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BRIEFING PAPER FOR EMPLOYERS ON USS 2023 VALUATION AND JOURNEY PLAN

A briefing paper for employers on the journey plan for the USS 2023 valuation, and potential responses to the technical provisions consultation

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(1) SETTING THE SCENE

This briefing from Universities UK (UUK) has been prepared to help employers to consider, and then provide their responses to, the USS Trustee's formal consultation on the USS technical provisions (TPs), and on the draft Statement of Funding Principles (SFP). The USS Trustee must carry out a valuation of USS at least every three years, and as part of this process it consults on the assumptions that it proposes to use to assess the funding of the scheme. This consultation is undertaken, in formal terms, by the USS Trustee with UUK as the employer representative body. UUK, in turn, consults with individual employers on the details and raises specific questions, in order that it (UUK) can respond with the collective view of employers.

The indicative outcome for the 2023 valuation is the most positive we have seen for many years. The quarterly monitoring reports of the last year or so had given cause for optimism, and we now see those improvements confirmed in the USS Trustee's proposed assumptions and projected contribution requirements with the results reflecting significant changes in the economy since the 2020 valuation was finalised; with 10 years of declining and low interest rates being reversed over just the past 18 months. We really are in a very different position, being able to consider reductions in contributions and improvements to benefits rather than having to negotiate the difficult path of rising contributions and other detrimental changes. The challenge is to make best use of the more advantageous position which is presented in the consultation.

We have been in discussion for some time with employers and with UCU about the potential outcome and our preferred responses. These have been positive exchanges, which have produced jointly agreed statements – which reflect the priorities signalled to UUK by employers over recent months – and which we think represent fair and balanced responses to the favourable financial position (and at the same time settle the USS elements of the industrial action). We use this consultation to formally test with employers that our planned responses are the right ones, and that they are aligned with what we have heard so far from employers in our engagement, and the broader future development of USS which employers seek.

The proposed 2023 valuation outcome is indeed part of a broader landscape of potential change within USS. There are a number of connected projects and initiatives underway, and this briefing brings together the various strands to describe an overall journey plan of which this 2023 valuation plays a central part. This consultation by UUK has two purposes; to gather specific comments from employers on the TPs and the underlying assumptions which are proposed to be adopted by the USS Trustee (we have provided guidance from our actuarial advisers, Aon, to help employers to comment), and on the SFP. Secondly, we want to set out the broader plan for the development, and reform, of USS and seek employers' views on the plan and we hope secure your continued support.

(2) THE JOURNEY PLAN, AND THE SPECIFIC OBJECTIVES OF THE NEXT 18 MONTHS

The 2023 valuation signals a substantial shift in the financial position of USS. The improved situation offers the potential to make important changes to the overall journey plan for USS which would benefit scheme employers, and members, for the long term.

The journey plan has nine interlocking elements, which are set out below with further explanation of the role that we expect each of the elements to play in improving, and building the resilience in, the scheme at and following this valuation.

(a) The importance of a stable position, avoiding pendulum movements at the next two valuations

Stability is fundamental to this valuation, as we seek to break the cycle of difficult valuation responses which trigger dissatisfaction amongst employers and unrest from members. Whilst it is impossible to guarantee future valuation outcomes and therefore contribution rates in a Defined Benefit scheme setting – it is Defined Contribution-type schemes which offer a guarantee on contribution rates – we believe that employers want to use this better financial position for USS to improve the chances of not having to make changes to contributions and/or benefits at the next and subsequent valuation(s).

The USS Trustee has undertaken some initial modelling on stability, and one of the headlines of its analysis is the result of its stochastic modelling on potential outcomes for the next scheduled valuation at March 2026. This shows that – based on the current investment strategy, and crucially assuming that a contribution of 20.6% of salary is paid in the intervening period – there is a 65% chance that contributions of higher than 20.6% will need to be paid after the next (March 2026) valuation – but please do see the Aon note with further commentary on this indicative modelling. This assumes that the scheme surplus of £7.4bn is utilised for other purposes. If that surplus is retained to underpin the scheme's financial stability, the likelihood of contributions higher than 20.6% of salary reduces to 57%.

If we are to look at the likelihood of contributions exceeding 25.2% of salary at the valuation in six years' time – with the reference to a 25.2% contribution being what is paid now to fund the current benefits (as part of the 31.4% overall current contribution, which includes the 2020 valuation deficit contributions) – the likelihood figure quoted is between 30% and 33% (depending on investment strategy) if the surplus is retained. This is a helpful – and we believe reassuring – indicator if employers consider the existing rate of future service contribution of 25.2% (to fund benefits) as a reference point and plan to prepare to do so in the future, if required, (even if the rate actually payable from 1 April 2024 were 20.6% as proposed by this consultation). Aon's explanatory note provides further helpful insight into the stability figures[1].

[1] this can be found on page 10 of the Aon note, and please note the important caveat regarding the asymmetry in the modelling approach which is explained by Aon

These figures emphasise that there are no guarantees on contribution rates when funding defined benefits. We should also bear in mind that this is the underlying stability embedded within the proposed assumptions, however there are other tools available to the USS Trustee and stakeholders which would impact upon the overall stability of USS's financial position:

(i) Changes to underlying assumptions: it would be possible to add more prudence into the scheme's assumptions, and in particular to the discount rate, effectively lowering the required level of investment return expected over the coming years to keep scheme funding on track. This would serve to reduce the amount of any surplus, and increase the future service contribution rate. We can see from the USS Trustee's sensitivity data that a reduction in the pre-retirement discount rate of 0.5% would add £1.7bn to the scheme's liabilities (so effectively reduce the surplus from £7.4bn to £5.7bn), and increase the cost of current benefits from 16.2% to 17% of salary. We need to be mindful that adding more prudence into the assumptions would build resilience, but questions arise:

- as to whether this offers value for money (for example the increase in future service costs would be 0.8% of salary or £82.5 million per annum in cash terms);
- we would need to make the case to members for an increase in their contribution rate under the 65:35 cost-share rule, and
- it might be more difficult to argue for a return to a less prudent position at the next valuation if that were needed.

(ii) Higher contributions and/or other changes: if the contribution requirement is increased at the next valuation from the illustrative 20.6% rate (assuming that a change is made to implement pre-April 2022 benefits from April 2024, and noting that the employer contribution share of the 20.6% overall requirement under the default rules would be 14.5% of salary), arguably the first response would be that employers – and members under the cost-share ratio – absorb the contribution increase. It is suggested that employers would have headroom to do so given the substantial reduction in employer contributions from the current 21.6% of salary, but with the same being true for members with their 6.1% contribution coming down from the current 9.8% of salary. The following table might be useful in explaining this further:

	Total	Employer	Member
Current Contributions (25.2% for current benefits + 6.2% deficit contributions)	31.4%	21.6%	9.8%
Proposed outcome with improvement in benefits to pre-April 2022 level	20.6%	14.5%	6.1%
Illustratively, the outcome of a 2026 valuation under the cost share rule if future contributions increased to 25.2%	25.2%	17.5%	7.7%

The above table suggests there might be scope to absorb an increase in contributions from the next valuation (2026) and beyond, especially if employers retain the current contributions for future benefits (of 25.2% of salary) if required, as a reference point.

Finally, we would also have the option of proposing changes to future benefits to again bring contributions to an affordable level, recognising of course the time it takes to do this and the potential for challenge and difficulty (although it remains a substantive lever available to the stakeholders).

(iii) Changes to investment strategy: this is covered in more detail in paragraph (h) below, however there is the option of increasing the fund's allocation to hedging assets and reducing exposure to growth assets (and the USS Trustee illustrates the broad effect of this in its TPs consultation with the 'less growth, more hedging' option), something we expect the joint stability group will want to consider in the coming months.

We expect that the discussions with UCU and the USS Trustee on stability will cover use of the surplus (see (e) below), and also importantly broader stability issues such as consideration of paying above the proposed level of required contributions through the concept of a contributions 'corridor' within which we might collectively seek to manage contribution requirements over the coming valuations. We will return to employers on these further stability discussions, which we expect will take place over the coming months – with some of the stability measures we are seeking achievable through this accelerated valuation, while others are unlikely to be deliverable in that same timeline but nevertheless a central part of our plans.

(b) A meaningful reduction in employer and member contributions, respecting the 65:35 ratio

The figures suggest we can achieve material reductions in contributions whilst at the same time making an improvement in future benefits. If an improvement is made to future service benefits (from April 2024) to implement the pre-April 2022 benefits, the TPs consultation indicates that the overall contribution requirement would be 20.6% of salary.

Under the cost-share provisions in the scheme rules, the default position is that we would see contributions of 14.5% and 6.1% of salary for employers and members respectively. This would be an historic low for the member contribution rate in USS, lower than the 6.25% contribution first collected from members upon the scheme's commencement in 1975.

We believe there is an important balance to be struck between securing reductions in member contributions for members and employers, and deciding on improvements to future benefits where there is the capacity to do so. The terms of the joint UUK/UCU statement, which proposes to make a return to the pre-April 2022 benefits from April 2024 (where that can be done in a demonstrably sustainable manner), would effectively share the overall savings at this valuation equally between reductions in contributions and in improvements in benefits. The reduction in the cost of future benefits is 9% of salary (from 25.2% to 16.2%), and if the improvement to future benefits is implemented higher contributions of 4.4% of salary would be required (the new rate would be 20.6%, or nearly one-half of the initial reduction). This seems balanced and equitable and would reaffirm the intentions of the joint statement (and is based on the premise that, including other elements [see (c-i) below], this would go a long way to settling the USS-aspects of the UCU dispute).

(c) An improvement to future benefits, returning to the pre-April 2022 level from April 2024

This has been partly covered in (b) above and would honour the joint statement with UCU and go a long way to ending the dispute on USS (but note the point regarding augmentation in section [e] below). We should also recognise that we retain the principle that valuations take place every three years, and we must make appropriate decisions in relation to them based on the position presented by the USS Trustee. The 2020 valuation showed a very difficult financial picture for USS, and had we not made benefit changes the contribution requirement would have been 42.1% of salary (or in other words 28.5% for employers and 13.6% for members) – even taking into account the substantial covenant support measures. We have seen and heard many arguments about the 2020 valuation and its timing, impact etc. It is important to remember that the Pensions Regulator wrote to the USS Trustee in 2021 stating that the 2020 valuation outcome was at the limits of acceptable prudence and that the USS Trustee could not have priced it more aggressively. Substantial covenant support measures from employers, and changes to the accrual of benefits, were the only things that prevented ruinous contribution levels.

Things are different at this 2023 valuation, due in large part to changed economic conditions and in particular rising interest rates, and we can make judgements now about future benefits in light of the improved position. From our engagement with employers over recent months, and soft consultation, we believe there is a broad consensus (although not universally shared) around a move to implement a change to future benefits – to put in place the same form of benefits as existed before 1 April 2022 – and this was reflected in our joint statements. Although there could be many arguments about other benefit formulae for the future – for example different accrual rate, DB salary threshold etc. – the quickest way to a resolution, implementable from April 2024, is to propose the benefits which existed prior to April 2022.

(d) Renewed commitment of the sector's employers to the covenant support measures

The USS Trustee has prepared its TPs consultation on the basis that the covenant support measures first introduced at the 2020 valuation would remain. It has emphasised that the measures provide considerable security for the USS Trustees, and that they allow(s) us to fund the Scheme and invest assets with more freedom than otherwise. That means all else being equal, we need lower contributions to fund a given set of benefits. The USS Trustee illustrates that without the covenant support measures the future service contributions would be 1.7% of salary higher for current benefits, and 3.2% higher for the pre-April 2022 benefits. At first glance these figures do not seem as high as expected (and not of the scale which applied at the 2020 valuation). However, we should recognise that these are based on the current improved position and if conditions deteriorated once more then the benefit gained from the measures would, we expect, be higher (and note that in 2020 the measures were worth broadly 10% or more, the difference between a 42.1% rate and a range of higher rates between 50% and 56% of salary).

The covenant support measures offer their real value at times of financial stress for the scheme, and the USS Trustee is keen to emphasise that knowing they would be in place at a future, more difficult, valuation enables them to take a particular view on risk on this occasion. Also, by their design the measures are not intended to be switched on and off; for example any decision to bring the moratorium provision to an end would then result in a diminishing period of 20 years over which the provision would gradually expire.

We do however believe there might be improvements, or refinements, to elements of the debt monitoring framework which might be considered – that could provide more reasonable arrangements based on the experience of recent years – and this is something we would take-up with the USS Trustee if there is support (without changing the substantive nature of the measures).

(e) A surplus which can be used to improve the measure of stability, and for some member augmentation

In the joint statement with UCU there was a commitment to "explore the options and costs of augmenting benefits in recognition of the lower benefits accrued between April 2022 and April 2024, within the 2023 valuation timetable". This is indeed something to explore, but it is a separate issue to the primary decision-making on the form of any changes to future benefits and contributions. We know that there are legal issues to consider, which the USS Trustee refers to in paragraph 9.6 of the consultation document, and these will need careful consideration.

The surplus also offers the opportunity to provide additional financial resilience at future valuations, which will benefit members and employers in terms of reducing the likelihood of contributions and/or benefits needing to be revisited. The USS Trustee's consultation material shows the effect of retaining, or not retaining the surplus (as they refer to it)[2] and we want to discuss this as part of our ongoing joint discussions on stability. We will also need to establish the order of our priorities, for example the importance of stability and the use of surplus to achieve it (and the effect of that decision on other planned responses, for example on the contribution levels, future benefit levels and exploration of augmentation).

(f) A Conditional Indexation project that gives hope of extra stability, lower contributions and/or better benefits, and further grounds for a joint governance review

The Conditional Indexation (CI) project looks promising, and we are grateful to the engagement of employers with the initial work which we plan to take forward in the USS Joint Negotiating Committee (JNC) at the earliest opportunity. In short, CI offers the prospect of improved benefits for lower contributions, but crucially it provides the means through which the scheme's investments might remain orientated to growth investments – as is arguably appropriate to a higher education sector which has an extremely long-time horizon, and over which it is anticipated pensions might be delivered more efficiently.

[2] See paragraph 3.2 on page 11 of the supporting information document, and page 30 of the consultation document which show the effect over three and six years

(g) A governance review of USS

The CI project also has a direct connection with the governance review. We will be progressing the governance review as soon as possible; it is scheduled to commence as soon as the primary decisions on the 2023 valuation are taken. We are very keen to get started with the review, and it will be crucial in improving the governing arrangements for the existing scheme. But the importance of the governance review is emphasised by the CI investigations which have taken place (explained in (f) above), which show that additional governance features will be needed to make CI operate successfully – for example an additional forum in which employer and member representatives discuss and make decisions on the distribution of (the anticipated) additional investment returns – and we believe these improved and extended arrangements would be in the very best interests of the scheme.

(h) A basis from which we can discuss any changes to long-term investment strategy

There are some important questions about investment strategy which arise with this valuation, but we need time to explore them (the USS Trustee has indicated that it plans to undertake more extensive engagement with employers on investment strategy early next year). The scheme surplus provides one opportunity to review strategy so that some of the volatility in the past service funding position might be reduced, but we are seeking employer views on whether this would be an appropriate use of the surplus – it would indeed benefit both employers and members, of course – and (for example) is it aligned with the longer-term objective to implement CI. As we have mentioned, we are committed to stability discussions with the UCU and the USS Trustee to see what can be done in the immediate term, but we believe there is more substantive work needed – to provide employers with a full and coherent report on the options, and to seek views to see if there is a collective position on future investment strategy.

(i) Lower cost saving / flexibility options

We have been in discussion with UCU for some months on the issue of lower cost and/or flexibility options within USS, which have not been straightforward but have been given additional importance in light of the current 9.8% member contribution rate.

The potential outcome of the valuation does raise different challenges, in that the headline member contribution is expected to reduce (the USS Trustee confirms to 6.1% of salary if the pre-April 2022 benefits are implemented from April 2024, under the default cost-share rules), which we hope might see members return to the scheme who had previously opted-out (or opted not to join) on cost grounds.

But we believe that this workstream remains important, not least in exploring other areas of flexibility which members might consider attractive. We would welcome the views of employers on this issue, for example on the importance that they attach to any potential options – whether there is an emphasis on lower-cost or flexibility options – given the headline reduction in the member contribution rate.

(3) THE USS TRUSTEE'S PROPOSED ASSUMPTIONS IN DETAIL, AND POTENTIAL AREAS OF RESPONSE

Employers will note that this consultation by the USS Trustee covers the Technical Provisions and the Statement of Funding Principles (SFP). We have not identified any particular points of concern with the draft SFP, although we do note the reference to an increase in the allowance for scheme expenses which is proposed (to 0.5% of salary from the 0.4%, which has been the level since the 2011 valuation). The size of the active payroll has increased substantially in the intervening valuation period, from £8.962bn to £10.32bn[3] and there have also been material changes to the structure, membership and regulatory environment for the scheme over the period since 2011 when the 0.4% allowance was set by the USS Trustee.

It might be helpful, if employers agree, for the USS Trustee to be invited to provide a little more detail on the factors which have led to the increase in the allowance for scheme expenses collected from contributions (in addition to the summary on page 35 of its consultation document and as part of a short briefing provided to the Employers' Pension Forum in February). We expect that the forthcoming independent governance review of USS will explore the issue of the value for money provided by the USS Trustee to employers and other stakeholders, and that would appear to be the appropriate place for more careful consideration (but of course we welcome employer views and comments).

[3] This would mean that the level of scheme expenses collected from contributions would rise from £35.8m per annum following the 2020 valuation to £51.6m per annum (following the 2023 valuation)

(4) IDENTIFYING THE EMPLOYER MANDATE, RISKS TO THE PROCESS, AND THE KEY NEXT STEPS

The TPs consultation is just one part of the story for the 2023 valuation. It seeks employer views on the assumptions underpinning the funding assessment and Aon has tried to spell-out some of the important elements in its paper (which are referenced in section 3 of this paper) – but we believe you will also wish to see the wider context which might influence our responses.

Through this briefing paper we ask for your views on the assumptions, but we also want to know if you support the overall journey plan for the scheme which has been outlined. Our engagement with employers, with UCU and with the USS Trustee through this 2023 valuation has to date been positive, and employer engagement on this journey has led to the joint statements with UCU. It will also be helpful for you to indicate which elements are the most, or indeed least, important to you and which do you believe should be changed and/or prioritised differently.

There are risks to the journey and to achieving the long-term outcomes that we believe would strengthen the scheme. We are very mindful that employers would need to be willing to support an improvement to future service benefits despite there being no guarantee that we won't need to make detrimental changes at some point in the future if conditions worsen. Employers would also need to express their support for foregoing some element of saving in contributions to improve future benefits (and promote a decision which would otherwise deliver a further reduction in member and employer contributions under the scheme's cost-share rule). Employers would also need to be content to continue to support the covenant measures as a necessary long-term foundation for the scheme, even if the mathematical benefit of them at this particular valuation in isolation seems small. Employers will also need to consider some of the long-term ambitions – for example to review additional stability measures, and also to look at conditional indexation – and to take immediate decisions on benefits and contributions which take us down that road (but which are not achieved at this point). But we believe that employers will recognise the situation, and we hope offer their backing for this further step along the way.

Through this consultation UUK firstly seeks a mandate from employers to finalise the TPs in line with those proposed by the USS Trustee (and meeting the accelerated timeline). This timeline will deliver the earliest conclusions including, it should be noted, the earliest possible change to contribution rates. Your mandate, if supported, would allow UUK to take the TPs outcome through the JNC to achieve the changes to contributions, and to future benefits, which are outlined. The remaining element of the mandate is to invite your support, in outline at least, to progress the other elements of the journey plan set out in section 2 of this briefing, returning to employers when there are substantive decisions to take in relation to them.

(5) QUESTIONS FOR EMPLOYERS

(A) Do you have any specific comments on the individual assumptions for the scheme's technical provisions (and future service contribution rate) put forward by the USS Trustee, or indeed on their collective effect?

[It would be helpful to refer here to the eight specific questions proposed by the USS Trustee, and which can be found on page six of the consultation document.]

(B) On the broader strategy, do you support the nine overall objectives set out in section 2 of this briefing and which do you consider the most / least important?

[The nine objectives are stability, reduction in contributions, improvement to future benefits, commitment to covenant support, utilisation of surplus, conditional indexation, governance review, changes to long-term investment strategy, and lower cost / flexibility options.]

(C) Given the valuation outcome proposed in these TPs, do you support the approach set out in the joint statements to improve benefits to pre-April 2022 levels from April 2024 (and do you agree that there is sufficient evidence of stability / affordability to do so)?

(D) More generally, are you content to provide a supportive mandate to UUK's JNC negotiators to finalise the responses to the valuation in alignment with the joint statement?

(6) RESPONDING TO THIS CONSULTATION

This consultation runs from 19 July 2023 until 29 September 2023, and we would ask that employers plan to provide formal responses to UUK **by 5pm on Friday 22 September** so that we can analyse the views provided and formally respond to the USS Trustee the following week. We welcome and encourage input from all 331 USS employers.

The USS Trustee has asked that we draw your attention to the "Important notice: please read" text box on page 2 of the USS TP consultation document, which sets out the basis on which the TP consultation document is being shared with us i.e. on a non-reliance basis.

Aon, UUK's actuarial adviser, has prepared a note setting out their specific thoughts on the proposed methodology, assumptions and overall funding approach, which is available alongside this note.

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