USS response to 'Options for Defined Benefit schemes: a call for evidence'

The Universities Superannuation Scheme (USS) welcomes the opportunity to respond to this call for evidence. We are mindful that USS is very different to most UK pension schemes, given its open status, size resources and hybrid nature. Proposals that might be appropriate for the generality of schemes may not be appropriate for USS.

While we have responded where appropriate to the specific questions posed below, we have also offered some broader thoughts.

We would welcome direct discussion on the themes of the consultation and our broader thoughts with Government as helpful.

About USS

The Universities Superannuation Scheme (USS) was established in 1974 as the principal pension scheme for universities and higher education institutions in the UK. We work with around 330 employers to help build a secure financial future for 528,000 members and their families. USS is primarily a defined benefit (DB) pension scheme, we are one of the largest pension schemes in the UK, with total assets of around £ 75.5bn (at 31 March 2023); this includes £27.7bn (at 31 March 2023) of private market assets (the default fund in our defined contribution or DC section also includes a significant allocation (c.20%) to private market assets). The scheme remains open to future DB accrual for both new and existing members, with members also able to build up DC benefits. As a non-associated multi-employer scheme offering DC benefits USS is an authorised trust.

The trustee of USS is Universities Superannuation Scheme Limited (USSL), a corporate trustee which provides scheme management and administration from its offices based in Liverpool and London. The trustee is regulated by The Pensions Regulator and has a legal duty to ensure that benefits promised to members are paid in full on a timely basis. The Joint Negotiating Committee (JNC) is a body established under the USS rules which is comprised of an equal number of individuals appointed by our stakeholders[1] and an independent chair. The JNC can propose rule changes for USS and must also approve any rule changes that the trustee proposes. If contributions need to be changed to provide a particular level of benefit, the JNC decides how these should be shared between employers and members, or whether there should be a change to future benefits.

Our investment strategy

USSL delegates implementation of its investment strategy to a wholly-owned investment management subsidiary company - USS Investment Management Limited (USSIM) - which provides in-house investment management and advisory services, and is authorised and regulated by the FCA. USSIM manages between 60% and 70% of the investments in-house and appoints and oversees external investment managers to manage the rest. This allows the investment approach to be tailored to the scheme's requirements and provides us with a unique

[1] University and College Union (UCU) is a trade union and professional association that represents individuals working in further and higher education throughout the UK and represents members of USS on the JNC. Universities UK (UUK) is the collective voice of 140 universities across the UK and represents participating employers on the JNC.

perspective compared to many other institutional investors. USS aims to be an active, engaged, long-term and responsible owner of the companies and assets in which it invests.

USS' asset allocation (and by extension, our investment in 'productive assets') is driven by a 'valuation investment strategy' (VIS), that sets an investment strategy in the context of covenant risk capacity and funding risk appetite. This VIS (set by the trustee following engagement with our sponsoring employers) shapes a mandate that the trustee delegates to USSIM, which has significant flexibility in implementation and is a large enough mandate to have a perspective across (and access to) most asset classes, public and private.

USS's VIS is shaped by a number of important contextual factors, including:

(i) USS has a large number of participating employers and members which creates a number of dimensions of 'scale'
(ii) that we are an open scheme with future inflows of contributions likely to remain consistent over a relatively long horizon
(iii) risk is 'mutualised' among a significant number of employers in the UK higher education sector, which minimises exposure to idiosyncratic institutional risk, leading to a 'strong' covenant(as reflected in our current valuation and a view of our covenant with which TPR are content).

If any one of these factors were removed, the capacity for investment in productive assets would be changed significantly. It is important to note that the wider UK DB landscape in aggregate lacks many of the above factors.

We believe that economies of scale can enable investment strategies that are more 'productive' without adding to risk, but these gains may be less significant while risk remains, for other schemes, underwritten as currently. The other aspects [unique to] USS – a strong covenant with a long term horizon, along with mutualised risk – is likely to be difficult to replicate while pension risks sit on employer balance sheets in the private sector.

Responses to Questions

We have responded, as relevant to USS, to a number of the questions posed in the call for evidence.

We would note that the Call for Evidence does not reference the forthcoming Funding Regulations (the draft Occupational Pension Schemes (Funding and Investment Strategy and Amendment) Regulations 2023 which were subject to DWP consultation in 2022) and the likely new DB Funding Code (subject to a second TPR consultation earlier this year). We are acutely aware that there is a potential inconsistency in policy between the ambitions outlined in the Call for Evidence and the potential de-risking pressures on schemes (including open DB schemes like USS) from the emerging DB Funding Code[2]. Open schemes are very different to the majority of DB schemes and would face particular challenges around covenant horizons and reflecting future accrual if the

[2] We would note a similar potential inconsistency in the PPF considering higher levies for large schemes and the Government's ambitions around consolidation and scale.

draft Code were adopted as consulted on. We'd welcome greater clarity from Government and TPR about how these approaches might better align[3].

We support the Government's willingness to explore innovation in the DB pensions space. We have previously been asked to explore conditional indexation by UUK[4]. Should our stakeholders want to take this concept further we'd welcome openness from Government to supporting broader innovation. As noted below, we offer no view in a number of the areas of innovation discussed in the Call for Evidence unless it increases risk (and potentially therefore costs) to remaining open DB schemes.

Question 1: Do you agree with the assessment of the position? Is there evidence to the contrary?

Published data (e.g. the PPF Purple Book) would indicate that, as defined benefit pension schemes in the UK have closed and matured, their asset allocation has moved toward lower risk and matching investment strategies. There is limited international comparator data for similar shifts (e.g. Ireland) as against countries such as the USA who have retained different forms of open DB, those that have adopted forms of 'shared risk' DB and DC schemes (such as Canada and the Netherlands) or countries with very different models (the Australian superannuation system or the German book reserve/insured model examples).

We would note the importance of disaggregating the behaviour of different types of DB scheme; as with many other open schemes, USS has substantial investment in 'productive' assets such as equities, private market assets and infrastructure.

Question 2: What changes might incentivise more trustees and sponsors of DB schemes to consider investing in productive assets while maintaining appropriate security of the benefits promised and meeting their other duties?

USS already has substantial investment in 'productive' assets while maintaining appropriate security of promised benefits and meeting our other trustee duties.

As has been noted in response to previous DWP and TPR consultations, and the recent Work & Pensions Select Committee DB pension schemes inquiry, this asset allocation might come under pressure from the policy direction of the draft Funding Regulations and draft DB Funding Code.

We would therefore reiterate our request for a more appropriate future regulatory framework for open DB schemes, particularly around issues such as covenant horizons. We, together with our stakeholders, have expressed concerns that the draft Funding Regulations and the draft DB Funding Code might require inappropriate de-risking and a move away from growth assets.

We would welcome:

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[3] Our concerns (and those of our stakeholders) are covered in detail here. The full consultation response on the draft Funding Code can be found here.

[4] UUK launched a consultation with employers on this initial work to explore whether a Conditional Indexation model could work for USS in May 2023. Together with a joint USS/UUK response in respect of CI to a DWP consultation on auto-enrolment requirements, the consultation materials can be found here.

- explicit separate treatment for open DB schemes in the regulatory approach, including relevant content in the DB Funding Code being grouped together;

- greater recognition that open DB schemes have remained open for scheme and employer/sector-specific reasons and therefore have very different covenant contexts;

- further clarity on DWP and TPR's wider strategic objectives for open DB schemes; and

- better consideration of the overlapping regulatory requirements from TPR and FCA that fall on pension schemes such as USS that have an in-house investment management arm (who may be best placed to invest in 'productive' assets).

Question 3: How many DB schemes' rules permit a return of surplus other than at wind up?

Question 4: What should be the conditions, including level of surplus that a scheme should have, be before extended criteria for extracting surplus might apply?

We have answered these two questions together.

We offer no view in response to these questions (our scheme rules do not permit a return of surplus in an ongoing scenario and our amendment powers are such we would not foresee that position changing), however, we do offer a number of observations.

We are mindful that while ongoing scheme valuation outcomes are important tools for scheme decision making, surpluses are only crystallised once the assets of the scheme have been properly applied in accordance with the scheme rules and member benefits have been fully discharged or secured. The position of open schemes is therefore fundamentally different to that of closed schemes as that while for both, although a periodic valuation may indicate the scheme is in surplus, crystallisation will not arise. For open schemes some risk is shared across generations and any surplus identified can be a useful stabilising tool for managing the impacts of financial market volatility between valuations.

The treatment of any valuation outcome or surplus should be a scheme specific matter, decided on by the trustees, sponsor(s) and any other relevant stakeholders, reflecting the statutory funding regime fiduciary duties and the context of the scheme. Schemes and their stakeholders may wish to evolve these frameworks in a scheme specific manner over time. We would therefore encourage the avoidance of prescriptive regulatory approaches or blanket statutory overrides.

Question 5: Would enabling trustees and employers to extract surplus at a point before wind-up encourage more risk to be taken in DB investment strategies and enable greater investment in UK assets, including productive finance assets? What would the risks be?

Question 6: Would having greater PPF guarantees of benefits result in greater investment in productive finance? What would the risks be?

We have answered these two questions together.

We offer no view on the potential changes to asset allocation from extraction of surplus prior to wind-up (we assume for closed schemes) or the adoption of greater PPF guarantees.

We are however concerned about the potential downside risks of resultant weaker scheme funding and/or higher levels of protected benefits leading to a higher value of claims on the PPF. This risk should not be borne by PPF levy payers who have not opted into the higher level of protection whether through past levies (via use of PPF's current surplus) or future levies (being charged higher levies to fund compensation claims from these schemes). Those likely to benefit should bear the risks.

Question 7: What tax changes might be needed to make paying a surplus to the sponsoring employer attractive to employers and scheme trustees, whilst ensuring returned surpluses are taxed appropriately?

We offer no view on the substance of this question.

We would note, however, that should such tax changes be made, we believe it would be appropriate to make similar changes to allow strong scheme funding, where the scheme has the power to consider that option under its rules, to be used to augment members' historic accrued benefits without triggering tax charges e.g. annual or lifetime allowance charges.

Question 8: In cases where an employer sponsors a DB scheme and contributes to a DC pensions scheme, would it be appropriate for additional surplus generated by the DB scheme to be used to provide additional contributions over and above statutory minimum contributions for auto enrolment for DC members?

We offer no view on this question, other than to note that we assume the DB scheme would be closed to new accrual in this model, with the benefits being invested in matching/low risk assets (or even secured).

Question 9: Could options to allow easier access to scheme surpluses lead to misuse of scheme funds?

We offer no view on this question, other than to note our comments above in respect of the potentially higher levels of risk.

Question 10: What impact would higher levels of consolidation in the DB market have on scheme's asset allocations? What forms of consolidation should Government consider?

Question 11: To what extent are existing private sector buy-out/consolidator markets providing sufficient access to schemes that are below scale but fully funded?

We have answered these two questions together.

We offer no view in response to the substance of these questions.

Given our size, we do however strongly recognise the benefits of scale for DB schemes. We are therefore able to invest in governance, administration and our in-house investment management function, and leverage these benefits for our members and employers. We can draw on the experience of our global peers and access a range of investment and other opportunities often not available to smaller schemes.

Question 12: What are the potential risks and benefits of establishing a public consolidator to operate alongside commercial consolidators?

Question 13: Would the inception of a public consolidator adversely affect the existing bulk purchase annuity market to the overall detriment of the pension provision landscape?

Question 14: Could a public consolidator result in wider investment in "UK productive finance" and benefit the UK economy?

Question 15: What are the options for underwriting the risk of a public consolidator?

Question 16: To what extent can we learn from international experience of consolidation and how risk is underwritten?

We have answered these five questions together.

We offer no view in respect of the principle of establishing a public consolidator other than to suggest that the Government should identify and be clear at inception as to what 'market failure' a public consolidator might be intended to remedy. Otherwise, if the intention is simply to facilitate greater use of scheme assets for investment in "UK productive finance" with no additional underlying security it might be difficult to see why trustees might select this consolidator and how any risks created should be borne.

As noted below in respect of the PPF, the risks (and costs) of a public consolidator should not be underwritten by other defined benefit pension schemes (and by extension their sponsors and members); we offer no view on whether those risks might therefore be borne by taxpayers, the consolidated members and/or their (former) sponsors. The investment activities of any public consolidator should also be regulated in a similar manner to those of other consolidation vehicles.

Question 17: What are the potential risks and benefits of the PPF acting as a consolidator for some schemes?

Question 18: Would the Board of the PPF be an appropriate choice to operate a public consolidator?

Question 19: How could a PPF consolidator be designed so as to complement and not compete with other consolidation models, including the existing bulk purchase annuity market?

Question 20: What options might be considered for the structure and entry requirements of a PPF-run public consolidator, for example:

- **are there options that could allow schemes in deficit to join the consolidator?**
- **what principles should there be to govern the relationship between the consolidator and the Pension Protection Fund?**
- **should entry be limited to schemes of particular size and / or should the overall size of the consolidator be capped?**
- **how could the fund be structured and run to ensure wider investment in UK productive finance?**
- **how to support continued effective functioning of the gilt market?**

We have answered these four questions together.

The Pension Protection Fund has served an important purpose in protecting members over the 18 years since it became operational. That it has a secure and robust balance sheet is testament to how it well it has been run. We look forward to it continuing to give reassurance to scheme members about their retirement incomes.

We are very mindful of the warning in the PPF's September 2022 levy consultation that larger schemes might be required to pay higher levies[5]; while USS poses a minimal risk to the PPF, the levies we pay in absolute terms at present are already significant. Firstly, larger schemes will have already made the largest contribution to PPF's current reserves. Secondly, we are concerned that as the PPF-eligible scheme universe continues to shrink, its ability to act as a mutual insurer, sharing and socialising risks between schemes may fall away.

Given that context, while we are broadly neutral on an extended role for the PPF, we are concerned about the implications for levy payers. This is particularly the case for large open schemes such as USS where we already potentially bear some or all of the PPF's tail risk for investment underperformance and/or unexpected claims where most current schemes have exited the PPF eligible universe. An extended role might worsen that - we do not believe that our sponsors and members should potentially be subsidising others to be able to step away from their pension commitments.

We believe therefore that current levy payers should bear none of the risks or costs should the role of the PPF be extended. Similarly, the existing PPF surplus, which constitutes pre-funding of future claims on the PPF, should not be exposed to such risks or costs.

We recognise that it might make sense for PPF's existing expertise and infrastructure to be used to establish any public consolidator (and acknowledge the potential benefits to levy payers from further economies of scale). As we note above, clarity on the need to be met by any public consolidator should determine whether the PPF is right to run such a consolidator. We would also expect clarity on how management time and costs (particularly during the current exploratory work and any future set-up phase) will be borne in a way that does not see costs falling on levy payers or potential under-resourcing of PPF's current important work.

[5] Paragraph 3.2.9 here