| PPF | Pension Protection Fund |
| RPI | Retail Price Index |
| SEDR | Single Effective Discount Rate |
| TPS | Teachers' Pension Scheme |
| ToR | Terms of Reference |
| TPs | Technical Provisions |
| TPR | The Pensions Regulator |
| UCU | University and College Union |
| USS | Universities Superannuation Scheme |
| USSE | USS Employers |
| UUK | Universities UK |

# 1. CHAIR'S INTRODUCTION

On behalf of the Joint Expert Panel I am pleased to present the Panel's second report. The conclusions and recommendations are the unanimous view of the Panel.

Our first report, published in September 2018, was specific to the 2017 USS actuarial valuation. The Panel made a number of proposals for adjustments to the valuation assumptions intended to enable the Stakeholders and Trustee[1] to conclude the 2017 valuation whilst also creating the space for the Joint Negotiating Committee (JNC) to consider the necessary short- and longer-term reforms to the Scheme. The report was well received across the higher education sector. However, the failure to collectively go forward with these recommendations was, in the Panel's view, a missed opportunity to resolve the dispute and provide room for a discussion of the longer-term issues facing the Scheme.

The Panel's second report considers future valuations. It addresses the key principles that should underpin the approach of UUK and UCU to the valuation of the USS fund, as set out in our Terms of Reference. This report also addresses the issues identified in our first report which we concluded required further investigation, namely:

- delivering an approach to future valuations that is clear (and clearly understood by Stakeholders) and that can deliver a sustainable Scheme;
- a review of the approach and involvement of UCU and UUK in future valuations; and
- whether there are different paths to concluding the valuation that would have the support and confidence of all parties.

The overriding theme of this report is that the valuation, whilst important, is only one part of the overall stewardship of the Scheme. Of much greater importance is the process that underpins the valuation and the governance of the Scheme itself. It is these which drive the culture and tone of the interaction between the Stakeholders and therefore the way in which the valuation is conducted, and its outcome enacted.

Currently in USS, it appears to be the other way around: the valuation and its methodology drive all else, including the relationship between the Stakeholders and between the Stakeholders and the Trustee. As we said in our first report, this leads to a valuation outcome which is 'test-driven'. The relationship issues appear to be reinforced by the Scheme Rules which do not foster a cooperative environment within which the Stakeholders can work well together.

[1] Throughout this report we use the term 'Stakeholders' to refer to UUK and UCU. We use the term 'Interested parties' to refer to UUK, UCU and the Trustee. Where we refer to the Trustee, this should be taken to mean the USS Limited (USSL) Trustee Company. Where we refer to Trustee Directors, this should be taken to mean the Directors of USSL who are the decisionmakers.

Our recommendations are focused on:

- ensuring that there is effective governance so that the interested parties can work effectively and cooperatively to support the Scheme's long-term sustainability;
- an approach to valuation governance that supports a clear and shared understanding of how the parties will together approach valuations; and
- adopting a simpler valuation methodology and assumptions which recognise the fiduciary and regulatory framework, better reflects the profile of the Scheme and can be accepted by all.

Our overriding aim – one we are assured is shared by Stakeholders and the Trustee – is to ensure the long-term sustainability of the Scheme. The Panel believes strongly that this is in the best interests of members and sponsoring employers. To support the Stakeholders, the Panel has proposed a set of **Shared Valuation Principles** to underpin the approach of UUK and UCU to future valuations. The Principles will ensure that there are clear expectations on all parties in terms of how they will engage to deliver a mutually acceptable outcome. We strongly recommend that the Trustee is also a party to these Principles since its concurrence is essential.

Any Shared Valuation Principles will only be effective (and the outcome of future valuations successful in delivering a sustainable Scheme) if they are supported by strong governance based, in turn, on trust and mutual understanding. The Panel recognises that all those involved in the Scheme are working hard to do their best for their respective constituencies. But it is clear that the many bodies involved in the Scheme do not currently work well together. The low levels of trust between all parties we identified in our first report persist.

The Panel has therefore made a number of proposals for **changes to the Scheme's valuation governance**. These include changes to the governance framework and to the approaches of the Trustee and Stakeholders. Amendments to the Scheme Rules will be required in some instances.

Taken together the Panel believes the combination of a set of Shared Valuation Principles and valuation governance changes will provide a robust way forward for the interested parties to approach future valuations and Scheme sustainability.

Ultimately, though, it must be for the Stakeholders, together with the Trustee, to take these recommendations forward. We recommend this work commences immediately to ensure the foundations are in place before work on the 2020 valuation is too far advanced.

The Panel has also made recommendations on the **valuation methodology**. This was a significant point of dispute in the 2017 valuation and remains a point of debate. We have made a number of suggestions regarding possible **alternative paths to the valuation methodology**. These include potential replacements for Test 1 more appropriate to the nature of the Scheme. One such approach, which we urge should be given detailed consideration, is the adoption of a **dual discount**

**rate** for pre- and post-retirement in the valuation methodology. This could better reflect the specifics of the Scheme and allow for the long-term interests of members, employers and the sector to be addressed.

The Panel was also asked to examine a range of issues that are of interest to the Stakeholders and consistent with our Terms of Reference. These were: adopting a different approach to **contributions** and the question of **mutuality**.

These long-term issues can sensibly be addressed only once the structural and governance issues identified by the Panel have been resolved and the Shared Valuation Principles agreed. These matters are rightly a matter for negotiation between the Stakeholders. The Panel has, therefore, simply offered some issues for consideration based on its preliminary assessment.

As with our first report, the Panel has not sought to be critical of any of the organisations involved in USS. We recognise that all have a difficult job and many (sometimes competing) interests to balance. Neither is our report about unpicking the past or re-examining the 2017 and 2018 valuations, but rather is about looking ahead and resolving future issues. Our observations, conclusions and recommendations are intended to be constructive and should be read as such.

Likewise, our conclusions and recommendations should be considered as a package which, taken together, can provide a way for the interested parties to work together to secure the future of the Scheme and a more holistic approach to the problems that arise. The Panel strongly urges UCU, UUK and the Trustee to now work at pace to jointly take forward these recommendations and to factor them into the timetable for the 2020 valuation. We have proposed a facilitated process to support the parties in this process.

The Panel believes that a failure to take forward the recommendations in this report would mark a failure for members, employers and the sector.

In arriving at our conclusions and recommendations the Panel has taken evidence and held discussions with a wide range of organisations and individuals involved in the Scheme. Importantly, this has included hearing directly from Scheme members and non-members. We are grateful to all those who have given their time and expertise to support the Panel's work.

I would like to thank all the members of the Panel for their contributions, commitment and expertise. Finally, thanks also go to Alan Scobbie, Stuart McLean, Matt Waddup and Jackie Wells who have provided expert support and advice to the Panel. Without their work this report would not have been possible.

**Joanne Segars,**
**Chair, Joint Expert Panel**

# 2. EXECUTIVE SUMMARY

## THE JEP'S TERMS OF REFERENCE, WORK PROGRAMME AND EVIDENCE BASE

This report focuses on the second phase of the JEP's ToR, namely, to agree key principles to underpin the future joint approach of UUK and UCU to the valuation of the USS fund. As such it looks at the longer-term issues facing the Scheme. The Panel's work programme, agreed by Stakeholders in early 2019, has been divided into two parts:

- Part 1: The Valuation process and governance; and
- Part 2: Considering how the long-term sustainability of the Scheme can be secured.

The JEP held 15 full day meetings between February and December 2019. The Panel has continued to take an evidence-based approach to its enquiries. It held 11 oral evidence sessions with a number of parties directly involved in the USS valuations and from other parts of the pensions sector and has challenged those called to provide evidence. To further build its evidence base, the Panel undertook more than 20 in-depth interviews with individuals associated with the valuation. Nearly 60 written submissions were received, each of which has been reviewed and considered by the Panel. The Panel was also keen to hear from Scheme members and those who had chosen not to join or who had left the Scheme and so commissioned a qualitative research report from Ignition House who are specialists in this area. The Panel also commissioned analysis from USS.

The Trustee has continued to provide the Panel with information, much of which has not been in the public domain. We are grateful for the continued engagement of the Trustee.

## DEFINING THE ISSUES

There have been a large number of changes to the Scheme over the last several years, with the result that it has become more diverse in terms of its sponsoring employer base and membership. It is also clear that there have been changes over the past year directly affecting the Scheme as well as the wider pensions sector. In particular, the approach of TPR is hardening as part of its new approach to regulation and this will continue to have implications for the Scheme and its valuations.

The Panel continues to be of the view that the specificities of the HE sector remain an important – and positive – factor underpinning the Scheme. Ultimately, it is the strength of the sector as a whole that matters to USS, rather than that of any one employer. This is particularly so given the mutual and 'last man standing' nature of the Scheme.

All the interested parties want the Scheme to be sustainable over the long-term. The starting point for any consideration of sustainability must be the Scheme's long-term goals and objectives which

should be agreed and supported by all interested parties to the Scheme. These set the overall context and purpose of the Scheme within which other decisions and considerations will take place. By taking this wider view of sustainability, the valuation becomes simply a tool available to the Trustee and the Scheme's management to assess progress and viability. This perspective will enable course adjustments resulting from the valuation to take place within a wider consideration of the overall long-term direction of the Scheme. It is an approach that will better support the long-term sustainability of the Scheme that the interested parties desire.

The Panel strongly encourages the interested parties to coalesce around a definition of sustainability which recognises regulatory requirements, but which also recognises the specificities of USS.

## ABOUT USS

USS remains the UK's largest occupational pension scheme by assets under management (AUM) with £67.4bn of AUM as at the end of March 2019. The Scheme has undergone a number of benefit changes, most notably the 2016 change to a hybrid scheme comprising defined benefits (DB) based on Career Average Revalued Earnings (CARE) along with a DC top-up scheme for higher earners.

The Scheme's relative immaturity means that contributions and income from investment returns exceed outflows (ie benefits and transfers paid out). The Scheme is cashflow positive, having grown by £3.9bn over the year to 31 March 2019. As noted in our first report, the strength and long-term nature of the HE sector mean that the Trustee can afford to take a very long-term view.

However, USS today is a very different Scheme to when it was established in 1974 and operates in a very different environment. The Scheme has grown rapidly over its 45-year existence with almost half a million members today compared to just 13,000 when the Scheme was established. Then the Scheme had under 180 participating employers, almost all HEIs, compared to 343 today, of which just over half are HEIs. The Scheme is becoming less homogeneous, which presents challenges in terms of its governance, valuation and funding arrangements.

## PRINCIPLES TO UNDERPIN THE VALUATION

A central requirement of the ToR for the Panel's second phase of work was to agree a set of principles to underpin the approach of UCU and UUK to future valuations. The Panel has considered the core elements of such principles and has set out a draft set of Shared Valuation Principles.

The Shared Valuation Principles provide a basis for UCU, UUK and the Trustee to approach and steer future valuations. They set out the respective roles and responsibilities of each of the parties forming, in effect, a memorandum of understanding as to the way in which the valuation will be conducted. They are written with the goal of achieving a successful outcome – an agreed valuation

and associated contributions schedule completed within the statutory timescale without recourse to industrial action.

The Shared Valuation Principles provided by the Panel are a starting point for discussion and agreement by the Stakeholders. They should be finalised and agreed by the Stakeholders as a matter of urgency before work on the 2020 valuation is too far advanced and substantive decisions made. The Trustee should also be a party to the Shared Valuation Principles. The Shared Valuation Principles would be part of the context to the valuation provided to TPR.

As the Panel stresses throughout this report, the valuation (and its associated process) is just one component in the operation and long-term sustainability of the Scheme. The Shared Valuation Principles need to be set in the context of the much broader core purpose or mission of the Scheme. A common purpose statement should be adopted. The Panel has suggested a purpose statement as a basis for discussion and agreement between the Stakeholders and Trustee.

The success of the Shared Valuation Principles, and more broadly the long-term future of the Scheme, will require recognition from each of the interested parties that they work towards, and take responsibility for, the whole of the Scheme and its valuation. They must, collectively, provide leadership to the Scheme – its members, participating employers and the wider HE sector.

## VALUATION GOVERNANCE

Whilst there are some features of the current valuation governance that are seen by all the interested parties to be working well, overall there is a view that the Scheme's valuation governance does not work well and is no longer fit for purpose. The Panel shares this view.

The Panel concludes that a number of changes are needed to the Scheme's valuation governance. Whilst some will simply involve changes to the way in which the interested parties work together, others will require changes to the Scheme Rules. Agreeing these governance changes alongside the Shared Valuation Principles should be a priority and should happen before work on the 2020 valuation is too far advanced and should be taken account of in the timetable for its preparation. Given the collective acceptance of the need for change, the Panel hopes agreement can be reached swiftly.

There is a widespread view that the Trustee is too distant from the Stakeholders and in the Panel's view this has contributed to a decline in levels of trust. The Trustee Directors must be more visible to the Stakeholders and JNC through more regular and direct engagement. It would be desirable for the Trustee to establish a funding and valuation sub-committee which could also work with JNC representatives in a joint valuation forum and to undertake engagement with Stakeholders.

There is a consensus, shared by the Panel, that the JNC does not work as well as it might. Changes are required to improve its effectiveness. The role and remit of the JNC should be reviewed,

including whether the Chair should continue to have a casting vote. It would be helpful if there was greater stability of the JNC's membership to improve decision making and continuity of approach. A joint forum should be established between the Trustee and JNC to undertake some joint modelling of the valuation assumptions (whilst recognising that it is the Trustee's legal duty to determine the assumptions) which would help establish buy-in to the eventual outcome. The Panel believes that consideration should be given to whether a more radical reform is appropriate, for example, the creation of a senior Steering Committee comprising the principals of the employer and member representatives.

The Panel notes that UUK has worked hard to represent sponsoring employers in relation to USS. However, UUK's core responsibilities are to lead cross-sector collaboration and to influence policy. Thus, its role as the employer body in USS is at odds with this mission and for this reason there is merit in considering whether UUK should continue as the main (or sole) employer body in relation to USS. The Panel understands that these issues are already being addressed by UUK in a working group that is investigating the best structure to facilitate employer involvement and engagement in the Scheme, and the Panel welcomes this initiative.

It is possible that all sides will wish to make changes to the Scheme in the future, particularly to provide flexibility for its increasingly diverse membership. UCU should have mechanisms in place to ensure and demonstrate that it can reflect the views of all Scheme members and potential members.

## ALTERNATIVE PATHS TO THE VALUATION

The Panel received a number of submissions that suggested a variety of ways of valuing the Scheme's liabilities and is mindful of the Trustee's fiduciary responsibilities and regulatory requirements.

The current valuation approach is overly restrictive and, when applied mechanistically within the Stakeholders' current risk appetite, denies the Trustee flexibilities in its choice of investment strategy. This does not appear appropriate for an open, strong, Scheme such as USS, with a very successful investment strategy. The Panel believes the introduction of the new DB funding code is an opportunity for USS to develop a simpler valuation methodology that reflects the Scheme's liability profile and the strengths of the sector.

The Panel is of the view that a simpler and more appropriate valuation methodology that is fair between age cohorts of members, and reflects the Scheme's demographics, cashflows and covenant is possible. If the interested parties could coalesce around a new way of thinking about rewarded risk (as the Panel would encourage) and slightly higher risk appetite, then there could be a number of alternative pathways to the valuation.

The starting point for a new valuation methodology should be the acknowledgement of the purpose of the Scheme and founded on a re-articulation of the Trustee's and employers' risk appetites and a recognition that the risk appetite of members needs to be reflected within the valuation process. This should be done on the basis of a clear understanding of the trade-offs of the risks and return. This will require the Trustee to work with Stakeholders to understand the point of overlap between all three attitudes to risk and ensure that it is monitoring all of the risks. This task should fall to the joint Trustee-JNC valuation forum described in the previous chapter. The Panel also acknowledges there is a wide range of employer and member risk appetites which the joint valuation forum will need to consider. A major contribution for the forum will be to avoid a drift to the lowest common denominator of risk. The Panel does not underestimate the challenge, but we believe the investment of time and effort will lay the foundations for delivering the sustainability of the Scheme over the longer term.

The Panel considers that there is considerable merit in investigating introducing a dual discount rate approach which could better reflect the profile of the Scheme while satisfying a desire to secure benefits as the Scheme matures. This will allow the common purpose which the Panel urges the Stakeholders and Trustee to adopt to be turned into a practical set of numbers with which they could have a mature discussion about risk appetite, investment strategy, benefits and contributions. This, in turn, will allow the long-term needs of members, sponsoring employers and the sector to be addressed. In light of the need to complete the 2020 valuation, the Panel strongly encourages UCU, UUK to work urgently with the Trustee (and – together – to engage with TPR) to commence this work and for these discussions to be factored into the timetable for the 2020 valuation.

## MEETING THE NEEDS OF MEMBERS

The research commissioned by the Panel from Ignition House revealed differences in attitudes towards the Scheme and pensions saving between faculty and non-faculty respondents and between younger and older respondents. The Scheme members participating in the research valued the Scheme and its benefits, and for many it has been an important reason for remaining in the sector. However, it was clear that there were poor levels of trust in the Scheme and concern for its future.

The cost of contributions was a major concern for younger members and non-members and the main reason for deciding to opt out of, or not join, the Scheme. Opt-out levels for USS stand at 15% – considerably higher than the national average and a cause of concern given the purpose of the Scheme.

Respondents voiced concerns over the 'one-size-fits-all' nature of the Scheme. This reflected in part the rising costs of the Scheme but also the changing patterns of employment within the sector and the growing number of part-time and temporary contracts.

Other contribution arrangements are available in other pension arrangements within the education sector. Such arrangements could be considered by Stakeholders. This would require an examination of any impact on the Scheme's funding level, unintended consequences (eg of higher earners leaving the Scheme because of increased contributions, and cliff edges between contribution levels which could leave Scheme members worse-off), and any adverse intergenerational impacts.

## EXPLORING MUTUALITY

The Panel remains of the view that mutuality is a strength of the Scheme. Strong employers support weaker employers and underwrite downside risks. It is also a strength to the HE sector as a whole and all participating employers, no matter their size, can share in the economies of scale offered by the Scheme.

Whilst providing some immediate benefits to some individual institutions, the disaggregation of the Scheme would be likely to have adverse consequences for many (if not the majority) of sponsoring employers and Scheme members. Importantly, it would be likely to result in an overall weakening of the sponsor covenant, which would undermine the long-term sustainability of the Scheme.

Moving away from the current mutual arrangement could damage the Scheme and the sector. Any move away from this structure should be taken with extreme care and with a full regard to the consequences for all sponsoring employers, Scheme members and the wider HE sector.

The Panel notes that the Scheme is far more complex and less homogeneous than when it was first established, and that the pressures on HEIs are also far greater. The Panel would have serious concerns were sectionalisation to be pursued.

## CONCLUSIONS AND ROAD MAP

Our recommendations provide the opportunity for the interested parties the room to have the room work together to secure the future of the Scheme and tackle the problems as they arise – an outcome that all the interested parties have made clear to the Panel they desire. The Panel believes that a failure to take forward the recommendations in this report would mark a failure for members, employers and the sector.

The Panel proposes that it is in the interests of all parties to commit to a road map for the facilitated implementation of the recommendations in the JEP's reports. It is essential that each of the interested parties commit themselves to this process and that it is driven forward by their senior decision-makers who are given a mandate to act on their organisation's behalf and work towards a greater understanding of each others' positions. For the road map to be fully effective, the Trustee and TPR must also commit to engaging with, and respecting, the process.

# 3. THE JEP'S TERMS OF REFERENCE, WORK PROGRAMME AND EVIDENCE BASE

This chapter sets out the Terms of Reference (ToR) that were set by UUK and UCU for the Panel for the second phase of its work and describes the Panel's working methods and evidence base. The ToR are set out in Annex 2.

## TERMS OF REFERENCE

The JEP was established under the agreement reached between UUK and UCU through the Advisory, Conciliation and Arbitration Service (ACAS) on 23 March 2018 and it is this agreement that forms the basis for the Panel's ToR. The ACAS agreement, set out in Annex 3, placed an emphasis on reviewing the 2017 valuation, its assumptions and methodology (ie the subject of our first report) and to agree the principles that should underpin the future valuations.

For the second phase of its work the ToR, which were jointly agreed by UCU and UUK, called on the Panel to:

- agree key principles to underpin the future joint approach of UUK and UCU to the valuation of the USS fund.

The Panel has continued to have regard to the following issues, also set out in the ToR:

- the unique nature of the HE sector;
- intergenerational fairness and equality;
- the need to strike a fair balance between ensuring stability and risk; and
- the current legal and regulatory framework.

In considering how to approach its ToR, the Panel designed Phase 2 of its work as follows:

**Part 1: Valuation process and governance.** Work under this heading has included:

- considering the roles and involvement of UCU and UUK in the valuation process so that a more collaborative approach could be adopted that would avoid future industrial action;
- examining the interaction of the various bodies with a formal role in the valuation process, including the Trustee and the JNC; and
- considering the potential for the involvement of Scheme members in the valuation process and how more effective engagement with employers can be achieved.

**Part 2: Considering how the long-term sustainability of the Scheme can be secured.** Work under this heading has included:

- developing an approach to future valuations that is clear (and clearly understood by Stakeholders) and which can deliver both a sustainable Scheme and a shared set of principles;
- exploring the different paths to the valuation of technical provisions and other aspects of the valuation methodology, including Test 1; and
- considering questions of risk sharing, including adopting a different approach to contributions (which could, in turn, address issues of intergenerational fairness and equality); examining further the question of mutuality and the question of employer appetite for risk; and the potential for risk sharing.

These areas for exploration were approved by UCU and UUK's relevant decision-making bodies in February 2019.

Our assessment of the issues relating to part 1 is covered in chapters 6 and 7, and our assessment of the issues relating to part 2 is covered in chapters 8-10.

In defining the scope of its work, the Panel has been clear that it is not its role to step into the position of negotiator. Neither is it the Panel's role to recommend the design of the Scheme's benefits. These are matters for the JNC. A number of the responses to the JEP consultation exercises, as well as from those interviewed and providing evidence to the Panel, highlighted issues related to benefit reform. However, the Panel has not investigated or provided a view on this issue.

**Figure 2: JEP 2 – in scope and out of scope**

| In Scope | Out of Scope |
|---|---|
| Principles to underpin future valuations | Benefit reform |
| Alternative paths to future valuations (including methodology and clarity of approach) | Collective Defined Contribution (CDC) arrangements |
| Consideration of how risk is shared (between employers and between Scheme members) | |
| The governance of the valuation process | |
| Contribution flexibility | |

## WORKING METHODS

The JEP met 15 times between February and December 2019. In addition, the Panel held two informal preparatory meetings, in December 2018 and January 2019. Membership of the JEP comprises three members appointed by UCU and three members by UUK together with an

independent, non-voting, Chair. The Panel has brought together a wide range of experience and expertise. The diverse specialisms of the Panel members have added robustness to the Panel's enquiries and analysis and our final conclusions and recommendations.

The Panel's membership has remained constant save for one change. Bryn Davies has replaced Catherine Donnelly as a UCU Panel member. The Panel has been supported by a small secretariat provided jointly by UUK and UCU and has benefitted from the support of Jackie Wells as expert adviser to the Chair. A full list of Panel members and the secretariat is set out in Annex 1.

Our ToR required two members nominated by UUK and two from UCU to be present at each meeting. Each meeting was quorate.

As with its first report, the Panel recognised the significant interest in its work from Scheme members and sponsoring employers. The Panel continued to believe it was important to operate in an open and transparent way.

## OUR EVIDENCE BASE

The Panel has continued to take an evidence-based approach to its work. It is this evidence, as well as the Panel's knowledge, expertise and judgement that has been used to arrive at the conclusions and recommendations in this report. We remain aware of the importance attached by Scheme members and sponsoring employers to the need to evidence our conclusions, and so we have sought to provide such evidence.

The Panel has continued to use written evidence (much of it not in the public domain) from the JNC and the Trustee. This information has been particularly helpful in supporting the Panel's assessment of alternative approaches to the valuation and informing its views on matters relating to the governance of the valuation process. The Panel is grateful to both bodies for their continued co-operation and support. Where it is relevant to our findings and proposals, we have referred to this information and quoted extracts from it (having first obtained the necessary permissions).

Beyond this written material, we have sought evidence from a wide range of Stakeholders including those associated directly with the Scheme and the wider pensions and higher education sectors. The Panel has taken oral evidence from a range of individuals and organisations at its meetings. In addition, a series of semi-structured interviews with a broader cross-section of those involved in the Scheme have been conducted. The evidence sessions and the semi-structured meetings were an invaluable opportunity to gather detailed insight to the operation of other, large, defined benefit schemes and to hear first-hand the views of those involved in the valuation.

To encourage an open and frank dialogue with the Panel, it was agreed that no views or comments would be attributed in the Panel's report to any individuals or organisations participating in the

semi-structured interviews or providing evidence unless that individual or organisation agreed otherwise. This follows the approach used in our first report.

The Panel was also keen to hear directly from Scheme members and those who had chosen not to join or to leave the Scheme. Therefore, the Panel undertook some qualitative research with Scheme members and non-members. Ignition House, experts in consumer and member-based research on pensions and financial service matters, was commissioned to undertake this research on the Panel's behalf. The research comprised a series of focus groups representative of the Scheme's membership base as well as some depth interviews with non-members, including those who had opted out of the Scheme. It provided the Panel with a flavour of these groups' perceptions and understanding of the Scheme and its benefits. A more detailed description of the research and its findings is set out in chapter 9 and Annex 9. A fuller presentation of this research is published separately alongside this report. The Panel also commissioned analysis from USS on alternative paths to the valuation methodology (described in chapter 8 and Annex 8). This followed some earlier assessments undertaken by AON and on which First Actuarial confirmed they would estimate a similar impact.

The JEP held a number of workshops with the JNC. These meetings helpfully identified some common areas of concern between the Stakeholders and some common solutions to those issues.

We are very grateful to all those who provided their time and expertise so generously to the Panel.

**Figure 3: Summary of evidence used**

**Written evidence**

- Documents available in the public domain and made available by the Trustee on its public website
- Presentations to, and discussions with, the Panel from the USS Executive and the Trustee Director
- Documents made available to the Panel by the Trustee and its advisers which are not in the public domain
- Documents made available to the Panel by the JNC which are not in the public domain.
- Further analysis by the USS Executive on how the valuation assumptions are derived

**Oral evidence**

- Chair, Railways Pension Scheme
- Chair and CEO, MNOPF
- Professor Gordon Clark
- Committee of University Chairs (CUC)
- AON
- First Actuarial
- The Pensions Regulator
- USS Executive

- Angela Hildyard, University of Ontario
- PwC (covenant adviser to the Trustee)
- USS Valuation Working Group

**Semi-structured interviews**

- Professor Sir David Eastwood, Chair, USS Limited
- USS Directors (a selection of independent, employer and member-nominated)
- USS Executive team members
- JNC (employer and union representatives)
- UUK executive
- UCU officials
- TPR
- Chair, Employers' Pensions Forum
- Sponsoring employers: University of Exeter, University of Manchester, Overseas Development Institute, Royal Holloway University
- UCEA
- Scheme Actuary to USS
- Actuarial advisers to UUK and UCU (AON and First Actuarial)

## SUBMISSIONS TO THE PANEL FROM STAKEHOLDERS

The Panel continued to take the view that it was important that Scheme members and sponsoring employers had the opportunity to provide input to the Panel's work. The Panel has therefore continued to actively seek evidence and views from Stakeholders and other commentators via its dedicated email account submit@jep.org.uk.

Two calls for evidence were issued during the course of our work on Phase 2:

The first was issued on 5 February with a closing date for submissions of 15 March 2019. It focused on the governance surrounding the valuation and sought views on:

- The valuation process, decision-making and engagement (rather than the methodology) and in particular the content and timing of the different aspects of the process and engagement between the Scheme and the various Stakeholders; and
- The governance of the valuation process and in particular the role of the different parties including UUK, UCU, the JNC, the Trustee and others in providing that governance.

The second was issued on 10 May with a closing date of 14 June 2019. It sought views on how the long-term sustainability of the Scheme could be secured. Specifically, it sought views on the following:

- Developing an approach to future valuations that is clear (and clearly understood by Stakeholders) and which can deliver both a sustainable Scheme and a shared set of principles.
- An exploration of different paths to the valuation of technical provisions and other aspects of the valuation methodology, including Test 1.
- Considering questions of risk sharing, including adopting a different approach to contributions (which could, in turn address issues of intergenerational fairness and equality); examining further the question of mutuality and the question of employer appetite for risk; and the potential for risk sharing.

To encourage as many submissions as possible, and to ensure that Stakeholders were able to give their views in a freely, the Panel continued to take the view that submissions would be treated confidentially. All submissions were carefully considered by the Panel. We have used the information received, where appropriate, to inform our conclusions and recommendations.

Nearly 60 responses were received. Fourteen came from sponsoring employers; 38 came from Scheme members; and the balance from Stakeholders and commentators.

A number of common themes emerged:

- Many raised the issues of affordability. This was looked at both from the perspective of affordability for Scheme members as well as long-term affordability for employers. A number of submissions raised the possibility of tiered contributions for Scheme members (where the member contribution rate rises with income).
- A number of the submissions focused on the governance of the Scheme. Views often ranged beyond the governance of the valuation process to the running of the Scheme more generally. There was much focus on the role of the JNC.
- The future shape of benefit design, including flexibility and choice for members, was an issue highlighted in a number of responses. Views ranged from the need for no detriment to a need for wholesale benefit reform. However, as noted above, benefit reform is outwith the Panel's ToR.
- There was a desire from many of those submitting evidence for more openness and transparency in the way in which the valuation is conducted.
- A number of suggestions were received relating to the structure of the Scheme and the possibility to move to a sectionalised Scheme.
- The low levels of trust that exist between UCU, UUK and the Trustee and the need to address this was a theme that ran through many of the submissions.
- A large number of the submissions commented on the valuation methodology. There were on-going criticisms of Test 1 and the approach to risk taken in the valuation methodology. A number of alternative suggestions were received. The need for an approach that could be better understood was voiced by many.

## THE PANEL'S WORK PROGRAMME

**Figure 4: JEP work programme**

| Date | Topic |
|---|---|
| **4 February** | Work programme and timescales and Call for evidence #1<br>Oral evidence session: Chair, Railways Pension Trustee Company Limited |
| **8 March** | Themes from semi-structured interviews<br>Valuation process and governance<br>Oral evidence session: Professor Gordon Clark |
| **22 March** | Themes from interviews to date<br>Oral evidence session: MNOPF |
| **26 April** | Themes from interviews to date<br>Consideration of principles and sustainability<br>Oral evidence session: TPR |
| **2 May** | Review of Phase 2a and approaches to risk and mutuality<br>Oral evidence session: CUC |
| **24 June** | Presentation by Ignition House on member research<br>Further consideration of sustainability and approaches to mutuality |
| **1 July** | Themes from interviews and member research<br>Oral evidence sessions: First Actuarial and AON<br>Consideration of alternative approaches to the valuation |
| **10 July** | Themes from interviews and member research<br>Oral evidence session: TPR<br>Oral evidence session: Angela Hildyard, University of Toronto<br>Oral evidence session: USS Executive |
| **1 August** | Interim findings from member and non-member research<br>Comparison of USS and TPS<br>Review of draft report |
| **23 August** | Findings from member and non-member research<br>Consideration of alternative paths to the valuation<br>Review of draft report |
| **4 September** | PwC – discussion of sponsor covenant<br>Consideration of alternative paths to the valuation<br>Review of draft report |
| **24 September** | Oral evidence session: USS Valuation Working Group<br>Review of draft report |
| **31 October** | Assessment of alternative approaches to the valuation<br>Review of draft report |
| **26 November** | Final review of draft report |
| **3 December** | Report sign off |

# 4. DEFINING THE ISSUES

SUMMARY

1. There have been a large number of changes to the Scheme over the last several years, with the result that it has become more diverse in terms of its sponsoring employer base and membership. It is also clear that there have been changes over the past year directly affecting the Scheme as well as the wider pensions sector. In particular, the approach of TPR is hardening as part of its new approach to regulation and this will continue to have implications for the Scheme and its valuations.
2. The Panel continues to be of the view that the specificities of the HE sector remain an important – and positive – factor underpinning the Scheme. Ultimately, it is the strength of the sector as a whole that matters to USS, rather than that of any one employer. This is particularly so given the mutual and 'last man standing' nature of the Scheme.
3. All the interested parties want the Scheme to be sustainable over the long-term. The starting point for any consideration of sustainability must be the Scheme's long-term goals and objectives which should be agreed and supported by all interested parties to the Scheme. These set the overall context and purpose of the Scheme within which other decisions and considerations will take place. By taking this wider view of sustainability, the valuation becomes simply a tool available to the Trustee and the Scheme's management to assess progress and viability. This perspective will enable course adjustments resulting from the valuation to take place within a wider consideration of the overall long-term direction of the Scheme. It is an approach that will better support the long-term sustainability of the Scheme that the interested parties desire.
4. The Panel strongly encourages the interested parties coalesce around a definition of sustainability which recognises regulatory requirements, but which also recognises the specificities of USS.

This chapter describes how the Panel has interpreted its ToR.

It starts, however, with a description of the changes that have taken place in connection with the USS and its valuation since the JEP's first report was published and which have been taken into consideration by the Panel. It then explores the wider sectoral changes that have had an impact on the Scheme and its Stakeholders.

## A YEAR OF CHANGE

There have been a number of significant developments since the JEP's first report. These relate to the resolution of the issues identified in our first report (ie the 2017 valuation); the issues under investigation in the Panel's second phase of work (including the approach to future valuations); and

broader changes affecting the HE sector and occupational pensions. Many of these have taken place towards the end of the Panel's work.

The main developments are summarised below (and a more detailed summary is provided in Annex 5). Whilst these changes have not driven the Panel's work, or altered the scope of its enquiries, the Panel has taken account of them.

### CHANGES DIRECTLY AFFECTING USS AND THE VALUATION

**2017 and 2018 valuations:** At the conclusion of the JEP's report in September 2018, the Trustee was under pressure to conclude the 2017 valuation rapidly. It was by that stage already three months beyond the statutory deadline. As part of its response to the JEP's first report, the Trustee undertook a special, interim, 2018 valuation to allow it to address the some of the issues raised in the JEP's first report whilst also allowing it to close the 2017 valuation. Work on the valuation commenced in December 2018 and included an invitation to sponsoring employers to consider contingent contributions. In May 2019 the Trustee rejected the employers' proposals for contingent contributions and proposed, instead, three options for concluding the valuation which have also been the subject of consultation by UUK with sponsoring employers:

- **Option 1: contributions fixed at 33.7%, reviewed in 2021/22.** The Trustee specified that this would be the rate required in the absence of sufficiently strong contribution arrangements. Unless an alternative was negotiated by the JNC, under this option employer contributions would rise to 23% and member contributions to 10.7%.

- **Option 2: contributions set at 29.7% alongside increases to certain conditions, reviewed in 2021/22.** Under this option, provided sufficiently strong contingent contributions were available to the Trustee, sponsoring employers would pay 20.4% and Scheme members 9.3%. The contingent contribution requirements had the potential to increase the required rate to 35.7% (in 2% increments) and USS explained that due to the complexity of shared-cost contingent contributions it was unable to implement this option until Summer 2020. So, either Option 1 or 3 would need to be implemented in the meantime.

- **Option 3: contributions fixed at 30.7% until October 2021, reviewed in 2020/21.** This option would be applied as an alternative to contingent contributions, but subject to a valuation in 2020, a year earlier than otherwise scheduled. Employers would initially pay 21.1% in contributions and Scheme members 9.6%. If the contributions arising from the 2020 valuation cannot be agreed and implemented before 1 October 2021, contributions would then rise to 34.7% at that time (reflecting the level of contributions the Trustee believes would have made if sufficiently strong contingent contributions had been available and were triggered by adverse experience).

UUK commenced a consultation exercise on the three options, the outcome of which was an acceptance of Option 3 as the best available option.

The Panel observes that the 2018 valuation as articulated under Option 3 includes some of the features it recommended in its first report in September 2018 and that it results in broadly similar contribution levels to the Panel's proposals.

**Figure 5: JEP1 recommendations and USS Option 3 compared**

| Issue | JEP1 | Option 3 (2018 valuation + O3) |
|---|---|---|
| **Contributions** | 29.2% (no matching) | 30.7% (no matching) |
| **Life expectancy** | CMI 2017 assumptions included | CMI 2017 assumptions included |
| **Outperformance on DRCs** | 50% outperformance allowed for on a £7.5bn deficit and 15-year recovery period | No outperformance on DRCs on £3.6bn deficit and 10-year recovery period |
| **Smoothing future service contributions** | Smoothed over two valuation cycles | No smoothing of future service contributions |
| **De-risking and an increased reliance** | Allowed for delay to de-risking and increased reliance on employers | No delay to de-risking or an increase in reliance |
| **Improvement in asset values** | Assets maintained at £60bn | Assets valued at £63.7bn |
| **Later retirement ages** | Not taken into account | Taken into account |
| **Expected future investment returns** | Not taken into account | Taken into account – average discount rate increased from CPI+0.71% to CPI+0.92% |

It should be noted that the JEP's recommendations relating to the valuation adjustments to the valuation methodology were specific to the 2017 valuation. It has been suggested by some commentators that by applying those same adjustments to the 2018 valuation it would be possible to reach a combined contribution level of 26% with the deficit eliminated. The Panel has not undertaken such an assessment itself and cannot comment on the accuracy of this claim.

In June 2019, Trinity College, Cambridge confirmed that it was withdrawing from the Scheme. It met its s75 employer debt obligations, worth £30m, in full to the Scheme. USS has said a further strong institution exiting the Scheme could cause the sponsor covenant to be downgraded from Strong to Tending to Strong. In addition, further concerns were raised by TPR over the strength of the sponsor covenant.

In light of these developments USS appended two 'conditions' to moving forward with Option 3:

i) a moratorium on employers exiting the Scheme for the duration of the fixed contributions; and

ii) the ability for USS to undertake additional scrutiny over sponsoring employers' borrowing and debt arrangements.

**The Trustee:** The Trustee has been under intense and increased scrutiny since the publication of the JEP's first report. In December 2018, TPR wrote to the Trustee to set out its expectations for the 2017 and 2018 valuations and reiterated its view on the degree of risk being taken by the Trustee. In January 2019 TPR wrote again to the Trustee expressing concern that the Trustee had described the Regulator as being a "gilts plus" regulator. This email was also shared for information only (by TPR) with UUK, as the Scheme's formal consultee, but not UCU. In June 2019, USS published on its website an explanation of its representation of TPR's views on risk.

In March it was also revealed that one of the UCU-nominated Trustees, Professor Jane Hutton, had raised a whistleblowing complaint to the Regulator. Further developments relating to this issue have continued throughout the course of the JEP's work. However, this is an internal matter for the Trustee and the Panel has specifically excluded this matter from its deliberations.

**TPR:** Throughout the course of the year, TPR has continued to be heavily involved with the Scheme and its Board. In May 2019 TPR wrote to the Chair of Trustee, Sir David Eastwood, raising concerns over Option 3, saying that it was at the top of its limit on risk tolerance. This letter also requested greater Regulator oversight of Trustee minutes and decision making generally and requested greater interaction with the Trustee Board directly (rather than the Executive). TPR wrote again to the Chair of Trustee in September 2019 raising further concerns over Option 3. Over the course of the year, there has been a hardening of TPR's regulatory approach (though it should be noted this has not been confined to USS.) The TPR's correspondence and engagement has clearly influenced the Trustee and sponsoring employers.

**UCU:** The union elected a new General Secretary, Jo Grady, in May 2019 following the retirement of Sally Hunt. At its annual conference, also in May, the union reaffirmed its policy of a 'no detriment' solution to any Scheme changes for Scheme members – in other words, any changes to the Scheme should not result in a worsening of benefits or an increase in member contributions. In June, the union wrote to a number of sponsoring employers warning that if they did not agree to the 'no detriment' position or to pay member contributions in excess of 8%, the union would ballot for industrial action. The union's intention to ballot for strike action was confirmed at the end of June and a ballot was held between 9 September and 30 October 2019. On 5 November it was announced that eight days of strike action across 60 universities would take place between 25 November and 4 December 2019.

**UUK:** UUK has undertaken a number of consultation exercises with sponsoring employers. These have covered the 2018 valuation and the structure and quantum of contingent contributions and the three options proposed by the Trustee in May. UUK has sought to take account of the concerns raised by the Panel in its first report over the nature of these consultation exercises. UUK sought a way to find a JEP 1-like outcome (in terms of contributions) in line with regulatory boundaries.

**JNC:** In May 2019, UCU elected a new set of representatives to the JNC.

## EXTERNAL CHANGES

Beyond USS and its Stakeholders, there have been a number of other developments in the wider higher education and pensions sectors which have directly or indirectly affected the Scheme and informed the Panel's deliberations:

- In May 2019 the **review into the funding of higher education**[2], led by Philip Augar, was published. This recommended that the maximum tuition fees for students should be reduced to £7,500 a year, with the funding 'gap' met by an equivalent increase in average per-student grant funding from government. It also recommended that institutions should bear down on 'low value' courses, which could lead to a realignment of higher education institutions, courses offered, and income generated. At the time of publication, the future of the Augar recommendations with regard to fee reductions remains in doubt.

- In the spring of 2019, the government agreed to undertake a review of the **NHS Pension Scheme** as a result of the impact of tax rules (introduced in 2016) on higher earners, which had led many to reduce their hours or retire early. Elsewhere, **DB schemes** have continued to close to accrual. One scheme closure that resonated with some USS sponsoring employers was that of the John Lewis scheme which closed to future accrual in May 2019.

- Changes to **TPS employer contribution levels** in 2018 continued towards implementation. The Government consulted on the funding available for some institutions affected by the increase to employer contributions[3]. Increases to employer contributions were deferred until September 2019 when the employer contribution rate increased to 23.6% from September 2019 until 31 March 2023 (with no change to the member contribution rate which averages 9.6%).

- In February 2019, the Government signalled its intent to enact legislation to give **TPR additional powers** in relation to DB schemes[4]. In March 2019, TPR published its **annual funding statement**[5] which suggested forthcoming changes to the DB funding code and the requirement for trustees to consider their long-term strategy for funding by setting a long-term funding target (LTFT). This has since been replaced with an intention in the subsequent White Paper for an intention that all schemes should set a Long-Term Objective (LTO). TPR consider the LTO to be wider than the LTFT because it has three elements:

    - an appropriate finding target;
    - an aligned long-term investment strategy; and
    - the timing for when these two elements are expected to be achieved.

[2] *Independent Panel report to the Review of Post-18 Education and Funding*, May 2019, CP117

[3] *Funding increases to teachers' pensions employer contributions.* Government consultation, DfE, January 2019

[4] *Government response to the Consultation on Protecting Defined Benefit Pension Schemes – A Stronger Pensions Regulator*, DWP, February 2019

[5] *Annual Funding Statement 2019 for defined benefit pension schemes* TPR, March 2019

Taken together, these developments mean that the environment surrounding USS and its valuations has become less stable. Meanwhile, the economic and political environment has also become less benign.

The current state of relationships also underlines the need for the strategic changes proposed in this report to be implemented as a matter of urgency.

## DEFINING THE TERMS OF REFERENCE

As noted in chapter 3, the ToR called on the Panel to have regard to the following issues:

- the unique nature of the HE sector;
- intergenerational fairness and equality;
- the need to strike a fair balance between ensuring stability and risk; and
- the current legal and regulatory framework.

These have been especially important considerations for the Panel in its second phase of work as it considers some of the broader, bigger, issues facing the Scheme and its Stakeholders.

The ToR were considered at length in our first report where we sought to provide a detailed definition of each term. The Panel has not seen evidence that would lead it to alter its views on these definitions. However, as noted above, there have been some developments over the past year which affect each of these issues. The Panel has therefore provided a summary of its definitions from its first report along with a commentary on new information where relevant.

### THE UNIQUE NATURE OF THE HE SECTOR

The HE sector has undergone significant change since the Scheme was established in 1974. At inception there was a much a smaller number of sponsoring employers which were more homogeneous in nature – 180 participating employers, around 17% of which were non-HE employers in 1975 compared to 343 participating employers today, of which 46% are non-HE employers[6] which tend to be small. Despite the diversity of its Scheme sponsor base, the Scheme's liabilities are not evenly spread – the majority (84%) are concentrated in the financially strongest institutional sectors[7].

Notwithstanding these changes, evidence considered by the Panel in its first report led it to conclude that as a whole, the HE sector is expected to have a strong future. And, in the context of the USS fund, were an institution to fail, students would take up places in a different institution with

[6] Data provided by USS. See chapter 5 for further information

[7] 70% of past service liabilities are held by the three strongest institutional segments: Broad-based universities (ie Russell Group) 54%; CUSP institutions 18%; Scottish Research Institutions 12%. Source: PwC and EY Parthenon analysis for USS. Quoted in JEP1

the result that fees (and hence income to institutions) would not be lost to the sector. Ultimately, it is the strength of the sector as a whole that matters to USS, rather than that of any one employer. This is particularly so given the mutual and 'last man standing' nature of the Scheme, as the Panel described in its first report. The Panel remains of the view that this an important strength of the Scheme.

It considered the report from the Office for Students in April 2019 (reported in the Augar review) which stated that "the sector is in reasonable financial health", noting that the sector overall has operated with a surplus for all of the years in the past decade. Total net assets, which provides an indicative measure of the strength of institutions, increased from £37.1bn at the end of July 2017 to £41.3bn at the end of July 2018 and was projected to increase further to reach £45.1bn in 2022. The Augar review did, however, note increasing debt and 'sale and leaseback' arrangements amongst some institutions (which have also been a concern to The Pensions Regulator and the Trustee) and expected growth in future student numbers not materialising[8] as potential risks.

### INTERGENERATIONAL FAIRNESS AND EQUALITY

The Panel remains of the view expressed in its first report that it is unlikely that any outcome can provide complete fairness between the generations. This is so in relation to deficit recovery where a faster deficit recovery might benefit members with the largest accrued benefits at the expense of those with smaller benefits, or of future members. Likewise, it is the case in relation to aspects of benefit design, that some benefit designs favour one cohort of members over others. The Panel concluded that intergenerational fairness is not an exact science. A workable approximation is that the valuation outcome, in terms of impact on contributions and/ or benefits, should not impose a disproportionate burden or advantage on any one cohort of Scheme members or make the Scheme unattractive to particular generations of Scheme members.

### ACHIEVING A FAIR BALANCE BETWEEN STABILITY AND RISK

In the JEP's first report, this was taken to mean satisfying the desire of employers for confidence in the affordability of providing benefits over the short and longer term, and on the part of scheme members for a stable benefit structure that will deliver a reasonable income in retirement. The Panel concluded that a collective, employer-backed, DB scheme was a better route to ensuring a fair balance between stability and risk than an individual DC arrangement.

### THE CURRENT LEGAL AND REGULATORY FRAMEWORK

In its first report, the Panel was clear that the Trustee must operate within the current regulatory framework. The Panel did not consider approaches that would fall outside the current legal and regulatory framework.

The Panel has also taken this approach for its second phase of work.

[8] *Independent Panel report to the Review of Post-18 Education and Funding, CP117,* May 2019, p69

However, the Panel notes that there have been some developments in the year since its first report was published in relation to the prevailing regulatory environment:

- In September 2018, TPR announced changes to its approach to regulation[9]. As part of a package of measures to enable TPR to adopt a clearer, quicker and tougher approach to regulation, **one-to-one supervision** especially in relation to "strategically important schemes", was introduced, initially the 25 largest schemes but with the expectation that the largest 60 would be included during 2019. Criteria for inclusion in the new supervisory regime includes size, risk and previous interactions with TPR. As the UK's largest scheme (by volume of assets under management) USS would fall within scope. USS has now entered one-to-one supervision.

- The **2019 Annual Funding Statement** published by TPR in March[10]. This sets out guidance on how TPR expects valuations to be approached by trustees and employers. It emphasises the need for an integrated approach to risk management and for sponsoring employers and trustees to adopt a LTFT. It categorises schemes into a number of groups based on a range of factors including their relative maturity, cash contributions being paid, strength of sponsor covenant, length of recovery plan and the scheme's risk analysis and sets out TPR's expectations in relation to these factors and the actions scheme should be taking. This suggests a rather more formulaic approach to the scheme valuations on the part of TPR. It is not clear to the Panel that this approach can take account of scheme specificities such as those that exist within USS, such as its mutuality or last man standing provisions.

- The Government published a consultation document in 2017 and a White Paper in 2018 that included proposals for tighter DB scheme funding. These proposals came in the wake of the high-profile failures of a number of DB schemes with large deficits. The reforms will require all defined benefit schemes to adopt a **LTO** (described earlier). Legislation to enact the new requirements, which also includes new powers for TPR, has been delayed due to the General Election. The LTO and what it could mean for an open Scheme such as USS is discussed further in chapter 8.

## SUSTAINABILITY

As part of its work for its second report, the Panel has been asked to consider how the long-term sustainability of the Scheme can be secured. 'Sustainability' is a term that is used widely in relation to USS (and DB schemes more widely). The Panel therefore believed it was important to set out its interpretation of this term.

[9] *Making Workplace Pensions Work: TPR Future – our new approach*, September 2018, TPR
[10] *Annual Funding Statement 2019 for defined benefit schemes*, March 2019, TPR

The Panel recognised that sustainability has a number of aspects:

- Sustainability for whom (employers, members, the Trustee, the wider HE sector)?
- Sustainability over what timeframe (short, medium or long-term)?
- Sustainability of what (security, benefits, contributions, risk exposure)?

The Panel has considered each of these dimensions in arriving at its definition of sustainability.

The starting point for any consideration of sustainability must be the Scheme's long-term goals and objectives. These set the overall context and purpose of the Scheme within which other decisions and considerations will take place. Sustainability requires a clear view (and validation) of how to satisfy long-term goals, and a recognition that there may be several ways of reaching that goal. In turn sustainability requires:

- agreement of the long-term objective(s);
- a shared understanding of risk between the interested parties (trustees, employers, members); and
- an acceptance that there is a shared responsibility for the success and sustainability of the Scheme.

This will require the Scheme to operate with a much higher degree of trust than is presently the case. Perceptions of value for money and perceptions of relevance that may vary between the interested parties require healthy debate and adjustment to arrive at a robust and sustainable outcome.

When considering sustainability, it's important that short-term decisions are weighed against, and are consistent with, the long-term objective(s) for the Scheme. Short and medium-term decisions must keep the Scheme on the right trajectory, that is to say be used as steering mechanisms to ensure the Scheme stays on course.

Targeting sustainability should mean creating resilience so that a bumpy ride can be smoothed out and the Scheme can potentially withstand short-term shocks. This in turn should mean that any significant changes to the Scheme can be foreseen and therefore plenty of notice can be given to sponsoring employers and Scheme members of any changes to contribution rates. In a sustainable Scheme, such changes would not happen suddenly, without warning, or without allowing employers (and members) to prepare. This is especially important in a scheme such as USS where contribution increases are shared between members and employers and the Scheme is a 'last-man standing' scheme.

The Panel also believes that any definition of sustainability must also incorporate adaptability (contributions, investment, contingent assets as the levers that can be pulled). If the cost of maintaining the Scheme is so prudent it damages the sector, then it is not reasonable (for example

if, as has been suggested to the Panel, it forces contributions to be so high as to require the closure of academic departments, curtail capital expenditure or force the closure of institutions altogether). The Scheme needs to adapt to remain sustainable over the longer term. This requires a governance structure that can make changes to the Scheme in a way that is appropriate for the wider HE sector.

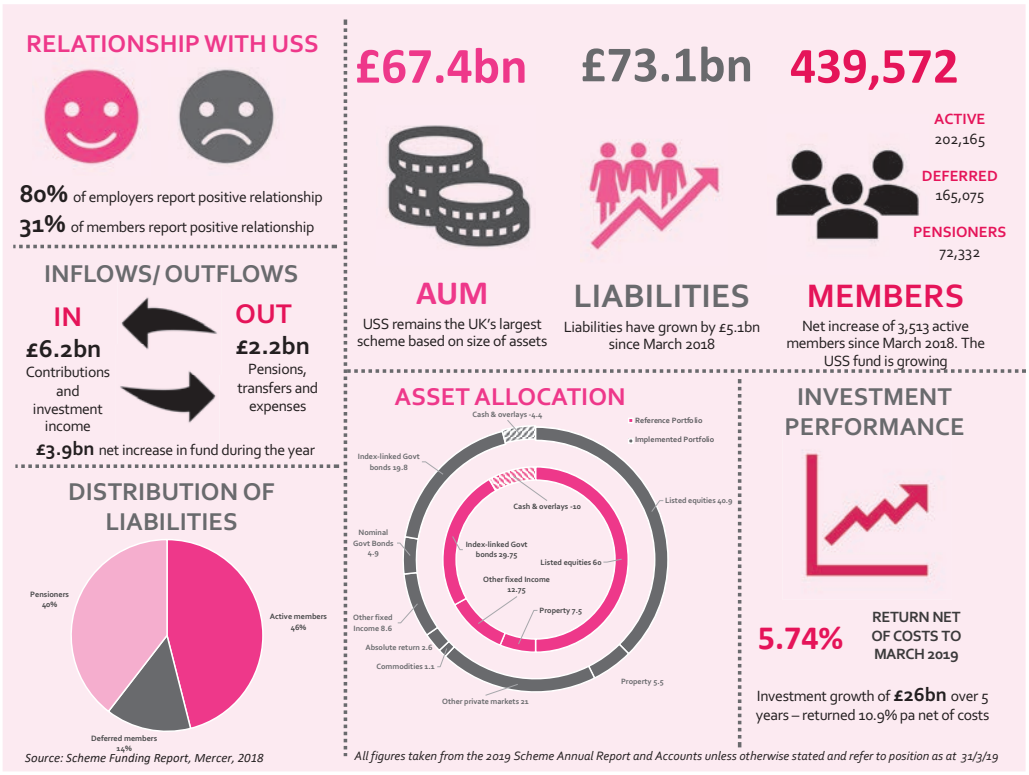
By the same token, a sustainable scheme is one that will reach beyond its current beneficiaries and members into the next generation. If the Scheme is to remain relevant for the sector (as a recruitment and retention tool, for example) and to its members, its Trustee and its employers and members must recognise and be prepared to live with the potential for the cross subsidies that are inherent in the Scheme. This also means that a sustainable scheme needs to be able to respond to changes in the labour market, the economics of the HE sector and the needs and preferences of members (that may change over time). What constitutes a good pension scheme may change and/or may need to change over time (as it already has since USS was established).

Taking this wider view of sustainability, the valuation becomes simply a tool available to the Trustee and the Scheme's management to assess progress and viability. Currently in the case of USS, the valuation (and its associated importance in the Rules and cost sharing negotiations) have become the measure of Scheme sustainability and, as the JEP noted in its first report, a very inflexible one at that.

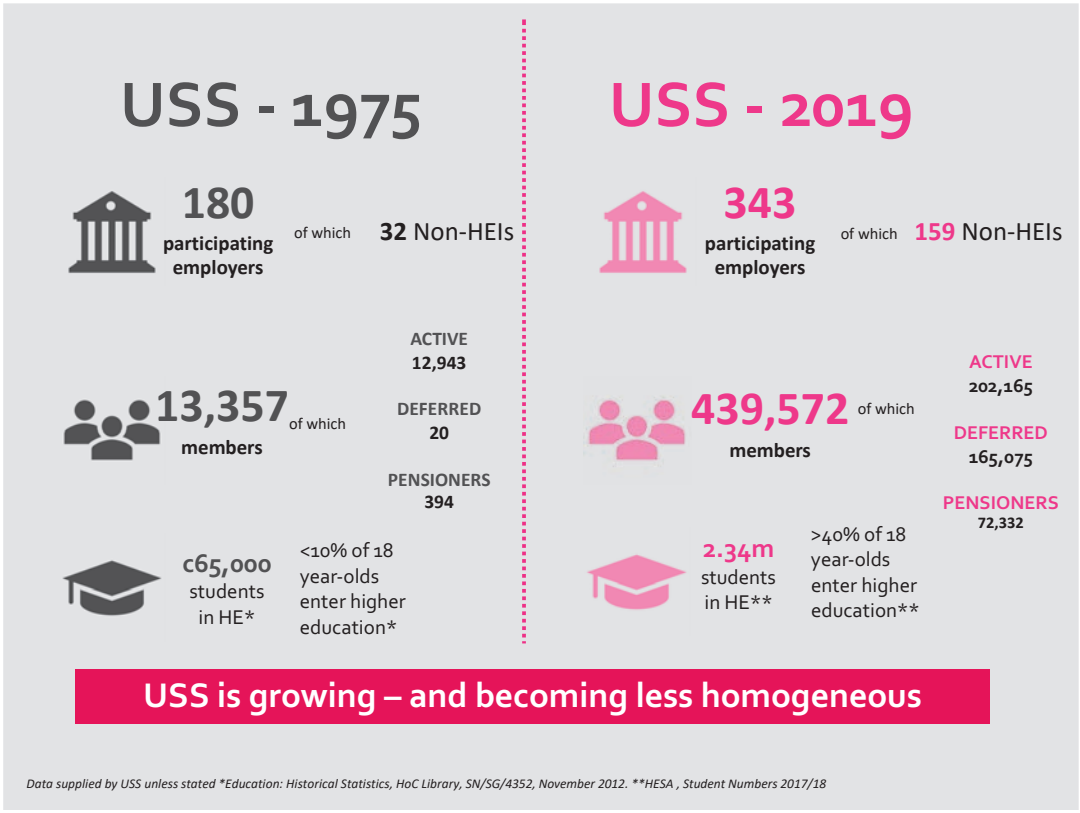
The Panel acknowledges that definition of sustainability is broader than the regulatory definition applied by TPR. However, the Panel believes that, given the open nature of USS, its relative immaturity, and the principles of mutuality underpinning the Scheme and its 'last man standing' status, it is appropriate to embrace a broader definition of sustainability.

The Panel strongly encourages the interested parties coalesce around a broad definition of sustainability which recognises regulatory requirements, but which also recognises the specificities of the USS fund.

# 5. ABOUT USS


RELATIONSHIP WITH USS
80% of employers report positive relationship
31% of members report positive relationship
INFLOWS/ OUTFLOWS
IN
£6.2bn
Contributions and investment income
OUT
£2.2bn
Pensions, transfers and expenses
£3.9bn net increase in fund during the year
DISTRIBUTION OF LIABILITIES
Pensioners 40%
Active members 46%
Deferred members 14%
Source: Scheme Funding Report, Mercer, 2018
£67.4bn
£73.1bn
439,572
ACTIVE 202,165
DEFERRED 165,075
PENSIONERS 72,332
AUM
USS remains the UK's largest scheme based on size of assets
LIABILITIES
Liabilities have grown by £5.1bn since March 2018
MEMBERS
Net increase of 3,513 active members since March 2018. The USS fund is growing
ASSET ALLOCATION
Reference Portfolio
Implemented Portfolio
Cash & overlays -4.4
Index-linked Govt bonds 19.8
Listed equities 40.9
Nominal Govt Bonds 4-9
Other fixed Income 8.6
Absolute return 2.6
Commodities 1.1
Property 5.5
Other private markets 21
Cash & overlays -10
Index-linked Govt bonds 29.75
Listed equities 60
Other fixed Income 12.75
Property 7.5
INVESTMENT PERFORMANCE
5.74%
RETURN NET OF COSTS TO MARCH 2019
Investment growth of £26bn over 5 years – returned 10.9% pa net of costs
All figures taken from the 2019 Scheme Annual Report and Accounts unless otherwise stated and refer to position as at 31/3/19

## USS – 1975 AND TODAY



# 6. PRINCIPLES TO UNDERPIN THE VALUATION


## SUMMARY

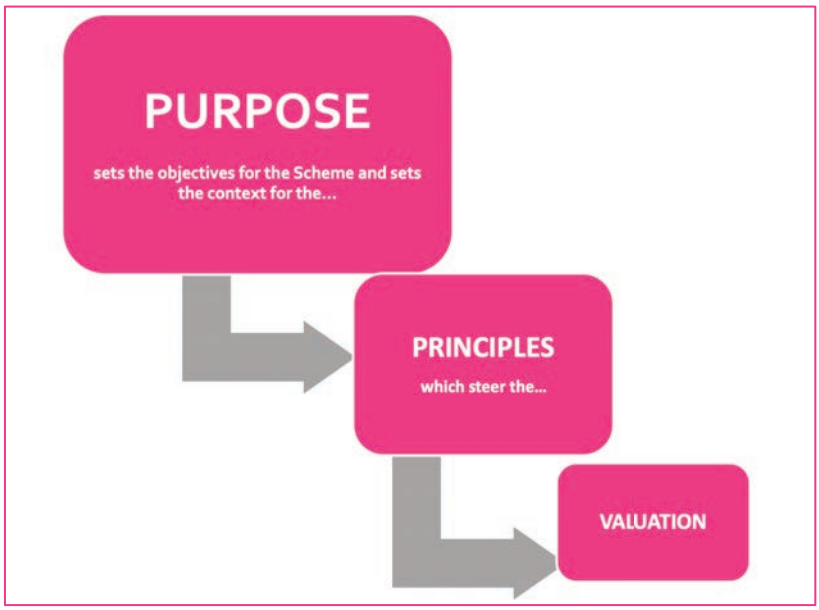
1. A central requirement of the ToR for the Panel's second phase of work was to agree a set of principles to underpin the approach of UCU and UUK to future valuations. The Panel has considered the core elements of such principles and has set out a draft set of Shared Valuation Principles.
2. The Shared Valuation Principles provide a basis for UCU, UUK and the Trustee to approach and steer future valuations. They set out the respective roles and responsibilities of each of the parties forming, in effect, a memorandum of understanding as to the way in which the valuation will be conducted. They are written with the goal of achieving a successful outcome – an agreed valuation and associated contributions schedule completed within the statutory timescale without recourse to industrial action.
3. The Shared Valuation Principles provided by the Panel are a starting point for discussion and agreement by the Stakeholders. They should be finalised and agreed by the Stakeholders as a matter of urgency before work on the 2020 valuation is too far advanced and substantive decisions are made. The Trustee should also be a party to the Shared Valuation Principles. The Shared Valuation Principles would be part of the context to the valuation provided to TPR.
4. As the Panel stresses throughout this report, the valuation (and its associated process) is just one component in the operation and long-term sustainability of the Scheme. The Shared Valuation Principles need to be set in the context of the much broader core purpose or mission of the Scheme. A common purpose statement should be adopted and agreed. The Panel has suggested a purpose statement as a basis for discussion and agreement between the Stakeholder and Trustee.
5. The success of the Shared Valuation Principles, and more broadly the long-term future of the Scheme, will require recognition from each of the interested parties that they work towards, and take responsibility for, the whole of the Scheme and its valuation. They must, collectively, provide leadership to the Scheme – its members, participating employers and the wider HE sector.


A central requirement of the Panel's ToR was to agree a set of principles to underpin the approach of UCU and UUK to future valuations. The Panel has set out a set of Shared Valuation Principles (in essence, a memorandum of understanding). The Panel recommends that – as a matter of urgency – the Stakeholders finalise and formally agree the Shared Valuation Principles work on the 2020 actuarial valuation is too far advanced. This will provide a firmer foundation from which to conclude discussions. The Panel also recommends that the Trustee is a party to the Shared Valuation Principles as, without their involvement, progress will be limited.

As we stated in our first report, in the case of USS the valuation has taken on a much greater significance than is the case for other large schemes. Rather than a mechanism to check that the Scheme is on track to meet its broader, long-term objectives and sustainability, the USS valuation has become the main driver of the Scheme and an end in itself. This is resulting in short-term decision making, near-term time horizons (looking only from one valuation cycle to the next), and a process-driven approach to the running of the Scheme.

The Panel is clear, however, that the valuation (and its associated process) is just one aspect of the operation and long-term sustainability of the Scheme. Indeed, it is a point that the Panel stresses throughout this report. Therefore, whilst important, the Shared Valuation Principles will be just one aspect contributing to the effective operation of the Scheme.

**Figure 6: Setting the valuation in context**




A high-level mission (or purpose) statement would be beneficial – one that sets out:

- the overarching purpose of the Scheme and which is shared by all interested parties; and
- the Scheme's direction and the collective ambition of the Stakeholders for the Scheme.

It would set the overall context within which the Scheme operates and within which the valuation – and its related considerations – take place.

## DEFINING THE SCHEME'S PURPOSE

A new purpose statement for the Trustee company (USSL) (as distinct from the Scheme) has been developed and was shared at the USS annual institutions meeting in December 2019: It is: *"Working with Higher Education employers to build secure financial futures for our members and their families".*[11]

The Panel considers this a significant step forward from its previous mission statement which was *"To be the Scheme of choice for the Higher education sector".* The revised mission statement is considerably more member-centric than the previous, more transactional and business-oriented, statement.

[11] https://www.uss.co.uk/how-uss-is-run/views-from-uss/uss-institutions-meeting-2019

However, it is just that – the Trustee's mission statement. There is no common view or articulation across UCU, UUK and the Trustee of the core purpose of the Scheme. The Panel is strongly of the view this is needed.

By providing a clear articulation of the objective of the Scheme and a common view of what the Scheme is for, a new – shared – mission statement would provide a common language for all the Stakeholders. By being agreed jointly it would help give a renewed sense of shared ownership and endeavour.

A statement of purpose for USS should be:

- member-centric – reflecting the Scheme's objective to support its members to save for retirement;
- contributing to sustainability – of the Scheme (including affordability) and the HE sector;
- long-term; and
- holistic – not simply about the valuation or its process.

A number of other large occupational pension schemes adopt mission or purpose statements:

- **NOW: Pensions:** To help everyone save for a better, more financially secure retirement.
- **Ontario Teachers' Pension Plan:** Outstanding service and retirement security for our members – today and tomorrow.
- **RPMI:** To pay members' benefits securely, affordably and sustainably.
- **NEST:** To help millions enjoy a better retirement.

Taking these factors into account, a purpose statement for USS might be:

> *To help members achieve a financially secure retirement and to instil trust and confidence in the Scheme, while providing an excellent service to members and employers that supports the long-term needs of the HE sector.*

This statement is proposed as a starting point for discussions between the Stakeholders and Trustee. It must be for them to jointly agree – and own – the statement of purpose for the Scheme.

## SHARED VALUATION PRINCIPLES

### WHY THE SHARED VALUATION PRINCIPLES ARE NEEDED

It is apparent to the Panel that all sides in the valuation process have a strong desire to execute the valuation successfully, and approach it positively. Our discussions with UUK and UCU, as well as with the JNC, made it clear that the Stakeholder organisations do not wish a triennial valuation to

become a source of triennial dispute. And, while having differing views of what the outcome should be, both sides are also keen to reach a positive and timely outcome.

These shared ambitions are supported by a view that, in theory, the valuation process itself works well. The fact that the 2017 valuation process started early, that USS published large amounts of information on its website, and that there was considerable consultation with employers were cited as evidence that the core elements to a successful valuation were present. However, the experience of the past two years clearly demonstrates that the valuation process does not work well in practice:

- the past three valuations have not been completed within statutory deadlines;
- there is a lack of clarity over roles and responsibilities; a lack of mutual understanding over process and purpose; and
- a breakdown of trust between the interested parties (issues which are examined in further detail in chapter 7).

The purpose of the Shared Valuation Principles is to address these issues with the goal of ensuring there are clear expectations on all parties in terms of how they will engage with the process; how they will engage with each other and a joint responsibility to find a mutually acceptable outcome.

It is the JEP's firm view that these Principles will support the interested parties to conclude the valuation efficiently and consensually. Achieving this will have the important benefit of ensuring that the valuation is seen proportionately, ie just one element that helps steer the Scheme, not the primary driving force.

### CORE ELEMENTS OF THE SHARED VALUATION PRINCIPLES

The Panel considered the following to be the core elements that need to be covered by a set of Shared Valuation Principles:

- The **relationships and interactions between the parties**: This will require defining the roles of the Stakeholders and the other parties to the valuation (which will include TPR), the relationships between the different parties (and a recognition that there will be different perspectives), ensuring the right people are engaged at the right time, and ensuring that all are adequately resourced to play their part effectively. This will ensure there are clear 'rules of engagement' between the interested parties.

- **Managing expectations:** This will require acknowledging and understanding the legal and regulatory constraints within which the valuation must take place, that a successful outcome will be reached within the statutory timeframe without recourse to industrial action, and the consequences of failure.

- Ensuring **the valuation process is conducted in an openly and transparently:** This will require Stakeholders to have a shared understanding of what the valuation is for, a timely

sharing of information and early and inclusive engagement in the process. It may also require Stakeholders to consult differently and/ or with groups whose views have not previously been sought.

- The **valuation methodology and its consequences should be clear** to all Stakeholders. This will require a greater consistency across valuations and an approach that commands the confidence of Stakeholders whilst also satisfying regulatory requirements.

Throughout this report we will continue to refer to these Shared Valuation Principles, with recommendations as to the changes needed to give force to the Shared Valuation Principles.

### Figure 7: Shared Valuation Principles

**Commitment to a good process**

*These Shared Valuation Principles have been agreed by UCU and UUK [and the USS Trustee]. They will be used by the Stakeholders and other interested parties to steer the actuarial valuation of the USS with the aim of reaching a mutually agreed outcome that supports the long-term sustainability of the Scheme.*

**All parties shall:**

1. Work together co-operatively with the objective of reaching a mutually acceptable agreement.
2. Respect the responsibilities of the different parties in the valuation.
3. Recognise the legal and regulatory boundaries that frame the valuation.

**The valuation will be:**

4. Founded on a shared (UUK and UCU) vision of the USS that supports the mission and purpose of the Scheme.
5. Undertaken using a methodology that is clear (and clearly understood by Stakeholders); consistent across valuations*; and commands the confidence of Stakeholders.
6. Based on early and proactive engagement, with options – including their consequences – explored jointly.

**There will be:**

7. A shared understanding of what the valuation is for, and what role each party plays (UUK, UCU, JNC, Trustee, Scheme Actuary, TPR).
8. Good quality, timely communications that inform and educate Stakeholders and a timely response to requests for information (including from the Trustee).
9. Adequate resources, so each party can play their part effectively.
10. Steps taken by UCU and UUK to ensure they reach all employer and Scheme members in consultation exercises about the valuation.

Notes

Stakeholders – UCU and UUK [or their successor bodies]

*But it is noted that the underlying assumptions may alter between valuations, eg to reflect changing life expectancy.

### AGREEING THE SHARED VALUATION PRINCIPLES

The proposed Shared Valuation Principles above are designed to serve as the starting point for discussions between the Stakeholders. However, it must ultimately be for the Stakeholders themselves to finalise and formally agree the Shared Valuation Principles.

The Panel strongly recommends that the Stakeholders immediately start work to agree the Shared Valuation Principles so that they are in place before work on the 2020 valuation is too far advanced and substantive decisions made. The Panel is also strongly of the view that the Trustee should be a party to the Principles as, without their involvement, progress is likely to be frustrated. Whilst TPR should not have a role in drafting the Principles, or be a signatory to them, the Panel also believes it would be sensible to share the Principles with TPR as they would be part of the context to the valuation provided to TPR.

Given the low levels of trust that currently exists between the parties, the Panel does not underestimate the work that will be needed to agree the Principles. It therefore proposes that the parties are supported through some facilitated discussions. These could take the form of the structured workshops the JEP ran with the JNC which successfully identified shared views and interests amongst the UCU and UUK representatives and is described in the concluding chapter of this report.

Alternatively, the Stakeholders could utilise the support of ACAS (with formal agreement of the Principles forming an addendum to the ACAS agreement reached by the Stakeholders in March 2018).

## TAKING COLLECTIVE RESPONSIBILITY

The Shared Valuation Principles, and more broadly the long-term future of the Scheme, will require a recognition from each of the interested parties that they must work and together take responsibility for the whole of the Scheme and its valuation. There is currently a tendency for each of the interested parties to work in silos and not to consider the Scheme holistically but simply to take responsibility for their own perspective or constituents.

Instead they must, collectively, provide leadership to the Scheme – its members, participating employers and the wider HE sector.

They should be finalised and agreed by the Stakeholders as a matter of urgency before work on the 2020 valuation is too far advanced and substantive decisions are made. The Trustee should also be a party to the Shared Valuation Principles.

# 7. VALUATION GOVERNANCE

## SUMMARY

1. Whilst there are some features of the current valuation governance that are seen by all the interested parties to be working well, overall there is a view that the Scheme's valuation governance does not work well and is no longer fit for purpose. The Panel shares this view.
2. The Panel concludes that a number of changes are needed to the Scheme's valuation governance. Whilst some will simply involve changes to the way in which the interested parties work together, others will require changes to the Scheme Rules. Agreeing these governance changes alongside the Shared Valuation Principles should be a priority and should happen before work on the 2020 valuation is too far advanced and should be taken account of in the timetable for its preparation. Given the collective acceptance of the need for change, the Panel hopes agreement can be reached swiftly.
3. There is a widespread view that the Trustee is too distant from the Stakeholders and in the Panel's view this has contributed to a decline in levels of trust. The Trustee Directors must be more visible to the Stakeholders and JNC through more regular and direct engagement. It would be desirable for the Trustee to establish a funding and valuation sub-committee which could also work with JNC representatives in a joint valuation forum and to undertake engagement with Stakeholders.
4. There is a consensus, shared by the Panel, that the JNC does not work as well as it might. Changes are required to improve its effectiveness. The role and remit of the JNC should be reviewed, including whether the Chair should continue to have a casting vote. It would be helpful if there was greater stability of the JNC's membership to improve decision making and continuity of approach. A joint forum should be established between the Trustee and JNC to undertake some joint modelling of the valuation assumptions (whilst recognising that it is the Trustee's legal duty to determine the assumptions) which would help establish buy-in to the eventual outcome. The Panel believes that consideration should be given to whether a more radical reform is appropriate, for example, the creation of a senior Steering Committee comprising the principals of the employer and member representatives.
5. The Panel notes that UUK has worked hard to represent sponsoring employers in relation to USS. However, UUK's core responsibilities are to lead cross-sector collaboration and to influence policy. Thus, its role as the employer body in USS is at odds with this mission and for this reason there is merit in considering whether UUK should continue as the main (or sole) employer body in relation to USS. The Panel understands that these issues are already being addressed by UUK in a working group that is investigating the best structure to facilitate employer involvement and engagement in the Scheme, and the Panel welcomes this initiative.
6. It is possible that all sides will wish to make changes to the Scheme in the future, particularly to provide flexibility for its increasingly diverse membership. UCU should have mechanisms in place to ensure and demonstrate that it can reflect the views of all Scheme members and potential members.

Any Shared Valuation Principles will only be effective (and future valuation exercises effective) if they are supported by strong governance, in turn supported by strong relationships built on trust and mutual understanding.

The Panel recognises that all those involved in the Scheme are working hard to do their best for their respective constituencies. But it is also clear that the many bodies involved in the Scheme do not currently work well together. There are low levels of trust (as we identified in our first report), a lack of clarity about the respective roles and a governance structure that, as it relates to the valuation, can no longer meet the demands of the complex nature of USS today.

This chapter:

- Summarises the views on valuation governance gathered through a programme of semi-structured interviews, written submissions and discussions with other large pension schemes.

  and

- Makes recommendations on potential changes to the Scheme's valuation governance arrangements. These changes are designed to support the Shared Valuation Principles described in the previous chapter; deliver the valuations more cohesively; and rebuild trust and confidence in the Scheme.

Much of the valuation governance is 'hard wired' into the Scheme Rules. A description of how the valuation process operates is set out in Appendix 6.

## FINDINGS FROM INTERVIEWS AND SUBMISSIONS

At the end of its first phase of work, the Panel stressed the importance of rebuilding trust through an open and transparent process and recommended that issue should be addressed in its second report.

As part of this exercise, an early task undertaken by the Panel in its second phase of work was to collect further evidence on the subject of the governance of the valuation process from:

- the key Stakeholders in the USS valuation process;
- other large multi-employer DB schemes; and
- those providing submissions to the JEP.

This information was gathered via the semi-structured interviews, evidence sessions with the Panel and the written submissions described in chapter 3.

The Panel undertook 25 semi-structured interviews with a wide range of those closely involved in the valuation process to discuss the issues surrounding the governance of the valuation. Interviewees included representatives of UCU and UUK and their respective advisers; the Trustee; and individual sponsoring employers. A list of those interviewed as part of this process is set out Figure 3 (in chapter 3). The topics covered in the discussion guide included exploring people's understanding of the process and the respective roles parties played within it; a discussion of the elements that work well and less well; and an exploration of what an ideal governance process might look like. The discussion guide is set out at Annex 7.

Whilst many of those interviewed identified a number of positive points about the current process and governance, almost all pointed to issues that do not work well. It was striking that across the stakeholder groups there was much agreement on aspects that worked well, but also on those areas where change was needed.

***The following section summarises the views of the people and organisations to whom the Panel spoke or who submitted written evidence to the Panel. They do not necessarily reflect the views of the Panel. They are, however, symptomatic of the level of distrust and dissatisfaction with the status quo.***

## WHAT WORKS WELL?

Positive points included:

**"Broadly speaking, the process works well"**

- USS plan the process well and the process has all the right components. In theory it should work well.
- The early and comprehensive engagement between USS and employers at the start of the 2017 valuation was felt to be a positive feature of the process adopted for that valuation cycle by many of those closely involved. However, as noted later, there were some reservations about the information communicated and the process by which USS and UUK drew conclusions from the process.
- Several commentators from both UCU and UUK remarked that the JNC is well-run and chaired, although there are a number of other issues about the JNC and its role that are noted below which were felt to work less well. The Funding and Benefits Committee of the JNC was also felt by some to be a very useful forum for understanding the valuation.

**"UUK have been fantastic – they took us under their wing"**

- UUK were praised by some respondents for their role in bringing employers together and including non-members of UUK in pension discussions.
- UCU were praised for the clarity and simplicity of their communication with members.
- Although the Panel is not part of the valuation process or its formal governance, many respondents remarked that it had been a very positive addition to the process.

**"A failure of a meeting of minds becomes ascribed to a failure of governance."**

Some felt that any problems could be ascribed to the state of relationships rather than structural deficiencies in the Scheme.

## WHAT WORKS LESS WELL?

Areas which were identified as working less well can be grouped under three broad headings:

- an asymmetry of relationships between the interested parties and a number of behaviours within the interested parties that are seen to put barriers in the way of a successful valuation;
- a governance structure that is not conducive to delivering a cohesive and shared outcome and which has been outgrown by the current complexities of the Scheme; and
- an asymmetry of information and poor communication between the interested parties.

### RELATIONSHIPS AND BEHAVIOURS

Discussions with all Stakeholders drew attention to relationships that were not seen to be working as well.

**"The Stakeholders have no role in setting the integrity of the Scheme."**

Whilst there was a recognition that the Trustee Directors needed to be able to act in a fiduciary capacity (and therefore independently) there was a view that the Trustee and the Stakeholders have diverging views. Stakeholders and their advisers saw the main pre-occupation of the Trustee as being about de-risking, whereas the Stakeholders have a wider view related to the future of the Scheme and the HE sector as a whole. There was a concern that this divergence could widen to the detriment of the Scheme and its Stakeholders.

**"The professionalism and growth of the USS Executive has led to a recalibration of the balance of power between the Trustee and the JNC."**

Similarly, there was a view expressed by both employer and member representatives, that the balance of power within USS itself had shifted as the USS Executive had grown in number and taken on more of the valuation process. Moreover, respondents felt that the Executive now dominated discussions with the JNC, UUK and UCU whereas in earlier valuations the Trustee

**"The Scheme Actuary has been put in a box."**

Directors and/or the Scheme Actuary were more visible. This created a suspicion that it is the views of the Executive rather than the Trustee or Scheme Actuary that are being conveyed. There was a clear view that the absence of the Trustee Directors had contributed to the breakdown in trust between the Stakeholders and USS. The perceived dominance of the Executive in discussions was also felt to contribute to U-turns in policy and decisions. One respondent described USS as old-fashioned, rigid and process driven. Others claimed that the relationship between the Trustee and UUK has been turned on its head and was no longer a relationship of equals, with UUK being seen as being responsive to the Trustee, rather than the other way around.

**"One would be forgiven for thinking that at times it [USS] was there to serve the Executive."**

By contrast, the Executive felt that they were responsive to needs of Stakeholders. In some cases they felt that they were too responsive, citing the additional time given for negotiations in Summer 2017 which, in their view, contributed to delays in concluding the valuation. This view was also shared by the Trustee Directors interviewed. The Executive took the view that their role was simply to serve the Stakeholders and to be guided by their views and wishes, rather than to provide the guidance themselves. However, there was an acceptance (again shared by the Trustee) that the Trustee could, and should, be more visible to Stakeholders.

**"We [USS] are here to serve the sector."**

**"More informal contact [between the Trustee and JNC] could help."**

The Executive also appeared to some of those interviewed as part of this exercise to be less sympathetic to views of employers and members than in the past. This led some to suggest that the Scheme was no longer run for the benefit of members. Over the past two valuation cycles, employers and members describe feeling less engaged, less respected and less listened to.

**"The Scheme was originally a creation of the employers, but it doesn't feel like that now with USS."**

Recent valuations had also exposed differences in needs and attitude between different employers in the Scheme, a situation compounded by the challenges now facing the sector and, for the non-academic institutions in the Scheme, a very challenging competitive landscape. This had affected the nature of the relationships and the behaviour of Stakeholders which had become more adversarial and contested in nature. It had also triggered a breakdown in trust between the interested parties. Views and behaviours had become more entrenched making negotiation more complex and less likely to succeed.

**"Relationships have moved from being open and transparent to closed and contested."**

The growing diversity of the financial strength of USS employers was also seen as creating tension when it comes to the valuation and different sets of needs in relation to pensions. Moreover, there was a sense that university governors, in their own governance role, are becoming more involved and more vocal about the risks to which their institution is exposed by the funding position of the Scheme and the costs of delivering pensions. This is leading not only to tensions in resolving the valuation but also between institutions, their employees and UCU.

The JNC was seen as an adversarial forum. Views were expressed that that the Stakeholders did not arrive at the JNC with a clear mandate from their respective organisations or desire to negotiate or find a settlement. Views were also expressed that the JNC was unclear on its remit and had wanted to get involved in issues which, under the Scheme Rules, did not belong to the JNC. The rapid turnover in JNC members was considered by a number of respondents as being unhelpful.

**"The JNC is not a useful place for negotiations; it is a useful place for grandstanding."**

Concerns were also expressed that UCU did not represent the views of the all members and that UUK did not represent the views of all employers and was not able to bind employers into a single viewpoint.

**"The interests of the Trustee and the interests of TPR are not the same."**

The Pension Regulator was not immune from criticism. The Regulator has been more evident and influential in the process, inappropriately so in the views of the majority of interviewees and respondents. Whilst there was an appreciation that this is in part a consequence of regulatory changes, there was also a belief that these changes are adversely affecting relationships and behaviours. In particular, TPR was seen as exercising too much influence over the Trustee, and the Trustee was seen as not pushing back sufficiently against TPR. Comments were also made about the timing of TPR's interventions which were seen by some as unhelpful.

### GOVERNANCE STRUCTURE

Strong views emerged relating to the perceived weaknesses in the valuation governance structure. The Scheme Rules were seen as a major source of problems which caused conflict between the Stakeholders and between the Stakeholders and Trustee. The separation of powers in the Scheme Rules gives the Trustee the unilateral power to set the 'price' of benefits (in terms of the contributions needed to meet the valuation) and the Stakeholders, through the JNC, taking that 'price' to determine how contribution increases will be split between sponsoring employers and members and/or benefits amended. There was a widespread view (though not one held by the Trustee or Executive) that this puts the

**"The process is set up for conflict…there is institutional polarisation."**

Stakeholders and USS on opposite sides of the table, and automatically in conflict with one another.

Whilst there was support and respect for the JNC Chair from both sides, views were expressed that the backstop of the Chair's casting vote, prescribed in the Scheme Rules to be used when the Stakeholders cannot reach agreement, meant there is little incentive for the Stakeholders to reach a negotiated agreement. It also institutionalises a point of conflict as the Chair must inevitably come down on one side or another.

**"They [the JNC and others] need to understand that the valuation is not up for negotiation – they can't challenge how the Trustee got to the numbers."**

There was a feeling from some that roles and responsibilities in the valuation were poorly understood contributing to a breakdown in trust and a failure to agree. It was seen that the roles of Trustee, Executive and JNC had been well understood in previous consultations but began to change with the 2011/2014 valuations. Some felt that the JNC had tried to overstep its remit (as price taker) by trying to get involved in determining the valuation methodology. Conversely, others said the need for the JNC to be more closely involved in the valuation methodology was because there was a lack of trust in the information given to the JNC – in part because it was not delivered directly by the Trustee or Scheme Actuary. A number of interviewees thought that it could be helpful for some kind of joint forum to be established between the Trustee, JNC and Scheme Actuary to undertake some joint modelling of the assumptions. This would help establish buy-in to the eventual outcome.

**"It's appropriate for the JNC to get involved in the valuation…they need to understand how the Trustee has brought its judgement to bear on pricing and assumptions."**

One consequence of the separation of powers is that the JNC's formal role starts at the end of the process, once the Trustee has determined the 'price' of benefits. This again was seen as unhelpful, and a further factor creating conflict between the interested parties. It was noted that whilst the Trustee consults with employers via UUK, what comes out of that process must be dealt with by the JNC.

**"The structures don't encourage joint decision making."**

A number of other issues were raised in relation to the JNC. Some concerned people and resourcing. It was noted that there had been considerable turnover of JNC membership in recent years (especially on the union side) and that could create a less consistent or stable approach to negotiations. It was suggested that this had also resulted in a loss of pensions and negotiating expertise on the JNC.

It was also felt that the JNC was under-resourced and did not have access to its own advisers. The JNC is dependent on USS to provide support and secretariat services. Yet the same individuals within the USS Executive also provide support to the Trustee. This is was seen as less than ideal, especially given the low levels of trust and confidence. There was a call for the JNC to have access to its own resources. Whilst not a reflection on the individuals providing the service to the JNC (in fact the JNC was seen to be well serviced) it was felt untenable for USS Executives to serve both bodies and there was a recognition that the same people cannot serve "two masters" on the same issue at the same time. It creates an inevitable tension and conflict of interest.

It was also suggested that the JNC's role should not be so tightly bound into the Scheme Rules.

Concerns were expressed about the operation of the Trustee Board in respect of the valuation. There was a view from some that the USS Board had become unbalanced and dominated by the independent Trustee Directors with the views of employers and members consequently less visible and considered. However, in interview, the Trustee Directors said that all the Trustees were treated equally and allowed, and encouraged, to have their say.

**"If the Trustees lose contact with the Universities, then the risk of conflict becomes greater".**

Whilst it was recognised that the independent Trustee Directors were experts in pensions and investment, there was a view that they were disconnected from the HE sector and had a poor understanding of it. Concern was also expressed by a number of parties that the Independent Trustee Director's detachment from the sector will grow. Following Master Trust Authorisation (MTA) for the Scheme's DC section, and the requirement that trustees are "fit and proper", a Trustee Director will sit on the selection panels for the selection of UUK and UCU nominated Trustee Directors with a super veto on appointments. Some saw the Trustee using the new Master Trust Authorisation Fit and Proper requirements as an excuse to change the composition of the Trustee Board.

**"USS has moved from a deferential relationship with UUK to a much more independent role."**

A number of interviewees commented on the fact that while the USS Board has a number of sub-committees (for example those responsible for remuneration and audit and risk) it does not have a dedicated sub-committee responsible for funding and the valuation. This was unlike the practice in other, large, DB schemes. Such a committee, it was suggested, could provide a greater focus and point of interaction for Stakeholders throughout the valuation.

UUK is responsible for dealing with the USS on behalf of employers, acting as negotiator (its role specified in the Scheme rules). This was seen as unhelpful and inappropriate by a number of those interviewed, including some employers themselves. First, it was seen as being at odds with the UUK core remit, namely, to make the case for the sector and investment in institutions. Second, it accentuated concerns that pay and pensions – a core part of overall remuneration – are considered separately and that there is no forum for a cohesive strategy on pay and benefits. Several respondents felt that the isolation of USS in UUK prevented a more holistic view of reward from being achieved and that this added to the tensions. For both these reasons, views were expressed that UCEA, which is responsible for negotiating on all other aspects of pay and benefits for the sector (although not for all USS employers) could be the more appropriate employer body for the purposes of USS.

**"UUK is effective in general but USS issues are problematic as they need to be considered as part of a wider debate on pay and benefits which is not UUK's domain."**

**"The negotiation of benefits to be integrated into each employer's overall considerations of reward."**

### ASYMMETRY OF INFORMATION

The interviews and written evidence highlighted the asymmetry of information between the Executive and Stakeholders.

Employers, members and their advisers expressed strong views about the poor standard of communication from the Scheme and the lack of transparency by the Executive and Trustee.

**"The biggest failure is communication…It's not clear whether the Trustee does enough to check whether their communications are good."**

There was a general recognition that USS had placed a lot of information about the valuation on its website. However, there was also a strongly held and consistent view that the information was not always appropriate for the intended audiences.

Despite its current hard wiring into the Scheme rules, there was also a feeling of isolation of JNC members from the wider Scheme. This manifested itself in comments that the JNC did not meet with the Trustee or the Scheme Actuary. This meant that the Trustee and JNC lost the sense of "we're all in this together" (in the words of one interviewee), which was a missed opportunity to develop common goals and solutions. This was seen as further contributing to an adversarial situation between the Trustee and the Stakeholders. There was a very strong feeling expressed by the Stakeholders that the Trustee Board needed to be more visible.

**"The Trustee is distant."**

**"Greater investment by USS ... should be made in open and transparent communication."**

This was compounded by the fact that Stakeholders did not always feel that they were getting the full picture from the Executive and that information was being held back. Criticisms were levelled at the Executive for relying on the confidential nature of information to withhold it from the Stakeholders. This reinforces the asymmetry in relationships and leads to a sense of disempowerment among employers and members and – fundamentally – a lack of trust. For employers, consultation timelines continued to cause concern as institutions were unable to debate and discuss issues with University Boards.

It was acknowledged that there was a growing professionalisation within USS. Alongside this, views were expressed that additional resources may be required within UUK and UCU to provide the necessary challenge to the Trustee and Executive.

## TAKING COLLECTIVE RESPONSIBILITY

It is clear from the information gathered through this part of the Panel's work that the parties are quick to blame each other for failings in the valuation governance: Stakeholders blame each other; the Trustee blames the Stakeholders; the Stakeholders blame the Trustee and everyone blames TPR. In short, no one trusts each other.

It is also apparent that no one takes responsibility for the Scheme as a whole. This 'silo' approach in part reflects the Scheme Rules:

- the Trustee is responsible for governance, administration and 'pricing' the cost of benefits, which produces a value for the TPs and Future Service Rate, but not benefit design;
- the JNC is responsible for benefit design and cost sharing but not for the 'pricing' of benefits.

In other words, the Trustee is the price maker and the Stakeholders (in the form of the JNC) are the price takers. While recognising the Trustee's legal duty to set the actuarial assumptions, consideration should be given to whether this division of responsibilities is desirable or sustainable.

As we note in the previous chapter, there needs to be a recognition from all of the interested parties that they must work for and take responsibility for the whole of the Scheme and its valuation, not simply their part. They must, collectively, provide leadership to the Scheme – its members, participating employers and the wider HE sector.

**"... the current governance arrangements are in need of reform."**

Helpfully, this is recognised by the interested parties and there is a clear appetite for change.

## CONCLUSIONS AND RECOMMENDATIONS FOR CHANGE

The interviews, written submissions and evidence sessions revealed that a number of changes are needed to the Scheme's valuation governance.

The Panel notes that some of these changes will simply require changes in how and by whom information is communicated. Others will require Rule changes. However, the Panel also observes that there is a fair degree of consensus between the Stakeholders not only on the need for change but also on what needs to change and be done differently. Therefore, the Panel hopes that the interested parties can reach agreement swiftly and implement any necessary Rule changes.

### THE TRUSTEE

Taking account of all the evidence and views gathered during this research phase, it is clear to the Panel that trust in the Trustee Board is low. This assessment is reinforced by the latest USS Annual Report and Accounts[12] which shows that whilst 80% of employers rated their relationship with USS as good or very good only 31% of Scheme members rated their relationship with USS in the same way. The Panel concludes that in large measure the poor perceptions of the Trustee are because the voice of the Trustee is not heard, or at least not heard directly, by the Stakeholders. There is a strong feeling that messages are mediated though the Executive and that the Trustee is remote from the Stakeholders and, increasingly, the sector.

The Panel notes that the Trustee has undertaken some positive steps forward in response to feedback (for example, Trustee Directors attending meetings of the JNC, and the creation of the stochastic modelling group which comprises JNC and members of the USS Executive). These are welcome developments. However, it is also clear that more engagement is required from the Trustee by Stakeholders.

The Panel therefore concludes that changes in the way in which the Trustee interacts with other parts of the Scheme are required. In particular, the Trustee (specifically the Trustee Directors as the Board's decision makers) must be more visible to the JNC and the Stakeholders more generally through more regular and direct engagement. This should include regular meetings and updates with the JNC throughout the valuation process. Stakeholders have expressed a strong desire to hear directly from the Trustee Directors rather than the Executive.

The USS Limited Board has five specialist sub-committees: Governance and Nominations; Audit; Remuneration; Investment; and Policy. Unlike many other large, complex, DB schemes, USS does not have a separate funding and valuation sub-committee. This seems to the Panel to be anomalous. It would be beneficial for the Trustee to establish a funding and valuation sub-committee which could provide a greater focus and point of contact for the Stakeholders throughout the valuation. Through its chair, the sub-committee should provide regular updates

[12] *USS Annual Report and Accounts 2019*

to the JNC and Stakeholders. As noted below, it would be highly beneficial if this sub-committee were to work directly with JNC representatives (drawn from employer and member representatives) in a joint valuation forum.

### THE JNC

The consensus view from all those to whom the Panel spoke or provided evidence was that – as currently constituted – the JNC does not work well. The JEP's enquiries reveal a picture of a JNC that is not acting as an effective negotiating forum. The JEP's own workshops with the JNC identified significant frustration from both member and employer representatives that there was too little contact with the Trustee, and that the JNC was too distant from the valuation process itself. There was a feeling amongst some that the JNC was involved too late in the process. As a result, it is apparent that there is little sense of joint ownership of the result and its consequences. This contributes to the lack of trust in the Trustee. The Panel recognises that there is already significant consultation with employer representatives and that, ultimately, it is for the Trustee to set a price for the benefits. Nonetheless, whether through the JNC or otherwise (eg the joint valuation forum described below), the Panel believes that early engagement of the Stakeholders could be improved. In particular, employer views on risk appetite eventually translate into contribution rates which, in turn, have consequences for members. It is the Panel's view that more "what if" discussions at an early stage would reduce the risk of unintended consequences at later stages of the valuation.

The Panel concludes that a number of changes should be implemented to ensure that the JNC can work more effectively:

- The JNC should be properly resourced and should have recourse to its own, dedicated, resources and secretariat rather than a secretariat that is also providing services to the Trustee. In addition, the JNC should have its own budget to give it the ability to undertake its own analysis or take advice independent of the Scheme. As noted earlier, the dependence on the Executive to provide the secretariat and any analysis creates conflicts (and low levels of trust) that are no longer tenable.

- Whilst recognising that it is the Trustee's legal duty to ultimately determine the eventual assumptions, steps should be taken to involve the JNC earlier in the valuation process. A joint valuation forum should be established between the Trustee, JNC and Scheme Actuary to undertake some joint modelling of the valuation assumptions. This would help establish collective ownership of the eventual outcome. The funding and valuation sub-committee of the Board which the Panel believes should be established (see above) should interact and work closely with the joint valuation forum.

The JNC's ToR and remit should be reviewed. In this context, it would be helpful if there was greater stability in the JNC's membership to improve decision making and continuity of approach (although there is clearly, too, a risk of tenures becoming too long – a balance must be struck).

Currently under the Scheme rules the JNC Chair has a casting vote. This has been used twice in the last two years (in relation to the 2017 and 2018 valuations) because the parties had failed to reach agreement through negotiation. Moreover, it is argued that the existence of the casting vote acts as a backstop, effectively removing the pressure on Stakeholders to be forced to reach an agreement – they can, in effect, rely on the JNC Chair to do this for them via the casting vote. The use of the casting vote, which is bound to leave one party or the other dissatisfied, has, therefore, become a further cause of friction between the Stakeholders and added to the breakdown in trust between the two sides. A different approach should adopted which encourages negotiation and consensus.

Consideration should be given to changing the Scheme Rules to remove the JNC Chair's casting vote. This would then require the Stakeholders to focus on reaching agreement. To support the Stakeholders, it may be appropriate to make use of independent mediation, an approach used elsewhere in industrial relations settings. Were the parties to fail to reach agreement, the Trustee would be required to step in and impose an outcome, as now under the Scheme Rules (section 76). This, the Panel believes, would focus the Stakeholders on reaching a consensus and provide an imperative to reach a negotiated settlement with the support of external professional mediation.

Taken together, these changes should make a positive change to the way the JNC operates.

However, the fundamental criticism from many parties is that the JNC does not do what it was set up to do, namely negotiate. A number of reasons have been suggested as to why this is so. In particular, it is suggested that the JNC representatives do not arrive at meetings with a mandate from their constituent bodies that allows for a settlement to be reached. The Panel understands that the real negotiations sometimes take place outside the JNC. This, in part, is a reflection of the fact that the senior personnel in UCU and UUK (eg the UCU union general secretary and the UUK CEO) do not formally take part in the JNC. This is very different from the situation that exists in the Railways Scheme, for example, where the Panel was told that the general secretaries of the railway unions and the chief finance officers of the rail companies lead the Scheme and discussions on its future. They also serve on the Trustee Board.

A number of those interviewed and who have submitted evidence have pointed out that the JNC is a concept and institutional structure that reflects the time in which the Scheme was established. They have suggested that such a structure is not a good fit for the Scheme as it exists today. The Panel believes the involvement of the senior representatives of Stakeholders – ie the principals of UCU and UUK (or their successor bodies) – in the negotiations at an earlier stage would be beneficial. It would be likely to improve the chances of an earlier negotiated settlement as those

individuals would have the necessary mandates from their respective organisations and could bind them to negotiated outcomes. Importantly, it would also provide a forum in which some of the long-term issues and challenges facing the Scheme could be debated. This would enable all the interested parties to take a longer-term, and collective, approach to securing the sustainability of the Scheme.

The Panel concludes that consideration should be given to whether a more radical solution could be found not only for negotiations on valuations but also to ensure that members and sponsoring employers are better able to shape the future direction of the Scheme. This might have the added advantage of addressing concerns that the Scheme is becoming distant from its Stakeholders.

A separate committee (which we call the Steering Committee) could be established to table, discuss and where possible agree on long range issues affecting the Scheme as well as to negotiate and agree changes to benefits and/ or contributions arising from valuations. This Committee would need to be small enough to be effective. Crucially, however, it would need to comprise the key people on both sides for example the UCU General Secretary and Chair of UUK's EPF (or any successor bodies). The Steering Committee could be supported by a number of joint working groups comprising representatives of the Stakeholders and, where appropriate, the Trustee to feed into the Steering Committee and/ or develop ideas emanating from the Steering Committee. This could include earlier involvement in the valuation cycle, eg through the joint forum to explore modelling.

It may also be appropriate to consider changes to the Trustee Board so that at least one member of the Steering Committee is appointed to the Board of Trustees (acknowledging that any conflicts of interests would need to be managed).

### UUK

Under the Scheme rules, UUK is the body that represents employers in relation to the Scheme. It also takes the role of statutory consultee on valuation matters and is the body through which consultation with individual sponsoring employers is managed. However, the Panel notes that UUK believes that its responsibilities in relation to USS conflict with its primary function to lead cross-sector collaboration and to influence policy.

The Panel concludes there would be merit, therefore, in considering whether it is appropriate for UUK to continue as the main (or sole) employer body in relation to USS. The Panel understands that there is appetite within UUK for such consideration. It should be stressed that this is in no way a criticism of UUK staff or its Employer Pensions Forum (past or present) but rather a recognition of the core functions of UUK.

A number of options have been suggested to the Panel. One could involve a greater role for UCEA, given its core purpose is delivering effective employment and workforce strategies to support HE institutions. UCEA also negotiates on pay and pensions for other parts of the HE sector (notably the LGPS and TPS) and already works with UUK on USS issues. UCEA's link to pay bargaining could help bring together bargaining on pay and benefits, which was a desire expressed by some through the Panel's research. The Panel notes that in many other organisations pay and pensions are determined jointly as part of an overall consideration of remuneration.

Another option proposed was to build out USS Employers (USSE) which has been set up by UUK to facilitate employer engagement with the valuation. It is currently partly funded by a special levy paid by sponsoring employers to meet the additional costs of dealing with the valuation and is supported by UUK. There could be scope to develop this body further (possibly jointly with UCEA) and make it a standalone body rather than part of UUK as now.

The final form of employer representation will, of course, be a matter for USS's participating employers to determine together. The Panel understands that these issues are already being addressed by UUK in a working group that is investigating the best structure to facilitate employer involvement and engagement in the Scheme, and the Panel welcomes this initiative.

### UCU

Under the Scheme Rules, UCU is the body that represents Scheme members. Given the Panel's recommended changes, including the need for members' views and their attitudes to risk to be taken into account, it will be important that UCU considers its wider role in relation to total Scheme membership so that it can demonstrate it can speak for all sections of the membership, including potential members.

This will also help to counter current criticism that UCU is not representative of the views of Scheme members as a whole. The Panel notes that the union does invite non-members to meetings and briefings about the Scheme held at institutions, for example. And, as the qualitative research amongst members and non-members demonstrates, the information UCU provides is valued and trusted by union and non-union members alike (see chapter 9). The Panel recognises that only rarely will a union have a 100% membership amongst pension scheme members and that there are practical difficulties for UCU in directly contacting members (it cannot have the names and addresses of all Scheme members).

Additionally, it is possible that all sides will wish to make changes to the Scheme in the future, particularly to provide flexibility for its increasingly diverse membership.

While the Panel notes that UCU currently has no role as a statutory consultee in the valuation process, nevertheless everyone would gain if UCU took steps to demonstrate that it is taking account of the views of USS members as a whole and not just UCU members. This will be especially important in light of the Panel's recommendation (see chapter 8) that members' attitude to risk should be considered as part of the valuation process.

UCU's role in the Scheme will be strengthened if it can build confidence that the views and position of all Scheme members are being well represented.

It is possible that all sides will wish to make changes to the Scheme in the future, particularly to provide flexibility for its increasingly diverse membership. UCU should have mechanisms in place to ensure and demonstrate it can reflect the views of all Scheme members and potential members.

## NEXT STEPS

Taken together the Panel believes these changes will:

- improve levels of trust between the interested parties; and
- facilitate the operation of the Shared Valuation Principles.

The Panel believes that agreeing these governance changes and the Shared Valuation Principles as outlined in the previous chapter should be a priority. They are a prerequisite to agreeing any of the wider changes in this report, including consideration of alternative paths to the valuation.

Achieving this outcome will require the interested parties to:

- start by agreeing the long-term purpose, vision and mission of the Scheme;
- go on to look at the roles and responsibilities of the parties to the Scheme (and whether the current parties are the right parties); and
- consider the appropriate structures (along with any Rule Changes) to enable the delivery of the valuation within the Shared Valuation Principles set out in chapter 6.

It will be essential for all the parties to move quickly to take forward these recommendations to improve the Scheme's valuation governance. In light of the work already underway on the 2020 valuation, the Panel urges the Trustee and TPR to factor in the governance reforms in the 2020 valuation timetable. The investment of time and effort by all parties in the early stages of the valuation process should enable the latter stages to move forward more rapidly – and smoothly.

# 8. ALTERNATIVE PATHS TO THE VALUATION

## SUMMARY

1. The Panel received a number of submissions that suggested a variety of ways of valuing the Scheme's liabilities and is mindful of the Trustee's fiduciary responsibilities and regulatory requirements.
2. The current valuation approach is overly restrictive and, when applied mechanistically within the Stakeholders' current risk appetite, denies the Trustee flexibilities in its choice of investment strategy. This does not appear appropriate for an open, strong, Scheme such as USS, with a very successful investment strategy. The Panel believes the introduction of the new DB funding code is an opportunity for USS to develop a simpler valuation methodology that reflects the Scheme's liability profile and the strengths of the sector.
3. The Panel is of the view that a simpler and more appropriate valuation methodology that is fair between age cohorts of members, and reflects the Scheme's demographics, cashflows and covenant is possible. If the interested parties could coalesce around a new way of thinking about rewarded risk (as the Panel would encourage) and slightly higher risk appetite, then there could be a number of alternative pathways to the valuation.
4. The starting point for a new valuation methodology should be the acknowledgement of the purpose of the Scheme and founded on a re-articulation of the Trustee's and employers' risk appetites and a recognition that the risk appetite of members needs to be reflected within the valuation process. This should be done on the basis of a clear understanding of the trade-offs of the risks and return. This will require the Trustee to work with Stakeholders to understand the point of overlap between all three attitudes to risk and ensure that it is monitoring all of the risks. This task should fall to the joint Trustee-JNC valuation forum described in the previous chapter. The Panel also acknowledges there is a wide range of employer and member risk appetites which the joint valuation forum will need to consider. A major contribution for the forum will be to avoid a drift to the lowest common denominator of risk. The Panel does not underestimate the challenge, but we believe the investment of time and effort will lay the foundations for delivering the sustainability of the Scheme over the longer term.
5. The Panel considers that there is considerable merit in investigating introducing a dual discount rate approach which could better reflect the profile of the Scheme while satisfying a desire to secure benefits as the Scheme matures. This will allow the common purpose which the Panel urges the Stakeholders and Trustee to adopt to be turned into a practical set of numbers with which they could have a mature discussion about risk appetite, investment strategy, benefits and contributions. This, in turn, will allow the long-term needs of members, sponsoring employers and the sector to be addressed. In light of the need to complete the 2020 valuation, the Panel strongly encourages UCU, UUK to work urgently with the Trustee (and – together – to engage with TPR) to commence this work and for these discussions to be factored into the timetable for the 2020 valuation.

In Phase 1 of its work, the Panel undertook a comprehensive review of the approach to the valuation and the valuation methodology adopted by USS in 2017, in particular Test 1. In this chapter, the Panel revisits its conclusions, examines changes in the regulatory environment and explores alternative approaches that could be adopted in future valuations.

Test 1 was central to the 2017 valuation and drove the valuation of TPs and the deficit. It also played an important role in exploring and shaping the employers' attitude to risk through the measure of future reliance on the employer covenant. The same approach to the valuation was adopted in the 2018 valuation.

The Panel has sought to derive (explicitly or by inference) the respective risk appetite of the Trustee, sponsoring employers and members from statements and actions surrounding the 2017 and 2018 valuations. Within the context of an open scheme with strong covenant the Panel could not identify any circumstances in which it believed that Test 1 should be the primary driver of funding and investment strategy. It is also the Panel`s view that unless the parties can coalesce around a different, and broader, shared, appetite for risk there is no alternative pathway to a sustainable valuation approach.

However, the Panel also believes that if there could be such a coalescing (and the Panel encourages such a coalescing) within which slightly higher risk appetites could be agreed then there could be a number of alternative pathways to the valuation.

The Panel believes that a simpler and more appropriate valuation methodology is possible that:

- satisfies the risk appetites of members and employers and can be understood by them;
- is fair as between age cohorts of Scheme members;
- provides a more consistent approach between valuations;
- reflects the Scheme's demographics, cash-flows and covenant; and
- meets statutory requirements.

## FUTURE VALUATIONS

As part of its work to consider how to secure the long-term sustainability of the Scheme the Panel was tasked with exploring the different paths to the valuation of TPs and other aspects of the valuation methodology, including Test 1. This chapter explores:

- the evolving regulatory environment as it affects valuations;
- the options put forward by individuals and organisations in submissions to the Panel; and
- how a new path to thinking about risks and valuations could be championed by UUK and UCU and developed in conjunction with USS.

## TPR POWERS AND LONG-TERM FUNDING TARGETS

Since the Panel's first report, one of the significant developments that will affect future valuations is the proposal for DB schemes to develop Long-Term Funding Targets (LTFTs, now described as a Long-Term Objective, LTO) over and above the statutory funding objective for the scheme[13]. The move to require schemes to have a LTO derives from a Government commitment to protect members of DB schemes, as set out in its consultation *Security and Sustainability in Defined Benefit Schemes*[14] and its subsequent White Paper *Protecting Defined Benefit Pension Schemes*[15]. The main policy drivers were concerns over growing deficits and corporate collapses, such as BHS and Tata Steel, and the impact on DB schemes, their members and the Pension Protection Fund (PPF).

The proposal forms part of a package of measures designed to "*strengthen the Regulator's ability to enforce Defined Benefit scheme funding standards, through a revised Code, focussing on:*

a. *how prudence is demonstrated when assessing scheme liabilities;*
b. *what factors are appropriate when considering recovery plans; and*
c. *ensuring a long-term view is considered when setting the statutory funding objective."*[16]

In the White Paper, the Government sets out its proposals for requiring trustees of DB schemes, particularly those with a weak employer covenant and a weak funding position, to go beyond their existing requirements to meet the statutory funding objective. It states that schemes should look to the longer term and, where appropriate, set a long-term objective for the funding of the scheme. In effect, this will require some schemes to target a funding ratio in excess of the current statutory (TP) level and to set contributions and an investment strategy to deliver that target, thereby reducing the probability of any future deficit and the reliance on the employer to fund it.

The White Paper focuses on the risks to which mature and closed schemes are exposed, in particular where timescales for recovering from any deficit may be shortened due to the cash calls on the scheme. USS is neither a mature (cash-flow negative) scheme nor closed. It has a strong employer covenant and is cash-flow positive for the foreseeable future. An excerpt (below) from the White Paper explores the options for long-term objectives, only the first of which is relevant to the USS:

[13] The statutory funding objective is that the scheme should have sufficient assets to meet the scheme's liabilities as measured by the technical provisions

[14] DWP, February 2017, Security and Sustainability in Defined Benefit Pension Schemes

[15] DWP, March 2018, Protecting Defined Benefit Schemes

[16] DWP, March 2018, Protecting Defined Benefit Schemes

**Figure 8: Excerpt from Government White Paper**

99. Examples of a suitable long-term objective could be to:
- run-on with employer support (for open schemes);
- reach self-sufficiency with low-risk investment strategy and run-off with minimal call on the sponsor employer;
- buy-out by a set time; or
- enter a consolidator vehicle within an agreed timeframe.

At the time of writing this report, the Pension Schemes Bill 2019-2020 was delayed due to the General Election. The Bill included provision for trustees of DB schemes to determine a Long term Objective (LTO) which would set out the level of funding at future dates and the investments that will be held.

In its 2019 annual funding statement[17], TPR anticipated that a new DB funding code would be consulted on in 2019 and set out its early thoughts on long term funding targets. The Panel understands that the consultation exercise may now be expected in early 2020.

TPR has expressed the view that all schemes will operate some form of LTO and that schemes should target a funding level in excess of TPs with an investment strategy that provides the scheme with resilience.

> *"Successfully run schemes often have a long-term strategy agreed by trustees and employers that includes a long-term funding target. This target is the level of funding the scheme will need to achieve in order to reduce its dependence on the employer and particularly when it has reached an appropriate level of maturity. This will then allow it to be managed with a high degree of resilience to investment risks.*
>
> *Since the majority of schemes are closed to new members, TPR expects scheme maturity issues to assume greater significance for setting funding and investment strategies in the future."*[18]
>
> *"Investment and funding strategies in the interim period are then aligned to the LTFT via journey plans which look beyond becoming fully funded on a TPs basis, to becoming fully funded up to the LTFT. This is consistent with our guidance on IRM"*[19]

[17] Annual funding statement 2019 for defined benefit pension schemes, TPR, March 2019
[18] Press release, TPR, March 2019
[19] Annual funding statement 2019 for defined benefit pension schemes, TPR, March 2019

The Panel has considered whether it is appropriate for a scheme such as USS to have a LTO that goes beyond TPs. If the legal requirement is for the scheme to be fully funded on a TPs basis, then that could be the target for USS.

USS could adopt a LTO more closely related to the opportunities provided by the size and maturity of the Scheme and how this is reasonably expected to evolve over time. The Panel suggests that the Scheme adopts a measure for TPs which automatically evolves into its LTO as the Scheme matures.

In considering TPs in a way which is better linked to a LTO for USS the Panel has been mindful that:

- the benefits of those in and close to retirement should be as secure as possible; while
- allowing for opportunities for investment in longer term return-seeking assets for those some way from retirement.

Taking these factors into account, the Panel has considered what a LTO for USS might look like. At one extreme, USS could continue to target self-sufficiency with an adjustment made for the reliance on employers (as implied by Test 1) but the Panel feels that this would be inappropriate for an open scheme, as we explained in our first report. At the other extreme, USS could value TPs using a higher, but still prudent, discount rate reflecting return-seeking assets. The Panel is of the view that, given the open nature of the Scheme, an appropriate balance would be one which employs a cautious and low-risk discount rate approach to the years of retirement and allows for higher rate for the pre-retirement years.

Whist acknowledging that any definition would need to take account of TPR's guidance on the LTO, expected to be published early in 2020, one suggestion for the framing of the USS long-term funding objective might be:

**Figure 9: Example of long-term funding objective for USS**

"USS aims to be fully funded on a technical provisions basis where technical provisions are valued on a low risk self-sufficiency basis for post-retirement years and on a prudent on-going basis for the pre-retirement years. The Scheme will also ensure that, at all times, the proximity to full self-sufficiency assessed on a low risk basis can be supported by employers over an appropriate time frame if the Scheme were to be closed to future accruals."

It is the view of the Panel that USS, its employers and the members should agree a new LTO that recognises that the Scheme can stay open and has a strong employer covenant.

## SUBMISSIONS TO THE PANEL

Several individuals and organisations responded to the Panel's call for submissions on the subject of alternative technical paths to the valuation. In summary, the submissions focused on a small number of connected subjects, many of which were reflected on by the Panel in its first report:

- USS's risk appetite and the assessment of the employer risk appetite;
- USS's investment strategy;
- Test 1 and the role of self-sufficiency in both the short and longer term;
- inadequate analysis of potential outcomes from the valuation and misinterpretation of modelling outputs; and
- the use of overly prudent assumptions in the calculation of future service rates.

***The following section summarises the views of the people and organisations who submitted written evidence to the Panel on the question of the valuation. They do not necessarily reflect the views of the Panel. They are, however, symptomatic of the level of distrust and dissatisfaction with the status quo.***

The most common comments centred on what is perceived by many to be an overly prudent attitude to risk on the part of the Trustee and the way that was translated into the investment strategy and valuation. The Trustee risk appetite is seen to be based in part on an inappropriate assessment of employers' risk capacity and in part upon a failure to recognise the consequences and true risks and costs of moving to a lower risk investment strategy. Several respondents re-stated the views expressed during the Panel's first phase of work that, with the Scheme being relatively immature, cash-flow positive and having a strong employer covenant, investing in return-seeking assets is a more appropriate strategy for the Scheme than de-risking. This in turn would imply a higher discount rate, thereby reducing the current value of the liabilities and, potentially, yielding a surplus either now or in the near term. Some also pointed to the risks and consequences of investing in expensive assets that are yielding negative real returns. A small minority of respondents from outside the sector said they thought the Scheme was taking too much investment risk.

Some respondents modelled the outcomes for the Scheme if no de-risking took take place during the next 20 years. Their modelling suggested that, at the level of prudence applied by USS, the 67$^{th}$ percentile, a return-seeking portfolio could potentially reduce or eliminate any deficit when compared to a de-risked portfolio. Others argued for employing an internal rate of return (IRR) based upon the return from equities, property and bonds which they modelled as delivering a lower contribution rate and a smoother pattern of funding than the approach adopted by USS.

Respondents also argued that Test 1, which drives the move to de-risking, while useful, is an inappropriate test to shape the valuation of an open scheme. In particular, some also argued that the assumption in the test that the portfolio is de-risked at year 20, rather than a gradual de-risking

from year 20, added to the problems embedded in Test 1. However, some recognised that to reject Test 1 and the consequent de-risking would require USS to continue to argue strongly against TPR's assertion that the current level of risk to which the Scheme is exposed is at the upper end of what they would expect. Moreover, it would require USS to adopt a different risk appetite, a move which would trigger interest from TPR.

A further argument against Test 1 put forward by those responding to the call for evidence rested with the measure of reliance on employers being the difference between the self-sufficiency measure of liabilities and the TPs rather than the gap between the self-sufficiency liabilities and the assets of the Scheme. Adopting this latter approach has been shown by a respondent to reveal a much lower level of reliance at year 20 were assets not de-risked than if they were (£2.8bn rather than £10bn) and a significant surplus on a TP basis. Implicit in many of the responses was the view that a new approach is needed to establish the employers' risk appetite with a new framework required to assess and confirm the risks facing employers and members.

Some respondents have maintained that the short term volatility evident in today's market means that it is inappropriate to make critical decisions based upon a value at a particular date and that mechanisms, such as smoothing or the use of averages, are needed to even-out results and avoid sudden leaps in deficits (or surpluses) and contribution rates. Others suggested that USS places too much importance on short-term volatility in prices, when the position of the scheme does not require the sale of assets to pay pension promises. Some charged USS with a failure to consider the positive on-going cashflow situation of the fund and the ability to hold assets in the fund in near perpetuity, paying benefits from contributions and income from investments. They also argue that since the need to move to self-sufficiency in the short term is unnecessary and inappropriate, its measurement is also inappropriate. Some questioned USS's focus on short-term reliance and short-term deficit monitoring. Some felt that short term reliance, if measured at all, should be measured using the Scheme's cashflow projections rather than self-sufficiency. Only if the cash-flow position of the Scheme changed from positive to negative should short-term changes be necessary.

Another assertion made by respondents was that the use of excessively prudent assumptions to estimate future service contribution rates has led to higher than necessary costs in the short term. This was believed to have exacerbated employer and member distrust and to have led to charging more for accrual than is necessary were a longer-term view and less prudent assumptions employed.

## ALTERNATIVE PATHS

The Panel is sympathetic to many of the views expressed by those responding to the call for submissions. However, it recognises that not all of the feedback takes full account of the responsibilities of the Trustee or of the DB funding code and requirements of TPR.

It is the Panel's view that the first step towards developing a new approach to the valuation must begin with an agreement about the purpose of USS and a set of Shared Valuation Principles. These issues were explored in detail in chapter 6. While a key part of the Shared Valuation Principles should be an acknowledgement of the fiduciary responsibility of the Trustee and the regulatory environment in which the valuation is taking place, nonetheless it will be critical for all interested parties – employers, members, the Trustee and the JNC – to be involved in the development of a new valuation approach.

The key issues that need to be addressed in developing a new approach include:

- a re-articulation of the employer and Trustee risk appetites and the development of a statement of members' risk appetites – including an assessment and understanding of how the trade-offs will affect outcomes – that will frame USS's approach to future valuations;
- an approach that reflects rather than drives the Scheme's investment strategy; and
- replacement of Test 1 with new tests that are simpler to communicate, take account of the need for a new LTO, allow for the unique nature of the Scheme and the buy-in of the sector.

### ARTICULATING RISK APPETITES

*Trustee risk appetite*

The Trustee has a detailed and comprehensive approach to risk management, as set out in a number of published documents. For the purposes of funding and securing member benefits, the most important risks are deemed to be the risk that fulfilling the employer covenant will require higher contributions than employers are prepared or able to pay. In extremis, this is particularly relevant if the Scheme closed to all future accrual and all contributions were to fall to the employers. Other risks are also relevant such as the risk of poorer than expected investment performance as well as a number of strategic risks related to the sector and the Scheme's relationships with its Stakeholders.

Earlier in this report we stressed the importance of all parties reaching an understanding of the concept of sustainability which, in the Panel's view, should include a reference to different generations of members. To the extent that the parties can accept this broader view of sustainability it is the Panel's view that the Trustee's current approach to risk is overly prudent given the nature of the Scheme, in particular its demographic and cash-flow profile, its mutual status and the longevity of the sector. Its appetite also appears to have been heavily influenced by the status of other DB schemes, TPR's view (which is the opposite to that of the Trustee, ie that the Trustee's risk appetite is at the upper end of the Regulator's risk tolerance) and a very specific, and imperfect measure of employers' risk appetite. The Panel encourages the Trustee to view the Scheme and its risk appetite through a different lens; one where the funding and investment strategies are aligned to the core purpose of the Scheme.

The Panel believes that it is appropriate for the Trustee's approach to risk in the Scheme to focus on there being not enough money in the Scheme to pay pensions on an on-going basis. However, the

Panel also believes that the Trustee is overly concerned about short-term TP funding and self-sufficiency rather than long-term sustainability and affordability. The more that the short-term becomes the focus and the monitored gap in funding is published, concerns about the sustainability of the Scheme become heightened beyond where is necessary. While short-term movements in interest rates or investment returns are important to monitor, and a triennial valuation and funding of any gap necessary, it is the 30 to 40-year outcomes that matter more since USS is not in a position of having to sell assets in poor conditions.

It would also be appropriate for the Trustees to articulate, measure and monitor their risk appetite for the reliance on the employers who might be called on as a 'last man standing' should the Scheme prove unsustainable. While such an outcome is undesirable, such a statement might be helpful in reassuring employers and ensure that this tail risk is better understood.

*Employer risk appetite*

The Trustee is rightly concerned about the ability to pay contributions in the situation where the Scheme is closed to future accrual. Employers also are right to consider how they would fund the Scheme should it close. However, consideration of the implications of Scheme closure should not drive the approach to valuation. Instead, the valuation can provide information about this how this tail risk outcome can be managed.

The Panel does not believe that it is necessary to attach a precise number to the employers' risk appetite. It would rather be better for employers to arrive at a view of the range of risks to which they are exposed through the Scheme, including the risk of industrial action and members or employers leaving the Scheme, and to monitor the capacity to absorb these risks.

As several submissions to the Panel pointed out, the calculation of reliance or the measure of the employers' risk appetite could be expressed in a number of different ways as one or more of:

- the difference between assets and the self-sufficiency measure of liabilities today and in the future;
- a measure based on the probability of additional calls on the employer/ higher contribution rates; and
- an explicit acknowledgement of the ability of employers to fund the deficit on a self-sufficiency basis, should the Scheme need to be closed.

This will need to allow for engagement with sponsoring employers as to how that additional risk would be supported, in a framework with which TPR would be comfortable.

*Members' risk appetite*

In addition to the Trustee and employers' risk appetites, the Panel considers it essential that work be undertaken to establish the members' risk (and eligible members') appetite – particularly active members affected by the cost sharing agreement. While securing members' pensions, particularly

those in and close to retirement, is important, so too is delivering pensions that are value for money for active members.

Once all three risk appetites have been calibrated and articulated, the Trustee should work with employers and members to understand the point of overlap among the three statements and ensure that it is monitoring all of the risks. We propose this task should fall to the joint Trustee-JNC valuation forum described in the previous chapter The Panel also acknowledges there is a wide range of employer and member risk appetites (as we have described in chapters 9 and 10) which the valuation forum will need to consider. A major contribution for the forum would be to avoid a drift to the lowest common denominator of risk.

The Panel does not underestimate the challenges in articulating, calibrating and reconciling these risk appetites (and assessing how the trade-offs in risk and return will affect outcomes) but we believe the investment of time and effort will lay the foundations for delivering the sustainability of the Scheme over the longer term.

The Panel considered a number of different alternative paths to the valuation, in particular:

- Alternative Path 1 – invest heavily in return seeking assets and use a higher discount rate and risk appetite.
- Alternative Path 2 – introduce benefit flexibility to the Scheme which would serve to reduce the value of liabilities and help to move the Scheme towards an improved funding position.
- Alternative Path 3 – splitting the valuation into two components where pre-retirement years are subject to a different treatment to post-retirement years.

*Alternative Path 1*

While attractive in terms of its implications for lower contribution rates and the potential for reaching a fully funded TP basis sooner than the current basis, this alternative also introduces greater volatility and risk than the Trustee and TPR are likely to find acceptable. It could also lead to much higher contribution rates, should the assumed higher discount rate not be achieved.

*Alternative Path 2*

It has been suggested that to reach a point where levels of risk and contribution rates are acceptable to all parties, it could be necessary to allow flexibility in benefits. A range of possible alternative means by which active members could share the risk could be explored, recognising that contribution levels may already be deterring some potential members from joining.

Although the Panel's ToR did not extend to benefit design, the Panel sought to understand the cost of guaranteed indexation of pensions in payment on future accruals. With no changes to benefits accrued to date (ie all benefits accrued to date would continue to be increased each year in line with the current Scheme Rules) but with no increase applied to pensions relating to benefits accrued

over the next 20 years, AON estimated[20] that USS self-sufficiency liabilities could be around 17% lower than under the existing rules. Applying just statutory increases to newly accrued benefits could reduce the self-sufficiency liabilities by around 5% in 2037 compared to the current rules on increases. These positions would also imply a better funding ratio (assuming no reduction in contributions) and could lead to greater flexibility in contributions and/or discretionary increases to pensions.

Clearly this would not only be a major change to the benefits offered under the Scheme but could also further undermine member confidence in the Scheme. As noted in the following chapter, members consider inflation protection as one of the most important aspects of a pension.

Such a move would require changes in legislation to allow the Scheme to remove guaranteed indexation of pensions in payment beyond statutory indexation. Although previous Governments have moved towards a position of legislating for greater flexibility through Collective Defined Contribution schemes (eg for Royal Mail), it is by no means certain that flexibility will be extended to all DB schemes.

*Alternative Path 3*

In seeking to find a middle ground between the starting point of self-sufficiency and a less cautious approach of employing a higher discount rate with an implied higher growth investment strategy, the Panel has explored the option of using a dual discount rate for the valuation of TPs. The Panel understands that the use of dual discount rates is not uncommon and that up to 50% of DB schemes currently use this approach.

This approach would be to split the valuation into two components: the discount rate applied during retirement years and the discount rate applied during the years pre-retirement. The former could be valued on the basis of a low risk portfolio that has a high probability of securing the benefits while the latter could be valued on the basis of a return-seeking portfolio.

This dual discount rate is best explained through examples based on types of member (all examples below assume benefits are paid to age 84 with a retirement age of 66):

[20] Approximate calculations based on calculations provided at 31 March 2017 by USS to the JEP for the first JEP report. Here, they estimated the self-sufficiency liabilities to reduce from £82bn to £81bn (in real terms) over 20 years. AON adjusted approximately these calculations to arrive at the 17% and 5% estimates, with First Actuarial confirming they would estimate a similar impact.

### Figure 10: Examples of applying a dual discount rate to liabilities

**Member 1** has just joined the scheme and benefits will not be paid for 41 years. The discount rate applied to accrued benefits is the higher rate for 41 years and then the lower rate for the years in retirement. Approximately 71% of the years attract a higher discount rate.

**Member 2** is 6 years from retirement. The higher discount rate will be applied to future benefits for 6 years and then the lower rate for the retirement years. Approximately 29% of the years will attract the higher rate.

**Member 3** is already retired with benefits in payment. The discount rate applied to all accrued benefits is the lower of the two rates, reflecting the low-risk portfolio designed to deliver close to self-sufficiency.




Once aggregated, the Single Effective Discount Rate (SEDR) would change automatically according to the maturity of the Scheme over time. In the short term as the Scheme continues to attract new members and accruals, the discount rate would be weighted towards the higher rate. However, should the Scheme ever mature due to shrinkage in the sector, or other reasons, the emphasis would shift towards the lower discount rate.

Having determined the discount rates, it would then be a separate decision as to how Scheme assets are actually invested. An investment strategy which matches the assumed discount rates would reduce expected valuation volatility, but there may be better ways of guarding against this outcome or minimising its impact while taking advantage of the USS team's ability to deliver good investment returns.

In this way, it becomes clear that in the post-retirement period, assets more closely match the liabilities while the opportunities for investment growth are maximised and facilitated by exploiting the long time horizon of those in the pre-retirement phase. This should not only produce a more robust and stable result in terms of measuring the liabilities and calculating contribution rates but also provide a simpler basis for communicating the methodology to sponsoring employers and members. An approach such as this would enable the Scheme to convey to employers, members and TPR the messages that:

- the post-retirement years are valued and secured against a low-risk portfolio that will have a very high probability of being able to pay out with no further call on employers while;
- the benefits of those further from retirement are backed by a valuation method that allows for returns over the longer term that a higher risk portfolio can generate[21].

[21] The Panel notes that the Scheme does not have a hierarchy of security of benefits promised

By contrast with the current valuation methodology, the new model for valuation would not involve any back-solving for technical provisions; all calculations would be forward looking. The Panel would also encourage USS to consider a different approach to the discount rate used to value liabilities in each of these two segments. Currently the Trustee employs a time-dependent discount rate, ie one that varies year by year. The Panel believes, as part of a move to a simpler approach to the valuation, employers and members would be better served by the adoption of an average rate (or average rates if a dual-discount rate is adopted) that is calculated over longer periods. For example, there could be one figure for the next 20 years and another beyond 20 years. This would provide for greater clarity of what assumptions are being made; greater consistency of contribution rates; and a longer-term perspective on the appropriate rate.

The valuation basis proposed here would need to automatically reflect the changing demographics of the Scheme as it matures over time. When, or if, the Scheme begins to mature, the overall funding target would be expected to be relying less on rewarded investment risk and employer covenant. The pace of that shift will depend in part upon the health of the sector and in turn the demographics and the proportion of the members remaining opted into the Scheme.

In considering the impact of a dual discount rate, the Panel was agnostic as to the outcome on TPs and whether it would result in a higher or lower deficit or higher or lower contribution levels. Rather, the Panel was motivated to identify an outcome that is better suited to the key features of the Scheme and which would evolve naturally as the Scheme evolves and matures.

It is the Panel's view that this approach has far fewer moving parts than the current methodology and as a result is easier to explain and provides a better platform on which to rebuild confidence. Whilst there will remain plenty of opportunity for debate around the key assumptions, it will be much easier for Stakeholders to see the extent to the approach remains consistent from one valuation to another.

The Panel was interested to examine the potential effects of adopting a dual discount rate and therefore asked USS to model a number of discount rate structures[22]. In arriving at these examples, the Panel did not propose these as appropriate levels, but rather sought to provide illustrative outcomes. Other discount rates or rate structures could be used which would produce difference outcomes and would need to reflect views on conditions and future returns. The results below should therefore be regarded as a first exploratory step.

[22] It should be noted that the Panel asked USS to model the data using Gilts+ rather than CPI+, the Trustee's default

The three discount rate structures were:

1. Gilts + 2.5% applied to pre-retirement years, gilts +0.75% post-retirement years (a combination of rates that produces results that are close to those for the 2018 valuation);
2. Gilts + 3.0% pre-retirement, gilts +0.75% post-retirement; and
3. Gilts +3.5% pre-retirement, gilts +0.75 post retirement.

The intention of the rates selected were that benefits in retirement are valued on the basis of a low-risk portfolio that has a high probability of being able to meet the benefits promised, but benefits in the pre-retirement stage can take account of the opportunities for investment growth facilitated by the longer time horizon of those in the pre-retirement phase, the Scheme's positive cashflow and the strength of the covenant.

The Panel is keen to emphasise that, whilst this approach can be used to identify the amount of assets which would be needed to back the post-retirement liabilities within a low risk approach, the actual choice of investment strategy and discount rate will be for the Trustee to decide after appropriate consultation and consideration of the relevant risk appetites.

The results of the USS modelling are presented below. A full explanation of the USS analysis and assumptions used is set out in Annex 8.

In interpreting the table, the Panel makes the following cautionary remarks:

- The numbers are all as at 31 March 2018. Market conditions have changed significantly since then so the numbers give, at best, a partial guide to the impact of adopting a dual discount rate as at 31 March 2020. They should not be taken as an indication of the potential outcomes of the 2017 or 2018 valuations.

- The material impact of varying the assumptions about CPI are just one indication of the additional work that would be required before definitive conclusions could be drawn.

- USS was not asked to give any opinion of what, if any, investment strategy could be appropriately linked to the discount rates. The Panel has not sought to infer any particular investment strategy, the different assumptions are merely intended to illustrate the sensitivities of changing the discount rates.

**Figure 11: Estimated valuation results based on adopting the requested discount rate structures, with the 2018 valuation for comparison**

| Discount rate structure | Indexation* | TPs | | | Future service cost (NPA 65) | "Gilts +" single equivalent discount rates ** |
|---|---|---|---|---|---|---|
| | | Non-pensioner | Pensioner | Total | | |
| **As per 2018 valuation** | TP CPI | £40.7bn | £26.6bn | £67.3bn | 28.8% | 1.33% |
| **G+2.5%** | TP CPI | £39.6bn | £27.5bn | £67.1bn | 27.4% | 1.35% |
| **G+0.75%** | SS CPI | £42.4bn | £29.1bn | £75.1bn | 29.3% | 1.34% |
| **G+3.0%** | TP CPI | £37.6bn | £27.5bn | £65.1bn | 25.5% | 1.51% |
| **G+0.75%** | SS CPI | £40.3bn | £29.1bn | £69.4bn | 27.3% | 1.49% |
| **G+3.5%** | TP CPI | £35.7bn | £27.5bn | £63.2bn | 23.8% | 1.66% |
| **G+0.75%** | SS CPI | £38.3bn | £29.1bn | £67.4bn | 25.4% | 1.64% |

** here, 'TP CPI' is breakeven inflation less 130bps, and 'SS CPI' is breakeven inflation less 80 bps applied to post retirement only, pre-retirement CPI is breakeven inflation less 130bps.*

*** calculated on past service liability equivalent basis as at 31 March 2018.*

*The future service costs include allowance for DC benefits and expenses consistent with the 2018 valuation.*

Although the discount rates used have been expressed as Gilts+, the Panel believes that there is considerable benefit in representing them as CPI+ for the pre-retirement years. This would have the benefits of:

- aligning the discount rate more closely to the growth in assets for this part of the portfolio;
- aligning it more closely to the growth in the liabilities of the Scheme; and
- making it considerably easier for Stakeholders to understand.

Notwithstanding the cautionary notes set out immediately prior to

Figure 11, the Panel believes that the results give practical support to their view that the concept of a dual discount rate is an alternative approach which is worth the Trustee and the Stakeholders exploring for the following reasons:

- The fact that a discount rate of G+2.5% for pre-retirement liabilities gives the same TPs as the Trustee's current approach shows that the Trustee's current approach and the dual discount approach can be relatively easily translated from one to the other.

- A pre-retirement discount rate of G+2.5% can therefore be regarded as having broadly the same amount of prudence as the Trustee's current approach.

- The corresponding single equivalent discount rate (SEDR) of G+1.33% lies at, or slightly below, the Upper Quartile of SEDRs in TPR's Scheme Funding Analysis[23] for Tranche 12 valuations, suggesting that such an approach would not be an outlier.

- Irrespective of the choice of CPI assumptions, the SEDR of circa G+1.5% associated with a pre-retirement rate of G+3% would only be marginally above the Upper Quartile and therefore within the envelope of assumptions in use within UK schemes at the time (the 95$^{th}$ percentile was a SEDR of over G+2%). It would seem to the Panel, therefore, that there may be some scope to ease the assumptions within the envelope currently deemed acceptable by TPR.

- Other than where the CPI assumption was set at the self-sufficiency level for both pre- and post-retirement service, the future rate decreases. This suggests to the Panel that there is at least scope to reflect better the actual circumstances of the Scheme and to improve intergenerational equity without any loss of prudence.

- The Panel also notes that if a pre-retirement discount rate of G+3.0% is adopted along with the CPI assumption which the Trustee currently uses for TPs there is some reduction in the deficit. In combination with a lower future service rate this may provide an opportunity to consider maintaining a greater element of investment risk and/ or building a buffer against future adverse experience.

- The Panel does not express a view on whether a higher pre-retirement discount rate would be appropriate, but strongly encourages the Trustee to explore what amended combination of risk appetites and associated investment strategies might permit such a move.

- If some movement in pre-retirement discount rate could be agreed (assuming it has not been entirely off-set by changes in market conditions since the 2018 valuation) this may

[23] Scheme Funding Analysis, TPR, 2019

create sufficient space for discussion to take place around the combination of funding, investment and benefits which would best meet the members' and the sector's needs for the long-term.

In light of these potential advantages, the Panel strongly urges the Stakeholders and Trustee to work together to actively consider the approach presented by the Panel.

### OTHER MEASURES

The Panel believes that it is appropriate to continue to calculate the liabilities on a self-sufficiency basis in order to monitor the implications for employers should the Scheme close to all future accrual. The Trustee and employers should jointly assess their appetite for risk in relation to the gap between this measure and the value of the liabilities calculated on the basis above (or another new measure). In communicating the self-sufficiency basis, it needs to be made clear to employers that the gap will only need to be filled should the Scheme close. Members and employers should be reassured that the new valuation methodology is explicit in assuming that the Scheme stays open.

## CONCLUSIONS

The Panel's ToR required it to explore alternative pathways to the valuation. In doing so the Panel has sought an approach which:

- is appropriate to the open, cashflow-positive, long-term, well supported nature of the Scheme and which can evolve as the Scheme evolves;
- offers some element of intergenerational fairness;
- is sufficiently simple and intuitive as to contribute to Stakeholders' confidence in the Scheme; and
- is compliant with the Trustee's fiduciary duty and the emerging regulatory framework of the LTO.

The Panel believes the dual discount approach will allow the common purpose which the Panel urges the Stakeholders and the Trustee to adopt to be turned into a practical set of numbers with which the Stakeholders and the Trustee could have a mature discussion about risk appetite, investment strategy, benefits and contributions. This in turn will allow the long-term needs of the members, sponsoring employers and the sector can be addressed.

In light of the need to complete the 2020 actuarial valuation, the Panel strongly encourages UCU and UUK to work urgently with the Trustee (and – together – engage TPR) to commence this work and for these discussions to be factored into the timetable for the 2020 valuation.

# 9. MEETING THE NEEDS OF MEMBERS

SUMMARY

1. The research commissioned by the Panel from Ignition House revealed differences in attitudes towards the Scheme and pensions saving between faculty and non-faculty respondents and between younger and older respondents. The Scheme members participating in the research valued the Scheme and its benefits, and for many it has been an important reason for remaining in the sector. However, it was clear that there were poor levels of trust in the Scheme and concern for its future.
2. The cost of contributions was a major concern for younger members and non-members and the main reason for deciding to opt out of, or not join, the Scheme. Opt-out levels for USS stand at 15% – considerably higher than the national average, and a cause of concern given the purpose of the Scheme.
3. Respondents voiced concerns over the 'one-size-fits-all' nature of the Scheme. This reflected, in part, the rising costs of the Scheme but also the changing patterns of employment within the sector and the growing number of part-time and temporary contracts.
4. Other contribution arrangements are available in other pension arrangements within the education sector. Such arrangements could be considered by Stakeholders. This would require an examination of any impact on the Scheme's funding level, unintended consequences (eg of higher earners leaving the Scheme because of increased contributions, and cliff edges between contribution levels which could leave Scheme members worse off), and any adverse intergenerational impacts.

The sustainability of the Scheme has been one of the central themes in the second phase of the Panel's work. As noted in earlier chapters, the Panel has considered the purpose of the Scheme and the Shared Valuation Principles that should underpin the valuation. With all of these issues, the Panel has suggested that:

- addressing members' needs should be a central part of the purpose of the Scheme;
- sustainability should incorporate adaptability to the needs of the Stakeholders, changes in the labour market, the economics of the higher education sector and the needs and preferences of members which may change over time; and
- intergenerational fairness, while inevitably imprecise, should not result in the Scheme being unattractive to particular generations of members.

Given these factors, and the high value placed on the Scheme by its members, the Panel was keen to hear directly from Scheme members and those who had opted out of the Scheme (in addition to those who had provided written evidence to the Panel). Therefore, the Panel commissioned Ignition House – experts in consumer and member-based research on pensions and financial services matters – to undertake research on the Panel's behalf.

This chapter summarises that research, its key themes and implications in terms of future member needs for future valuations, input to formulating member risk appetite, and Scheme sustainability.

## MEMBER AND NON-MEMBER RESEARCH

In order to deepen its understanding of the views of members of USS as well as those opting-out, the Panel commissioned qualitative research from Ignition House, a research agency that specialises in pensions research.

In total, Ignition House spoke to 113 people across eight higher education institutions[24] through a combination of focus groups and depth interviews. Individuals taking part included those who are members of the Scheme as well as those who have opted out, both UK and non-UK nationals, a mix of union and non-union members, faculty and non-faculty staff, those under and those 40 and those who identified as either a man or a woman.

The qualitative nature of the research and the nature of the sampling mean that the results of the research cannot be generalised for the population of USS members and opt-outs. However, the findings among respondents illustrate both the importance of defined benefit pensions and the broader issues facing respondents.

The high-level findings from the research are summarised below. A copy of the full report to the Panel is published alongside this report[25].

In the sample there were clear differences in attitude between faculty and non-faculty respondents and between younger and older respondents in terms of:

- **Their experience and expectations of their careers in academia:** Non-faculty respondents were more exposed to working in the private sector, being members of different pension schemes whereas faculty respondents often had little experience of the private sector or different pension schemes. Younger faculty respondents expected to have a different and more difficult career path than their older peers, moving between institutions more frequently and with less certain tenure of job or clarity of career progression.

*"Also, when I was younger, I didn't have student debt… I've got a 35 year-old who works for me and is still paying off student debt and doesn't think she'll ever manage to pay it off." Non-Faculty >40s*

- **Their financial situation:** Older respondents felt more secure and comfortably off while younger respondents expressed concerns about job and financial insecurity, lack of pay rises, struggling to make ends meet and pay off debt.

[24] Cambridge, Glasgow, Imperial, London Business School, Manchester, Oxford, Leicester and Birkbeck.
[25] www.ussjep.org.uk

- **Reasons for opting out of the Scheme**: For younger respondents, affordability of contributions was the primary reason for opting out whereas for older respondents, difficulty with the pension tax environment was given as the main reason. For some younger respondents, the 'noise' created by recent valuation cycles is making them question the value of the Scheme and some younger respondents who are in the Scheme felt that future increases in contributions could trigger them to opt out on the grounds of affordability.

- **Their experience of pensions:** In general, non-faculty respondents had often been members of other pension schemes before joining USS. Some had been members of a DC scheme at their institution before reaching a grade where they qualified for USS while some had experienced other DB schemes such as LGPS or the NHS or other private sector DC schemes. In general, faculty members had little experience of schemes other than USS.

*"I have worked in the university for 12 years, I have only ever held a USS pension here and that's the only pension I have ever paid into. I have just merrily sailed along..." Faculty <40*

Although few respondents claimed to have taken on their job because of the pension Scheme, many mentioned it as an important reason for staying in the sector. Moreover, they said that without the benefits of USS, the sector would be less attractive to work in when compared to salaries and opportunities in the private sector. Overall, having a generous pension was ranked number three in a list of nine employee benefits that respondents valued, behind salary and holiday and just ahead of flexible working hours. However, younger respondents were less likely to rank it in their top 4 than older respondents, sometimes preferring more immediate benefits such as flexible working hours and gym membership. Nevertheless, 6 out of 10 younger respondents ranked a generous pension in their top 4 most valued employee benefits.

*"Without the pension you would lose a major incentive to working in administration in the university sector; if I can command a higher salary with a similar lack of certainty about my retirement elsewhere, why would I stay in this sector? So the pension is a very big deal compared to the private sector. It's the big thing". Non-faculty <40*

Both older and younger respondents recognised the value of a DB pension and felt that DB (however configured) would constitute a generous pension whereas any type of DC scheme would not be considered generous. That a generous pension should also allow for inflation proofing was the view expressed.

Another important pension feature for many respondents is not having to make investment decisions leaving those decisions to experts. Many respondents had little or no experience of savings or investments other than cash-based accounts.

Respondents were asked to choose between two types of pension (broadly wordings that reflect DB and DC):

- *"a known and predictable retirement income for life even if the amount I contribute each year can change"*; and
- *"knowing how much you are going to contribute each year even it means that I won't know how much pension I'll get".*

Whilst some knew that the ideal would be to have predictability of retirement income *and* certainty of contributions, when pushed to choose, 78 out of 91 who were asked the question opted for predictability of retirement income over certainty of contributions. Among those who chose certainty of contributions, a fear of future increases in USS contributions played a part in shaping their answer.

*"Some [members] would choose lower contributions which could reduce the opt-out and double the number of members, which would strengthen the Scheme."*

Not all respondents recognised or felt that USS provided them with predictability of retirement income, reflecting the changes to the Scheme that have taken place over recent years and the prospect of further changes that arose during the 2017 valuation. Respondents felt that the unpredictability of the Scheme was reinforced by some of the language used in recent valuations; language that has raised fears in the minds of some about the very future of the Scheme. In fact, some respondents felt that USS presented them with the worst of all worlds – rising contribution rates and unpredictability of retirement income. Furthermore, USS, was not seen to be as generous given the recent changes to benefits and contribution levels when compared to other pension schemes such as Teachers, LGPS, SAUL, the Police and Civil Service schemes. However, not all respondents – including some of those expressing views about the relative generosity of USS – were aware of the contribution rates being paid by employers into USS, or the member contributions being paid into other schemes.

Concerns about USS raised by respondents focused on the sustainability of the Scheme due to:

- rising contribution levels creating uncertainty and fears about future affordability and the sustainability of the Scheme;
- wealthy colleges exiting the Scheme leaving the Scheme weaker; and
- younger members leaving with the result that cashflow turns negative.

*"Junior academics are not opting out in big numbers, but it may come soon if contributions go up [again]"*

The lack of flexibility in the Scheme was also a concern for some. Several younger respondents referred to the binary nature of the Scheme, that is, paying either the required contribution for USS or leaving the Scheme, as unattractive. They said they would prefer to have a third option of paying a lower contribution.

Poor communication was also confusing and eroding understanding and trust in the Scheme.

However, many respondents recognised and valued the scale and collective nature of USS, in particular that it is supported by multiple employers and includes both faculty and non-faculty staff. Non-faculty staff particularly recognised that having senior faculty members in the Scheme provided members with a stronger voice.

In summary, the Ignition House research identified strong support for the Scheme (and its collective defined benefit format) but concern for its future, the affordability of its contributions and the one-size-fits all nature of its benefits and contributions. These latter points were contributory factors in the increasing number of Scheme opt-outs and a reflection of the changing employment patterns, particularly for academic staff since the Scheme's inception, with higher numbers of eligible staff on short-term and sessional contracts (see Figure 13).

Together, these factors could have implications for the sustainability of the Scheme.

## OPT-OUTS

The issue of opt-outs from the Scheme was raised to the Panel during its first phase of work and again at the start of this second phase. In investigating this issue, the starting point for the Panel was to ask USS for data on opt-outs from the Scheme. This is set out below[26]:

**Figure 12: USS opt-out levels 2015-2019**

| Year | Joiners | Opt outs | Opt out rate |
|---|---|---|---|
| **2018/19** | 29,519 | 4,485 | 15% |
| **2017/18** | 28,715 | 4,341 | 15% |
| **2016/17** | 29,475 | 4,382 | 15% |
| **2015/16** | 22,865 | 4,739 | 21% |

Notes:
Joiners refers to new joiners only and excludes members re-joining the Scheme.
Data is based on employers informing the Scheme of members that were eligible to join the Scheme but elected not to.

These opt out levels are significantly higher than the national average and do not include existing members who select to leave the Scheme (while continuing in employment). By way of comparison, DWP reports that the active opt-out rate for automatic enrolment schemes is currently running below 5%[27] . DWP also reports that opt-out rates have not increased since the increase in statutory minimum contributions in April 2019 and in fact appear to be falling since the end of the staging of new employers. However, comparisons with USS are difficult given the lower minimum employee contribution rate for members being automatically enrolled into a DC scheme (currently 4% of

[26] Data supplied by USS. Available online in the Scheme's Annual Reports and Accounts
27 Automatic Enrolment Evaluation Report 2018, December 2018, DWP

banded salary) rather than contractually enrolled into USS at 8.8% of salary (the member contribution rate at the time the USS opt-out data was gathered).

Additional analysis of opt-outs provided to the Panel by USS provided revealed that 65% of those opting out were aged 36 or under – in large part because this age group represents the largest group of new potential members of USS. Opt-out rates drop down among those aged 40-55 but then rise again and were highest among those aged 61 and over at around 31%. However, in terms of share of opt-outs, this older age group represents only 5%.

USS sought to understand more about the motivation behind opt-outs in 2018/19. Their analysis suggests that three themes dominate the opt-outs (which in turn will be dominated by the views of the younger opt-outs in the Scheme):

- affordability – 27% claimed that they could not afford the contributions right now;
- future or current work patterns – 19% do not expect to stay in the UK and are concerned about accessing USS benefits when overseas; 13% gave fixed-term contracts as a reason for not joining; 8% do not expect to work in academia for long and 6% gave part-time or variable hours contract terms as the reason; and
- 6% stated that they felt that USS did not offer them valuable benefits while just 2% had opted out because of issues with either the lifetime or annual allowance for pensions.

The Panel's qualitative research is therefore supported by the USS quantitative analysis.

The picture is somewhat different compared to the DWP analysis of those making active opt-out decisions from automatic enrolment schemes. DWP data suggests that opt-out rates have been consistently lowest among the youngest members of such schemes with rates rising gradually with age. Moreover, opt-out rates have been consistently low among the lowest earners and slightly higher among higher earners.

Concerns about the rising level of opt-outs were also voiced by members and other Stakeholders in discussions with the Panel. It was a commonly expressed view that the structure of the Scheme and the outcome of recent valuations means that the Scheme does not satisfy the needs of all of its members or potential members. Some employers expressed the view that significant numbers of potential members of the Scheme were opting out due to affordability. Employers also pointed to the potential benefits to employees of a more flexible approach to contributions that could ultimately strengthen the Scheme if there were fewer opt outs. The Panel recognises that, were this implemented, employers too might benefit from lower contribution rates.

> *"It's pushing to the point where its going to go up any higher that people will start dropping out. The closer your contributions get to double digits…losing 10% of your salary into a pension is a lot to swallow". Non-faculty <40*

## CONTRIBUTION STRUCTURES

A theme that emerges strongly from this part of the Panel's investigations is concerns over the the "one-size fits all, take it or leave it" nature of the Scheme. This appears to be driven by a combination of the increasing costs of member contributions and changing employment patterns meaning that the Scheme is unable to accommodate today's more varied university workforce. Out of an academic workforce of around 235,000 (excluding staff on A-typical contracts) an increasing number are on short-term and non-traditional contracts:

**Figure 13: Academic employment patterns 2017/2018**

| Type | Typical description | Size of workforce | Part time | On fixed term contracts | On hourly paid contracts |
|---|---|---|---|---|---|
| **Teaching and research** | Lecturer, Senior Lecturer, Professor | 100,120 | 18,205 (18.2) | 7,830 (7.8%) | 28,450 |
| **Research only** | Research Assistant, Research fellow, Research Associate | 49,515 | 8,850 (17.9%) | 32,985 (66.7%) | |
| **Teaching only** | Teaching fellow, Tutor | 61,050 | 43,750 (71.7%) | 29,810 (48.8%) | |
| **PhD students who teach** | Graduate teaching assistant | 25,000* | n/a | n/a | n/a |
| **A-typical** | Range of descriptors, includes visiting lecturers as well as range of 'off-piste' practices | 68,000 | n/a | n/a | n/a |

*(estimate based on PhD cohort of 100,275)

Those in teaching and research are most likely to have permanent, open-ended contracts whilst those in research roles are the most likely to have fixed-term employment. Typical contract lengths are 1-3 years and often linked to external funding. Those in teaching only roles are most likely to be part time and most likely to have an hourly-paid contract.

The Panel has therefore considered ways in which some flexibility or changed contribution patterns could be introduced into the contribution arrangements of the Scheme.

In doing so, the Panel has drawn on experience from other schemes, notably those in the public sector where greater flexibility in contributions (mainly for members, but also somewhat for employers) has been introduced a) to provide flexibility for members so as to retain them in the scheme; and b) to support the sustainability of the scheme (including through its funding position).

Two options have been considered:

- tiered contributions; and
- 50/50 contributions arrangement.

In considering these options the Panel has been acutely aware of issues around intergenerational fairness and equality as well as the potential implications for funding and sustainability and cross-subsidy.

### TIERED CONTRIBUTIONS

The Panel investigated the contribution arrangements of schemes that are used in the education sector; namely the Teachers Pension Scheme (TPS) and the Local Government Pension Scheme (LGPS). Both schemes differ in a number of ways from USS in terms of the treatment of members' contributions and both have contribution rates that increase with the salary of the member:

**Figure 14: Comparison of contribution rates - USS, TPS and LGPS**

| Salary (examples, not bands) | USS contribution rate (October 2019) | TPS contribution rate | LGPS contribution rate |
|---|---|---|---|
| **£12,000** | 9.6% | 7.4% | 5.5% |
| **£20,000** | 9.6% | 7.4% | 5.8% |
| **£30,000** | 9.6% | 8.6% | 6.5% |
| **£40,000** | 9.6% | 9.6% | 6.8% |
| **£50,000** | 9.6% | 10.2% | 8.5% |
| **£60,000** | 9.6% | 11.3% | 8.5% |
| **£70,000** | 9.6% | 11.3% | 9.9% |
| **£80,000** | 9.6% | 11.7% | 9.9% |
| **£100,000** | 9.6% | 11.7% | 10.5% |
| **£120,000** | 9.6% | 11.7% | 11.4% |
| **£170,000** | 9.6% | 11.7% | 12.5% |
| **Employer contribution level (2019)** | 21.1% (Oct 2019) | 23.68% (Sept 19) | 20% (average) |

Tiered contributions in the LGPS were set to achieve a number of outcomes, mainly to:

- reflect the change to higher rate tax to ensure that pension contributions net of tax increased in a linear manner;
- achieve an aggregate contribution of 6.5% across the membership; and
- reflect the view that higher pay means higher pensions and that therefore higher paid members should pay more.

The tiers will need to be adjusted to adhere to these objectives where the aggregate level of member contributions is not achieved and/ or where the member contribution rate ceases to increase in a linear manner.

Whilst the LGPS is a single scheme established under statute, it is divided into separate funds, each comprising many – sometimes hundreds – of separate employers. Each employer will have its own contribution rate that is determined by its own circumstances and each administrating authority for that fund responsible for funding and contribution levels (which can vary from fund to fund – see chapter 10 for further details). Tiered contributions can have an impact on funding for individual employers – the lower the employee rate, the higher required the employer rate. If an employer has a large majority of low paid staff, they may see an increase in the employer rate while those with higher paid staff may see a decrease.

Tiered contribution rates also imply a form of cross-subsidy between members, from higher paid (and therefore higher contributing) members towards lower paid (and lower contributing) members. Analysis by the Pensions Policy Institute (PPI)[28] describes that because in a CARE scheme pensions accrued are directly based on the salary achieved in that year, any unfairness in favour of 'high-flyers' is removed. Further analysis by the PPI[29], based on an assessment of the impact of proposed tiered contribution rates in the NHS Pension Scheme shows that tiered contributions will mean that the value of the pension received by higher earners will be higher as a percentage of salary than that of lower earners, as higher earners must pay higher contributions for the pension they receive, compared to lower earners.

### 50:50 OPTION

LGPS also offers flexibility in the form of a 50:50 option where members can choose to pay half of their standard level of contribution in their pay band in return for half of the accrual. Employers continue to pay the average contribution rate – they do not pay half the standard contribution rate in respect of members paying the 50% rate.

The 50/50 option was initially targeted at lower paid scheme members in response to concerns to ensure the scheme remained affordable to lower paid workers and to reduce the risk of opt outs amongst this group. The actual experience of the 50/50 option has been somewhat different. Whilst there is little hard data available, it is clear that there has been relatively little take up of the option (less than 5%) and that, where the option has been taken up, it has tended to be amongst higher paid scheme members who are using to 50/50 option to manage their Annual and Lifetime allowance limits.

It is by no means certain that LGPS experience would be repeated in USS as the Schemes have quite different features. For example, USS does not have the tiered contribution structure present

[28] *The Future of the Public Sector Pensions*, PPI, 2010

[29] *The Implications of the Coalition Government's Public Service Pension Reforms*, PPI, 2013

in LGPS, and member contributions are lower at lower salaries in LGPS (starting at 5.5%) than in USS which has a standard contribution rate of 9.1%.

## CONCLUSIONS AND OPTIONS

USS remains important to members and maintaining DB provision is important to members and to employers. The loss of DB could have important ramifications for staff retention since for many it is one of the reasons to stay working in academia.

The opt-out rate is of concern, particularly among younger potential members and further rises in member contribution rates seem likely to increase opt-outs and further erode trust and confidence in the Scheme. This is particularly likely if increases are either sudden and/or significant. Finding a valuation methodology that does. Not lead to volatility in contribution rates could improve levels of participation and levels of trust in the Scheme. A simpler valuation methodology could also lead to stronger levels of trust.

Affordability is clearly an issue for younger members of staff eligible to join the Scheme and a range of options is open to address this. The Panel suggests that USS, UUK and UCU work together to evaluate the implications of offering choice within the Scheme. There are a number of ways that this could be achieved, including:

- A 50:50 option (or some other proportionate option) such as that offered in LGPS which would help those at an early stage of their career to build up benefits without leaving the Scheme. Members would pay half their contributions. The Panel recognise that this may also help those seeking to avoid the consequences of tax allowances later in their career. One of the important consequences to consider would be the impact on deficit recovery payments and the recovery period. However, if it were found to reduce opt-outs, this might outweigh the reduction in per-member contributions.

- Tiered contribution rates could also be examined. A range of issues would need to be considered:
  - The implications of any cross subsidies between different cohorts of members so as not to introduce any undesired intergenerational unfairness would need to be assessed.
  - Cliff-edge effects when Scheme members move between income bands or tranches. Whilst an additional £1 of additional income would not result in someone automatically paying a higher percentage of contributions as the tiered contribution levels would operate across bands (or tranches) of income, there could be implications for Scheme members moving between bands or income tranches.
  - Careful calibration of the contribution tiers would be required in order to arrive at an aggregate member contribution that is sustainable for members and employers, and which could be easily adapted were it found not to be sustainable.

Other contribution arrangements are available in other pension arrangements within the education sector.

Such arrangements could be considered by Stakeholders. This would require an examination of any impact on the Scheme's funding level, unintended consequences (eg of higher earners leaving the Scheme because of increased contributions, and cliff edges between contribution levels which could leave Scheme members worse-off) and any adverse intergenerational impacts.

These issues should be examined together by the stakeholders in order to address concerns amongst members about the affordability of the Scheme and to help stem to high level of Scheme opt outs.

# 10. EXPLORING MUTUALITY

SUMMARY

1. The Panel remains of the view that mutuality remains a strength of the Scheme. Strong employers support weaker employers and underwrite downside risks. It is also a strength to the HE sector as a whole and all employers, no matter their size, can share in the economies of scale offered by the Scheme.
2. Whilst providing some immediate benefits to some individual institutions, the disaggregation of the Scheme would be likely to have adverse consequences for many (if not the majority) of sponsoring employers and Scheme members. Importantly, it would be likely to result in an overall weakening of the sponsor covenant which would undermine the long-term sustainability of the Scheme as a whole.
3. Moving away from the current mutual arrangement could damage the Scheme and the sector. Any move away from this structure should be taken with extreme care and with a full regard to the consequences for all sponsoring employers, Scheme members and the wider HE sector.
4. The Panel notes that the Scheme is far more complex and less homogeneous than when it was first established, and that the pressures on HEIs are also far greater. The Panel would have serious concerns were sectionalisation to be pursued.

This chapter explores the mutuality which currently underpins the Scheme. It considers how a sectionalised scheme could (theoretically) operate and the implications of sectionalisation for employers and Scheme members. The Panel has made a provisional assessment of these complex issues. We have not made any recommendations but simply offered some options for consideration by the Stakeholders should they wish to develop these ideas further. Moreover, it is not the role for the JEP to consider questions of employer participation. These matters rightly belong to the Stakeholders and the JNC.

The chapter starts with a description of the mutuality which currently underpins the Scheme.

## THE IMPORTANCE OF MUTUALITY

In our first report, the JEP considered the issue of mutuality in the context of the unique features of the HE sector and its impact on the Scheme. We noted that mutuality is embedded in the Scheme through a number of aspects of the Scheme's design:

- all employers pay the same contributions regardless of the strength of the institution or the makeup of the institution's membership. Furthermore, all Scheme members are entitled to the same benefit structure;

- the sponsor covenant is assessed at the aggregate level, not at individual institution level with the result that there is potential for cross subsidy from stronger to weaker institutions; and
- the Scheme is a 'last man standing' Scheme so if all but one of the participating institutions failed, all the liabilities of the Scheme would fall to the last remaining institution.

In its first report the Panel said[30]:

> *Ultimately, therefore, it is the overall strength of the sector, as opposed to that of individual institutions, which matters most in the context of the USS. This is particularly so given the Scheme's 'last man standing' arrangement, the principles of mutuality that underpin the Scheme's funding and contribution base, as well as the pooling of risk that insulates the Scheme in a way that is not possible in a single employer or other multi-employer scheme. The diversity of business models and financial strength across the institutions that sponsor USS acts as both:*
>
> - *a strength in reducing overall systemic risk and ensuring the long term sustainability of the sector; and*
> - *a challenge, not least in managing the potential cross-subsidies between institutions which sponsor USS and their divergent interests in the governance of the Scheme.*

In other words, the Panel took the view that mutuality provided a form of insurance to sponsoring employers, providing a way to share risk in the Scheme.

The importance of mutuality to the overall strength of the Scheme was highlighted in evidence given to the Panel by PwC, covenant advisers to USS. PwC explained, the 'last man standing' and joint and several nature of the Scheme meant a decline in an individual institution or overall sector performance would not necessarily have a material impact on the covenant, provided the Scheme could continue to rely on the strongest employers. Strong employers support both future and current orphan liabilities. They also underwrite potential downside risk. The impact on the Scheme of stronger employers leaving the Scheme would not be a short-term risk around affordability, but a longer term tail risk of reducing the overall level of underlying support provided by the stronger employers, which could call into question the covenant horizon, noting that the Scheme may need to rely on the sector over the long term.

The Panel assesses that the same could be true if the Scheme were to adopt a more disaggregated structure.

The point about the collective nature of the Scheme and the strength it brings to the Scheme and sector was further illustrated in a discussion about the withdrawal from the Scheme of Trinity

[30] *Report of the Joint Expert Panel on the Universities Superannuation Scheme*, September 2018, p20

College, Cambridge. While Trinity's overall share of the deficit was small (0.6%), the potential impact on other participating employers was clear. PwC explained that:

- Trinity would no longer support orphan liabilities arising in the event an employer is unable to meet its obligations, ie as a result of the insolvency of other employers.

- Trinity could no longer be relied upon in a downside scenario to underwrite the Scheme should the deficit materially increase, and the Trustee decide to move to a self-sufficiency target.

- By reducing its exposure to USS, the College could be considered to be exposed to less risk than other institutions. It may therefore attract more funding, having the impact of reducing funding to other universities and colleges whose individual covenants may weaken as a result.

PwC has maintained the Scheme's covenant rating as Strong following Trinity's withdrawal. However, whilst it is acknowledged that only a small number of participating employers could readily afford to withdraw from the Scheme and meet their s75 debt obligations, the prospect of others doing so could lead to a downgrade in the covenant assessment as those employers would no longer be available to provide support to the Scheme as a whole. It is one reason why the Scheme's covenant was placed on 'negative watch'.

In other words, the mutual support provided through the collective sharing of employer risk and underwriting, which has been a strength to the Scheme and the sector as a whole, becomes frayed as the Scheme becomes disaggregated. The Scheme becomes weaker as a result.

The Panel therefore remains strongly of the view that mutuality remains a strength of the Scheme. Any move away from this structure should be taken with care and with a full regard to the consequences for sponsoring employers, Scheme members and the wider HE sector.

Nevertheless, it is apparent that there is growing concern amongst some employers over the continuing application of the principle of mutuality within the Scheme.

- In their evidence to the JEP, both in its first and second enquiries, some employers made the case for the Scheme to move towards a sectionalised structure. They were concerned that stronger employers within the Scheme were disadvantaged by supporting weaker sponsoring employers. The argument was put that "The financial dynamics of the sector have changed significantly…This has resulted in the asset base, surplus generation and investment needs being more divergent and we therefore urge the Joint Expert Panel to consider options including further examination of the current mutuality arrangements". Another said: "We believe that sectionalisation…should be explored if this contributes to the Scheme's long-term sustainability and affordability". One suggested that whilst "[T]he

mutual nature of the Scheme leverages the combined strength of the sector....USS should consider the covenant strength of individual employers and seek to move those with weaker covenants into a defined contribution-only section of the Scheme".

- Smaller employers (such as research institutes that are now part of USS) on the other hand said in their submissions to the Panel that they felt "trapped" in a Scheme that is unaffordable (and unaffordable for them to leave). They were also concerned that the Scheme may not be suitable for their employees who have different employment patters than staff at more traditional USS sponsoring employers.

- There was a view that some wealthier institutions were being prevented from leveraging their assets (to grow and expand their own institutions) because of concerns over the need to shore up USS.

- Some employers were concerned that a 'one size fits all' benefit structure limited their ability to offer some of their eligible staff a different benefit structure and that a scheme which offered a menu of benefit arrangements could help affordability issues and better meet the needs of employees, especially younger employees.

## WHAT DOES SECTIONALISATION MEAN?

A sectionalised pension fund is one that contains two or more 'sections' that are formally separate for funding and, sometimes, benefit purposes. Employers in such schemes are allocated to (or choose) one of the sections. To be considered sectionalised a scheme must ensure that contributions payable in respect of an employer are allocated to that employer's section of the scheme and that each section bears its own share of the costs. Furthermore, the appropriate share of the assets of the scheme must be attributable to each section and cannot be used for the purposes of any other section. In practice, this means that each section of the scheme will, in effect, be a separate scheme and subject to its own valuation with assets, liabilities and the covenant measured independently of the other sections.

**Figure 15: Case Study - Railways Pension Scheme**

The Railways Pension Scheme (RPS) is one of the UK's largest schemes, with assets of £30bn and a total membership of 340,000. Whilst it has many similarities with USS in that it is a multi-employer scheme that provides defined benefits and is an open scheme, there are also some important differences – not least in terms of its structure.

Each participating employer in the RPS sponsors a separate and distinct 'section'. As such, the RPS has 108 separate sections (40 of which are open to new entrants). In other words, they are a scheme within a scheme and each employer is responsible for its own section. The only exception

to this is that a group of very small employers with fewer than 50 members each are grouped in an omnibus arrangement which allows these employers to gain the benefits of scale.

Each section is independent and, for funding purposes, can be considered to be a separate scheme. It has its own actuarial valuation with TPs set with reference to its investment strategy and its own covenant assessment. The covenant assessment is conducted by RPS's own internal covenant assessment team. Based on the assessment and valuation results, the Trustee will negotiate with each employer about the implications for funding and contributions. Each section has its own funding level and Schedule of Contributions, with contributions specific to that section.

Whilst there is a common benefit structure framework, each section has its own rules which can be amended by agreement between the Trustee and employer. Over time, since privatisation of the railways in 1994, sections have introduced benefit changes leading to a range of benefits now provided in different sections. Assets are managed centrally within a pooled fund structure. Each section allocates its assets to the various pooled funds in proportions which reflect its covenant strength, maturity profile and funding plan. Funding levels on each section's own Technical Provisions basis range from 70% to 130% (as at the beginning of 2019).

## POTENTIAL OPTIONS FOR SECTIONALISATION

There are many possible ways in which the USS could be demutualised and divided into sections. The options below are simply illustrative of potential models for de-mutualisation or sectionalisation. They should not be seen as definitive – other potential options exist.

**Figure 16: Potential models for sectionalisation**

| Model | Description |
|---|---|
| **Status Quo – no sectionalisation** | As now. A single scheme with a single benefit structure and a collective assessment of risk and covenant strength. All employers pay the same contributions (future and deficit). Investment management and Scheme administration managed centrally. |
| **Partial sectionalisation – a special section for very small employers** | Under this option, the vast majority of sponsoring employers would remain in a single section as now with a single benefits structure, collective assessment of risk and covenant strength and all paying ay the same contributions. However, very small employers (such as research institutes that are not 'traditional' USS employers) could be grouped into a separate section with, potentially, different benefits to reflect the different labour market for these employees.<br><br>A similar approach is followed by the Railways Pension Scheme which has a separate section for very small employers. |

| | |
|---|---|
| **Partial sectionalisation – covenant based** | Employers could be grouped into sections based on the strength of their sponsor covenant. For example, EY Parthenon divided USS's 350 sponsoring employers into 8 groups[31] that share characteristics related to their income profile and institutional focus. This model could see a single benefit structure but contributions (future and deficit contributions) determined by the overall strength of the covenant group in which the institution sat. Therefore, some covenant groups could pay higher contributions than others, depending on the strength of the covenant and liability profile for that group. Investment management and Scheme administration would be managed centrally.<br><br>The LGPS has a single benefit structure, set out in statute, but is divided into 89 sections (funds). The contributions for each section can vary (subject to a cap) depending on the underlying strength of the employers within that section. |
| **Partial sectionalisation – benefits based** | Under this option the Scheme could offer a range of benefit options designed to meet the different needs of employers and Scheme members, with each section offering a particular style of benefits. Employers could then opt for a section depending on the benefits options on offer. Contributions would depend on the benefit structure selected. Investment management and Scheme administration could be managed centrally. |
| **Fully sectionalised – same benefits, covenant based** | Under this option, each sponsoring employer would form its own section (so there would be c350 separate sections) within a Scheme with the same benefits structure across all employers. However, contributions (future and deficit) would depend on the individual employer's (section's) strength and liability profile. Employers would pay based on their own circumstances. |
| **Fully sectionalised – different benefits** | Under this option, each sponsoring employer would form its own 'section'. Each section would determine its own benefits structure. There would be an individual assessment of risk and employer covenant for each section. Contributions (future and deficit) would be based on individual covenant strength *and* benefit design. Investment management and Scheme administration would be managed centrally.<br><br>This arrangement is similar to that of the Railways Pension Scheme |

[31] See JEP's first report, pages 19 and 90 for further information on EY Parthenon's analysis

These options may be seen as sitting on a spectrum with a fully sectionalised scheme in which each sponsoring employer is its own section at one end of the spectrum and the status quo of a single, mutual, scheme at the other.

## THE CONSEQUENCES OF SECTIONALISATION

Each potential option raises a number of questions and challenges that would need to be resolved before any decision could be made to proceed with a sectionalised approach. But assessing these issues is not straightforward: what looks like a benefit to one individual sponsoring employer may be a detrimental to another. And – viewed from the perspective of the strength of the Scheme as a whole – as well as the members' perspective – it may be highly disadvantageous. In addition, moving away from the current structure would require the Scheme and its Stakeholders to operate very differently. There would also be issues around cost and administrative efficiency to consider.

In reflecting on sectionalisation, the Panel considered that were sectionalisation deemed to be both possible and desirable, any sectionalisation of USS could deal only with future accrual, thereby leaving benefits accrued at the point of any sectionalisation in a separate mutual section to which all employers would remain required to contribute. This would have the effect of separating quite clearly contributions for past deficits from future service contributions at the point of sectionalisation. With regard to past accrual at the date of sectionalisation, all employers would continue to support each other (as now), while support between employers for future service would be shared within different sections or individually. Any deficits arising within sections after sectionalisation would then be the responsibility of the employer(s) within the section.

The following paragraphs consider the implications for the Scheme and its Stakeholders.

### THE IMPACT ON EMPLOYERS

Currently, as described above, there are cross subsidies between employers across the Scheme which enhance the overall strength of USS. In a partially sectionalised arrangement these cross subsidies would be diluted, restricted to cross subsidies within the section. In a fully sectionalised scheme, there would be no cross subsidy between employers – employers would be responsible for their liabilities alone. This may mean that there could be gains for one group (or individual sponsoring employers) which may translate as losses for another group (or individual sponsoring employers) as factors affecting the consideration of contributions, risk, and strength which are currently taken at a Scheme-wide level are disaggregated. Put simply, some employers would be likely to find themselves paying higher contributions under some forms of a sectionalised scheme, in particular those employers deemed to have a weaker covenant.

Viewed from the perspective of the sector as a whole, the implications could be negative. For example, higher contributions could force some into financial difficulties as the cross subsidy from everyone paying the same percentage contribution is lost. And as PwC point out, the ability of

strong institutions to borrow more cheaply (because they were unencumbered by responsibilities within USS for other institutions) would have a negative impact as it could reduce the stream of funding to other institutions whose covenant could worsen as a result.

There may be some cost efficiencies that could be generated though sectionalisation. For example, very small employers could be better supported and gain efficiencies through the operation of a small schemes section. This may address some of the concerns that have been raised with the Panel about the suitability of the Scheme's current structure for very small employers. However, there would also be cost increases, for example as multiple valuations would be needed. The cost implications would need to be fully modelled as part of the consideration of any option to sectionalise the Scheme.

There would also be implications for collective bargaining across the sector. For the purposes of pensions, this is currently conducted nationally via the JNC which negotiates benefit changes and the allocation between employers and scheme members of any contributions increases. Sectionalising the scheme by groups (for example, according to a menu of benefits or based on covenant strength, based on the examples above) would mean that collective bargaining could still take place at national level but would be based around the different groupings, so there would be a number of negotiations. If the Scheme were fully sectionalised with each sponsoring employer providing its own benefits arrangement, then bargaining would take place at the institution level.

### THE IMPACT ON MEMBERS

Chapter 9 explored how the differing needs of members, in particular those with less conventional contracts, are met within the current 'one size fits all' benefit structure. A less mutualised structure could result in different sections of the Scheme providing different benefit structures. This may provide a means to address some of the concerns raised by members about the costs of the Scheme and thus tackle worries about the high levels of opt-outs the Scheme is currently experiencing.

However, overall, the future security of members' benefits may be weakened as a result of the weaker overall covenant assessment. Additionally, members at different institutions could build up different benefit levels and types if HEIs are free to set their own benefit arrangements. This may impact the ability of members to transfer between institutions and it could result in a worsening of benefits for members whose employer chose to reduce benefit levels.

### THE IMPACT ON COVENANT AND SCHEME SUSTAINABIILTY

As described earlier in this chapter, the Panel has taken the view that the collective, mutual, nature of the Scheme is a strength. This derives from the collective assessment of Scheme covenant and from the 'last man standing' provisions.

In terms of covenant, sectionalisation would inevitably impact negatively on the overall sponsor covenant position: the weaker sections would be rated as tending to 'Weak' or 'Tending to Weak' and, whilst some individual employers may benefit from a Strong rating, overall the stronger

sections would be likely to become 'Tending to Strong' because of the weakening of the breadth of the pool.

The 'last man standing' provisions mean that, if all the other employers in the Scheme fail, the last remaining employer would take on the liabilities of the others before the Scheme became dependent on the Pension Protection Fund. This serves to act as insurance to all participating employers (and to TPR, which has a duty to protect the PPF). It is also a form of implicit cross subsidy from stronger to weaker sponsoring employers. Given the overall long-term strength of the sector and the flows of money around the sector, the Panel concluded that it would be unlikely that the 'last man standing' provision would ever need to be invoked. The more disaggregated the Scheme becomes, the less likely it could be that it could retain its last man standing provision – the employers in the section will be dependent on a smaller number of other employers to be the 'last man'. And in a fully sectionalised Scheme, the employer has no other employer to turn to.

The implications of the loss of these protections – the ability to cross subsidise, the loss of the 'last man standing' provision and the collective nature of the covenant – would need to be fully modelled before any assessment to move away from the current collective nature of the Scheme was taken as there could be long-term consequences for the sustainability of the Scheme.

### THE IMPACT ON USS

There would be implications for USS of running a sectionalised Scheme. A less homogeneous scheme is likely to mean a more complex Scheme, requiring more direct interaction with the individual sections and the Trustee. In the case of full sectionalisation, in which each participating employer could have its own benefit arrangements, this could require direct interaction with each separate employer. It would require USS to operate very differently from today, with a much more focused approach to stakeholder management as it would have c350 very different participating employers to manage. The relationship with sponsoring employers could become much more transactional as they become much more like clients than traditional sponsoring employers of an occupational pension Scheme. This is a very different approach to stakeholder management which currently operates through UUK in the case of participating employers.

USS would also be required to undertake multiple valuations where there was more than one section in the Scheme. Different sections with different benefit structures could also add some further administrative complexity. Stakeholders would need to be sure USS had the capacity and skills to move into this new world.

## CONCLUSION

A number of participating employers have suggested to the Panel that a de-mutualised, more disaggregated approach would be more appropriate for the Scheme as it exists today. However, it is the Panel's view that mutuality remains an important feature of the Scheme and one that adds to

its overall strength in terms of covenant strength and long-term sustainability. As a consequence, this collective strength helps to support the HE sector as a whole.

Whilst the Panel notes that the Scheme is far more complex and less homogeneous than when it was first established, and that the pressures on HEIs are also far greater, the Panel would have serious concerns were sectionalisation to be pursued.

# 11. CONCLUSIONS: ROAD MAP

The evidence gathered by the Panel over the course of its two reports suggests that, whilst different perspectives remain, all sides in this difficult dispute want to resolve the key issues. There continues to be strong support for the Scheme and a desire to secure its long-term sustainability for the benefit of employees, employers and the HE sector. However, we are disappointed that the interested parties remain far apart, that the Stakeholders are currently engaged in an industrial dispute, and that there are low levels of trust amongst Scheme members and some employers in the Trustee and in the role TPR has played.

Our two reports have set out a suite of recommendations for change to:

- how issues relating to the long-term sustainability of the Scheme are considered, backed by agreement on the Scheme's purpose
- how the Stakeholders interact, engage and negotiate with one another and the Trustee and TPR
- how the valuation is approached; and
- how the valuation methodology could better reflect the open nature of the Scheme and the dynamics and specificities of the sector.

Our conclusions and recommendations should be considered as a package which, taken together, can provide a way for the interested parties to work together to secure the future of the Scheme and a more holistic approach to the problems that arise. They are not about unpicking the past or re-examining the 2017 and 2018 valuations, but rather are about looking ahead and resolving future issues.

Realising the outcomes these reforms are designed to achieve requires not only their rapid adoption but also a change in culture and mindset.

Effective negotiation between the Stakeholders requires a common commitment to ensuring that all interested parties have access to the information that is needed to understand each other's positions clearly; to have space and a clear mandate to develop negotiating positions and, crucially, to ensure that the right people are in the room. Those who support the negotiations, either formally or informally, such as the Trustee and TPR need to play a constructive role in making this happen. The role and influence of other interested parties, such as TPR, need to be clear to all concerned. While achieving this structural and cultural shift will not eliminate the legitimate differences in perspective, it should make them easier to resolve and reduce conflict.

Notwithstanding significant agreement on the problems and stated appetite for change that has emerged over the course of our enquiries the Panel has serious concerns that without a clear commitment to action, the Scheme will end up in the same place again – in dispute. The failure to

capitalise on the Panel's recommendations from the first report was, in the Panel's view, a missed opportunity to resolve the dispute and provide the space for a discussion of the longer-term issues confronting the Scheme. The Panel believes that a failure to take forward the recommendations in this report would mark a failure for members, employers and the sector.

Therefore, the Panel wishes to propose that all of the interested parties commit to a 'road map' for the facilitated implementation of the recommendations in the JEP's reports. The choice of facilitator will be a matter for the Stakeholders. The Panel itself would be happy to act as facilitator, through its Chair, or the Stakeholders may wish to use an alternative facilitator (such as ACAS). However, the Panel is clear that without such approach, change will not happen quickly or coherently enough. It is clear that as work on the 2020 valuation gathers pace, urgent action is needed.

The roadmap would consist of a series of facilitated meetings between the Stakeholders and Trustee and TPR (where appropriate) to reach a common position on the implementation of the JEP's report. This would enable rule changes to be adopted (where necessary) by the Trustee and/or Stakeholders. Three key areas that should be addressed are:

- governance, including the role of the JNC;
- the 2020 valuation and beyond; and
- the long-term strategy for the Scheme.

It is essential that each of the interested parties commits themselves to this process and that it is driven forward by their senior decision-makers who are given a mandate to both to act on their organisation's behalf and to work towards a greater understanding of each other's positions. For the road map to be fully effective the Trustee and TPR must also commit to engaging with, and respecting, the process.

# GLOSSARY OF TERMS

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| **Covenant** | The covenant is the extent to which the funding of the Scheme relies on the legal obligation and financial capability of the employers in the event of the Scheme being under-funded. |
| **De-risking** | De-risking in a pension scheme context means removing risks from the scheme. This will come at a cost and may result in replacing one type of risk by another kind of risk. For example, moving to a low-volatility, low-return investment strategy may reduce the volatility of investment returns and hence the volatility of contributions. However, such a strategy is expected to result in higher contributions due to lower expected investment returns. |
| **Gilts plus** | In a gilts plus valuation, the projected investment return on each asset is calculated as the yield on government bonds plus a fixed amount – called a risk premium. The size of the risk premium depends on the asset. Discount rates are expressed by reference to government bond yields, where discount rates are set equal to investment returns less a margin for prudence. |
| **JNC** | Joint Negotiating Committee. |
| **Last man standing** | In the USS, if a sponsoring employer goes bankrupt then the remaining, solvent sponsoring employers are liable for the bankrupt employer's share of the Scheme's liability. In a doomsday scenario, the last solvent sponsoring employer is liable for the Scheme's total liability. |
| **Long-Term Funding Objective** | Takes a broader definition of the LTFT (described below) – it will require schemes to set am appropriate funding target; have an aligned long-term investment strategy; and consider the timing for when these two elements are expected to be achieved. |
| **Long-Term Funding Target (LTFT)** | The level of funding schemes will need to achieve in order to reduce their dependence on the employer particularly when it has reached an appropriate level of maturity. This will then allow it to be managed with a high degree pf resilience to investment risk. |
| **Match** | All active members of USS can choose to contribute an additional 1% of their salary to the USS Investment Builder by selecting "the match" online in their USS member account and their employer will match this contribution, and no more, by also contributing 1% of that member's salary. (The match ceased from 1 April 2019.) |
| **Prudence** | Prudence tries to make sure that liabilities are not under-stated. It represents adjustments to the best estimate assumptions, in order to increase the chance of the assets being sufficient to pay all the |

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| | benefits without the need for additional contributions. An assumption of future outcome is a best estimate if there is a fifty-fifty chance of the actual outcome being better or worse than the assumption. |
| **Reliance on covenant** | In USS' terminology reliance is the difference between the value of assets required to attain self-sufficiency and the actual asset value held by the Scheme.<br><br>The Reliance capacity indicates how much employers are willing to contribute above 18% of payroll over a fixed number of years. The reliance capacity can be used to see if the reliance is within the willingness of employers to contribute above the regular contribution rate. The reliance capacity may be much less than the covenant, as the reliance emphasises the willingness of employers to contribute rather than their ability to contribute. |
| **Salary threshold** | The annual pension accrued each year by a member in the Retirement income Builder based on their annual salary, but with their salary capped at the salary threshold. The salary threshold for 2019/20 is £58,589.70. |
| **Self-sufficiency** | For the 2017 and 2018 valuations, the self-sufficiency liability value is the amount of money which is enough to pay for the liabilities in 95% of modelled future scenarios assuming that a specified investment strategy is followed. The self-sufficiency basis is the set of financial and demographic assumptions used to value the self-sufficiency liability. |
| **Technical Provisions** | The technical provisions (TPs) value is the amount of money which is anticipated to pay for the liabilities assuming that a specified investment strategy is followed. The technical provisions basis is the set of financial and demographic assumptions used to value the technical provisions liability. |
| **TPR** | The Pensions Regulator. |
| **Trustee** | A company called USS Limited (USSL) acts as the trustee for USS. The trustee of a pension scheme holds assets in the trust for the beneficiaries of the Scheme and acts separately from the employers. Trustees are responsible for ensuring that the pension scheme is run properly, and that members' benefits are secure.<br><br>The Board of Trustees are the Directors of USSL. They are a group of 10-12 people of whom between 3-5 are independent members, 3 are nominated by UCU and 4 are nominated by UUK. Currently there are 12 directors. |

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| | Day-to-day management of the Scheme is delegated to the USS Executive, who are employees of USSL. The Board of Trustees take decisions on the management of the Scheme, advised by the USS Executive and professional advisers. |
| **UCU** | University and College Union, the member representative body under the USS Scheme Rules and other governing documents. |
| **USS Investment Builder** | The Investment Builder is the defined contribution section of the Scheme. Members who earn above the salary threshold are automatically enrolled in the Investment Builder section. Other members may choose to join. |
| **USS Retirement Income Builder** | The Retirement Income Builder is the defined benefits section of the Scheme. |
| **UUK** | Universities UK. Representative body for Universities in the UK under the USS Scheme Rules and other governing documents. UUK has 136 members. However, for the purposes of USS, UUK represents all 350 institutions in the UK participating in the Scheme. |

# ANNEX 1 – JOINT EXPERT PANEL MEMBERS

The JEP has six members, three nominated by UCU and three by UUK, and an independent chair.

### JOANNE SEGARS OBE (INDEPENDENT CHAIR)

Joanne is currently the Chair of LGPS Central Ltd, which pools the assets of 9 Midlands-based local authority pension funds. She is the Chair of Trustees for NOW: Pensions, which is the UK's third largest Master Trust pension scheme, and a member of the Legal and General Independent Governance Committee. She is a Director of the Pensions Policy Institute. From 2017-2018 she served on the Board of the Environment Agency and chaired its pension schemes. She was previously the Chief Executive of the Pensions and Lifetime Savings Association (formerly the NAPF). Joanne held the pensions brief at the Trades Union Congress for 13 years. She was a Board member of PensionsEurope from 2010-2017 and its Chair from 2012-2015.

### RONNIE BOWIE (APPOINTED BY UUK)

Ronnie is an experienced actuary, currently Partner (previously Senior Partner) at Hymans Robertson having joined the firm in 1980. Since August 2016 Ronnie has undertaken the role of Chair of Court at the University of Dundee. Ronnie was President of the Faculty of Actuaries and was a driving force behind its merger with the Institute of Actuaries becoming the first President of the combined Institute and Faculty of Actuaries. He is Chair of the Royal Bank of Scotland Pension Scheme, Chair of the With Profits Committee of the Prudential Assurance Corporation, Chair of Byhiras Trust and a fellow of the Royal Society of Edinburgh.

### SALLY BRIDGELAND (APPOINTED BY UUK)

Sally is an actuary with pensions and investment experience both as an adviser and a trustee. She currently combines governance consultancy for Avida International with a number of non-executive and advisory roles. She is a trustee at the Lloyds Bank pension schemes and at the Nuclear Liabilities Fund. Until recently a trustee and Investment Committee Chair at NEST Corporation, Sally was previously the Chief Executive Officer of BP Pension Trustees Limited. Before BP, Sally spent twenty years working both as a pensions actuary and in investment research and innovation. Sally was the first lady Master of the Worshipful Company of Actuaries in 2016-17 and currently serves on the Royal Society's Advisory Committee on Mathematics Education (ACME).

### CHRIS CURRY (APPOINTED BY UUK)

Chris is the Director of the Pensions Policy Institute (PPI) with overall responsibility for leading and managing the PPI. At the PPI Chris has authored and presented a number of research reports analysing and other provision for retirement income. In 2017, Chris was one of the three co-chairs for the DWP Automatic Enrolment Review Advisory Group. The review looked at ensuring workplace pensions continue to meet the needs of individual savers, and employers, whilst remaining fair, affordable and sustainable for future generations. Chris started his career as an Economic Adviser at the Department of Social Security (now the Department for Work and

Pensions) before joining the ABI as Senior Economist. In July 2019 Chris was appointed Principal of the Pensions DashBoards Industry Delivery Group.

### BRYN DAVIES (APPOINTED BY UCU)

Bryn is an experienced actuary, currently the Director and Actuary of Union Pension Services, providing collective bargaining support for trade unions. He was previously the pensions officer at the Trade Union Congress and a research partner at a leading firm of consulting actuaries. He has also been a member elected trustee of a pension scheme and a member of the Occupational Pensions Board.

### SAUL JACKA (APPOINTED BY UCU)

Saul is a professor of statistics at the University of Warwick and a Turing fellow at the Alan Turing Institute. He has worked in mathematical finance for over 30 years, and much of his research has focussed on how this field links with actuarial science. He is also a trustee of a defined benefit pension scheme for non-USS staff at the University of Warwick, and an independent actuarial examiner for the Institute and Faculty of Actuaries (IFoA).

### DEBORAH MABBETT (APPOINTED BY UCU)

Deborah is a professor of public policy at Birkbeck. Her research is on welfare states and social regulation in a comparative perspective, including changes to public pay-as-you-go pensions and regulation of the interaction between public and private (occupational and personal) pensions. Her current research focuses on the implications of rising and flexible retirement ages for public and private pensions. She holds a PhD in Economics from the University of Oxford and has previously worked as an adviser to the World Bank in Lithuania and Moldova. She is also currently co-editor of the Political Quarterly.

# ANNEX 2 – JEP TERMS OF REFERENCE

**1. Background**

UCU and UUK have agreed to form a Joint Expert Panel.

**2. Scope**

The agreement reached on 23 March 2018 under the auspices of ACAS was formally adopted by UCU and UUK and forms the foundation of the Panel's process.

The Panel published its first report in September 2018 which examined, and made recommendation on, a number of the issues specified in the ACAS agreement, notably those specified in paragraphs 4 and 5 of the ACAS agreement.

The purpose of the Panel's second phase of work is to:

- agree key principles to underpin the future joint approach of UUK and UCU to the valuation of the USS fund.

The Panel will continue to take into account:

- the unique nature of the HE sector, intergenerational fairness and equality considerations (paragraph 4 of the Acas agreement)
- the clear wish of staff to have a guaranteed pension comparable with current provision whilst meeting the affordability challenges for all parties (paragraph 4 of the Acas agreement)
- the current regulatory framework (paragraph 4 of the Acas agreement)

This document (Terms of Reference) underpins and supplements the 23 March agreement but does not override it.

**3. Reporting**

The Panel will aim to submit a report to UUK and UCU in September 2019 that meets the purpose described above.

**4. Chair**

The Scheme Stakeholders UCU and UUK will jointly agree the independent Chair.

The Chair will be involved in determining the order of work within the reporting timescales above.

The role of the Chair will be to provide leadership for the Panel, to ensure that it functions effectively, that its members are able to participate fully and that its purpose is met.

**5. Membership**

The Scheme Stakeholders UCU and UUK will each select 3 Panel members.

In nominating the Panel members, UCU and UUK shall have regard to the responsibilities required of these individuals and will appoint those who possess the relevant skills and capabilities.

**6. Remuneration/expenses**

Any costs incurred relating to the Chair and secretariat and will be covered 50/50 between UUK and UCU. Any additional costs will be incurred by the relevant side for their nominated members.

**7. Secretariat**

The Panel shall be supported by a joint secretariat appointed by UCU and UUK in agreement with the Chair.

**8. Meeting arrangements**

**Meeting frequency:** Meetings will take place at regular intervals and will be timed to facilitate the production of reports to the JNC.

**Meeting locations:** To be determined by the Chair

**Quorum requirements:** All Panel members should endeavour to be present for all meetings. If it is not possible for Panel members to join the meeting in person, they may join via telephone conference or videoconference. The quorum for the meeting will be 4 Panel members, with a requirement that there are at least 2 Panel members appointed by UUK and two by UCU present at each meeting.

**Meeting actions:** Panel will produce action points to be agreed by the Chair. These action points will be available within 7 working days of each meeting.

**9. Advice, evidence and information**

The Panel will have access to a collection of expert witnesses, including (but not limited to) the actuarial advisers of UUK and UCU, the USS Trustee, the Scheme Actuary and the Pensions Regulator.

The Panel may also refer to evidence submitted by interested parties.

**10. Confidentiality**

The contents of all Panel meetings are confidential to the Panel members, except the agreed action points which will be provided to UUK and UCU.

All material provided to the Panel is confidential to the Panel, whether from the evidence pack, expert witnesses or submitted evidence.

**11. Conflict of Interest**

All members of the Panel will be asked to declare any current or potential conflicts of interest related to the subject matter of the Panel deliberations.

A conflict of interest log will be maintained as the responsibility of the Chair, and this will detail any action taken to mitigate potential conflicts. The log will be monitored by UUK, UCU and the Panel's secretariat.

**12. Reaching conclusion**

The Panel is expected to reach a consensus on the content of its reports.

If a vote is required, the Chair shall not participate.

# ANNEX 3: ACAS AGREEMENT MARCH 23 2018

1. A formally agreed Joint Expert Panel, comprised of actuarial and academic experts nominated in equal numbers from both sides will be commissioned, to deliver a report. Its task will be to agree key principles to underpin the future joint approach of UUK and UCU to the valuation of the USS fund.

2. It will require maintenance of the status quo in respect of both contributions into USS and current pension benefits, until at least April 2019.

3. There will be a jointly agreed chair whose first step will be to oversee the agreement of the terms of reference, the order of work and timescales with the parties. Any recommendations by the group must be based on a majority view of the Panel without the use of a casting vote. A secretariat, jointly agreed by the parties, will be appointed.

4. The Panel will focus in particular on reviewing the basis of the scheme valuation, assumptions and associated tests. It will take into account the unique nature of the HE sector, inter-generational fairness and equality considerations, the need to strike a fair balance between ensuring stability and risk. Recognising that staff highly value Defined Benefit provision, the work of the group will reflect the clear wish of staff to have a guaranteed pension comparable with current provision whilst meeting the affordability challenges for all parties, within the current regulatory framework.

5. The Panel will make an assessment of the valuation. If in the light of that contributions or benefits need to be adjusted in either direction, both parties are committed to agree to recommend to the JNC and the trustee, measures aimed at stabilising the fund to provide a guaranteed pension broadly comparable with current arrangements.

6. Alongside the work of the Panel both sides agree to continue discussion on the following areas: comparability between TPS and USS; alternative scheme design options; the role of government in relation to USS; and the reform of negotiating processes to allow for more constructive dialogue as early as possible in the valuation process.

7. Support for this process will need to be sought from the USS trustees and the pensions regulator, recognising their statutory responsibilities. Both UCU and UUK will make the necessary approaches to seek this support.

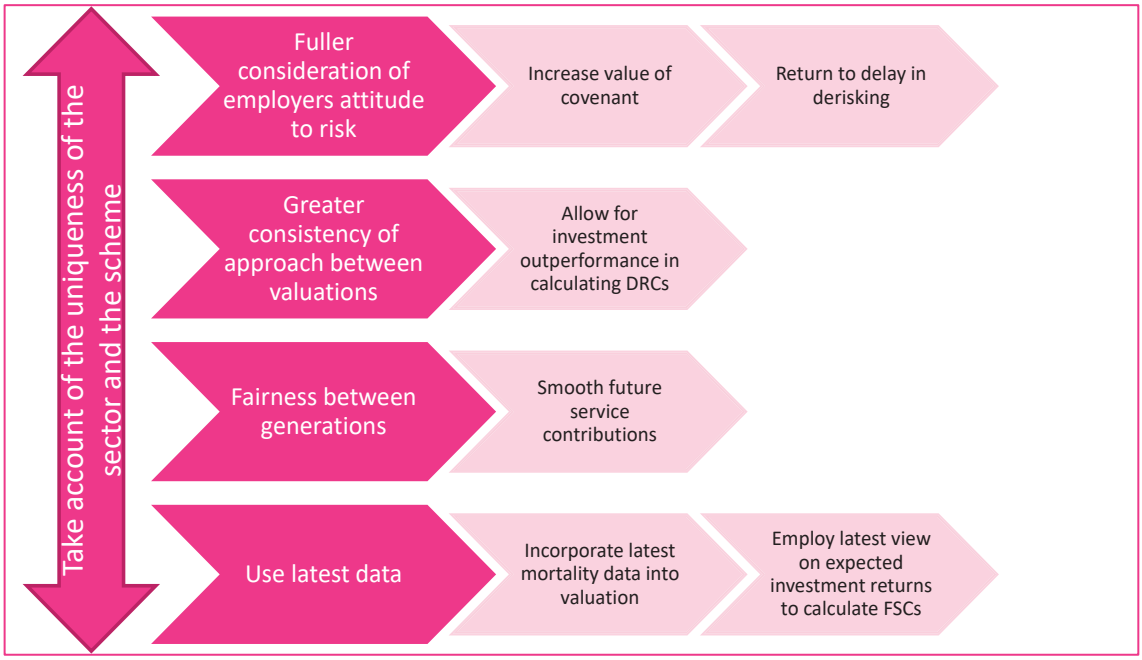
8. Should this process prove acceptable to all parties this could provide the basis for the UCU to consult its branches and members on ending the industrial action currently underway within the sector.

# ANNEX 4: SUMMARY OF JEP'S CONCLUSIONS AND PROPOSALS FROM FIRST REPORT

## THE PANEL'S PROPOSALS

The Panel made a number of proposals for concluding the 2017 valuation that could result in a lower deficit and lower contributions for both employers and members; thereby using up less of the employer risk capital. These included the following adjustments:

**Figure 17: JEP proposals relating to Test 1 from its first report.**




The Panel concluded that a number of ways could be found to arrive at an overall contribution rate for employers and members below 30% and set out how the changes above could achieve this. The Panel demonstrated that if its proposals were taken into account, a contribution rate of 29.2% might be achieved but acknowledged that this did not allow for an assessment of the additional risks to which the Scheme would be exposed.

UUK consulted employers on the Panel's proposals and received widespread support for them, subject to USS providing more information on the additional financial risks involved and if and how they could be managed and mitigated. USS concluded that the Panel's proposals "would require employers to take on greater risk, and both members and employers paying higher contributions, than we were advised they were originally willing to support"[32].

[32] USS website - concluding the 2017 valuation

## USS ASSESSMENT OF THE PANEL'S PROPOSALS

The consultation explored USS' views on the proposals made by the Panel in its first report. USS attributes a risk score to each of the proposals and explains why each of the proposals has either been incorporated into the 2018 valuation or has been rejected.

Two of the changes put forward by the Panel were considered to be of low risk and were incorporated into the 2018 valuation, namely the expected future investment returns and the changes to mortality experience data during the year. However, USS rejected four of the proposals made by the Panel on the basis that they were perceived to introduce additional risks to the Scheme:

- increasing the target reliance at 20 years from £10bn to £13bn;
- deferring de-risking of the investment portfolio for 10 years;
- smoothing contribution rate increases over two valuation cycles; and
- allowing for outperformance relative to the technical provisions discount rate in the calculation of deficit recovery contributions (in spite of the fact that the conclusion of the 2017 valuation included a 10% allowance for out-performance of assets between best estimate and the prudent discount rate).

USS expressed the view that individually each of these proposals could be worthy of consideration but that collectively the additional risk would be 'significant' and implied an average discount rate for the valuation above the benchmark of the 2017 valuation. The benchmark 2017 discount rate is also expressed as being "at the maximum acceptable risk at that time", presumably acceptable to the USS Board and the regulator. USS also expressed concern about down-side risks that would affect the level of reliance placed on employers (self-sufficiency liabilities less the assets of the scheme).

## RECOMMENDATIONS FOR INVESTIGATION FOR THE JEP'S PHASE 2 REPORT

In addition to recommendations relating to the 2017 actuarial valuation, the Panel made a number of observations relating to the operation of the Scheme and its valuation which it said should be considered in the Panel's second report. These were:

1. Delivering an approach to future valuations that is clear (and clearly understood by Stakeholders) that can deliver a sustainable Scheme.
2. A review of the approach and involvement of UCU and UUK in future valuations.
3. Whether there are different paths to reaching a conclusion to the valuation that would have the support and confidence of all parties.

These issues have been addressed in our second report.

# ANNEX 5: CHANGES SINCE THE JEP'S FIRST REPORT

| Month | USS | Wider HE/ pensions developments |
|---|---|---|
| **September 2018** | • JEP's first report published. | |
| **December 2018** | • Work on 2018 valuation commences.<br>• TPR writes to USS stating | |
| **January 2019** | • TPR sends email to USS raising concerns about the misrepresentation of TPR's views on discount rates in the 2018 valuation. | • DfE consults on the funding available to state schools to cover the additional costs of employer pension contributions in 2019/20. |
| **Feb – March 2019** | • UUK consults with employers on contingent contributions. Broadly, employers support pledging contingent contributions.<br>• UCU-nominated Trustee, Professor Jane Hutton, submits a whistleblowing report to TPR, which led to TPR requesting further information from Professor Hutton and USS. | • Government publishes it response to its consultation on the Regulator's powers. |
| **April 2019** | • UUK approach to contingent contributions rejected by USS Trustee. | • TPR publishes its Annual Funding Statement for DB schemes. |
| **May 2019** | • USS publishes three options for concluding 2018 valuation.<br>• UCU reaffirms its policy of 'No Detriment' at its annual congress. New UCU JNC negotiating team elected.<br>• TPR writes to USS expressing concern at Option 3 and raising concerns about USS's decision-making processes and interactions with TPR.<br>• USS receives Master Trust Authorisation from TPR. | • Jo Grady elected as General Secretary of UCU.<br>• Augar Review on the funding of higher education published. Recommends cap on student fees should be reduced to £7,500. Questions over government top ups to make good funding gaps for some institutions. |
| **June 2019** | • As part of agreeing Option 3, USS proposes rule changes to Scheme designed to give the Trustee | • Changes proposed to NHS scheme to take account of the impact of |

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| | discretion on employer withdrawal/ exit – moratorium rule agreed to October 2021. Trustee also requests greater oversight of sponsoring employers' debt and pari-pasu for the Scheme on future secured borrowing.<br>• UCU writes to 69 institutions warning of possible strike action if certain conditions are not met relating to the Scheme. Union confirms on 28 June that it will ballot for strike action between 9 September and 30 October.<br>• Trinity College Cambridge exits USS – buys out its section 75 debt with a contribution to the Scheme of £30m.<br>• Work and Pensions Select Committee Chair, Frank Field MP, writes to TPR over its handling of whistleblower complaint.<br>• USS responds to TPR's concerns regarding misrepresentation of its position on discount rates. | the tax 'taper' on higher paid scheme members. |
| **July 2019** | • UUK consults with employers on the three options and gets a clear picture for option 3 as the "best available" option as well as agreeing to work with the Trustee on covenant supporting measures.<br>• JNC agreed rule change, subject to Trustee confirming Option 3 | |
| **August** | • 2 August – UCU National Disputes Committee (NDC) published a template letter for UCU branches to send to employers.<br>• UUK provides template answers for employers to use in response.<br>• 20 and 22 August – JNC meets to consider whether to accept Option 3 and its associated conditions. Fails to | |

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| | reach agreement on way forward (based on Option 3). Chair's casting vote used to reach a settlement.<br>• USS starts consulting with UUK (who in turn consult with USS employers) over schedule of contributions and recovery plan to conclude the 2018 valuation.<br>• 23 August – USS writes to UUK regarding the consultation exercise. USS warns that conditions in the financial markets mean that before the end of the consultation exercise the Trustee may need to reconsider the contribution rate or other mitigating actions that may be required. | |
| **September** | • UCU commences ballot for industrial action.<br>• 11 September – deadline for employer responses to the consultation.<br>• 13 September – Trustee meets and confirms its intention to progress the 2018 valuation in line with its option 3 proposals.<br>• 2018 valuation concluded, 3 months beyond the statutory deadline. | |
| **October** | • USS writes to UUK and TPR to formally conclude the 2018 valuation ahead of the higher increases planned for the 2017 valuation.<br>• Contributions increase to 9.6% for members and 21.1% for employers.<br>• 30 October – UCU ballot closes. | General Election called. Pensions Bill that would have brought forward LTO shelved. |
| **November** | • 5 November – UCU announces that following the conclusion of the ballot for industrial action, strike action across 60 universities to take place between 25 November to 4 December. | |

# ANNEX 6: USS VALUATION PROCESS AND ITS GOVERNANCE

Many of the features of the USS valuation process – and its associated governance – are similar to those applied in other occupational pension schemes and are specified in legislation. Other features are specific to USS and reflect the specifics of the Scheme and, in particular, its multi-employer nature, and are set out in the rules of the Scheme.

USS, in common with other UK DB schemes, is required by section 224 of the Pensions Act 2004[33] to conduct a valuation of the scheme at least every three years. The same section also requires at least annual actuarial reports for the intervening years.

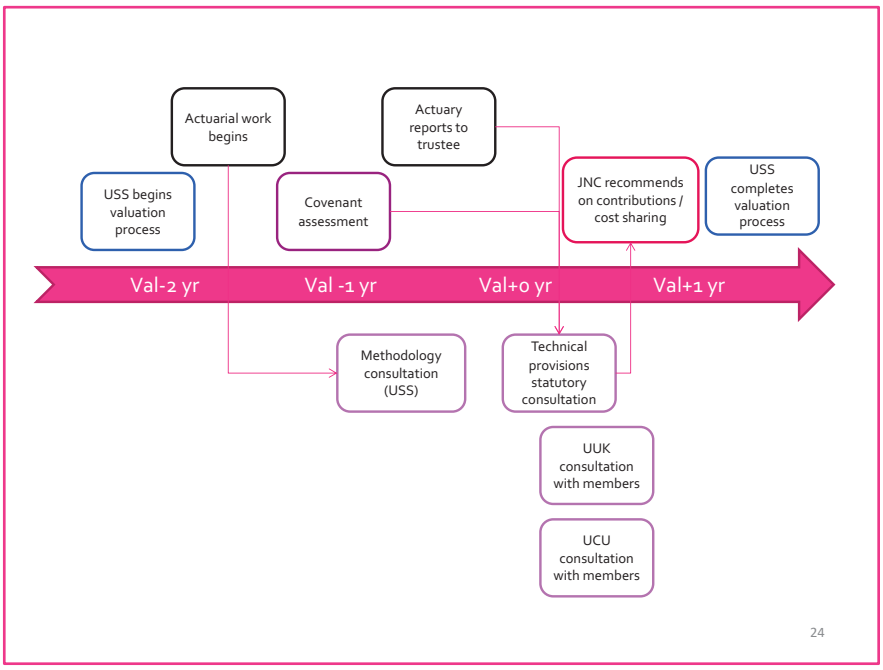
Under the Rules of the Scheme, the USS triennial valuation process is initiated by the Board of USS, typically 1-2 years ahead of the valuation date. It will include a series of assessments of and consultations on factors that will be taken into account in determining the valuation assumptions (for example an assessment of the strength of the employer covenant and a consultation with sponsoring employers on their appetite for risk and technical provisions (TPs)). (UCU is not a formal consultee during this process although it does play a role in informing members.) In addition, a number of consultation exercises with employers in the form of 'town hall meetings' will typically take place. The outcome of the valuation influences the assumptions used by the Trustee, including the employers' risk appetite.

The JNC will then take the outcome of the valuation to determine how any contribution increases (if required) will be shared between sponsoring employers and Scheme members, and/or recommend benefit changes to manage any deficit.

A simplified (and theoretical) schematic of the process is set out in Figure 18. It shows that the process is complex, lengthy, and has a number of stages. It also shows consultation phases, some required by statute, which are initiated by the Trustee. The process also includes a number of exercises aimed at explaining the valuation to Scheme members and sponsoring employers.

[33] http://www.legislation.gov.uk/ukpga/2004/35/section/224

## Figure 18: The valuation process (simplified version)




One further feature that sets USS apart from other Schemes' approaches to valuations is the number of organisations involved. Some parties have a formal role set down by regulation and the scheme rules, others have an important role to play in shaping the outcome of the valuation, whilst the role of others is confined to communicating or responding to the outcome.

The roles and responsibilities of the various bodies and their relationship to one another as regards the valuation are shown below:

## Figure 19: USS valuation governance - players and roles

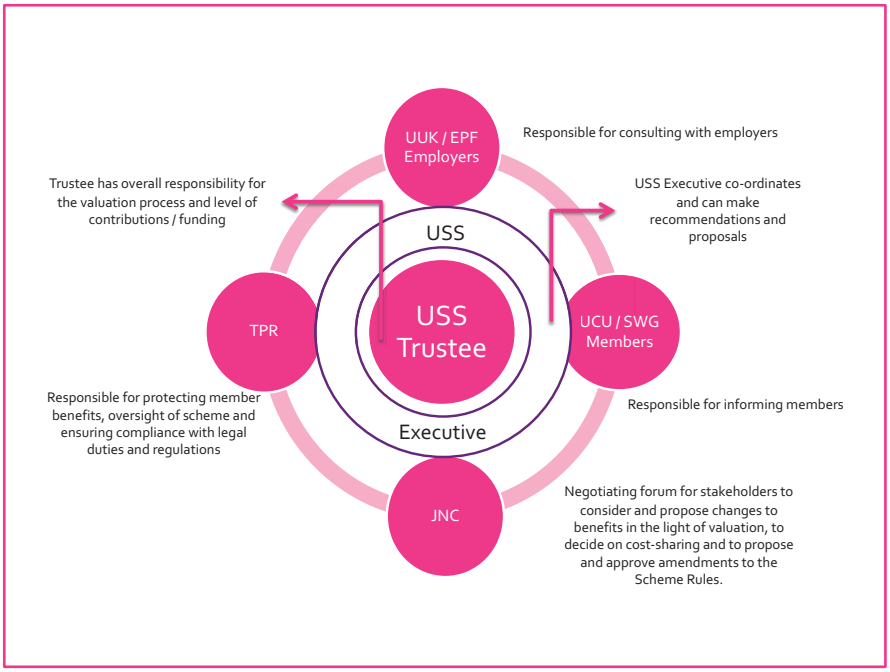


Figure 20 summarises the current roles and responsibilities of the various players and the source of their locus in the valuation.

**Figure 20: Current roles and responsibilities and source of remit**

| Party | Roles and responsibilities | Source of remit |
|---|---|---|
| **The USS Board (Trustee)** | Ultimate responsibility for the valuation, as set out in s224 of the Pensions Act 2004[34] and TPR's code of practice[35]. Responsible for approving the triennial valuation and process (including assumptions, methodology and outcomes) but delegates responsibility for performing the valuation to the Group Chief Executive of USS[36]. Rules of the Scheme provide the Trustee with unilateral powers over the level of contributions required to fund the scheme. Ultimately the Trustee can impose contribution rates, a feature that is unusual in DB schemes. The Trustee Board (the Board of USS) has very limited powers over the benefits provided by the Scheme. Scheme Articles define the composition of the Board. | Scheme articles and rules (and legislation and regulation) |
| **USS Executive** | Take on most of the responsibility for communicating with Stakeholders over the valuation and ensuring that consultations take place. Much of the work around the valuation assumptions, methodology and the mechanics of the valuation itself is conducted by actuaries employed by USS. | The USS Board of directors and governance framework |
| **JNC and its committees** | Part of the USS governance framework and is constituted, empowered and governed by section 64 of the Scheme Rules[37]. It is responsible for considering, approving and advising on rule changes and to decide on contributions increases or decreases and/or benefits changes under sub-rule 64.10. It can also instigate changes to the Scheme Rules. It has no direct influence over the valuation itself or over contribution rates. | Scheme rules and JNC ToR |
| **UUK/ employers** | UUK is the sole body responsible for consulting with employers over the valuation (in line with the statutory requirement) and establishes the risk appetite of employers, an important input to the valuation. It appoints members to the JNC and nominates up to four Trustee | Scheme Rules and the statutory requirement to consult |

34 Pensions Act 2004

35 *Code of practice No. 3, Funding defined benefits*, TPR, 2014

36 USS Governance Framework, updated March 2019

37 USS Scheme Rules April 2019

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| | Directors. Under the Scheme rules, the Chair of the Board of USS is currently a UUK nominee. (This is due to change when the new Chair is appointed in 2020 and the Chair will be an independent Trustee). | |
| **UCU/ members** | Limited formal role in the process, but a significant role in providing information to Scheme members. No formal role in consultation. Elects members to the JNC via its internal processes and nominates three members to the USS Board. | |
| **Scheme actuary** | An individual independent of the Scheme. Responsible for producing and signing off the valuation report to the Trustee as set down in legislation. The individual must hold a practicing certificate from the Institute and Faculty of Actuaries and is subject to regulation by the profession[38] and oversight by the Financial Reporting Council (FRC)[39]. | Legislation plus professional requirements and FRC |
| **Advisers** | Each of the Stakeholders has its own advisers, including actuarial advisers who are governed by their professional standards. | UCU and UUK plus professional standards |
| **TPR** | The Pensions Regulator has five statutory duties, set out in primary legislation[40]. In addition, the 2017 Pensions Schemes Act extends the Regulator's statutory powers to include the authorisation of Master Trusts, of which USS is one. TPR has also introduced a regime of one-to-one supervision for larger schemes which will, in due course, include USS. This is part of the TPR's more proactive approach to supervision of its regulated community. | Legislation |

Compared to single employer schemes (where the discussion and consultation about the assumptions would be between the trustees and the employer) or even other multi-employer Schemes, the USS valuation process is far more complex. This in part reflects the fact that there are more bodies involved (the Stakeholders, JNC etc) some with roles which were set out in the Scheme rules when the Scheme was established. But it is also a reflection of the fact that the valuation methodology is extremely complex.

38 In particular, APS P1, which sets out the 'duties and responsibilities of members undertaking work in relation to pension schemes'

39 FRC oversight of the actuarial profession

40 Pensions Act 2004

# ANNEX 7: SEMI-STRUCTURED STAKEHOLDER INTERVIEWS – DISCUSSION GUIDE

Thank you for agreeing to participate in this programme of interviews for the Joint Expert Panel's second phase of work on the USS valuation. The second phase of work has two parts, the first of which is concerned with the valuation process and governance. It includes consideration of:

- The roles and involvement of UCU and UUK in the valuation process so that a more collaborative approach could be adopted that will avoid future industrial action disputes.
- An examination of the interaction of the various bodies with a formal role in the valuation process, including the Trustee and the JNC.
- Considering the potential for the involvement of Scheme members in the valuation process and how more effective engagement with employers can be achieved.
    - We would welcome your views on how well the current process and governance of the process operates and any thoughts you have on how the process and governance could be improved.

## THE VALUATION PROCESS

Perhaps we could start by asking you to describe how you see the valuation process working from end to end. How does the valuation process start and when?

- are there distinct stages to the process?
- what are they? Are they defined by scheme rules, by regulation or by agreed practice?
- what is the purpose of each stage?
- how long is each stage?
- what is the desired outcome for each stage?
- what triggers the start of the next stage? which Stakeholders are involved in each stage?
- what role do different Stakeholders play in each stage?

## GOVERNANCE OF THE VALUATION PROCESS

Is there an overarching governance structure for the valuation process?

By governance we mean oversight and leadership of the process and accountabilities for the performance of the process?

- Who controls the process?
- What roles do people/organisations play in the governance of the process?
- Where does the back stop?

## STRENGTHS AND WEAKNESSES OF CURRENT PROCESS AND GOVERNANCE

What would you describe as the strengths of the current process and governance? What would you describe as the weaknesses of the current process and governance? What changes, if any, would

you like to see made to the process and governance? Does the timing of the process work and is the sequencing of consultations right?

### ROLES AND RESPONSIBILITIES

Are the right people playing the right roles and are the roles defined properly? Does every stakeholder have a voice in the process? Is the system weighted to some groups more than others?

- Who makes sure members' views are represented?
    - Who makes sure employers' views are represented?
    - What role does UUK play in consultations? How does it interact with USS and JNC? How does it construct its consultations with members?
- What role does UCU play in in consultations? How does it interact with USS and the JNC? Should members be engaged given that cost sharing applies? If so, how should that work?

### DESIGNING AN IDEAL VALUATION PROCESS AND GOVERNANCE

- What would an ideal process look like? What, when and who? What should the governance of the process look like?
- Is it possible to define some principles that should apply to the process and governance?
- Are there examples of how it works elsewhere – similar schemes / not just UK?

**Thank you for your time**

# ANNEX 8: ALTERNATIVE PATHS TO THE VALUATION – USS MODELLING




## USS: Impact of pre & post retirement discount rates

### 1. Background

This paper sets out the results of some calculations requested by the Joint Expert Panel (JEP), in an email of 15 November 2019 in relation to the impact on the Scheme's liabilities and contribution requirements of adopting various pre and post retirement discount rate structures. The specific discount rate structures that were requested by the JEP were as follows:

a) Gilts + 2.5% pre-retirement, gilts + 0.75% post-retirement
b) Gilts + 3.0% pre-retirement, gilts + 0.75% post-retirement
c) Gilts + 3.5% pre-retirement, gilts + 0.75% post-retirement

The intention being the benefits in retirement are valued on the basis of a low risk portfolio that has a high probability of being able to meet the benefits promised.

The Panel also requested the relative length of the pre- and post-retirement periods, weighted by liabilities.

The purpose of this note is to provide the output of the requested calculations.

### 2. Results and commentary

We have estimated the Technical Provisions and future service rates based on the discount rate structures specified, as at 31 March 2018. All other assumptions required to undertake the calculations are as used in calculating the technical provisions for the 2018 actuarial valuation. As you are aware all assumptions used by the Trustee in establishing the technical provisions (TP) and contributions are "best estimate", with the exception of the discount rate and mortality, importantly this results in the level of CPI being some 50bps lower than that used in calculating the liabilities on a lower risk (self-sufficiency (SS)) basis. Given this difference we have produced two sets of figures in Table 1 which gives a potential range of outcomes depending on the approach taken to calculating the post–retirement liabilities.

It should be noted that in producing the figures in Table 1 no consideration has been given to how these discount rates would align with the Scheme's investment strategy or the risk capacity and appetite of the employers and Trustee.

All the underpinning assumptions will be reviewed by the Trustee as part of the 2020 valuation. None of these illustrations should be interpreted as indicative of the approach that the Trustee is prepared to adopt for the 2020 valuation.

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*Table 1: Estimated valuation results based on adopting the requested discount rate structures, with the 2018 valuation position for comparison*

| Discount rate structure | Indexation* | Technical Provisions | | | Future service cost (Normal Pension Age 66) | "Gilts +" single equivalent rates** |
|---|---|---|---|---|---|---|
| | | Non-pensioner | Pensioner | Total | | |
| As per 2018 valuation | TP CPI | £40.7bn | £26.6bn | £67.3bn | 28.7% | 1.33% |
| G+2.5% / G+0.75% | TP CPI | £39.6bn | £27.5bn | £67.1bn | 27.4% | 1.35% |
| | SS CPI | £42.4bn | £29.1bn | £71.5bn | 29.3% | 1.34% |
| G+3.0% / G+0.75% | TP CPI | £37.6bn | £27.5bn | £65.1bn | 25.5% | 1.51% |
| | SS CPI | £40.3bn | £29.1bn | £69.4bn | 27.3% | 1.49% |
| G+3.5% / G+0.75% | TP CPI | £35.7bn | £27.5bn | £63.2bn | 23.8% | 1.66% |
| | SS CPI | £38.3bn | £29.1bn | £67.4bn | 25.4% | 1.64% |

** here, 'TP CPI' is breakeven inflation less 130bps, and 'SS CPI' is breakeven inflation less 80 bps applied to post retirement only, pre-retirement CPI is breakeven inflation less 130bps.*
*** calculated on past service liability equivalent basis as at 31 March 2018.*

The future service costs include allowance for DC benefits and expenses consistent with the 2018 valuation. We have not considered deficit recovery contribution requirements.

In response to the second part of the request, we have estimated the following statistics. These are approximate only (and vary slightly by assumptions) but are intended to give orders of magnitude. Note we have provided durations rather than periods. These are based on the TP CPI approach; the proportion of liabilities and duration relating to the post retirement period would increase slightly under the SS CPI approach.

- Estimated overall proportion of liabilities based on pre and post retirement discount rates are 33% and 67% respectively (i.e. this is the proportion of the pre and post retirement discount rate that is equivalent to the single rate)
- Estimated duration of:
  - Non pensioner (actives and deferred) liabilities for accrued service pre-retirement: 11 years
  - Future service liabilities for service accruing in the next year pre-retirement: 17 years
  - Non pensioner liabilities for accrued service post-retirement: 14 years
  - Pensioner liabilities: 12 years

Whilst we have performed the requested calculations, we have not considered the investment strategies that would support the discount rates used in the calculations or whether such an approach is consistent with the risk capacity and appetite of the employers and Trustee.

As you will be aware, gilt yields have fallen significantly since March 2018, and updating the above liabilities and future service costs for current yields would likely lead to significant increases in both.

USS Limited

3 December 2019

Restricted Business Sensitive (RBS)




The numbers in this note have been provided for information only, they do not constitute advice and should not be used as a basis of any decisions. Further, this document does not and is not intended to provide all the information that would be required under TAS to support a decision.

The Trustee accepts no liability or responsibility to any third-party including members of the Joint Expert Panel in respect of the numbers contained in this document and recommends any recipient take their own advice, including actuarial, before taking any decisions using any information provided in this note.

This document is covered by the confidentiality agreement in place between USSL and the members of the Joint Expert Panel.

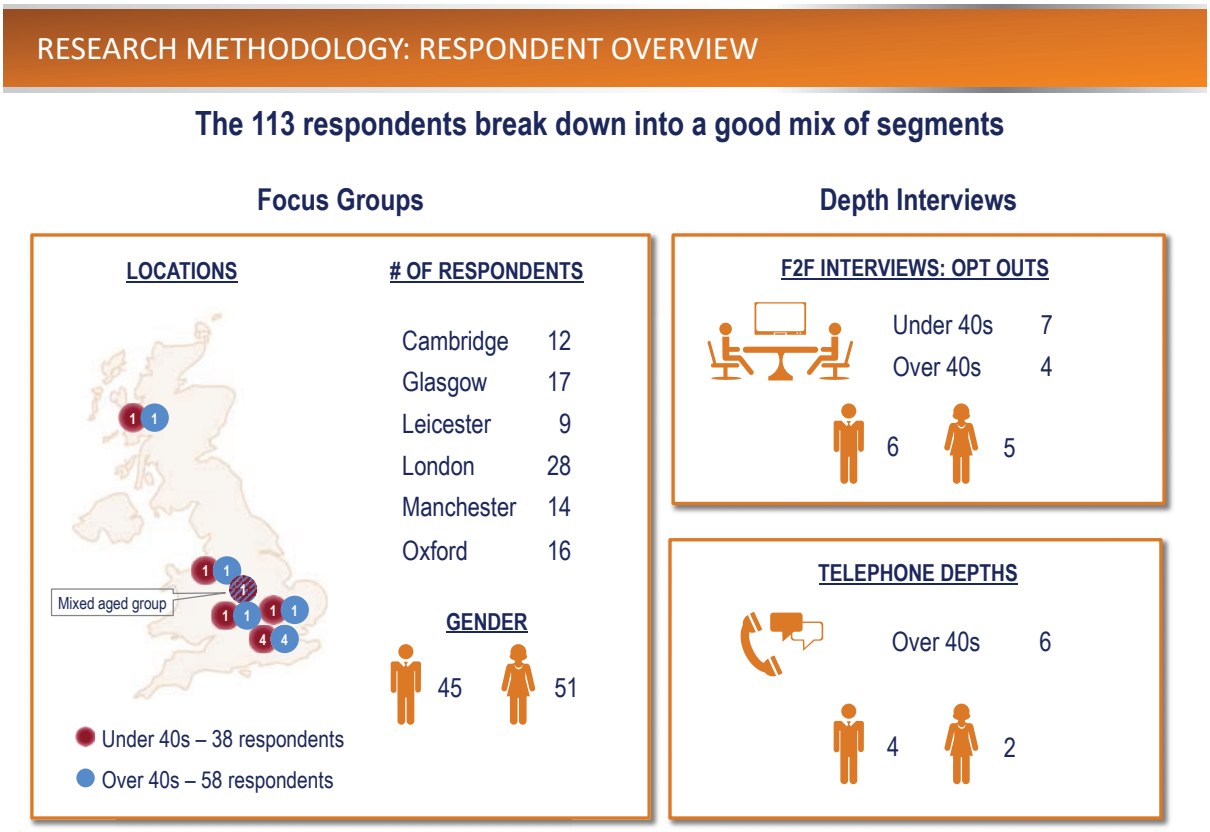
# ANNEX 9: MEMBER AND NON-MEMBER RESEARCH

The Panel commissioned a programme of qualitative research from Ignition House. The research was conducted during the Summer of 2019.

## RESEARCH RESPONDENTS

Ignition House were asked to provide a broad geographical spread as well as a mix of genders, ages and both faculty and non-faculty members. Specific interviews were designed and recruited for those who had opted-out of the scheme.

The research consisted of 13 two-hour focus groups, six telephone depth interviews and eleven face-to-face interviews.

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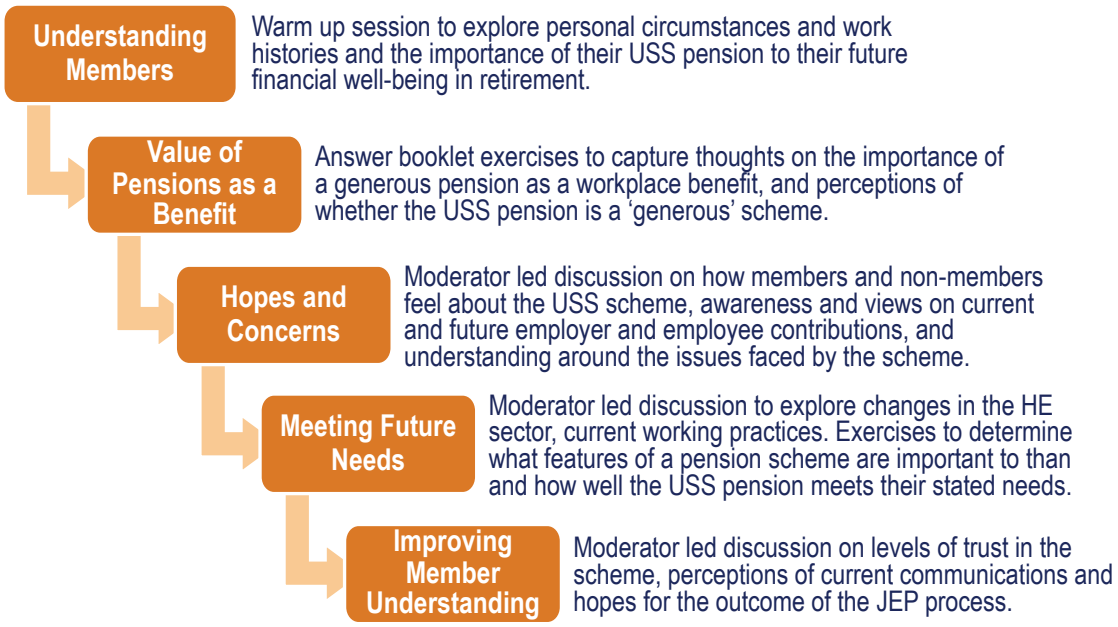
## DISCUSSION STRUCTURE

A discussion guide was developed by Ignition House based on an outline provided by the Panel. Ignition House developed a range of stimulus material to support the broad structure of the discussion set out below.

## RESEARCH METHODOLOGY

**We ran 2 hour exploratory sessions to explore what members understand about their pensions and how well the pension fits with their working lives**

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# ANNEX 10: THE PANEL'S RECOMMENDATIONS - SUMMARY

## PRINCIPLES TO UNDERPIN THE VALUATION

1. A new purpose statement should be jointly agreed by UCU, UUK and the Trustee to establish a shared vision for the Scheme.
2. Shared Valuation Principles should be agreed between UCU, UUK and the Trustee that will lead to a mutually agreed outcome for a valuation that supports the Scheme's sustainability.

## VALUATION GOVERNANCE

3. To help rebuild trust, the Trustee Directors should be more visible to, and engaged with, the Stakeholders[41].
4. The Trustee should establish funding and valuation sub-committee to provide greater focus for the Stakeholders.
5. The Trustee and JNC should establish a joint forum on valuation to facilitate a common understanding of issues relating to the valuation.
6. Steps are required to improve the effectiveness of the JNC, including greater consistency membership and consideration of removing Chair's casting vote.
7. A more radical approach should be considered including a high-level Steering Committee to agree issues relating to the future direction of the Scheme.
8. Consideration should be given to employer representation in the Scheme, given UUK's primary responsibility as a co-ordinator of cross-sector collaboration.
9. UCU should take steps to demonstrate it represents all sections of the membership and potential members.

## ALTERNATIVE PATHS TO THE VALUATION

10. A simpler and more appropriate valuation methodology is possible that meets the needs of employers and members and reflects the Scheme's demographics, cashflows and covenant.
11. The starting point for a new valuation methodology should be the acknowledgement of the purpose of the Scheme, a re-articulation of the Trustee's and employers' risk appetites and a recognition of the risk appetite of members.
12. Consideration should be given to adopting a dual discount rate approach to the valuation that would better reflect the profile of the Scheme. And by evolving automatically as the Scheme matures, it would anticipate the requirements for a long-term funding target.

## TAKING ACCOUNT OF THE NEEDS OF MEMBERS

13. Stakeholders should investigate different approaches to contributions as part of a move away from one-size-fits-all approach. This could help address the high level of Scheme opt outs.

[41] Stakeholders means UCU and UUK

EXPLORING MUTUALITY

14. Mutuality is a strength of the Scheme and the sector. Weakening its mutuality would damage the Scheme.

CONCLUSION AND ROAD MAP

15. A failure to address the recommendations in this report would mark a failure for members, employers and the sector.
16. The Stakeholders and Trustee must urgently come together and make them work. This process would need to be facilitated through mediation.

The Joint Expert Panel (JEP) is a panel of independent experts who have been examining issues surrounding the valuation of the Universities Superannuation Scheme (USS).

The JEP comprises six actuarial and academic experts nominated equally by Universities UK (UUK) and the University and College Union (UCU), with a jointly agreed chair, Joanne Segars OBE.

The findings in this report are expected to inform the future direction of the Scheme and its actuarial valuations.

For further information please visit:
www.jep.org.uk