

Universities Superannuation Scheme

The Pensions Regulator's consultation on the draft Defined Benefit Funding Code of Practice and Regulatory Approach

Detailed response

Introduction

USS has many specific characteristics that differ from most defined benefit pension schemes in the UK. While most are now closed to new accrual and moving towards the 'end game', the regulatory regime is still required to deal with open schemes such as USS, and with a range of varying characteristics: different maturities, different levels of employer support, sectionalised and non-sectionalised multi-employer schemes, and different levels of member interest.

We note that the draft Code has developed significantly since it was last consulted on in March 2020. However, the circumstances of USS should in our view be better reflected in the Code. Due to the significant funding provided to PPF by levies from large schemes like USS, and due to the impact of recent market conditions on scheme funding, the PPF is now far less financially exposed than at any point since its inception. Given that USS is possibly the only scheme in the PPF universe that could significantly compromise PPF reserves by itself, and noting TPR's stated objective to minimise the risk of calls on the PPF, working together to support the ongoing health and viability of USS over the long term (and not undermining that artificially through unnecessary prudence/derisking) should be of paramount importance to all stakeholders. In addition an open USS arguably supports the UK Higher Education sector's ability to attract and retain high quality employees, and in turn the sector's sustainability and growth – which chimes with TPR's objective to ensure employers balance the needs of DB pension schemes with growing their business.

Turning to this consultation on the Code itself, our first and minimum request, as per our cover letter, would be for the Code to give appropriate recognition of the specific issues relating to open schemes, and greater clarity for all parties, through **placing all content relating specifically to open schemes together into a single chapter of the final Code**. We believe this is a reasonable request, and doing so would:

- recognise the particular status of open schemes;
- provide a single point of reference to trustees, stakeholders, advisors, and TPR;
- allow greater clarity in relation to the specific issues open schemes will have addressed in their consultation responses without complicating the picture for closed schemes;
- ensure that the recognition of open schemes and their special circumstances has longevity within a Code that may guide regulatory behaviours and practice for many years to come; and
- Will help to build trust that Ministerial commitments previously made will be followed through.

Also, ahead of our technical response, we would like to highlight our particular concerns relating to the potential impacts of the Code on USS:

- **We would like the Code to reflect that some schemes will have covenant reliability over long time horizons, potentially much longer than most single-employer commercial sector DB schemes.** The nature of the higher education sector, and the fact that the USS employer base is sector-wide, means the USS employer covenant is very different to that of most other schemes. The factors outlined in the draft Code, including profitability and free cash generation, may give too narrow a view of our covenant. USS believes there is good visibility of covenant support over a substantially longer period than most DB schemes and pressure to significantly reduce that view would also potentially have consequences for the funding of the scheme.
- **We would like assurance that the scheme will not be artificially forced into an unnecessary derisking journey.** Without proper recognition of the effect of new entrants over a long visibility period that is perhaps unique to USS, the time horizon for the scheme will become artificially short which, in turn, will mean an unnecessary pressure to de-risk toward a point in time that is known to be too early. We recognise that USS would have to show appropriate evidence to support its view but suitable pragmatism to do so should be acceptable and we would welcome assurances that where the time horizons allow it that current levels of risk could be continued.

It is in the interest of DB schemes, sponsoring employers, members, the government and the wider economy that the Code does not take an overly restrictive approach that fails to take into account the unique structure of open, multi-employer DB schemes and the strength and nature of their employer covenants. To do so may limit the ability of such schemes to serve their members without placing undue demands on their sponsors.

Finally, we would note that an unfortunate tension in this consultation has been the unknown impact of the final DWP Funding and Investment Regulations, which will need to reflect and support some of the proposals for regulation set out in this draft Code. We assume that the final Regulations will reflect this draft Code (with any resulting changes) and have provided our responses on that basis.

Our detailed consultation response

Please note that in some areas we wish to raise points which do not fit easily with the Code's consultation questions. We have therefore set out our response below to reflect the structure of the draft Code, rather than answering specific consultation questions.

Chapter 1 - Codes of Practice

At the time of writing, DWP has yet to provide its response to the consultation responses it received in relation to the proposed Funding and Investment Regulations, and there is no final version of those Regulations yet available.

The Code is designed to set out how TPR aims to regulate funding in line with those Regulations. There are also aspects of the draft Code which don't appear to be reflected in the draft Regulations issued for consultation in 2022. Clearly these anomalies will need to be resolved by TPR and DWP, and if the final provisions under the Regulations and/or Code differ from those consulted in any significant way then further consultation with stakeholders should be considered.

Also note that this consultation response is submitted on the assumption that everything in the draft Code will be allowable by the Regulations when finally published.

Chapter 2 - Outline of the Funding Regime

This chapter summarises the requirements of the proposed funding regime. We set out below detailed comments on the provisions under the draft Code, but some key points we would flag here are:

- The Code and regime suffer from having to apply to the full range of DB schemes. It is also written in the context of the largest number of DB schemes (closed schemes with a single, or a very small group of, sponsoring employers) and doesn't reflect that, by liability and risk, the most relevant schemes will be large multi-employer schemes who may still be open to accrual or even new entrants. These large schemes cannot currently refer to a convenient summary of how the Code applies specifically to them, and must instead pull together information scattered across the Code to interpret and infer the requirements that apply to them in order to understand how they should act. This could lead to issues if TPR's view of areas of the Code is found to differ.
- There is an assumption within the Code that 'long' term the position that needs planning for is scheme closure. In the case of USS our 'long' term view is one of a scheme open for an indefinite period into the future and so closure is not a logical or reasonable planning goal. (Note this is different to preparing for potential scheme maturing, which is allowed for through the dual discount rate funding approach USS currently uses).
- The proposed need for a Statement of Strategy, including a Funding and Investment Strategy (FIS), overlaps significantly with the content of the existing Statements of Funding Principles (SFP) and of Investment Principles (SIP). It is also arguably unnecessary for an open scheme accepting new entrants and not expected to close in the future. We're concerned that the work here does not create significant additional value but could create significant additional costs.
- The Code refers to trustees being required to "obtain the employer's agreement to" the FIS. This is confusing and potentially misleading particularly for those schemes, like USS, where the requirement to agree is modified to a consultation requirement. Whilst it appears the

intention is that the wording in Appendix 1 (paragraphs 374 and 385) is intended to clarify the employer role, we think this should be made clearer in the body of the Code – for example a footnote (here in paragraph 20) cross-referencing to the discussion on roles and responsibilities in Appendix 1. Alternatively, we note the previous Code has some useful detail (including a table) in this respect, and this might usefully be reinstated.

Chapter 3 - Low Dependency Investment Allocation

Here the draft Code summarises how scheme assets should be invested on/from the Relevant Date.

- *Low dependency investment allocation (LDIA)*: in our own case, the nature of our employer base (effectively an industry-wide group of employers who together constitute a strategic UK quasi-public sector) means our covenant reliability period is likely to be very long, well beyond significant maturity. As with other aspects of the Code therefore it is difficult to see how the work needed to derive a detailed LDIA will be of value - if such a scheme as USS were to adopt a pragmatic approach to deriving a broadly suitable LDIA (on the basis it will not be needed for many years) that should be sufficient.
- *Broad cashflow matching*: more assistance on what may be regarded as “broadly matched”, and what latitude there may be for interpretation around that, would be useful as the Code only contains some high level commentary.
- *High resilience to short-term adverse changes in market conditions*: There is a very substantial requirement on the LDIA to show resilience. For USS the LDIA, arguably, is more a theoretical concept than a practical one whilst the scheme is expected to remain open to new entrants for many years to come. Currently the expectation of reaching significant maturity is many years into the future (if at all). So while evaluating the resilience to stresses of the LDIA may be useful information, it would not be a priority piece of work for USS – but it is not clear that the proportionality paragraphs 87 to 90 include this stress aspect.
- *Liquidity*: To what extent will the proposed liquidity requirements be relevant to open and cash flow positive or neutral schemes: is the code concerned with pension and benefit payments only, or the ability to meet any required cash flow (margin calls etc)?
- *Proportionality*: no comments.

Chapter 4 – Low Dependency Funding Basis

Chapter 4 sets out (alongside Appendix 3) the requirements of a low dependency funding basis. The critical issue for USS, as discussed above, is the timing of the transition to this basis rather than the details of the basis itself – particularly having to do so unnecessarily early.

We note the proposal to reflect future expenses through a capitalised reserve, which USS does not presently do (it is included in the contribution rate required). This is not unreasonable, although the approach to calculating and explaining the amount will require additional work.

Chapter 5 – Relevant Date and Significant Maturity

In Chapter 5 the draft Code explains significant maturity and relevant date and sets out how trustees are expected to evaluate their schemes to determine their own maturities. In particular it states that the duration of the scheme's liabilities, measured using the scheme's low dependency funding basis, is the measure to be used.

Our concern here is that if duration is going to be used then, given trustees will be setting long term strategies based on this information, it needs to be a robust measure and the current proposal is too likely to produce varying results even in the short term as interest rates change. In addition, the proposed formula is difficult to apply for open schemes. A simplified approach that doesn't use market driven discounting would be our preferred option. The precise target can then be set in the full knowledge of the implications of the simplifications.

We also feel it would be helpful for some reference to open schemes to be made here (preferably a link to a separate Code section for open schemes, as requested above), given the particular issues significant maturity and related requirements could cause for schemes like USS which are not currently intending to close or mature significantly.

Chapter 6 – Employer covenant

Understanding and reflecting employer covenant is a key part of our approach to funding. We therefore spend a lot of time and resource on ensuring we have a clear and correct picture of the employer covenant, both currently and over time, so that we may set the scheme's funding requirements appropriately.

We set out some detailed comments below, but our concern with the Code as drafted is primarily that it simply does not reflect the specific circumstances of the USS employer covenant. As previously noted, the Code endeavours to cover all schemes but is mostly written from the position of a single employer DB scheme. There are only three paragraphs on multi-employer schemes, which merely reflect some common-sense application of the single-employer rules to more than one employer. In the USS case we have around 330 employers, covering a large, strategically-important UK sector, who support the scheme on a last-man-standing basis. The USS scheme is a valuable part of their offering to staff, allowing recruitment and retention of the individuals required to support the sector's continued value and growth, including its global recognition.

Our concern is that if the unique strength of that sector is not allowed to be fully recognised when the funding and investment of the USS scheme is considered, this could lead to artificial derisking of the scheme, causing increased costs for employers (and members – USS is a shared cost scheme) and thus a gradual erosion of both the value of the scheme and the value of the sector.

In relation to detailed points:

- Covenant "Reliability" is an extremely important consideration for USS with implications in a number of areas. As currently drafted, it is not clearly defined in paragraph 132. USS already has what appears to be a similar concept of "covenant horizon" which it has discussed and debated with TPR colleagues in recent valuations and "reliability" would appear to be similar to the USS concept. However, the absence of a clear and objective definition of "reliability" (and indeed "visibility") could lead to future differences of view between TPR and USS.

- Covenant “Visibility”: it is not clear what the characteristic of “visibility” is such that it “typically covers a period of between one and three years” and then falls away.
- What is the difference between “visibility” and “reliability”? The latter would appear to require the former anyway?
- It would be helpful if TPR could set out the characteristics it considers are relevant for determining whether trustees have “reasonable certainty” over employer cash flows and funding and therefore for determining an appropriate “reliability” period.
- Cash flow is given as a key factor in the covenant consideration, and paragraphs 136-143 set out some quite detailed points for trustees to take into account. However, for multi-employer schemes aggregated cash flow forecasts are not typically available and it would be unrealistically onerous to expect trustees to create them. It would be helpful if this and similar issues were to be fully recognised in sections 160-162.
- In relation to not-for-profit employers (which is relevant for USS), we believe the considerations are not unreasonable, but note that they could encompass a wider range of not-for-profit scenarios and issues of greater relevance to USS and others here, e.g., in relation to the position of not-for-profit employers funded from sources other than donations.

Chapter 7 – Journey Planning

Chapter 7 sets out how trustees should approach and document the transition from their current funding position to the long-term funding target, set out in the FIS. This “journey plan” will form part of the FIS.

- The Code again refers to the FIS requiring “employer agreement”. As noted above in our comments under Chapter 2, a footnote (here in paragraph 175) cross-referencing to the discussion on roles and responsibilities in Appendix 1 would help make the intentions here clearer.
- We have previously in this response raised questions in relation to covenant “reliability” and how its meaning needs to be made clear. However, within this section:
 - We note that paragraph 192 uses a different definition of cash flow to that used in paragraph 136. It would be preferable for the purposes of clarity and simplicity to use a single definition throughout.
 - It is not clear why trustees are not allowed to take ongoing covenant reliability into account beyond the relevant date. Where trustees have assessed that covenant reliability continues to be an asset that they can reasonably fall back on, it seems illogical not to allow the trustee to do so.
- If a scheme as large as USS reached the derisking stage then the scale of derisking, de- and re-investment needed would have to be acknowledged alongside an acceptance that it may take significant time to execute.
- We were glad to see specific mention of the ability for trustees of open schemes to allow for new entrants when considering their significant maturity and relevant date, which makes the draft code more relevant for open schemes than would otherwise be the case.

Presumably the ability to allow for new entrants is intended to apply to all aspects of the Code and is not merely limited to matters relating to journey planning (and Technical Provisions where it is also covered)? It is not clear that this is the case given where the comments on new entrants appear in the document (e.g. paragraph 217, paragraph 274). This is another factor why we believe a separate section for open schemes would help with clarity and understanding, as the position for new entrants could be more clearly marked there.

- In paragraph 218, it is not clear what an ‘equivalent closed scheme’ to an open scheme may be.

Chapter 8 – Statement of Strategy

The Statement of Strategy is the document overarching the FIS and linked funding and investment matters.

Our concern here is that for USS much of this work will be superfluous, given USS is an open scheme which is not expected to close either to new entrants or future accrual, let alone in the near future. When added to the fact that there appears to be significant overlap with the existing SFP and SIP documents, actuarial reports required by legislation and so on, there is a lot of work required (using valuable time and resource) for very little real gain for a scheme like USS.

Chapter 9 – Technical Provisions

The approach to agreeing the Technical Provisions (TPs) is a vital part of scheme funding with trustees being required to take advice from the Scheme Actuary when setting appropriate assumptions for their scheme.

- We were glad to see specific mention of the ability for trustees of open schemes to allow for future accrual and new entrants when considering their significant maturity and relevant date.
- There is more information here about what might be a “reasonable” allowance to make for future accrual and new entrants. However, based on our reading, the approach here seems to be very prudent which causes concerns in our own case as it is not clear TPR would place the same interpretation on “reasonable” as the trustees. We also note the potential limitations imposed by “reasonable certainty” over covenant aspects i.e., the covenant reliability period which we have flagged may be viewed differently by trustees and TPR.
- We note that the draft Code states that demographic assumptions must be chosen “using prudent principles”. Is this an intentional expansion of the need for prudence in the non-financial assumptions given it used to apply to mortality only?
- Paragraph 273 requires compliance with the principle that past service in an open scheme should have the same level of security with that of an “equivalent closed scheme”, without the TPs necessarily being the same. It is not clear how this might be achieved, and thus what this paragraph may actually mean for an open scheme. (Again it is not clear what an “equivalent closed scheme” may be).

- Paragraph 281 could be interpreted to mean that future service liabilities should be assessed using the same assumptions as the TPs, which appears to be a new constraint being imposed on funding.
- The options for the use of surplus are covered by legislation and case law – is the intention of Paragraph 283 to add further restrictions on when or how trustees may utilise surplus?

Chapter 10 – Recovery Plans

Chapter 10 sets out proposed updated approaches to determining the length and structure of Recovery Plans, when a funding deficit is required to be addressed.

We are concerned about the requirement for deficits to be recovered “as soon as the employer can reasonably afford”. It appears to start from an unbalanced position that a trustee should require all available cash to be diverted to the pension scheme, only moving away from that position if other uses for that cash can be ‘justified’ by the employer on the grounds of being beneficial in the long term or being needed for other pension arrangements. That stance is unlikely to be helpful in practical negotiations. It leaves trustees, who have made a balanced decision based in integrated risk management principles, getting a lower additional contribution into the scheme than their view of the available cash and then potentially in an uncomfortable position having to ‘justify’ the outcome to the Regulator. The definitions of reasonable alternatives exclude the option for the employer to retain cash flow to build up prudent cash reserves (and e.g., strengthen the covenant visibility/reliability by ensuring future financial sustainability), which does not therefore appear to be permitted where there is a deficit.

It is also difficult to apply some of the principles here to a multi-employer scheme, especially one where the use of cash is different to a commercial employer with investors/shareholders. In such sectors a strict following of these requirements would cause significant additional work for trustees and would not lead to a suitable evaluation of the employers’ ability to fund the scheme deficit compared to other uses for that cash.

On specific points in this Chapter:

- There appears to be no flexibility for trustees to take into account ongoing covenant reliability in determining recovery contributions and recovery plan length: the rationale for this is not explained and the underlying logic is not apparent.
- It is reassuring to see that trustees retain the flexibility to allow for post-valuation experience, and that they can revisit this approach from valuation to valuation where appropriate.
- Paragraph 314 appears to require trustees to form their own view on what level of growth is sustainable and reasonably achievable for their employer(s), and effectively disallow the employer from making investment that targets growth that is more aggressive than this. Trustees are ill equipped to make such an assessment and it is not their responsibility to involve themselves in operational management decisions of sponsoring employers. The requirement to do so may potentially be damaging to the relationship between scheme and employer.

Chapter 11 – Investment and Risk Management Considerations

Chapter 11 again sets out requirements that, for an open scheme like USS, relate to largely theoretical scenarios given that it will not be expecting to reach significant maturity or actually start transitioning to the low dependency positions. Many schemes will already have in place some form of risk management plan, which will include funding and investment – for example USS has its Integrated Risk Management Framework which details when and how it will move towards a lower risk strategy. Having to draw up these statements on top of such a scheme running its own detailed risk framework, with the input of the relevant advisers, and with the proposed requirement to have to agree the statement with employers, will add significant time, work and cost requirements.

On some specific points where further clarity is required:

- how does a derisking journey plan interact with an open scheme where the investment strategy is expected to be re-evaluated at each valuation? Even if the implied derisking strategy given by a dual discount rate approach (which would be robust to closure) would pass as a justifiable “journey plan”, to what degree would an open scheme be expected to actually implement it?
- To what extent will the proposed liquidity requirements be relevant to open and cash flow positive or neutral schemes: is the code concerned with pension and benefit payments only, or the ability to meet any required cash flow (margin calls etc)?

Appendix 1 – Responsibilities and Roles

We largely agree with this summary of key roles and responsibilities. However we do have two points to make here:

- Paragraph 383: is it TPR’s intention that trustees should retain evidence and explanations for every single decision made? We believe some reference to materiality would be pragmatic here, with non-material decisions requiring lesser documentation than clearly material ones.
- Paragraphs 374 and 385: as previously noted, whilst it appears clear here that the requirement for employers to “agree” to the rate of contributions payable is modified to “consult” for certain schemes (such as USS where this is the requirement set out in the Rules), we assume this also applies in other areas where “agree” is used e.g. where the Code refers to the need to “agree” the FIS with employers. It would be helpful if this could be made clearer in the body of the document and we have suggested this could be done via footnotes.

Appendix 2 - Key documents, reporting requirements and intervaluation requirements

In the statement relating to Summary Funding Statements, the draft Code says that these must be issued “within three months of the trustees receiving the valuations or reports.”

This would appear to be a change from the current requirements which give deadlines as 15 months from the effective date of an Actuarial Report or 18 months from the effective date of a full actuarial valuation. Is this intended?

Appendix 3: low dependency funding basis – expectations for setting assumptions

We have covered our points within the main body of our consultation response above.

Appendix 4: Allowance for expenses in low dependency liabilities

We have covered our points within the main body of our consultation response above.

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24 March 2023