

17 September 2020

## **USS's Response to the Defined Benefit Funding Code of Practice consultation**

The Universities Superannuation Scheme (USS) welcomes the opportunity to respond to the TPR's consultation on the DB funding code of practice consultation and provide below our views on the proposals put forward in the document.

### **Background:**

Universities Superannuation Scheme was established in 1974 as the principal pension scheme for universities and other higher education institutions in the UK. It has more than 400,000 members across more than 350 institutions and is one of the largest pension schemes in the UK, with total fund assets of approximately £68 billion (as at 31 March 2020).

The Scheme's trustee is Universities Superannuation Scheme Limited, a corporate trustee which provides scheme management and trusteeship from its offices based in Liverpool and London in the UK. The trustee company delegates implementation of its investment strategy to a wholly-owned investment management subsidiary company - USS Investment Management Limited - which provides in-house investment management and advisory services. The purpose of the trustee company is to work with higher education employers to build a secure financial future for our members and their families.

### **Executive Summary**

This paper sets out the USS Trustee's view on the proposed defined benefit code of practice, as set out in the Regulator's consultation document dated March 2020. However, in summary, the Trustee believes the following issues require further consideration before the code is finalised.

- The use of a dual track compliance regime is understandable, but 'Fast Track' approval and its requirements must not explicitly or implicitly become the benchmark expectation for an acceptable funding approach for DB schemes;
- Similarly, schemes which depart from a 'Fast Track' approach should not be required to explain their strategy in terms of deviation from 'Fast Track';
- A 'Fast Track' may still place undue pressure on trustees to consider funding in terms of compliance with the regime rather than what is appropriate for their scheme;
- Greater thought needs to be given to the unique elements of open schemes, particularly if a Long Term Objective is to be required (and the Regulator sets some detailed requirements for such an Objective);
- The ability to acknowledge and utilise stronger and longer-visibility employer covenants needs to be reflected, particularly where there are strengthening or supporting factors such as detailed expert third-party covenant advice, multiple employers, some element of public sector exposure and so on.

## The Trustee's response

The Trustee first sets out the context in which it has considered the proposed revised defined benefit funding code. This context is important as it emphasises that, to the Trustee, there is greater complexity in the type and number of factors that must be taken into account when considering the funding of a defined benefit pension scheme:

- TPR's statutory objectives require the Pensions Regulator (TPR) to protect the benefits of members of Defined Benefit (DB) schemes, to reduce the risk of compensation being payable from the Pension Protection Fund (PPF) and to minimise any adverse impact on the sustainable growth of employers. These objectives will often be in congruence with each other; very occasionally they will conflict. When regarded together they reflect the complex judgements that must be made about cost, security and risk.
- The complexity of the judgements required under these objectives, and the range of circumstances in which individual schemes are placed by – among other things – the relative size of the scheme to the sponsoring employer(s), the sponsoring employers' health, the pension scheme rules etc - means that it is very difficult to move away from the 'scheme specific' regime that has been in place to date and move to a more standardised regime.
- The USS Trustee's primary objective is to ensure pension benefits promised by USS will be paid as they fall due. The Trustee must act in the interests of beneficiaries – employers and future scheme members are stakeholders, as well as those with accrued benefits in the Scheme. Our stakeholders request that the Trustee also has a view to the 'sustainability' of the Scheme. Though the Higher Education sector is somewhat of a homogenous group, participating employers and members are diverse in their views and circumstances. The judgements required of the USS Trustee are complex and challenging, and the complexity of these different objective types are recognised by TPR in the existing code of practice on DB funding.
- It could be said that the primary objectives of the Trustee and the objectives of TPR are consistent. This is consistent with the role of TPR in overseeing the DB scheme funding activities of the Trustee, and the very substantial powers that exist to intervene in that regard. However, we must acknowledge too, that the secondary objectives of both organisations can create different perspectives on important issues.
- The legal framework protecting DB pension benefits is very robust, but not always consistent in its treatment of the issue of security. Changes in the early 2000s to section 75 of the Pensions Act 1995 rightly mean that solvent employers seeking to sever their responsibility to a scheme must ensure that accrued benefits will be provided with effectively no risk to members (ie by securing them with an insurance company). However, where employers have no intention of severing their responsibility to a scheme, funding legislation does not require that a "no risk" (or even low risk) approach be taken, provided it is prudent. In our view this is a good thing, as to do otherwise would make provision of further benefits unaffordable for most sponsors. We would be concerned if changes in the code of practice were used to prescribe a requirement for lower risk funding which does not exist in the legislation, and is not necessary where a scheme is able to rely on the strength of their employers' covenant into the longer term.

The Trustee now moves on to its views in relation to the overarching approach to DB funding regulation that is being proposed in the consultation.

A dual regime with a “Fast Track” compliance option:

- In terms of a high-level approach to encompassing such a challenging and varied set of objectives, a dual regime with a ‘Fast Track’ option is reasonable if it is primarily designed to allow schemes to choose to take a simpler approach to compliance with the funding requirements in order to (for example) minimise administration and adviser costs;
- The Trustee also understands how a Fast Track approach may help TPR in applying its resources efficiently and to best effect;
- However, this implies that the underlying approaches and assumptions to Fast Track are likely to be cautious and conservative and this is reflected in the consultation. Whilst this may achieve the above aims of a Fast Track compliance approach it of course means that for many schemes it will not be an appropriate regime at all.
- Therefore, we are pleased to see that TPR has stated that the assumptions and characteristics required for a scheme to satisfy the ‘Fast Track’ route would not necessarily imply a negative indication for any schemes which did not satisfy those requirements, and therefore by deduction that TPR agrees that a dual regime must allow for the fact that a scheme could achieve an appropriate level of funding prudence without each and every assumption or characteristic fitting into the narrow ‘acceptable’ Fast Track band.
- For example some elements of ‘Fast Track’ would not appear appropriate for more sophisticated open DB schemes with access to and support from a long-term employer covenant, where the level of maturity of the scheme is not expected to significantly increase in future.
- We are however concerned that the consultation suggests that an initial step in reviewing a Bespoke scheme would be to compare to the ‘Fast Track’ assumptions and we believe this would not be appropriate nor useful. We are also concerned that this may lead to additional pressure on trustees when designing their funding approaches. We think that Bespoke should be assessed more widely, in particular by reference to a genuinely integrated risk management approach, taking account of covenant, investment and funding risk, and noting that in some cases this can lead to approaches that would not be consistent with a Fast Track benchmark.

A ‘Bespoke’ approach under a dual regime:

- For the reasons above we agree a ‘Bespoke’ approach must be available to trustees, and we expect a significant number of schemes to utilise the Bespoke approach, including USS;
- This is because a large number of schemes will have developed their funding and risk approach as a coherent structure across all key areas (funding, investment, covenant, governance, risk etc) in line with the current regulatory regime;
- Such schemes should therefore continue to be assessed in terms of their own individual circumstances – again we agree with TPR that Bespoke must not be deemed as an approach used by schemes which were not able to meet the ‘Fast Track’ requirements;

- However we would again make the point that it may not be appropriate for some schemes to have their approach measured directly against ‘Fast Track’ characteristics, especially if that would lead to a discussion where each variance would have to be explained and justified. That said, we can see that such an approach may be useful for some schemes which only deviate from Fast Track in one or two areas. We would therefore suggest that trustees have the option to either have their approach measured directly with Fast Track or produce a custom statement of strategy to justify their approach to their valuation under the Bespoke route. Under either approach we would seek to minimise any potential additional burden on trustees and their advisors.

We now discuss some of the detailed proposals within the consultation document.

### **Open Schemes**

The consultation primarily reflects a funding regime which assumes DB schemes are moving towards maturity by being closed to accrual and/or new entrants, and so has separately included in section 12 how it is expected open schemes will be dealt with. Whilst it is encouraging that it is recognised that there will be major differences in how trustees may look at funding for an open scheme, we would make the following comments:

- The proposals require adoption of a LTO, a similar strategic approach to that which may be expected for closed schemes, and set out some detailed features they would expect of such an LTO. However, it would be very difficult for open schemes to make a rigidly-defined approach fit with its overarching characteristics and so if open schemes are required to adopt an LTO, the framework must allow more flexibility in the construction of that LTO, given appropriate evidence, if the unintended negative impacts on such schemes are to be avoided.
- The consultation suggests trustees should target reaching the LTO when the scheme becomes “significantly mature”. However, for a scheme open to new entrants, they may expect never to reach this point, and so the LTO is really an artificial construct. We do not consider that it is useful to build an artificial LTO into the technical provisions. Whilst recognising that a low-dependency measure (often referred to as self-sufficiency) is a useful measure to assess reliance on the employer covenant, we believe the current regime with its focus on technical provisions, rather than a journey to an LTO, is more appropriate for open schemes. That is, the low-dependency measure should be a measure of the reliance on covenant and the suitability of the technical provisions, rather than a funding objective for open schemes.
- Further, the proposed LTO approach is, we would argue, similar to the approach a scheme may adopt when ultimately seeking to buy-out rather than follow a low-risk strategy. Those schemes which are currently open to accrual are probably those least likely in the pensions universe to seek to buy-out in the short to medium term and so again the proposed LTO appears unduly cautious. One option would be to adopt more flexibility in setting the discount rate for an LTO, particularly for schemes that might seek to achieve returns in a way that is not directly linked to gilts. This could involve deriving a discount rate based on

the expected returns on a scheme's long-term low-risk portfolio, with a margin for prudence. This could have further benefits – removing the requirement for schemes currently open to accrual to target an LTO with a low discount rates would help such schemes stay open rather than force them to close. We recognise that such schemes should be able to demonstrate sufficient covenant support to justify the continued accrual of benefits.

### Covenant

The approach to incorporating covenant into funding appears to primarily reflect schemes where there is a single sponsoring employer (or a small number thereof), likely in a commercial environment. This means the evaluation of covenant can often be straightforward and would consider a limited range of data and scenarios.

Whilst we acknowledge this is likely to be the situation for a number of DB schemes, we would highlight that in many cases there are many more aspects to the scheme's employer covenant that are relevant, and the trustees will need to consider these if they are to reach a fair assessment.

In particular, we set out the following more detailed points:

- We understand that for many DB schemes covenant is more focussed on scope for access to assets if and when necessary rather than visibility of long-term support. Some schemes may have greater long-term visibility of covenant however, and this should be taken into account as a key feature when assessing covenant strength, which should reflect the specifics of the scheme in question. We see this being particularly relevant in schemes whose covenant may involve some degree of public sector exposure.
- We would like to see more clarity from the Pensions Regulator around their position in relation to covenant where detailed independent third-party expert analysis has been commissioned by a trustee. In many schemes the trustees will commission such expert analysis and use it to form their opinion of the covenant strength, particularly where the analysis gives good insight into the length of the covenant horizon and can quantify its value – this is a key element in designing their funding approach. The value and sanctity of such advice should be recognised in the funding code, as should the trustee's ability to rely on and use it.
- We understand the Regulator may find it expedient and necessary to have 'pro-forma' approaches to covenant assessment, but the restrictions on the appropriateness of these views should also be recognised, especially when comparing to trustees' own independent expert covenant advice submitted in support of their funding approach. In particular, there are sectors and types of business where a proforma approach to covenant analysis by the Regulator may not be the most suitable. For example, the proposed code places a high emphasis on an employer's cash status and we presume this is indicative of how the Regulator may develop its own view of an employer covenant. However, this may not be the right metric for many employers, for example not-for-profit organisations.
- Similarly, the proposed code talks about "value leakage" and uses the example in a number of places of dividends being paid to shareholders. There are many employers who do not

have shareholders – universities being one. How will the concept of “leaking value” be applied to these institutions? The concept of restricting dividends is also used as potential additional covenant support: we might therefore expect that organisations which do not pay dividends to be rated more highly reflecting this.

- The consultation acknowledges the special circumstances of non-associated multi-employer schemes and we look forward to specific proposals that appropriately reflect the nature of the covenant supporting such schemes like USS.
- Whilst the USS Trustee is unlikely to use the Fast Track option, we wanted to comment on one particular question in the consultation; whether the covenant should be factored into the Fast Track approach. Given the covenant’s key role in all elements of the valuation we do not see how it cannot be factored in to Fast Track. If it was not, then the only solution would be to assume no covenant, therefore a low risk investment strategy and a high value of Technical Provisions, which risks being seen as a standard for solvency.

### **The role of a trustee**

Pension scheme trustees develop their approach to funding through analysing and understanding as many of the specific characteristics of their membership, benefits, investments and covenant as they can, alongside the relevant financial and economic factors. This leads to an approach to funding that is bespoke to and appropriate for their scheme. This approach is reviewed regularly and adjusted whenever it is necessary. This is the essence of the scheme specific funding regime.

The proposed new funding code could introduce new pressures for trustees where they do not fit with the Fast Track approach and assumptions. It appears there may be implicit pressure for schemes to fit as closely as possible to the Fast Track characteristics, and additional work and effort required to justify and evidence if and why they don’t. Therefore there is a risk that schemes may start to move away from the most appropriate funding approach for their schemes in order to satisfy the new funding code requirements, which would not benefit the scheme’s stakeholders and may lead to worse funding and benefit outcomes, as well as additional costs related to the changes. This is surely not the intention.

We would therefore propose that the Regulator also introduces a “Full Bespoke” option for those schemes who wish to look at their total risk holistically rather than consider their funding strategy as a series of departures from a (perhaps) narrow definition of Fast Track.

I hope that our response to your consultation will assist in your deliberations and please let me know if we can provide any further information or assistance as you consider the next steps in this process.

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