USSEmployers

RESPONSE FORM

A consultation by Universities UK with employers on the indicative outcomes of the valuation

CLOSING DATE: 24 MAY 2021

REPLY TO: PENSIONS@UNIVERSITIESUK.AC.UK

MAKING YOUR RESPONSE TO THE CONSULTATION

We welcome responses to this consultation from each and every one of the scheme's participating employers.

We are keen to have the widest possible range of views and perspectives ahead ofthe next steps of the 2020 valuation.

Through this consultation we are formally seeking views and direction fromemployers on some key questions, particularly on:

- Covenant support measures
- Contributions
- Future benefit structures
- Addressing the high opt-out rate and flexibilities
- Governance
- UUK's Alternative Approach

This template form is optional and can be used for the response from your institution,you may also want to feedback this information another way.

With these views, UUK can then progress the negotiations with the University andCollege Union (UCU) within the Joint Negotiating Committee (JNC).

Please send the response from your institution to pensions@universitiesuk.ac.uk by 5pm Monday 24 May 2021.

SUMMARY

A contribution of 25-30% of salary should be sufficient to secure a good pension in retirement for staff in the employer base of USS. The fact that it does not under the current proposals represents a significant failure of the regulatory approach to pension fund valuation, which does not appear to fully take into account the unique nature of the HEI sector in the UK and the nature of USS and the inability or unwillingness of USS to present an alternative approach that would achieve a better outcome for employers and members while keeping within an acceptable level of risk.

The UUK Alternative Proposal is a well thought through attempt to deliver the best possible outcome given constraints of:
- Maintaining the hybrid scheme
- Not increasing costs to members and employers, and
- Working within the valuation framework set out by USS

However, while significantly better than the options presented by USS, it imposes material benefit cuts and additional inflation risks on members. If this is indeed the only option available, then it should be adopted for absolutely the minimum amount of time necessary to explore and implement an alternative formulation which delivers better value for money - which may well involve risk and reward sharing with members (e.g. through conditional indexation) and USS governance reform.

Our preference over the UUK Alternative is to start work on a redesigned scheme immediately based on a valuation date of 31st March 2021, to maintain current benefits and to meet the October increases in contributions for a short period of time with a view to implementing this redesigned scheme from October 2022. We provide more detail on this in our responses to questions 8 and 9.

We support the proposed covenant enhancement measures but recognise that these are easier to implement for the University of Cambridge than for others in the sector. We would be prepared to consider other measures also but note that the wide variety of types of employer and the need to take a long term perspective in budgeting means that many traditional types of covenant enhancement that would work easily in a single employer scheme are difficult to implement for USS.

We strongly support the proposals to provide an optional alternative scheme – that in our view needs to be both lower cost and provide portability between sectors and internationally. Our single largest cohort of staff are early career researchers who may only be in the UK or in the sector for a few years and for whom the current USS benefit structure is a poor fit. This, and the high member cost of USS has led to many employees dropping out of USS and missing out on a significant amount of value. It should not be the case that the lowest paid and those with the most insecure jobs miss out on our most valuable benefit. We believe it is entirely possible to rectify this without undermining the main scheme.

COVENANT SUPPORT MEASURES

1. Would you be willing to support the alternative covenant support package which UUK has outlined in section 4, as the means to achieve a solution which might be acceptable in the round (see also question 15)?

We support the alternative covenant support package proposed by UUK (as set out in section 4 of the consultation document), on the condition that a longer moratorium leads to a longer deficit recovery period at the 2020 (and future) valuations. The link between the deficit recovery period and moratorium for employer exit is important and we would support a moratorium for the 2020 valuation and future valuations of no more than the deficit recovery period plus two years. Therefore, a moratorium of 20 years should lead to a deficit recovery period of 18 years for the 2020 valuation. There should be a formal process to review the moratorium at each valuation to establish whether it is still necessary and provides adequate value.

We welcome UUK's call for compromise across USS stakeholders, and the alternative support measures (if agreed) would represent a significant compromise from employers which we hope would be reciprocated by the USS Trustee.

COVENANT SUPPORT MEASURES

2. If the USS Trustee is not willing to accept UUK's alternative proposal (should there be employer support for it), would you be willing to support the USS Trustee's scenario 3 covenant support package to obtain a 'strong' covenant rating? If not, why is this and what level of covenant support would you be willing to provide?

We would be very disappointed if UUK's alternative covenant proposal is not accepted by the USS Trustee. If this is not accepted, we would hope the USS Trustee is able to amend their proposals to allow a longer moratorium on exits (20 years) in exchange for a longer deficit recovery period (which would be consistent with this longer moratorium).

We support the USS Trustee's scenario 3 covenant support package, however refusal from the USS Trustee to strengthen this in line with the wishes of employers (i.e. UUK's alternative) would be surprising.

COVENANT SUPPORT MEASURES

3. Are there areas of the covenant support measures which cause you particular concern, or which you would wish to see modified? Please provide details.

None of the covenant support measures cause particular concern.

It is also important, however, to consider what would be provided in exchange for these covenant measures. An increase in covenant support measures should lead to an improvement in the covenant rating and a lower cost of benefits.

Whilst accepting the alternative covenant support measures, we ask UUK to continue challenging the USS Trustee on the valuation methodology, choice of assumptions and allowing for the impact of post valuation market changes on the resulting contribution rates.

On a point of detail, we continue to believe that the debt monitoring metrics should reference net debt rather than gross debt as the use of gross debt penalises HEIs that keep long debt and cash rather than relying on a revolving credit facility. Use of long-term debt and cash is a less risky position than relying on a revolving credit facility which might not be available in difficult circumstances. We also continue to believe that non-recourse debt that supports covenant enhancing projects should not be included in the debt monitoring process.

COVENANT SUPPORT MEASURES

4. Are there other areas of covenant support you would wish to consider such as contingent contributions or asset pledges?

We would be willing to consider any other forms of covenant support proposed by UUK or the USS Trustee in order to demonstrate the strength of the higher education sector and to ensure that this is not underestimated by the USS Trustee.

While, in principle, we would support an approach which would permit a lower level of prudence in the setting of the Technical Provisions in exchange for a contingent contribution arrangement, in practice, the propositions put forward by USS in the past have required large additional contributions at short notice depending on short term market movements. We do not think this approach is compatible with the long term-planning required for University finances.

CONTRIBUTIONS

5. Do you agree that the current levels of employer contribution (21.1% of salary) and member contribution (9.6%) are the maximum sustainable – and should be the foundation for any solution?

a. If not, please state the level of employer contribution you would be willing to pay to USS following the 2020 valuation.

b. We would welcome any commentary on the reasons for your views.

c. We would also welcome employer views on the level of member contribution.

Feedback received from USS Employers seems to confirm that the current levels of contributions are the maximum payable by the sector over the long term.

Our view is that the current levels of contributions should be sufficient to meet the cost of a high-quality pension scheme for staff provided that the split between future service and DRCs is reasonable e.g. c25% towards future service and c6% towards deficit recovery.

We are willing, therefore, to pay the current level of contributions if the core benefits provided by the Scheme are attractive. Specifically, whilst the current level of contributions are affordable, we would not be willing to pay this level of contributions for the proposed benefits set out by the USS Trustee as this would be very poor value to the University and members (https://www.uss.co.uk/news-and-views/latestnews/2021/03/03032021_uss-pension-contributions-will-need-to-rise-sharply). This would cause real difficulties in attracting high quality and experienced staff to the University (especially from overseas).

It is clear that long-term increases to the member contribution rate would lead to further opt-outs and create real dissatisfaction across the HE sector (as indeed would benefit reductions for the same cost). We would not want the USS to become a Scheme that only better-off members of staff can afford to join.

BENEFITS

6. Do you support the broad principle of seeking to retain the hybrid benefit structure?

We support the broad principle of seeking to retain the hybrid benefit structure. Members understand and appreciate the hybrid benefit structure and we would wish to retain this in the design of any future changes to the Scheme. We believe amendments to scheme design and governance would be desirable (see below).

BENEFITS

7. Looking at the illustrative hybrid benefits which UUK has put forward, would you consider this an acceptable outcome in terms of benefits at this valuation – based on the positions on covenant support and contributions laid out?

We appreciate the work carried out by UUK to prepare their alternative proposal and present this to employers.

The UUK Alternative Proposal is a well thought through attempt to deliver the best possible outcome given constraints of:

- Maintaining the hybrid scheme
- Not increasing costs to members and employers, and
- Working within the valuation framework set out by USS

However while significantly better than the options presented by USS, it imposes material benefit cuts and additional inflation risks on members. If this is indeed the only option available, then it should be adopted for absolutely the minimum amount of time necessary to explore and implement an alternative formulation which delivers better value for money - which may well involve risk and reward sharing with members (e.g. through conditional indexation) and USS governance reform.

Our preference over the UUK Alternative is to start work on the redesigned scheme immediately based on a valuation date of 31st March 2021, to maintain current benefits and to meet the October increases in contributions for a short period of time with a view to implementing the redesigned scheme from October 2022

BENEFITS

8. If the illustrated hybrid would not be acceptable, what alternative benefit arrangements would you wish to provide (and please indicate alternative positions on covenant and contributions as appropriate)?

(For example, if the USS Trustee does not ultimately amend its assumptions, would you wish to offer a hybrid solution as set out in the USS Trustee's illustrations (p18 of the Update Report) or would you prefer to move to a different offering, such as DC provision?)

Benefit accrual at the level set out by the USS Trustee (in p18 of the March 2021 update) would not be acceptable in exchange for the current level of contributions. This would be very poor value for the University and we would not be willing to pay this 'price' for the provision of pension benefits at this level.

As set out in our response to question 9, we believe a sustainable, affordable and high quality pension scheme can exist if based on a form of conditional indexation (or other risk and reward sharing option).

We would prefer that rapid progress is made on a sustainable solution now based on a valuation date of March 2021 and that we should not wait until a 2023 valuation to design and implement such a solution. As a stopgap, our hierarchy of preference for an interim arrangement would be as follows:

1. Retaining current benefits and accepting the October cost increases
2. Maintaining current costs and seeking the maximum benefits available in the current hybrid format as per the UUK alternative proposal.

We would also be happy to explore further short term options that avoided implementation of a new benefit package for a year.

We also note that the Scheme Normal Pension Age (NPA) could be amended to align this to State Pension Age for each individual member, as opposed to the current USS approach which sets a single NPA for all members. This revised approach would bring the USS into line with the Public Service Pension Schemes and would generate a small cost saving which we believe could be justified and which could be used to minimise the impact of changes on accrual rates.

BENEFITS

9. Would you wish to explore conditional indexation or other conditional benefit models as a possible solution (likely longer-term, beyond the 2020 valuation)?

Cost of benefits is currently driven to a significant extent by the perceived need for the scheme to remain within reasonable distance of "self-sufficiency" – that is to be able to pay out benefits under very bad market conditions without recourse to the sponsoring employers. The cost of assets in a self-sufficiency portfolio (such as inflation linked government bonds) that closely match future pension payments is very high and has been increasing in recent years.

For the scheme to have sufficient funds to be within reasonable distance of achieving self-sufficiency has therefore required dramatically increasing contributions to be made to the scheme for a given level of benefits.

Taking a more balanced approach to assets would give higher levels of volatility in the short term but are likely to deliver materially better returns making the scheme more sustainable. Risk and reward sharing (for example through conditional indexation) is a solution that allows risk to be better managed and can potentially provide materially better expected (but not completely guaranteed) benefits for the same contribution levels. To gain acceptance for risk sharing, design of the scheme would clearly need to demonstrate how risk sharing was only carried out if (and for the time) necessary and how higher long-term investment performance would flow into improved benefits.

We believe that this alternative approach is likely to be significantly better for members than the one currently adopted by USS where benefits must be cut now to address the remote possibility of both exceptionally bad market conditions and the insolvency of the sector. Even if the gap to self-sufficiency measure can be made less relevant (see Q14), it is likely that an optimised scheme design will include some form of risk and reward sharing.

However, careful communication will be required to ensure members understand this (and how it differs to the current Scheme).

Whilst it will not be possible to agree to a contingent indexation/benefit model within the timescale of the 2020 valuation, we request that discussions on such changes commence immediately with a view to these being implemented within a period of 12-24 months. It would be unacceptable for discussions on conditional models to be deferred until the 2023 valuation.

FLEXIBILITIES AND OPTIONS

10. Would you like to see flexibilities implemented for members to move away from the current uniformity of the USS structure, and if so which flexibilities do you think are particularly important?

We would like to see additional flexibilities introduced to the USS as this has the potential to reduce the level of opt outs and improve member engagement.

We strongly support proposals to provide an optional alternative scheme – that in our view needs to be both lower cost and provide portability between sectors and internationally. Our single largest cohort of staff are early career researchers who may only be in the UK or in the sector for a few years and for whom the current USS benefit structure is a poor fit. This, and the high member cost of USS has led to many employees dropping out of USS and missing out on a significant amount of value. It should not be the case that the lowest paid and those with the most insecure jobs miss out on our most valuable benefit. We believe it is entirely possible to rectify this without undermining the main scheme.

We believe the lower cost pension option is better than tiered contributions. In our view, tiered contributions are a sub-optimal approach as they:

- Could only apply over a limited salary range (there is already a large cross subsidy from those earning above the threshold)
- Would add complexity
- Would increase the level of cross subsidies between different employers.

FLEXIBILITIES AND OPTIONS

11. Would you support the creation of a lower cost saving option for members and which of the parameters described in this paper are most important / or would need modification?

(If yes, we would welcome employer views on the options to achieve this (potentially informed via engagement with eligible USS employees).

We strongly support the introduction of a lower cost option (and more portable) pension option. It is important that the alternative introduced does not undermine the main scheme and that it is not used as an excuse for employers to contribute less to the scheme overall. For example, if the alternative is DC, we would expect that the employer would continue to meet deficit recovery contributions and probably additional contributions to reflect the nature of the group moving to the lower cost alternative.

The University surveyed both current members of the scheme and eligible members to understand employee views on these issues. From our survey response (1300 responses – response rate 14%), amongst current members, the large majority (c80%) of respondents would not like to move to a lower cost alternative themselves, but a significant minority of respondents (c16%), particularly amongst early career researchers, would opt for a lower cost alternative. Among this minority, there is a slight preference for lower cost DB over lower cost DC. Some 4% of current member respondents said they would opt out in any event. For the low number of respondents that had already opted out of USS, a lower cost scheme was attractive to a material number but approximately half said that they would opt out in any event.

In the event that a lower cost DB option is adopted, we would like USS to offer a quick and easy transfer to a DC pot with indicative transfer value shown on valuation statements (as is done on other schemes).

In the event that a lower cost DC option is adopted, we would like the option for a member who has built up a DC fund to buy DB benefits with that fund at the end of (say) a five year period at the appropriate cost at that time (but without penalty).

In all cases we would like USS to make information available about how to transfer benefits internationally.

FLEXIBILITIES AND OPTIONS

12. Would you support the creation of an option for members to switch (from the hybrid structure) to wholly DC pension saving?

(We invite employer views on whether the same deficit recovery contribution should be made for members choosing any new flexible DC alternative option, and what levels of member and employer contributions devoted to DC pensions saving should apply).

We would support the creation of an option for members to switch (from the hybrid structure) to wholly DC pension saving option provided that such an arrangement doesn't damage the main scheme. More modelling would be required to establish the necessary parameters / safeguards.

We would expect employers to continue to pay deficit recovery contributions to meet the cost of the past service deficit for continuing members in whatever format their pension is accruing.

FLEXIBILITIES AND OPTIONS

13. Would you wish to explore options for employers so that they can offer some variations to the USS standard benefits in the future – and if so, what would those variations be?

USS employers are varied in their outlook and ability to financially support pension benefits for staff. We would therefore welcome a discussion on allowing variations to USS standard benefits in the future.

There is no doubt that the University of Cambridge would be able to provide a lower cost and more targeted scheme than that provided by USS if allowed complete flexibility. However, we consider that there remains significant value in a sector-wide scheme allowing easy understanding and transfer between HEIs. There is also widespread support in the University for Cambridge for us to play our part for the sector as whole.

Nonetheless, it may be that given the restrictions that come from having to take account of so many diverse employers, the scheme can be made more effective for all by having some further flexibility for different types of employer. Flexibility is likely to be most effective if applied to different types of HEIs rather than a complete "free for all" from different employers.

This is a complicated area and we believe that the all the focus now should be on exploring conditional indexation (or alternative) and governance over the next 12-24 months.

GOVERNANCE

14. We would welcome views from employers in relation to the governance of the scheme and the valuation process (including views on the Joint Negotiating Committee). Specifically, would you support a post valuation governance review, and what areas what you like to see covered in such a review?

Trust in the USS Governance process has been damaged by events surrounding the valuation process over the last 3 years. Over the years, a combination of continually low real interest rates and a tightening view of prudence linked to "self-sufficiency" has led to a continuing ratchet up of costs and reduction in benefits. The old way of responding to the USS Trustee after each triennial valuation may lead to short term 'solutions' but a longer term view is required to provide certainty to members and employers.

UUK have engaged much more effectively with employers at the 2020 valuation (than prior valuations) and the quality of the documents prepared to support this consultation is excellent. Indeed, the benefits of engagement between UUK and UCU since the last valuation, via the JEP and VMDF (also including USS), are clearly seen in the approach to the 2020 valuation.

More needs to be done to build an affordable, sustainable and high quality scheme for members. The USS Trustee is not focussed on this and we understand this is because their remit (as set by tPR) is to ensure that past service benefits are secure.

We therefore ask UUK to take the lead in developing a strategy for redesigning the scheme. It is important for this work to commence immediately. We cannot wait until the next valuation to re-commence discussions on scheme reform.

Scheme design and valuation needs to start with the assumption that the scheme will invest in the assets that will deliver the best overall return over the long term without excessive concern for volatility along the way (much like a University Endowment). This should provide the best pensions for members with the lowest overall level of contributions. Only if it is demonstrated that under plausible scenarios that the scheme will be unable to pay benefits should we move away from this efficient long-term portfolio, and then only when other mechanisms to manage the risks identified have been demonstrated to be unworkable. At present, USS is using a standard and easy approach to risk that may be appropriate for single employer closed schemes but is not appropriate for USS and leads to scheme that is not fit for purpose. It is not good enough – employers and members deserve better.

A small group of employer and member representatives needs to work with a willing, diligent and transparent USS management that is prepared to try to optimise the scheme and find ways to manage risk that do not rely on a "gap to self-sufficiency". Such a scheme design may well involve compromises by employers and members compared to the existing arrangements but it will at least be a design that is optimised for our needs and the risks and mitigations identified transparently.

We also believe the Trustee Board needs to have a more diverse membership. Given how different USS is from almost all other UK Defined Benefit schemes, the Trustee Board needs to include members who are expert in both the finances of the sector and in overall risk management (without resorting to asset and liability matching). It is unlikely that a Trustee Board with a view of pension risk derived substantially from experience of other (quite different) UK DB schemes will be well placed to optimise USS and manage its risks efficiently.

UUK ALTERNATIVE APPROACH

15. As part of a solution to the 2020 USS valuation would you support the alternative covenant support package illustrated by UUK *(headlines – moratorium of a minimum of 20-years with debt-monitoring and a pari-passu arrangement for secured borrowing above c15% of gross/net assets)*, to provide a hybrid benefits package at current contribution rates in the order of *(pension accrual of 1/85 of salary [plus 3 times lump sum] up to a salary threshold of £40,000 with the CPI indexation of benefits [for active, deferred and pensioner members] capped at 2.5% per annum, and with DC above the salary threshold at an overall contribution of 20% of salary),* together with a lower cost alternative to address the high opt-out rate, as well as a governance review of the scheme and valuation process?

The UUK Alternative Proposal is a well thought through attempt to deliver the best possible outcome given constraints of:

- Maintaining the hybrid scheme
- Not increasing costs to members and employers, and
- Working within the valuation framework set out by USS

The proposal however, while significantly better that the options presented by USS, causes material reductions to new member benefits as well as increasing the inflation risk to benefits at a time when there is increased risk of inflation – and we believe the alternative would be very badly received by members. If this is indeed the only option available, then it should be adopted for absolutely the minimum amount of time necessary to explore and implement an alternative formulation which delivers better value for money - which may well involve risk and reward sharing with members (e.g. through conditional indexation) and USS governance reform.

In the event that no alternative scheme can be designed and the UUK Alternative is adopted for a full three years pending a 2023 valuation, then in the 2023 valuation any improvement in the markets should flow first into restoring benefits and only subsequently into reducing the deficit recovery period or de-risking. This should be established as a requirement in exchange for the covenant support measures provided by employers.

Please send your completed form to: pensions@universitiesuk.ac.uk by Monday 24 May 2021

Thank you for taking the time to respond to this consultation.

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