3 March 2021

USS

USS briefing: The Joint Expert Panel's recommendations

The Joint Expert Panel (JEP) assembled by UUK and UCU made several recommendations across both of its reports (see Table enclosed for a summary). The recommendations in its first report (see page 52) specifically related to the 2017 valuation. A summary of its much broader subsequent recommendations for future valuations is provided on page 120 of its second report. Some of these are primarily for the Trustee, others are primarily for UUK and UCU rather than the Trustee, or for all three parties working together.

Which recommendations have not been adopted?

JEP 1 recommended allowing for investment 'outperformance' in the Recovery Plan and smoothing contributions. These were not adopted by the Trustee for the 2018 valuation. In the context of the Pensions Regulator's (TPR) view that the 2017 valuation was already "at the limit" of complying with the legal requirement for prudence, they would have introduced additional layers of risk which would need to be justified.

The Recovery Plan and the question of smoothing were both influenced by post-valuation experience. Funding conditions improved between 31 March 2017 and 31 March 2018 and this influenced both the Recovery Plan for the 2017 valuation and the conclusions in the JEP's first report. But conditions deteriorated in the months after JEP 1 was published and during the course of the 2018 valuation.

In its letter of October 2019, shared with UCU and UUK, TPR raised concerns with a "significant deterioration in the funding position" and restated its view that the 2018 valuation was again "at the limit of what we consider to be compliant".

We have been consistently clear that the question of risk must be considered in the round, in relation to the financial conditions at the time and the commitments made by employers in support of taking risk, and not by simply looking at the components of a valuation in isolation.

Which recommendations are outstanding?

For the 2020 valuation, employers can secure a Recovery Plan of up to 15 years with appropriate covenant support measures – in particular, through agreeing to a longer moratorium commitment on a rule change on employer exits for a period of at least that length.

Given TPR's repeatedly stated view, we do not believe it would be credible for the Trustee to argue for a longer Recovery Plan without at least a matching commitment from employers to remain in the Scheme. UUK will consult employers on these issues shortly and a rule change would then need to be agreed by the JNC.

We continue to support UUK and UCU's consideration of the other issues raised in JEP 2 that are primarily for stakeholders to lead on.

They continue to discuss **the effectiveness of the JNC** (including greater consistency of membership and consideration of removing the Chair's casting vote) and **employer and member representation**[1].

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[1] *"Consideration should be given to employer representation in the Scheme, given UUK's primary responsibility as a co-ordinator of cross-sector collaboration. UCU should take steps to demonstrate it represents all sections of the membership and potential members."*

On **member needs**[2], we have shared new data and information with UUK and UCU representatives on the Joint Negotiating Committee (JNC) – and via the JEP tripartite working group – for them to consider the trends we have been seeing.

One in six people joining the Scheme are currently opting out. Data from a subset of employers collected from the start of 2019 shows that between a quarter and a third of members who opted out put their decision primarily down to affordability reasons. The second and third most common reasons selected were being on a fixed term contract and having plans to move out of the UK in the future.

Nobody involved with USS could consider this to be a good outcome but benefit design is a matter reserved for the JNC rather than the Trustee. UCU and UUK have the ability, via the JNC, to discuss and propose potential changes to the Scheme's design that could address these issues, and we stand ready to support them. For example, in its second report, the JEP posited a lower cost option and/or a tiered contribution structure.

While **mutuality** is primarily a matter for stakeholders to consider[3], we have been discussing a long-term rule change on employer exits with UUK since spring 2019 as we were completing the 2018 valuation. We understand UUK will be consulting employers shortly on covenant support proposals, including a moratorium on employers exiting the Scheme.

Which recommendations have been addressed?

The 2018 valuation reassessed the uniqueness of the Scheme and the HE sector and the ability and willingness of employers to bear risk. It considered the latest data (including mortality experience and the outlook for expected future investment returns).

The covenant was rated by the Trustee as 'strong, but on negative watch' despite TPR's view that it was tending to strong and employer affordability was constrained. This reflected the interim commitments to the Scheme employers were willing to make – at the time – to support the covenant following Trinity College Cambridge's decision to leave.

This resulted in a slight reduction in the overall contribution rate from 35.6% (under the 2017 valuation) to 34.7% - initially phased in at 30.7%.

Our own review of the valuation methodology in preparing for the 2020 valuation led us to removing 'Test 1' and adopting a dual discount rate (DDR) approach, as recommended in the JEP's second report.

UUK subsequently said employers representing 84% of our active membership support this approach

It better aligns with the **open nature** and **maturity** of the Scheme, its **demographics** and its **evolution**.

It leads to a **much larger long-term 'risk budget'** and taking **more risk in the long-term**. These are all key 'asks' raised by our stakeholders and are consistent with both JEP reports.

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

[3] *"Mutuality is a strength of the Scheme and the sector. Weakening its mutuality would damage the Scheme."*

It involves being tens of billions of pounds away from self-sufficiency over the long term while the Scheme remains open – provided this can be justified by the covenant. We have, accordingly, reiterated the covenant commitments required of employers to support greater risk-taking.

Alongside our new Integrated Risk Management Framework, this means we have also effectively adopted the **long-term funding objective**[4] suggested by the JEP (page 58 of its second report).

In respect of the Recovery Plan for the 2020 valuation, we plan to make an allowance for investment outperformance above the discount rate in all the scenarios detailed in our Trustee Update document. (As set out in the section above, the length of the Recovery Plan depends on the covenant position and the additional commitments employers are willing to make.)

We continue to engage with TPR on these matters. Given TPR's repeatedly stated view, we do not believe it would be credible for the Trustee to argue for a longer Recovery Plan without at least a matching commitment from employers to remain in the Scheme.

New forums have been established to exchange views on the valuation methodology and consider modelling: we have engaged extensively with UCU and UUK through 11 meetings of the Valuation Methodology Discussion Forum and 17 JEP tripartite meetings to progress the **governance-related aspects** of JEP 2.

In terms of **the visibility of the Trustee Board**, directors have attended each of these meetings as well as the 10 JNC meetings held since January 2020.

Shared valuation principles and **a definition of sustainability** have been agreed by all parties via the tripartite JEP discussions, and UCU and UUK have agreed a **joint purpose statement** for the Scheme, compatible with the Trustee's own purpose statement.

We have redoubled our efforts **to engage and share information with stakeholders, employers and members** for the 2020 valuation. We believe this is consistent with the shared valuation principles and the spirit of greater collaboration championed by the JEP and reflects our hope that a shared understanding and acceptance of the challenges will increase the prospect of a joint solution.

Ultimately, there are still issues on which we disagree. This reflects differences of opinion, perspective and duty.

The Trustee has specific duties under common law, statute and the regulatory regime, including ensuring that the Scheme has enough assets to cover its liabilities (as required under the statutory funding regime) so that members' benefits can be paid when they fall due.

Illustrated discount rates

In its response to our consultation on the Technical Provisions for the 2020 valuation, UUK said: *"The vast majority of employers support a pre-retirement discount rate of at least gilts +3.5% per annum, which is considered commensurate with the mid-range of the JEP recommendations."*

We do not believe the JEP recommended a set of discount rates, as it recognised that the appropriate discount rates must reflect the financial conditions at the time. The illustrations it

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

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provided in its second report were simply to show how a DDR approach could work, as it made clear on pages 66 and 67 of its report:

- *…the Panel did not propose these as appropriate levels, but rather sought to provide illustrative outcomes. Other discount rates or rate structures could be used which would produce difference outcomes and would need to reflect views on conditions and future returns.*
- *The numbers are all as at 31 March 2018. Market conditions have changed significantly since then so the numbers give, at best, a partial guide to the impact of adopting a dual discount rate as at 31 March 2020.*
- *The material impact of varying the assumptions about CPI are just one indication of the additional work that would be required before definitive conclusions could be drawn.*
- *USS was not asked to give any opinion of what, if any, investment strategy could be appropriately linked to the discount rates. The Panel has not sought to infer any particular investment strategy, the different assumptions are merely intended to illustrate the sensitivities of changing the discount rates.*

The global economy has since been deeply affected by the Coronavirus pandemic. Long-term interest rates fell by around 0.5% to 31 December – a relevant factor that must be explored. The outlook for future investment returns was also poorer, as shown in our Financial Management Plan reports. This mirrors general market sentiment.

If our own modelling and wider market sentiment suggests that investments will generate less income over the long-term than we assumed in the past, our members’ pensions are at risk of being under-funded. This could also increase the cost of funding new pensions in increasing the contributions we need to invest today to generate the returns that will pay benefits in future.

These are developments we would be duty bound to investigate and act upon in order to make sure that our members’ benefits can be paid when they fall due.

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