A consultation by Universities UK with USS's participating employers on the Joint Expert Panel recommendations

September 2018

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1. Introduction

This is a consultation with Universities Superannuation Scheme (USS) employers on the recommendations prepared by the Joint Expert Panel (JEP) in its report which was published on 13 September 2018.

Universities UK (UUK) welcomes the JEP's report and wishes to formally express its thanks to the members of the panel, and to its Chair, Joanne Segars OBE, for their thoughtful and independent examination of the complex issues affecting the 2017 valuation, and for making recommendations to assist in creating the space to find common ground to conclude the 2017 valuation.

There are four stakeholders who have a key role and/or responsibility in relation to the recommendations and any potential outcome: UUK on behalf of the employers, the University and College Union (UCU) on behalf of the members, the USS Trustee and The Pensions Regulator (TPR). Any decision at the Joint Negotiating Committee (JNC) will need to satisfy both the USS Trustee and TPR that it underpins the pension obligations that have already been accrued and those accruing in the future. UUK is taking steps to engage with each stakeholder group. The path to delivering the JEP recommendations is likely to be complex and challenging.

The JEP recommendations cover a range of issues regarding the USS valuation processes and assumptions. A two-phased approach is recommended by the JEP, in which Phase 1 sets out specific recommendations which aim to help resolve the 2017 valuation quickly while Phase 2 provides for a more fundamental review of the valuation approach. In this consultation UUK wishes to highlight specific recommendations raised by the JEP and to seek the views of employers.

UUK acknowledges that the views of some employers have evolved since the start of the valuation process and therefore need reassessing. UUK believes that USS employers are open to considering the JEP's recommendations as a route to a potential settlement to the 2017 valuation, and that is the perspective from which this consultation has been prepared.

UUK also wants to ensure that employers have information (as far as it is able at this preliminary stage before other stakeholders have expressed their views) as to the potential implications of accepting more risk, and highlight that employers may ultimately be invited by the USS Trustee to demonstrate their backing for a greater tolerance of risk.

The aim for UUK is to agree with UCU an acceptable joint solution to the 2017 valuation in a timely way. It is clear that employers wish to avoid a scenario where the cost increases proposed under the scheme's cost-sharing provision (Rule 76.4–8) from October 2019 and April 2020 come into effect.

We are committed to finding the solution to the 2017 valuation in the knowledge that a second phase of work through the JEP will be commissioned to consider underlying questions in USS ahead of any discussion on the next valuation in 2020.

2. UUK's role in USS

UUK is the representative body for scheme employers.[1] The views that it represents to the USS Trustee, to UCU and other relevant bodies in this role represent the collective view of USS's participating employers as determined by UUK. There are approximately 350 employers that participate in USS, which vary considerably in terms of size, status, legal structure, financial position etc. UUK recognises that individual USS employers will undoubtedly hold specific views on matters relating to USS, and the challenge for UUK is to bring together those views in order to represent the best consensus view on any particular issue.

3. Questions for employers

At this stage UUK would like to receive views from employers on the specific recommendations of the JEP report using associated indicative costings the JEP has provided. If the information changes and/or if costs differ, we will consult employers again for their views.

As we explain later in this consultation document, there are a number of complex and interrelated issues to consider. We expect that future engagements with employers will allow us to draw responses to further specific questions, once general responses have been considered and the inputs from other stakeholders have been taken into account.

The following sections of this consultation provide further analysis of the JEP's proposals and their implications, however the three questions on which we invite the views of employers are as follows:

1	Would your institution support the JEP recommendations regarding the 2017 valuation (see Table 2 – page 10), in overall terms, subject to the acceptance of such a position from the USS Trustee (and TPR as appropriate)?
2	What further information would you need to provide a final view for question 1?
3	Employers currently pay **18%** towards the USS scheme, and the mandate agreed immediately following the Acas discussions was **19.3%.** If the recommendations of the JEP were accepted <u>in full</u> by all parties, the outcome would be that existing benefits – minus the employer match of 1% – could be provided at an <u>indicative</u> employer contribution of **20.1%** of salary (with a member contribution of 9.1%). (a) Would you accept employer contributions at that level? (b) If not, what balance of additional risk, higher contributions and/or benefit change would you prefer to see as an outcome?

UUK would like responses which can be confirmed as being the formal view of the employer. Each response should indicate how the view put forward was reached. We strongly recommend that employers ensure they have sought the necessary input from their governing bodies.

[1] As defined in the USS scheme rules and other governing documents.

4. Approach to this consultation

The JEP recommendations for Phase 1 are intended to be a pragmatic way forward to provide a swift resolution to the issues facing the scheme at this valuation, ahead of a more fundamental review before the next valuation in 2020. There are a number of challenges to employers in considering the JEP report at the current time, not least because:

- The detailed views of the USS Trustee (who set the contributions under the rules) on the JEP recommendations are as yet unknown. We understand that they are unlikely to be provided formally until UUK (on behalf of employers) has provided, at least initially, its response and has outlined areas where employers may wish to re-express their views on affordability and risk appetite. TPR will also likely have views on the proposed approach.
- The calculations in the JEP report are indicative and would require confirmation by the scheme actuary and the USS Trustee. The JEP report also notes that there may be different ways to get to a similar answer on contributions, and the USS Trustee may prefer a different formulation once it formally considers the JEP report.
- The approach taken in the 2017 valuation is complex with many interrelated assumptions that impact on costs and risks.

However, employers' views are vital at this time if the 2017 valuation assumptions are to be revised. If we fail to develop alternative proposals that are acceptable and implementable to the USS Trustee the cost sharing proposal set out in the rules will fully come into force by April 2020.

This document marks the opening of a consultation period that closes **at noon** on **Tuesday 30 October 2018**. During this period, we encourage employers to ask UUK questions and share their views. Supplementary information to this document will be provided by UUK if further relevant information becomes available from the USS Trustee, for example. Further information may also be provided that is tailored to respond to common questions that are raised by employers.

By receiving as many views as possible from employers, UUK will be able to represent the most informed view to the USS Trustee, UCU and other stakeholders. UUK will additionally seek to gain a current understanding of employer views through additional engagement[2] activities throughout the consultation. It is vital that individual employers respond to this consultation formally (see section 10 for more information).

This document is being made publicly available on UUK's new USS employer content hub: www.ussemployers.org.uk. UUK will not disclose individual employer responses to this consultation.

It should be noted that further consultation with employers is likely to be necessary over the coming months with the aim to continue to offer valuable defined benefits (DB) as part of the scheme and concluding the 2017 valuation. This will be particularly important should there be different requirements regarding risk, or different contribution levels, as we will need to reassess the position with employers.

[2] UUK will engage with as many employers as possible through individual exchanges, through sector group meetings – including those representing senior management groups for finance directors, HR directors and registrars – as well as through vice-chancellor networks.

Parallel discussions will be held with UCU, the USS Trustee and TPR during this consultation, although definitive views of the employers will not be given until this consultation finishes. To the extent that views from other parties become apparent during the consultation process we will communicate these to employers.

5. Summary of 2017 valuation (to date)

The USS Trustee's actuarial report[3] has identified a continuing scheme deficit – that is a gap between the scheme's assets and the calculated value of the scheme's liabilities, as at 31 March 2017 – as well as a material increase in the cost of providing future DB promises. The results of the valuation represent a significant challenge for the scheme's stakeholders. See **Annexe A** for a summary of recent activity relating to the USS 2017 valuation.

The USS Trustee – after consultation with employers (through UUK) – determines the overall contribution required to fund the future benefits that are to be provided, alongside any contributions to finance the scheme deficit. In a situation where the contribution requirement for the scheme's benefits increases, the default arrangement under the scheme rules – absent any decision by the JNC to make any other changes in response to the increased contributions – is for any increased contributions to be shared on a defined basis between employers and active members. The defined cost-share in USS is for employers to bear 65% of any increase in contributions, and members a 35% share.

The USS Trustee's proposed position in concluding the 2017 valuation is as follows:

The cost of providing the current benefits in the future	31.4%
The deficit recovery contributions	6%
Aggregate contribution rate required	**37.4%**[4]
Current contribution rate (in aggregate) – 18% from employers, 8% from members	26%
Scheme deficit	£7.5bn

Table 1

Under the rules of USS the USS Trustee must make any decisions relating to the valuation assumptions having taken advice from the scheme actuary and having consulted with UUK. The JNC's role is to decide on ways to apportion the costs and/or make adjustments to benefits. This means that the JEP's report is advisory, and neither UUK nor UCU can compel the USS Trustee to change its valuation assumptions. However, as a consultee in the valuation process UUK can express views, make proposals and reflect further views for the USS Trustee to consider.

[3] An actuarial valuation of USS must take place every three years, and it is the USS Trustee's role to undertake this valuation and prepare a valuation report. Under the scheme rules, it is the USS Trustee's appointed actuary who must undertake this exercise and prepare a report on the financial condition of the scheme and make recommendations to the USS Trustee as to the contributions payable.
[4] This figure includes the cost of the 1% employer match. Without the 1% employer match the required rate is 36.6% of salaries.

The JNC comprises an equal number of UUK and UCU representatives along with an independent chair appointed by the JNC.

There were extensive discussions throughout 2017 on the details of the valuation and on the potential responses to it. This involved a series of engagements with employers to seek their views on some of the key elements, for example regarding the level of contributions that employers thought was sustainable, the overall level of risk which employers believe it is appropriate to bear, and the nature of the future benefits that should be provided.

In January 2018 the JNC decided on a proposal put forward by UUK on behalf of employers to change the future benefits provided by USS, essentially from benefits provided predominantly in a defined benefit form to benefits provided in a defined contribution form. This would have maintained contributions at 18% of salary for employers and 8% of salary for members, and were measures planned to be implemented through to the next actuarial valuation of USS. These proposals were decided upon by the JNC with the independent chair of the JNC's casting vote and opposed by UCU's JNC members. UCU successfully balloted for strike action in opposition to these reforms. These measures were subsequently withdrawn in the light of requests from many employers for the reopening of negotiations during the period of industrial action.

Formal talks between UUK and UCU took place at Acas – the Advisory, Conciliation and Arbitration Service – in March 2018. Arising from these talks, indicative agreement was reached by negotiators on proposals which would have seen the future benefits in USS remain predominantly defined benefit in nature, up to a salary threshold of £42,000 per annum, a headline pension accrual rate of 1/85th of salary, and a capping of indexation/revaluation at 2.5% p.a. Under this proposal, employer contributions would have increased from 18% to 19.3% of salary and member contributions would have increased from 8% to 8.7% of salary. The headline agreement struck at Acas between UUK and UCU negotiators was unable to be taken forward as it was rejected by UCU branches. Following further Acas talks UUK proposed the JEP to UCU on 23 March, and UCU members (as well as USS employers) endorsed the creation of the JEP in April 2018, with the JEP's work starting in May 2018.

The agreement to convene an independent expert group to examine the valuation assumptions and process, the JEP, was important in helping to build confidence, trust and increased transparency in the valuation process. The JEP is comprised of actuarial and academic experts nominated in equal numbers by both UCU and UUK, with an independent chair proposed by Acas and agreed by both parties. The JEP is outside of the formal USS governance machinery, and as such has been able to consider the valuation independently and form views which can be used by UUK and UCU in taking forward their responsibilities within the more formal structures.

The JEP's report on the 2017 valuation was published on 13 September and is available on the JEP website.

Earlier this month the USS Trustee began a formal consultation on proposals for phased increases to member (and employer) contributions. The USS Trustee is using USS's Rule 76 to take steps to implement higher contributions under the cost-share formula in order to conclude the 2017 valuation and submit it to TPR (it has already passed the statutory deadline of 30 June 2018) and the JNC has not decided on any other adjustments to benefits and/or contributions. Subject to your views, UUK hopes that the JEP's recommendations can assist in developing an alternative way forward that can be implemented before the full cost sharing requirements come into effect. UUK notes that the JEP report stated that *'the Panel does not underestimate the practicalities of concluding an actuarial valuation so long after the valuation date. Nonetheless the Panel believes it would be in the public interest if all the stakeholders, including TPR, could find a way forward to implementing our recommendations within the 2017 valuation.'*

6. Next steps

It is UUK's aim to work constructively with UCU so that a suitable joint solution to the 2017 valuation can be found. We look forward to positive discussions with UCU, the USS Trustee and TPR, so that we can meet our pledge of continuing to offer valuable DB as part of the overall scheme and to conclude the 2017 valuation.

Activity will need to be undertaken swiftly to ensure that the higher contributions levels proposed by the USS Trustee – from October 2019 – do not take effect. UUK believes it would be damaging for members, employers and the scheme if these levels of contributions were to be implemented. Given the likely implementation timescales of any new agreed proposal, we expect the first step of proposed increases through the cost-sharing process in April 2019 to take place.

The JEP report is clear that it was not possible to consider a number of issues in the time available in order to conclude the 2017 valuation. UUK supports the view that a second phase of work (Phase 2 of the JEP) would be helpful in assessing how to address the longer-term stability of the valuation process which will have the support and confidence of all parties. We expect that any solution to the 2017 valuation under Phase 1 will be reached on the understanding that both UCU and UUK agree to undertake further work to assess how to ensure the longer-term stability and sustainability of the scheme, its structure, governance, funding and the benefits it provides.

7. Context for this consultation

This consultation is taking place in response to the JEP report, in order to explore employers' views about the JEP recommendations under Phase 1 to assist in agreeing steps to complete the 2017 valuation.

The focus of the JEP's first report is to review the basis for the USS 2017 valuation assumptions and associated tests.

The assumptions used for a valuation are affected by the risk taken by employers and members in the scheme. The JEP was not asked to consider the specific benefits that USS provides or the appropriateness of certain contributions levels for employers or members – although its terms of reference asked that it consider '*the clear wish of staff to have a guaranteed pension comparable with current provision whilst meeting the affordability challenges for all parties*'. The JEP does use its findings on assumptions and risk taken in the scheme to express a contribution level that could be paid to maintain current benefits (focusing on the scenario where the 1% DC match is removed, consistent with the USS Rule 76 consultation), if all items suggested by the JEP are incorporated into the 2017 valuation.

The JEP notes that there are a number of paths the USS Trustee (with the support of stakeholders) could adopt to reduce the aggregate contribution rate to below 30% of salary and it illustrates one approach that could reduce the rate to about 29.2% of salary – which we primarily focus on in this consultation document. We acknowledge that, all else being equal, other approaches to get to a similar contribution rate (of about 29.2%) may be preferred by the USS Trustee or other stakeholders.

It is important to note that the contribution figures quoted are approximate and would need to be validated by the scheme actuary and the USS Trustee.

8. JEP's recommendations

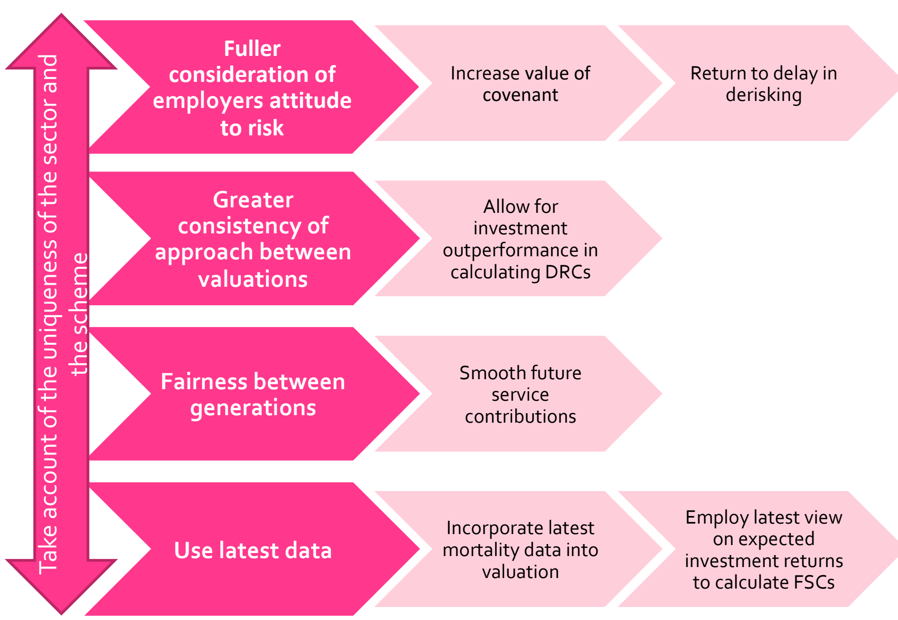
The JEP's report has made a number of important recommendations in respect of the assumptions used in the 2017 valuation which it suggests could be adopted in order to conclude the 2017 actuarial valuation.

The risk taken in the scheme is multifaceted and complex. **Annexe B** sets out some considerations of the risk taken in USS as a whole, however in the main body of this consultation document focus has been given to the JEP recommendations.

UUK does not wish to recreate the JEP's report in this consultation document, and this paper is not a substitute for reading the JEP's full report. References are made to the recommendations of the JEP and explanations of these are given in the JEP report.

The JEP summarised its recommended areas for possible adjustment on page 53 of its report, in figure 8 which is repeated below:

Areas for possible adjustment to the 2017 valuation



In addition, the JEP report proposed that the uniqueness of the scheme and the higher education sector should be more fully taken into account. The JEP supported the view given by the USS Trustee’s advisors, EY Parthenon and PwC, that the covenant provided to the scheme is strong. This differs from the view expressed by TPR in September 2017, that the covenant is ‘tending to strong’.

In practical terms, the list of specific areas of change to the 2017 valuation assumptions that the JEP has suggested are set out below. We also include high-level comments, with more detailed comments set out in **Annexe C**:

The JEP’s recommendations in relation to the 2017 valuation		
#	**Area**	**UUK comments**
1	Fuller consideration of the employers’ attitude to risk –return to delay in ‘de-risking’, ie moving back to the September 2017 technical provisions –increasing the target reliance used by the USS Trustee from £10bn to £13bn	In September 2017 UUK expressed to the USS Trustee the view that the level of risk was at the upper limit of acceptability for employers, recognising that a significant minority also took the view that a lower level of risk would be preferred, and asked the USS Trustee to consider whether there might be a more optimal investment strategy with less reliance on the future path of interest rate reversion. The USS Trustee, based on UUK’s feedback and considering the views of their advisor PwC and of TPR, took a more prudent position relating to de-risking. The JEP also suggests increasing the target reliance on covenant from £10bn to £13bn in 20 years' time. This would move the ‘target reliance’ up to the ‘maximum reliance’ the USS Trustee indicated it would be comfortable with in the September consultation in light of consultation with UUK. For the USS Trustee to revisit its response to this consultation, it may require firmer or more tangible support from employers and further formal consultation.
2	Allowing for outperformance to bring the deficit recovery payments back down to 2.1% of salary	UUK has consistently made clear to the USS Trustee that it does not believe the case has been made for an increase in deficit recovery contributions, and a formal consultation on this has not yet been undertaken. UUK remains supportive of maintaining the current level of deficit recovery payments as per the JEP’s recommendations. Employers are asked to restate their support for this position. It should be noted that the USS Trustee did originally propose to maintain deficit contributions at 2.1% but asked that employers support trigger contributions if the short-term deficit on the self-sufficiency basis worsened. Employers did not view trigger contributions as appropriate, leading to the USS Trustee proposing increased deficit recovery payments. UUK notes that the JEP has recommended that

		trigger contributions are considered in Phase 2 rather than Phase 1.
3	Smoothing the year-by-year increase in the cost of providing future DB promises	This is a potential adjustment of the USS Trustee's approach recommended by the JEP. Overall it results in lower contributions and could be helpful as a means to help finalise the 2017 valuation.
4	Moving to the CMI 2017 mortality data and updating to market conditions at 31 March 2018	We believe it would be reasonable to regard this as not exposing employers to additional risk and simply a refinement for new data. The JEP's 29.2% figure makes specific allowance for the change to CMI 2017. Using market conditions at 31 March 2018 is not explicitly allowed for in the deficit (but we note could potentially be allowed for through consideration of post-valuation experience in the Schedule of Contributions and Recovery Plan). It is noted by the JEP that this could be considered by the USS Trustee as a reason to accept the other recommendations.

Table 2

We would emphasise that it is the USS Trustee's responsibility under the rules of USS to decide on the above issues, subject to consultation with employers through UUK, and it has indicated that it wishes to understand whether the areas are of interest to employers before it gives the JEP's recommendations formal consideration.

If all of the JEP's recommendations listed above were to be incorporated this would reduce the total contribution levels – using the JEP's calculations – from 36.6% to 29.2% of salary to maintain existing benefits – minus the employer match of 1%. In this scenario the indicative employer contribution would be 20.1% of salary, with member contributions at 9.1% of salary.

The table on the following page sets out the contribution levels quoted in the JEP report in the context of other proposals.

	September 2017 consultation[1]	**Rule 76 (April 2019)**	**Rule 76 (October 2019)**	**Rule 76 (April 2020)**	**JEP example**
Future benefits	29.3	28.3	32.9	30.6	27.1
Deficit contributions	2.1	0	0	6	2.1
Total	**31.4**	28.3	32.9	**36.6**	**29.2**
Employer contributions (under 65:35 cost sharing)	*21.5*	*19.5*	*22.5*	*24.9*	*20.1*
Member contributions (under 65:35 cost sharing)	*9.9*	*8.8*	*10.4*	*11.7*	*9.1*
Total annual contribution (estimated £ amount)[2]	£2.51bn	£2.45bn for 2019–20	£2.93bn for 2020–21		£2.34bn

Table 3

Note: all figures in the above Table 3 exclude the 1% employer match

[1] Allowing for Trustee mortality addendum provided in November 2017

[2] All figures are based on an estimated total payroll of £8bn

We set out further comment on the detailed recommendations presented in the JEP report in **Annexe C**, along with some wider comments on risk in **Annexe B.**

9. Determining the employer position

<u>Risk</u>

Should employers wish to consider increasing the level of risk they bear in relation to USS (for example in line with the JEP's recommendations) the following should be taken into consideration:

- The recommendations from the JEP would represent a reduction in contributions from 36.6% to about 29.2%. Most of this change (ie from 36.6% to 31.4%) would represent a movement back to the September 2017 consultation position from the USS Trustee.
- That the JEP proposes a more fundamental review of the valuation approach under Phase 2, ahead of the 2020 valuation, and so the recommendations only effectively apply to how the scheme is run until the 2020 valuation is completed. This will allow a fuller consideration of risks and other areas, set out in **Annexe B.**
- While the JEP envisaged swift resolution to Phase 1, it is possible that the USS Trustee may request further or more tangible support from employers. It is important that employers anticipate such requests from the USS Trustee and/or TPR and recognise that in any response regarding bearing extra risk.
- If additional risk to that currently provided in the USS Trustee's assumptions is taken in the assumptions (or alternatively some prudence is removed) this will increase the likelihood of further contributions being required in the future from employers and members should an adverse scenario arise.

- The USS Trustee and TPR have not yet commented in detail on the JEP report and the USS Trustee's acceptance is necessary for the completion of the 2017 valuation.

Annexes B and **C** explain in more detail the risk recommendations from the JEP, and the potential implications.

Contributions

The regular employer contributions to USS are currently 18% of salary. UUK's most recent mandate supports a maximum employer contribution of 19.3% of salary as part of the negotiated settlement agreed at Acas (since rejected by UCU). This level of employer contribution would have supported a lower level of DB pension benefits within the current hybrid structure[5] based on the current USS valuation[6].

The feedback from many employers on the implications of contribution increases and the analysis and reports that UUK has considered suggest that the level of financial risk in the sector is considerable and that any increase to the current employer pension contribution rate of 18% would be challenging for the sector.

10. Responding to this consultation

All USS employers are invited to respond to this consultation to share their views on the valuation. UUK would like responses which can be confirmed as being the formal view of the employer. It is of course a matter for each employer to decide on its own governance arrangements for doing this, however we strongly recommend that employers ensure they have sought the necessary input from their governing bodies. Each response should indicate how the view put forward was reached.

The closing date for responses is **noon on Tuesday 30 October 2018**. The responses should be sent via email to pensions@universitiesuk.ac.uk.

[5] Members accrue DB benefits up the salary threshold of £57,216.50 (2018–19) and DC benefits above that threshold.
[6] Acas agreement 12 March: https://www.employerspensionsforum.co.uk/epf-news/agreement-reached-uss-pension-talks

Annexe A – Recent history of the 2017 valuation

Date	Event
Pre September 2017	Initial consultation material from the USS Trustee, including the USS Trustee's initial conclusions from its review of the employer covenant and the USS Trustee's initial assessment of the methodology and key inputs to be used in the valuation.
September 2017	USS Trustee consults with USS employers via UUK on the technical provisions. The Pensions Regulator writes to the USS Trustee with concerns relating to the covenant assessment.
November 2017	Following engagement with stakeholders, the USS Trustee advised that the deficit as at March 2017 had increased to £7.5 billion, and the cost of building up benefits had increased by around one third compared with the 2014 valuation.
13 November	UUK submitted a proposal to the JNC† on reforms to USS.
December – January 2018	UUK held multiple meetings with UCU and revised its reform proposals as a result.
23 January	The JNC approved a proposal that there would be no further defined benefit (DB) build up for the following three years. USS would offer DC benefits through the USS Investment Builder.
February – March	14 days of industrial action at 64 institutions.
5–12 March	Acas talks between UUK and UCU to agree a revised benefit proposal on 12 March.
14 March	Acas agreement rejected by UCU branches.
21–22 March	Second round of discussions at Acas results in JEP proposal.
13 April	UCU member vote on JEP successful and proposal accepted by employers, industrial action paused.
1 May	USS Trustee confirms Rule 76 process being followed involving higher contributions from employers and members.
May	USS Trustee commissions its covenant advisor, PwC, to gather information on employer affordability.
May	Establishment of JEP, first meeting 31 May.
September	Publication of the JEP's first report.

† the JNC consists of UUK and UCU appointed members and an independent chair. The JNC is the body that initiates or considers alterations to the USS benefits.

Annexe B – Risk supplement

In recent months, a number of employers have suggested that it would be helpful if UUK were to provide some further supplementary material on risk.

What is pensions risk?

At its simplest level, risk for employers is the possibility that they will need to pay more contributions to the scheme than they expected. And risk for members is the possibility that they do not receive their promised benefits in full. However, the true situation is much more complex.

Why is it so complicated?

Risk is multi-faceted. For example:

- Risk is a combination of factors – how investments perform in practice, the valuation method used to determine contributions to the scheme and the nature of the benefits offered by the scheme – to what extent are these benefits fixed, or can they be varied? USS is in a different position to many schemes in that it remains open to future accrual. For the majority of private sector schemes, closed to future accruals, risk relates to the ability of the employer to deliver the benefits promised for past service – in simplistic terms can they meet the pension deficit? The role of covenant (the ability and willingness) of the employer to pay future contributions comes into play in answering this question.

- For employers, there are trade-offs between different types of risk. For example, should less investment risk be taken to secure a narrower (but higher) range of expected contributions?

- For members, there are wider risks identified by the panel in terms of (active) members being responsible for a share in increased contributions under the cost-sharing agreement. There is risk then of opt-outs, but also of future generations of members receiving materially lower benefits if too much risk is taken for current members.

Risk is also subjective:

- Its quantification usually relies on many modelling parameters.

- The JEP itself notes that 'de-risking' introduces another type of risk. It could be observed that 'de-risking' to achieve more stable contributions may be considered 'risky' by some employers if the resulting higher (expected) contributions cause business difficulties in the shorter term.

Trustee risk framework

The USS Trustee has developed a risk framework involving three tests. These tests are well documented and independently assessed in the JEP report.

Better engagement on risk

The JEP states that the presentation of risks under the three-test framework could be improved, and UUK will have its part to play in that. Two observations:

- Because the sector is long term in nature – the JEP has supported the view of the USS Trustee's specialist covenant advisors that the covenant is 'strong' – the principal risk is that higher contributions are needed. It would perhaps be helpful to see supplementary information given to employers and also members by the USS Trustee about the possibility of contributions going outside of certain ranges, to deepen understanding, to help manage expectations, and also help ensure benefit provision is fair across generations.

- It would also be helpful for the USS Trustee to consider how to further enhance the ways in which it shares risk information regularly with both employers and employees, to aid understanding, and in the run up to the March 2020 (and subsequent valuations). We believe it would help to move away from valuations being a three-yearly set-piece, and instead for information to be shared more regularly and indeed more widely. We would acknowledge that the USS Trustee has provided quarterly risk information to the Employers Pensions Forum, and indeed to the JNC and its related sub-committees, and we would look forward to working with the USS Trustee to further improve the accessibility of the information and the way that it might be more widely communicated.

In Phase 2 of its work, the JEP proposes to revisit the whole valuation approach so that it is more clearly understood. We acknowledge that this is not a simple task and agree that it should form part of Phase 2, as time is of the essence to avoid the Rule 76 contributions being implemented in full.

The JEP set out a number of areas where different approaches to the valuation or risk could be taken for the 2020 valuation and beyond (in addition to the changes recommended for the 2017 valuation):

- The reliance on covenant being assessed differently considering the importance of Tests 2 and 3 for the long-term prospects of the scheme, and in particular the potential role of contingent assets or negative pledges.
- The potential for the reliance on covenant being assessed over a longer horizon.
- Taking into account members' appetite for risk, given the cost sharing point.
- Potentially investigating the USS Trustee's investment modelling assumptions in much greater detail.
- Further consideration of future improvements in mortality, and some further consideration of whether all of the second-order assumptions are really best-estimate such as the proportion of females leaving dependants.
- Looking further at how reliance on covenant is inflated over time (under a Test 1 type construct).
- Further consideration of the percentile adopted for the discount rate.
- Consideration of engagement – including adequate consultation periods, framing of questions, and mechanism for engagement with members.
- Different paths for the investment strategy, including the potential for not de-risking the scheme in the longer term.

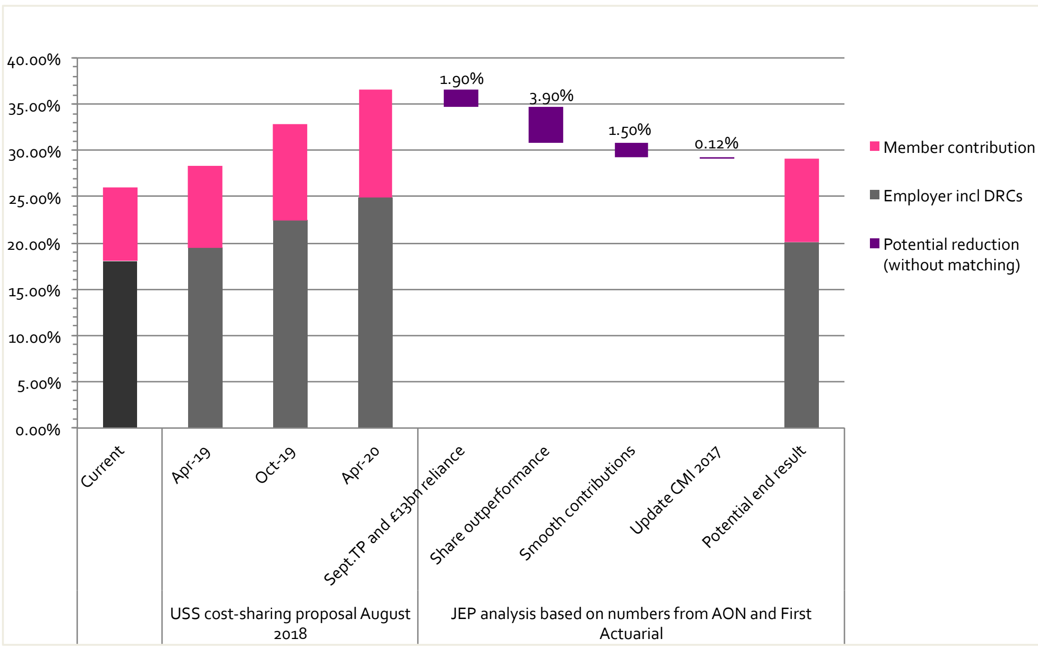
UUK looks forward to engaging with the JEP along with UCU for Phase 2.

Annexe C – Detailed comments on changes proposed by the JEP for the actuarial valuation

In its illustrated approach, the JEP sets out four recommended updates to the Rule 76 approach, which together reduce the total cost from 36.6% to about 29.2% of salary.

The following chart was published by the JEP in its report (figure 10 on page 61 of the JEP's report):

Potential impact of adjustments on member and employer contributions (no employer match for DC)



This annexe provides some comments on each of the components of the JEP analysis illustrated in the above chart.

<u>September technical provisions (around half of 1.90% reduction, as set out above)</u>

As part of concluding the 2017 valuation under the current framework, the JEP recommends reverting to the technical provisions consulted on during September 2017, rather than the later update in November 2017. Effectively this reintroduces the assumption of no de-risking for the first ten years.

In its response to the September 2017 consultation, UUK was supportive of the proposals, but stated:

> 2.3 Based on extensive engagement with employers, UUK's view is that the proposed assumptions are at the very top end (in terms of risk) of what would be acceptable. Employers have reiterated to UUK that pension costs and risks need to be controlled, so that promises made today do not preclude institutions from offering good pensions to employees in the future.
>
> 2.4 UUK's overall view on the proposed technical provisions is based on the assessment that a small majority of employers (53%) have a preference to accept the level of risk proposed, with many qualifying that the proposals are at the very edge of what would be acceptable. However, it must be added that a significant minority (42%) of survey respondents want less risk to be taken – including some of the very largest employers.

The acceptance of the JEP's recommendations in this area would represent a movement from the position reached in the November 2017 technical provisions.

We do of course acknowledge that there was a challenge last year – with TPR writing to the USS Trustee midway through the September 2017 consultation window setting out that its assessment of the covenant was 'tending to strong' rather than 'strong'. TPR is likely to engage further with the USS Trustee and other stakeholders following the JEP report.

<u>Move to £13bn target reliance under Test 1 (around half of 1.90% reduction)</u>

Reliance, as defined by the USS Trustee, is the difference between the value of the scheme's assets at a point in time and those assets required to allow the scheme to be self-sufficient ie a low probability of requiring further contributions to secure accrued pensions. The USS Trustee decides on a target reliance as a fundamental part of its actuarial valuation.

The JEP believes it is sensible to set the target reliance higher (ie £13bn rather than £10bn in real terms in 20 years' time), until there can be a more fundamental review of the valuation. This involves adjusting one parameter of Test 1, and results in a slightly higher target discount rate being applied.

On this, UUK notes that the JEP stated that *'The Panel has concluded that the outputs of Test 1, while very specific and quantitative, are highly sensitive to the input assumptions, many of which are very subjective. Consequently, we believe that Test 1 is given too much weight in determining the valuation and its effects extend beyond its original purpose.'*

In a practical sense, we believe it would be very difficult for many employers to provide a clear answer to the isolated question: 'What level of pension risk do you believe will be acceptable in 20 years' time?' With this in mind UUK believes it may indeed be helpful for the JEP to reconvene in a Phase 2, with updated terms of reference, to focus on a more fundamental review of the valuation approach. In the meantime, this is one parameter that Aon and First Actuarial advised the JEP might credibly be amended (since it involves resetting the covenant to be the value of 7% of contributions over 20 years rather than 15, which the USS Trustee had described in their September 2017 consultation to be their 'maximum reliance').

The acceptance of the JEP's recommendations in this area would represent a movement from the position reached in the November 2017 technical provisions.

Deficit recovery contributions – Share outperformance (3.90% reduction)

The principal change from the contributions outlined in the September 2017 consultation, to those then communicated in November 2017 – and being consulted on under Rule 76 – was the move in the proposed deficit contributions.

The JEP proposes moving back from 6% to 2.1% of salary. This is in line with what UUK requested in its response to the USS Trustee's consultation on the technical provisions and is we believe achievable with a recovery plan structure that is no less prudent than for the 2014 valuation.

In practice, the USS Trustee used the employers' unwillingness to accept contingent (or trigger) contributions as a driver to increase the deficit recovery contributions from 2.1% to 6% of salary (so rather than have a contingency plan to secure automatic additional contributions from employers or employees if market conditions worsened, it was incorporated from the outset).

Most positively, the deficit is estimated by the USS Trustee to have reduced in practice from £7.5bn to £4bn on the USS Trustee's current method at 31 March 2018, and this would potentially help in providing comfort to the USS Trustee in reducing the potentially required deficit contributions back to 2.1% of salary in line with the JEP recommendations.

Smooth contributions (1.5% reduction)

This is a potential refinement in the accuracy of the USS Trustee's approach, where the JEP recommends smoothing the increase in the cost of future benefits. Under the USS Trustee's approach, the cost of future benefits falls over time because the USS Trustee assumes lower investment returns on growth assets in the early years, and 'normal' returns from year 10 onwards. The effect is explained in further detail in the JEP report.

The USS Trustee had not accepted a suggestion to use such an approach during the original consultation because it does lead to the scheme receiving lower contributions than the theoretical cost of benefits in the early years, potentially adding to the deficit. However, the JEP has suggested a compromise of looking at a six-year term for the smoothing period, and also makes the strong point that the refinement will improve fairness among generations of members.

Overall it results in lower contributions and so more risk for employers and members and is potentially helpful and justifiable.

Update CMI 2017 (c.0.1% reduction)

The JEP suggest updating the mortality assumption to the latest published tables. We regard this as not exposing employers to additional risk and simply a refinement for new data.

Although not covered in the waterfall chart above (from page 61 of the JEP's report), there is potentially a further 0.8% of salary reduction in the cost of benefits if the valuation assumptions are reset to conditions at 31 March 2018.