Alex Burghart MP
Parliamentary Under Secretary of State (Minister for Pensions and Growth)
Department for Work and Pensions

Ref BG/JMR
Date 19 October 2022

By email: MINISTER.PENSIONS@DWP.GOV.UK

Dear Minister

USS/Stakeholder response: Draft Occupational Pension Schemes (Funding and Investment Strategy and Amendment) Regulations 2023 (the "Regulations")

Firstly, congratulations on your recent appointment as Minister for Pensions and Growth.

As you know, the pensions sector is vital to the economic health of the UK and to the retirement plans and well-being of millions, and has evolved considerably over the past decade.

We are writing to raise our concerns regarding the Department of Work and Pensions' (DWP) draft Regulations relating to the funding and investment of defined benefit schemes. Whilst we support the headline aims, we believe that as drafted the Regulations could stymie future investment by forcing DB schemes to be unnecessarily risk averse, therefore reducing support for UK businesses and increasing costs for members and employers unnecessarily. The Pensions Regulator's (TPR's) draft new DB Funding Code will have an important role in articulating TPR's view of the law and, we hope, in recognising the nuances of individual schemes and sectors, but it is vital that the regulatory framework upon which the Code is based is fit for purpose.

A unique structure

By way of introduction to us, the Universities Superannuation Scheme (the "Scheme") was established in 1974 as the principal pension scheme for universities and other higher education institutions in the UK. It has more than 500,000 members across 330 institutions and is one of the largest pension schemes in the UK, with total fund assets of £90.8 billion (as at 31 March 2022). It is a hybrid defined benefit (DB)/defined contribution (DC) scheme, with 212,000 active members as at 31 March 2022, and continues to grow. Indeed, it is one of the few remaining open DB schemes in the UK.

Almost half of USS's investments are in the UK, including major infrastructure assets, for example our recent additional investment in Thames Water. We firmly believe that private capital can play a critical role in achieving the Government's key policy aims, accelerating growth, increasing long-term investment in infrastructure and supporting the transition to Net Zero. The current proposed Regulations may reduce our ability to support such objectives.

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Our consultation response

USS welcomes the opportunity to respond to the DWP's consultation on the draft Regulations, and our full response accompanies this letter. We would also like to emphasise that this is a collective view agreed by the Scheme's stakeholders – Universities UK, which represents the employers, and the University and College Union, on behalf of our members - who share similar views and have co-signed this letter. We would like to take this opportunity to highlight some of the pressing concerns we raise about the draft Regulations, which we share with a number of other open DB schemes, and these are set out below. Our stakeholders also have deep misgivings about the broader impacts the draft Regulations would have on the future prospects and retirement provision of those working in the higher education sector, and more broadly on the wider UK economy if the impact of the Regulations leads to diverting university resources away from teaching and research activities because they are required to support lower risk pension scheme strategies.

Our headline concerns

Much of the operation of the proposed Regulations will be set out in TPR's code of practice, which is not expected to be issued until after the consultation on the Regulations has closed. As such, it is difficult for the impact of the proposed Regulations to be fully understood as yet. However, the Regulations as drafted are overly restrictive to open schemes like ours, and may have the following consequences:

- **Requiring trustees to determine a time period over which a movement to low risk and low dependency for funding is required without explicitly recognising the open nature of some schemes (including USS) and in particular new entrants being admitted.** Without recognition of new entrants, the Regulations require open schemes to move to low risk and low dependency positions over time horizons which will drive up funding costs significantly, which in turn, will mean an unnecessary and unwelcome greater contribution burden being placed on employers and members, or even employers considering scheme closure. For USS we estimate the requirement to move to low dependency within the funding and investment strategy would result in an increase in the scheme's technical provisions and corresponding assets of more than 10%, and would drive increases in the cost of future benefits of c25%. Based on the Scheme's position at 31 March 2022 we estimate this would equate to an extra £10bn of funding that would need to be found from our sponsors plus an additional £0.6bn per year in future contributions.

- **Reducing trustees' ability to determine and operate suitable long-term funding and investment strategies for their scheme.** Pension scheme trustees are long-term investors, and the assets they hold support economic activity. Particularly if the draft Regulations are intended to impose binding investment restrictions on trustees (rather than only affecting the setting of technical provisions at each valuation), trustees' capacity to invest in growth assets would be reduced, requiring them to move away from those currently felt to be appropriate to those providing lower return and make a lesser contribution to the growth agenda. As an illustration, USS currently holds shares in Thames Water: because of the requirement to invest heavily in the infrastructure, profits are intended to be reinvested with no dividend flow in the near term and the majority of cash flows only being realised thirty years or more into the future - whilst USS could divest of such assets in an orderly manner over time, open pension schemes such as USS fulfil a key role in the UK economy that other investors cannot by holding these assets over a long period. As currently drafted these regulations are less supportive of that role than the current regime.

- **Reducing/removing the ability of trustees to place appropriate reliance on employer covenant.**

- **Allowing trustees to assess covenant using only limited permitted factors, currently on the basis of cashflow and the probability of insolvency (with the other factors permitted currently unclear).** For the majority of our sponsoring employers in the higher education sector (and for that matter, not for profit organisations) these are not the most appropriate measures.

- **Reducing the Trustee's ability to set appropriate contribution rates by introducing a requirement that deficit recovery contributions should be set to clear the deficit as soon as is reasonably affordable.** This could conflict with trustees' discretion to take into account other relevant matters such as (but not limited to) the employer's need to invest in and fund its business and commitments. We would also remind that TPR has a statutory objective under the Pensions Act 2004 Section 5(1)(cza) to "minimise any adverse impact on the sustainable growth of an employer" in the exercise of its functions.

As outlined in more detail in our full response, to address the above concerns we are calling for the following:

- An explicit recognition that open schemes, when considering the period to significant maturity, should be allowed to take into account their open nature and incorporate an allowance for future accrual and new entrants in the duration calculation. Allowing this would remove the most significant issues with the draft Regulations; it would mean open schemes would not have to de-risk inappropriately, would prevent the significant rises in costs for employers and members that would otherwise be required, and would allow open schemes to continue to invest for the long-term and thus support economic growth.

- Explicit recognition that trustees *must take into account all relevant factors* in assessing employer covenant, not just those related to cashflow, insolvency probability and contingent assets, for example the risk of any insolvencies adversely impacting the funding position of the scheme given wider employer commitments (in the case of a multi-employer scheme), and the business models of the relevant employers.

- Clarity that the need to pay off funding deficits as soon as an employer can "reasonably afford" involves appropriate consideration of the specific circumstances and sustainability of the employer and the ongoing affordability of contributions for members building up new benefits in the scheme.

It is in the interest of DB schemes, sponsoring employers, members, the government and the wider economy that the final Regulations (and TPR's forthcoming Code) do 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, therefore limiting the ability of such schemes to serve their members and to invest, grow and support the government's wider investment objectives.

As drafted the Regulations could unintentionally force open DB schemes to implement actions which will unnecessarily drive up costs and put members' future benefits at risk. If the Regulations instead allowed DB schemes to factor appropriate levels of risk into their funding and investment strategy, schemes such as USS should be able to continue their exposure to growth-based assets for the benefit of both members and the broader economy.

In closing, we would like to thank your officials for the time they have taken to discuss these issues with us, and for their willingness to engage. We also appreciate that the DWP has said it wants to listen and take views on board and has expressed openness to suggestions. This response is presented in that spirit: to investigate improvements which help DWP achieve its high-level aims without negatively impacting the ability of employers to support DB schemes, including ongoing provision of benefits under open schemes.

We hope that in your deliberation and review of the Regulations in light of the consultation response, you will be able to address our concerns by adopting the measures we have proposed. We would be happy to discuss these with you further if that would be helpful.

Yours sincerely

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