

An introduction to Conditional Indexation

Conditional Indexation – or “CI” – is a defined benefit pension scheme design where the future increases (also known as indexation) applied to benefits built up are conditional on the funding position of the scheme.

It is relatively new territory for the UK (only a few schemes use CI-type models), but it does have similarities with how many large UK pension schemes operated in the 1970s and '80s. CI is more common internationally particularly in Canada and the Netherlands.

Under USS’s current arrangements, the value of all the Retirement Income Builder benefits members have built up is increased each year (both before and after retirement). The Retirement Income Builder is the defined benefit part of USS and you can read more about it [here](#).

The annual increase is broadly in line with that of official pensions (public sector schemes such as the LGPS and NHSPS, which are currently pegged to the Consumer Prices Index (CPI)), but subject to certain caps under the USS scheme rules depending on when the benefits were built up.

You can [read a guide](#) describing how this works currently in practice at USS, but it effectively provides members and their dependants with a degree of inflation – or ‘cost of living’ – protection to, and through, their retirement.

The benefits USS members have already built up - including any promised annual increases - are protected by both law and the Scheme Rules. They will be paid for many decades into the future, and one of the primary legal duties of the USS Trustee is to ensure they can be paid.

This means the Trustee needs to have a high degree of confidence that the scheme will have enough money to do this both now and in the future. And, by law, its funding assumptions must be set prudently.

These are among the duties that can make it expensive to protect members’ benefits from inflation. The future is unknowable, but the USS Trustee’s statutory duties require that it evidence that the scheme can meet its commitments.

This means it effectively has to fund in advance for a range of possible outcomes – such as higher-than-expected inflation, or investment returns not keeping pace with inflation or falling short of our expectations which in turn drives up the price for benefits.

Under a CI design, future increases (also known as ‘cost of living’ increases or adjustments) to members’ benefits are not guaranteed, and instead are applied each year depending on how much money the scheme has to support those increases. (Note that, as mentioned above, the benefits USS members have *already* built up are protected and would not be changed under any future CI design).

If the scheme doesn’t have enough money to support the future annual inflationary increases (i.e., a funding shortfall or deficit), then lower/no increases are granted to help to bring the scheme back into balance.

When there’s more money available than needed to support future cost-of-living increases (i.e., a funding surplus), increases to benefits can be made good, in part or in full, in respect of increases foregone previously. (For the avoidance of any doubt, there is no change or flexibility in relation to benefits already ‘promised’ or increases granted at prior annual reviews.)

CI can be used to address changes in a scheme's funding position before changes to contribution rates and/or the future benefit structure need to be considered.

As such, it could potentially provide greater stability in both contributions and benefits (or, depending upon the overall design, reduce the impact of future funding pressures across contributions and/or benefits). In the past, USS has seen changes to contributions and/or its benefit structure to address deficits and changes in future service costs shown in actuarial valuations. In fact, changes to either contributions and/or benefits have been required at every valuation since 2008.

And because less prudence is baked-in up-front to provide the inflation protection, CI could also lead to lower regular contributions being required of both members and employers to fund a given benefit structure. But it also means the value of the pension due to members, or paid to them in retirement, might not always keep pace with inflation every year.

To understand this a little better, modelling has been requested by Universities UK (UUK), the body that represents employers in USS, and produced by the USS Trustee, in respect of the current benefits provided by USS, and other potential CI benefit packages.

This work has been requested by UUK to explore ways to mitigate against successive scheme changes being required, which can bring disruption for members and employers alike, and to consider if a CI scheme design can provide an alternative pre-agreed mechanism for responding to changing conditions.

To support the modelling and help bring this to life, UUK proposed a theoretical scheme design based upon a model used by the Ontario Teacher Pensions Plan ("OTPP"). This has been adapted where necessary to align the scheme design more closely with the current USS benefit structure and regulatory landscape for DB schemes in the UK.

The modelling suggests that a CI design applied in the USS and UK context potentially could deliver similar benefits to the pre-1 April 2022 hybrid benefits, with a high probability of full cost-of-living increases being provided to both pre- and post-retirement benefits, for contribution rates within the range of 20%-31%. While this is initial exploratory work, the early results suggest this is a promising structure for the stakeholders to explore with the aim of delivering greater stability between valuations in future.

There are, however, a range of policy, legal and practical issues to consider and address before a CI arrangement could be introduced. These are touched upon later in this document.

Why is CI being explored?

This is a question primarily for UUK, which requested the exploratory work to support one of its strategic objectives.

Broadly speaking, the objective is to see if a CI scheme could potentially deliver high quality defined benefits on a more predictable basis at an affordable level and mitigate, or even avoid, the changes that have been experienced to contributions and benefit structures over the course of the last decade. This would arguably lead to greater intergenerational fairness.

One feature of CI that arguably leads to greater intergenerational fairness is that any shortfall in funding is reflected in the level of CI increases granted to all members of the scheme, as opposed to the current design whereby only the current active members experience the change.

What work has been produced?

The work carried out by the Trustee in response to UUK's request has two strands. One is to identify the high-level policy, legislative and governance matters to be considered for CI to progress as a practical option that can be implemented. The second is the modelling mentioned above, to understand the potential outcomes and whether the trade-off could provide a more sustainable outcome overall.

In respect of the first strand, there are legislative requirements on pension schemes which mean that there are currently some restrictions on how CI may operate in the UK. These are explored further in the [Conditional Indexation Modelling document](#) and in the next section.

A more detailed review – of the policy matters, benefit specification options and outcomes, and governance implications for the stakeholders (through the [Joint Negotiating Committee](#) (JNC)) and the Trustee – would need to be taken forward in a further phase of development (should that be agreed by the stakeholders).

The key take-aways in our view are set out in the next section – we appreciate these may differ from yours and/or other stakeholders.

The modelling work has been an extensive exercise over several months and the key supporting outputs from the work are in the [Conditional Indexation Modelling document](#).

There are also several detailed technical points on which the stakeholders and the Trustee would need to engage in order to develop a more detailed understanding of the work undertaken, how it has been constructed, and its limitations.

Results of the modelling work

The modelling we have carried out at UUK's request is as at 31 March 2022. It uses the same assumptions as those underlying the [Accelerated Year-end Review \(AYR\)](#) at that date, incorporating a “best estimate” approach.

Modelling has been undertaken on both deterministic and stochastic bases.

The modelling has been based on a hypothetical benefit structure of $1/75^{\text{th}}$ of salary up to £50,000 with an associated lump sum of three times the annual pension based on a contribution rate of 25%.

The targeted conditional increase is full CPI, with no cap. Above the salary threshold of £50,000 it is assumed that funds would continue to be built up within the Investment Builder, the defined contribution part of USS.

The deterministic modelling indicates:

- The required investment return to support the proposed CI benefits was within the expected returns of the Trustee's current Valuation Investment Strategy
- Combining the existing benefits and assets of the scheme with a new CI arrangement would reduce the investment return required to support the benefits (note that existing benefits would continue to receive their guaranteed increases)
- Over time, the CI structure builds up a buffer which allows adverse experience to be managed by reducing the level of CI increases without the need to change contributions.

The stochastic modelling indicates:

- There is a high probability of being able to grant full CPI increases in each year
- Where CI increases are restricted below full CPI increases, in many scenarios there is the opportunity to catch up these increases in the future as 'surpluses' emerge
- The need to comply with the UK defined benefit funding requirements may limit the ability to grant full CPI increases in the early years, but these restrictions generally fall away as the buffer for CI increases grows
- In the majority of scenarios the level of benefit being granted is higher than those under the current arrangements (1/85th with increases in line with CPI capped at 2.5%).

Full detail of the modelling can be found [here](#).

The above outcomes assume that if a CI design were implemented, the future payments out of the scheme would continue to benefit from investment returns on the scheme's existing assets (i.e., those covering guaranteed benefits USS members have already built up). The alternative modelling assumption would be for the assets in respect of new benefits built up under the CI design to be separated from existing assets. The latter approach requires higher investment returns for a CI design to grant increases, because returns on prior investments would only support benefits already promised (and not future benefits). This is effectively a release of prudence in the current funding arrangements. (There would also be challenges to address with the segregation of the fund, but these have not been considered as part of this work.) Outcomes for both approaches are shown in the [Conditional Indexation Modelling document](#).

Matters to consider if the work is to progress further

A couple of key issues would need to be considered if stakeholders decide they want to explore CI in more detail. (More detailed work on potential designs would also likely identify other points or challenges to address, but for now we have set out a high-level list.)

As touched upon in the previous section, there are currently restrictions to how flexible CI could be under UK legislation:

- In occupational pension schemes such as USS, pensions in payment must be increased to reflect changes in CPI, capped at 2.5% a year
- to be compliant with automatic enrolment, the funding of a Career Revalued Benefits (CRB) scheme such as USS must assume revaluation of the lesser of 2.5%, CPI and RPI before retirement, meaning that for funding purposes any CI design wouldn't be fully reflected when determining the scheme's funding level.

There may be a number of ways to address these points, which would be for stakeholders to consider.

There are also policy design principles to be considered including (among others):

- Governance around future decision making in relation to CI, when it is to be applied, and which body/bodies make that decision – and particularly the role of the Trustee, the JNC and the stakeholders, and any associated consultation requirements or formal roles and responsibilities
- The mechanism that would be used under the Scheme Rules to set increase rates, and any impact on the setting of contribution rates
- The overriding scheme-specific funding provisions under the Pensions Act 2004 must continue to be satisfied.

Communications and transparency

A potential CI scheme design is an inherently complex structure, which would be introduced within an already complex hybrid scheme structure if it were to progress for USS. However, the experience of the Canadian funds in particular appears to suggest that challenges around complexity can be overcome, and that trust between all parties involved in such a scheme can be established. The Trustee will continue to work with employer and member representatives to build on that trust and remain transparent if and when any further work on CI is proposed by stakeholders.

What should you bear in mind when reading the modelling information?

The Trustee has produced this information in response to a direct request from UUK (and the progress of the review has been regularly reported to the JNC and to the Trustee Board). It is primarily a matter for the Scheme's stakeholders through the JNC to determine benefit design, and CI is no different.

Several factors could impact the attractiveness of a CI scheme design, but this would be for stakeholders to consider (should they want to explore it further).

The modelling outcomes should be considered as a snapshot of a particular design. For instance, depending upon design choices made and design priorities, the cost for a set level of benefits could go up, the probability of inflation matching could go down or the chances of changes to benefits could go up. Any solution would need to explore these trade-offs and balance the key inputs of contribution rates, required benefit level and the predictability of benefits over time.

It should also be borne in mind that CI could be part of an overall approach that could include agreeing other steps to take in response to changing funding conditions alongside the use of CI. That is not modelled in this work and would be for further discussion between stakeholders, but it would be a key component of any solution.

Overall, this is a promising first step which provides a starting point for stakeholders to explore further, if they decide to do so. It is, however, at a very early stage and needs to be considered and read on that basis.

What happens next?

We have provided the [Conditional Indexation Modelling document](#) to UUK to support its planned engagement with employers on the potential of CI as a future option for USS. We look forward to receiving the results of that consultation.

We are happy to support appropriate exploration of CI in response to any further request(s) from stakeholders.

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