Universities UK

Revised UUK proposal to the JNC for future benefit reform – 23 January 2018

1. Summary benefit reform proposal

1.1 Since 19 December 2017, UUK has met with UCU four times. In response to the points put forward by UCU, UUK has revised its proposal to the JNC. There are six substantive areas of revision, which were tabled in a meeting with UCU on 18 January and are summarised in section six.

1.2 The priority for employers at this valuation is to ensure that USS remains sustainable and affordable, so that members and employers have greater stability, so that the security of existing benefits in difficult economic circumstances is maintained and further underpinned, and so that attractive benefits can be afforded now, and in the future. This is a difficult balance, but UUK believes that this proposal achieves an appropriate recognition of these priorities.

1.3 UUK proposes an approach at this valuation that preserves the existing benefit architecture, applying the full flexibility of the hybrid scheme by modifying the salary threshold so that, there is no defined pension benefit accrual for the period of this valuation. USS would offer a market-leading defined contribution (DC) saving (through the USS Investment Builder) to all employees. UUK has carefully considered how best to maximise the value of this benefit design for members and this paper, as well as the benefit specification in annexe 1, set out how this could be achieved.

1.4 Throughout the negotiations, UCU have made clear that they want to retain an element of guaranteed USS pension so that scheme members have more certainty in retirement. Employers hear this view and propose that UUK and UCU convene beyond the constraints of a valuation to discuss the long-term future of USS and explore innovative options for risk sharing. This would include discussions on how to benefit from the genuinely valuable flexibilities that DC saving can provide for members in terms of how and when they access their pension savings, alongside considerations of the possible reintroduction of defined benefits (DB) in the future. To provide continuity and to make clear employers' commitment to USS members in the long-term, employers are willing to extend the duration of their commitment to maintaining employer contributions at 18% of salaries to March 2023 (from the current commitment to March 2020).

1.5 The proposal presented to the JNC meeting initially on 13 November 2017 was one of a range of possible approaches which came forward from employers during the earlier periods of consultation. UUK has been keen to retain the existing scheme architecture in finalising its proposed response to the latest valuation of USS, despite (for example) calls from some institutions to go further and make a more permanent move away from DB provision. UUK's 13 November 2017 proposal represented a balanced and moderated response from employers. This revised proposal contains some further movements which we hope will enable the JNC to reach agreement on the proposal to take to consultation with employees.

2. Why a sustainable solution is necessary at this valuation

2.1 The USS trustee has a fiduciary duty to secure accrued member benefits. It therefore needs to carefully assess the cost of benefits in order that it has (or can obtain) sufficient funds to meet all pension promises when they fall due. The trustee has engaged extensively with all stakeholders on both the method and assumptions by which the cost of benefits at the 2017 valuation is determined, and has sought professional advice on risk capacity. UUK understands that the trustee has used all the information provided to reach a professional judgement on its technical provisions.

2.2 The trustee's analysis concludes that:

- The cost of providing current future service benefits has risen by over a third since the last valuation
- A substantial past service deficit of £7.5bn[1] exists, having grown from £5.3bn as at March 2014.
- Reliance on the sponsoring employers has grown significantly since the last valuation, it was £23bn at the valuation date (compared to £14bn at the 2014 valuation).

2.3 USS is designed to meet the retirement needs of the higher education sector, and must be configured in line with the requirements of both employers and employees. Most USS employers are registered charities or otherwise operate on a not-for-profit basis, and many carry out the critical public functions of teaching, research and knowledge exchange. UUK believes that a failure to address the rise in cost and risk of USS would not be justifiable to students, current and future employees or the other funders of the higher education sector.

2.4 For over a decade the scheme has faced challenging valuations that have each required contribution increases and/ or benefit changes. That important context must be recognised given that both employers and members require greater stability and future certainty in respect of the benefit offering and cost. The priority for employers is to know that they can offer attractive benefits to their members now, but also in future. Failure to act appropriately at this valuation could lead to further future crises that could prohibit employers from offering attractive pensions. This would be to the severe detriment of future generations and the higher education sector.

2.5 For an outcome at this valuation to be sustainable, it must be affordable to scheme employers and members. In its proposal tabled at the JNC on 19 December, UCU proposed an approach that requires employers and members to pay much more for reduced benefits, with the accrual rate reduced from 75ths to 80ths. UUK has engaged extensively with USS employers on contribution levels, and whilst UUK was and is content that the employers' position on an 18% limit for regular contributions is clear, this position was retested following the 19 December 2017 JNC meeting through a further general call for evidence.

2.6 UUK is clear that increasing employer contributions beyond the current 18% is not affordable or sustainable, with employers reiterating that this would necessitate significant budget cuts and the diversion of funding away from employers' core missions. This view has been even further substantiated through the call for evidence, and is set out in detail in annexe 5. Ultimately, paying higher regular employer contributions would represent a diversion of funds that would be unjustifiable to students or other funders of higher education and research. It would also lead to job losses, and in the long-term could damage the sustainability of some institutions, and therefore the overall covenant strength which supports USS.

2.7 Employers also have little evidence to suggest that members would be willing to pay higher contributions. Extensive engagement in 2016 by the Employers' Pensions Forum revealed significant concerns that some employees were opting out of USS due to the 8% contribution rate. Similarly, UCU have also raised the issue of affordability concerns associated with the current level of contributions. As a result, UUK has designed a lower-

[1] Based on the valuation assumptions developed at the last valuation in 2014, the USS deficit at March 2017 would have been £12.7bn. The revised assumptions that USS consulted on in September 2017 brought this to £5.1bn. Following consultation with employers, a further consultation on the mortality assumptions as well as considering the view of the independent Pensions Regulator and USS's covenant advisors, PWC the deficit now stands at £7.5 billion based on the trustee's agreed technical provision position.

cost saving option to ensure that USS remains suitable scheme for all. In this option, members can pay contributions of 4% rather than 8% whilst still benefitting fully from the 18% employer contribution (as detailed in UUK's benefit specification). Significantly increasing member contributions would be contrary to evidence of members' affordability concerns, and would greatly disadvantage certain members.

3. The implications of maintaining some DB at this valuation

3.1 UUK and UCU have tried hard in the previous three valuations to solve the problems facing the scheme, retaining DB whilst most other private sector DB schemes were moving to DC. However, with economic conditions for DB schemes getting worse, employers have seen a dramatic increase in risk and cost and members have faced benefit change and great uncertainty.

3.2 UUK understands that UCU wishes to see the retention of some DB at this valuation, and has therefore considered the option of maintaining a small element of DB within the current contribution rates in detail. The example prepared by the USS executive (shared 8 January 2018) demonstrates one way in which an element of DB could be retained for an unchanged contribution rate. It would rely heavily on DC benefits being cut for medium and higher earning members to subsidise a higher DB component. Alternative and potentially simpler options (i.e. which require a smaller number of changes to the current structure) include a £3,000 salary threshold (using the existing accrual rate, level of indexation etc.) or the existing salary threshold and 1/110th accrual rate.

3.3 UUK's advisors, Aon, have analysed the example put forward by the USS executive (put forward at the JNC chair's request to help progress negotiations). This analysis shows that a series of adjustments to all elements of the DB offer can be made (effectively watering-down the quality of the DB provision) to offer a salary threshold of £30,000. The additional risk being taken by maintaining the maximum level of DB in the current uncertain economic environment means that a high likelihood would remain of further changes to benefits and/or contribution levels being necessary in future. A key challenge at this valuation is the very high level of reliance being placed on the USS sponsoring employers that, if not controlled, could threaten the future of the scheme and the sustainability of scheme sponsors. If current benefits are maintained, self-sufficiency liabilities in three years' time are estimated at £81.5 billion. UUK's proposal, contrary to options that maintain some DB, offers a credible means of reducing self-sufficiency liabilities to a more manageable £73.3bn over the next three years. It should also be noted that in most scenarios in which an element of DB is maintained, deficit recovery contributions (DRC's) would also be higher. This would most likely lead to higher accounting provisions by employers, which would damage employers' balance sheets and risk breeching debt covenants. UUK would not regard this as an acceptable outcome for employers or for members.

3.4 The UUK proposal and the USS example offer broadly comparable outcomes for members, however the UUK proposal offers substantially lower risk (as illustrated by the self-sufficiency liability numbers above), and greater stability. Managing scheme risk now is the best way to ensure meaningful DB can be reintroduced and sustained in the future should economic conditions improve. For these reasons, UUK remains committed to its proposal to move the salary threshold to zero as the response to the 2017 valuation outcome subject to consultation with employees, but wishes to make a clear proposal for discussions on a longer-term strategy. Unlike the vast majority of employers outside of the public sector, UUK is not proposing a departure from DB or risk-sharing alternatives entirely; it could have done so, and some of the scheme's employers would have supported such a position. There is however a need to take action now to maximise options for the future.

4. DC benefit design to maximise value to members

4.1 Employers have made very clear that they remain committed to offering market-leading and attractive pensions to all of their staff. UUK has over several months carefully considered how best to maximise value to all members, envisaging an evolution of USS into a scheme that offers greater flexibility and choice to meet the increasingly diverse needs of employers and employees. UUK wants to ensure that members are supported and protected throughout this change. The paragraphs below set out the measures that UUK proposes to ensure that a DC proposition is valuable to members.

4.2 Employer contributions: Employers continue to be committed to an overall 18% contribution, having paid 14% for many years, and having accepted step ups to 16% in 2009 and to 18% in 2016, an increase of almost a third in this period. This increase came alongside increased employer National Insurance contributions (costing a typical 2-2.5%) following the abolition of contracting out in 2016.

4.3 Market-leading DC: The proposed new arrangements will still be market leading[2] pension provision, with substantial headline employer contributions of a planned 13.25% (subject to agreement with the trustee on the DRCs), along with an extremely valuable employer-funded subsidy of investment management charges.

4.4 Protecting members in case of death and ill-health: To further demonstrate its market-leading commitment, UUK proposes full DB style cover for members who suffer death in service or incapacity. This provides members and their families with substantial value, and certainty, in the most difficult of circumstances.

4.5 Encouraging all USS eligible employees to save for their retirement: UUK has proposed designing a new lower-cost USS option for members. Employers want to offer a pension scheme that works for everyone, and are concerned that some employees are unable to afford the high member contributions that USS currently requires. The UUK proposal allows employees to choose a lower and more affordable level of pension saving (4% is suggested), whilst still benefitting from the full employer contribution.

4.6 Flexibility for employers who can pay more: Employers have the flexibility to make additional pension contributions if they so wish. A uniform proposal is put forward by UUK in accordance with the mutual structure of the scheme, however the existing scheme provides employers with a power to make special employer contributions, and this will continue to be made known to institutions.

4.7 Attractive DC design and post-retirement options through USS: the USS trustee carried out a survey of thousands of its scheme members to shape its DC product design (the USS Investment Builder), and its investment funds continue to perform strongly. UUK is working with the USS trustee through the JNC to undertake a review of retirement, and is also committed to working with stakeholders to fully explore new and innovative post-retirement options that can be genuinely attractive for members. In addition, it is critical that stakeholders work jointly on understanding what support members with DC savings require.

[2] To put this into context, of the 7.7 million active members of private sector schemes, 83% of members receive DC only benefits (based on latest ONS research), and the median employer contribution rate based on Aon research is 7% (meaning that the members would receive almost double the average employer DC pension contribution under our proposal).

4.8 To achieve the best outcome for members, employers are willing to carry greater risk in the recovery plan in order to maximise the contributions made to future benefits provided on a DC basis. Employers are pushing the allocation for spending on future service benefits as far as possible (and possibly slightly further than the trustee will permit) rather than focusing more of the 18% contribution rate on addressing the deficit. Following discussions with UCU, UUK believes there is agreement on the need to make a clear case to the USS trustee for lower DRCs and UUK proposes taking this forward jointly (UUK would also continue to make its own representations on these issues, on behalf of employers, as appropriate).

4.9 Another matter that UUK suggests is taken forward jointly relates to the implementation of the trustee's planned de-risking. UUK believes that it would be useful – over and above that which is included in any consultation on the statement of investment principles – to allow additional engagement with stakeholders on the way that any investment de-risking is to be implemented by the trustee, for example to ensure that any specific portfolio de-risking approaches deliver the most benefit for the associated expected reduction in target return.

5. Employers' longer-term commitment to USS members

5.1 It is clear that the Scheme Actuary and Pensions Regulator view the technical provisions as being at the weakest end of what can be accepted (with the Pensions Regulator cautioning that the deficit may be understated based on its own assessment of covenant). Likewise, UUK's advisors Aon view the assumptions as being at the weakest end of market practice. It is also clear from the trustee's work that there are credible scenarios in which the scheme will no longer be sustainable, and the trustee may need to step in and request a greater proportion of the 18% is used to address the deficit potentially over very long periods (leaving minimal contributions available to pay future service benefits for current and future generations of members). The significant challenges at this valuation require urgent action to ensure the sustainability of the scheme.

5.2 UUK understands UCU's position that it wishes to maintain guaranteed pensions for scheme members. In UUK's view, this can best be achieved in the long-term by ensuring that the scheme's sustainability is secured now, rather than maximising the risk taken at this valuation with the significant possibility of further reforms being required in 2020 or sooner. Managing risk in the USS scheme offers the best opportunity of USS being able to provide a meaningful level of guaranteed future benefits, potentially in DB form, if future economic conditions for DB pensions improve. UUK's proposal is to maintain the USS hybrid structure, for the express reason that DB could be reintroduced in future by raising the salary threshold to a positive value if stakeholders so wished and if the funding and economic conditions permit.

5.3 In the discussions on 19 December 2017, UCU indicated an interest in exploring alternative and innovative risk-sharing structures, including Collective DC (CDC) scheme design. UUK does not believe it would be possible to implement such a solution at this valuation given the fact that the UK currently lacks the secondary legislation needed to make CDC possible. Employers are open to exploring options jointly with UCU once the immediate challenge presented by the outcome of the 2017 valuation has been fully addressed.

5.4 UUK proposes establishing a forum with UCU to consider the longer-term future of USS, and the possible implementation of risk-sharing and guaranteed benefit options. In order for joint discussions on a longer-term strategy to progress productively, UUK does reiterate the need to manage the level of risk currently inherent in the scheme. This would allow time and opportunity for options to be properly explored. It is also understood that in order to set clear parameters for these future discussions, some continuity is helpful. UUK is therefore also willing to agree to extending the duration of employers' commitment to maintaining employer contributions at 18% of salaries for a period of six years following the valuation date (i.e. March 2023).

6. Revisions to UUK's proposal since December 2017

6.1 In response to discussions with UCU, UUK has revised its proposal to the JNC and made six specific propositions to align with the priorities put forward by UCU. These are each reflected in earlier sections of this paper, but are summarised here for clarity.

6.2 Risk sharing alternatives: In the lead-up to the 18 December 2017 JNC UCU requested that parties should consider alternative risk sharing scheme structures that might provide members with greater certainty in retirement, such as CDC. UUK sets out clearly in this revised proposal that it wants to engage with UCU and the USS trustee to consider, on an ongoing future basis, how risks are shared between members and employers, and to evaluate the merits of such novel scheme designs. It is noted that CDC is not believed to be an option currently available to stakeholders, as the UK lacks the secondary legislation required to make CDC possible.

6.3 DB re-introduction: UCU want to maintain a level of guaranteed benefits as part of the USS benefit design. UUK believes that the managing scheme risk now is the best way to ensure meaningful DB can be reintroduced and sustained in the future should economic conditions improve. Employers would be willing to explore the framework within which stakeholders might decide on the re-introduction of a level of DB benefits (in addition to death and ill health benefits) in future as part of the longer term strategic direction for USS. We would envision these discussions to take place concomitant with considerations of alternative risk-sharing options (such as CDC).

6.4 Better DC options in retirement: UCU have raised concerns that DC places greater uncertainty on members in retirement and facing a high cost of commercial annuities. UUK proposes discussions with UCU and the USS trustee on how to benefit from the genuinely valuable flexibilities that DC saving can enable for members in terms of how and when they access their pension savings. UUK is working with the USS trustee through the JNC to undertake a review of retirement, and is also committed to working with stakeholders to fully explore new and innovative post-retirement options that can be genuinely attractive for members. UUK believes member outcomes can be significantly improved by making sure appropriate work is carried out on post-retirement options for our employees.

6.5 Lower deficit recovery contributions (DRCs): UCU has expressed significant concern regarding the increased DRCs that the USS trustee suggests will be required at this valuation. UUK shares this concern, as significantly higher DRCs constrain funding for future service benefits and has serious ramifications for the higher education sector. Whilst a matter to be determined by the trustee subject to consultation with UUK, UUK would be supportive of jointly making requests to the trustee to reconsider the level of DRCs which the trustee is seeking from 1 April 2019 and to ensure that these are no higher than necessary (it is emphasised that UUK would continue to make its own representations on these issues, on behalf of employers, as appropriate).

6.6 Investment de-risking: UCU have raised several questions regarding the USS trustee's proposed investment de-risking. The way that the fund's investments are assumed to change over time, in with the context of the trustee's building block approach for determining the discount rate with the technical provisions, is a matter on which the trustee has consulted and decided its position – and is outside the remit of the JNC. However, UUK believes that it would be useful – over and above that which is included in any consultation on the statement of investment principles – to allow additional engagement with stakeholders on the way that any investment de-risking is to be implemented by the trustee, for example to ensure that any specific portfolio de-risking approaches deliver the most benefit for the associated expected reduction in target return. To confirm UUK is not proposing to try to reopen the technical provisions discussion which is already agreed and is outside of the remit of the JNC.

6.7 Employer contributions: UCU have proposed that employers should increase their contributions to USS. UUK has considered this option fully and has explained why any increase above 18% is unaffordable. However, UUK does understand that certainty of employers' commitment to contributions is valuable and could help discussions on the longer-term design of USS. In accordance, employers propose further extending the duration of their commitment to maintaining employer contributions at 18% of salaries for a period of six years following the valuation date (i.e. March 2023).

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