WARWICK
THE UNIVERSITY OF WARWICK

Mr Stuart McLean
Head of Pensions
Universities UK
Woburn House
20 Tavistock Square
London
WC1H 9HQ

Via email *pensions@universitiesuk.ac.uk*
Stuart.McLean@universitiesuk.ac.uk

13 March 2019

Dear Mr McLean

Response to UUK in relation to the papers released on 27 February 2019 Business Confidential

Thank you for the opportunity to respond.

We were hopeful that when the Stakeholders commissioned the Joint Expert Panel (JEP) that all parties, including USS would look at the valuation methodology afresh. It is particularly striking based on the material coming from USS along with the Institution's meeting of last year that USS are largely not in agreement with the findings of the JEP, hence their continued focus on "Self-Sufficiency". We do not deny that Test 1 has some use but it should be used as described by the JEP as below.

"The Panel has spent a significant amount of time understanding and assessing the three Tests, and Test 1 in particular. The Panel has concluded that the outputs of Test 1, while very specific and quantitative, are highly sensitive to the input assumptions, many of which are very subjective. Consequently, we believe that Test 1 is given too much weight in determining the valuation and its effects extend beyond its original purpose. Rather than being used as a "stop and check" reference point, Test 1 is being used as a constraint on benefit design and driver of investment strategy. The Panel does not consider this helpful. It would be far better if Test 1, were its use to continue, was used as a test that informed other aspects of the valuation and funding strategy rather than acting as its lynchpin. By contrast, Tests 2 and 3 appear not to play a significant role in either the valuation or the on-going monitoring. Yet Tests 2 and 3 reflect considerations which are important to stakeholders and the long term prospects of the Scheme."

Professor Stuart Croft
Vice-Chancellor and President
University Executive Office
University of Warwick
Coventry CV4 8UW UK
T +44 (0)24 7657 4951
E: S.Croft@warwick.ac.uk
www.warwick.ac.uk

If USS base their contingent contribution modelling on Self Sufficiency rather than Technical Provisions (as argued against by Aon) it seems very unlikely that progress can be made and so it would put at risk the work done by the JEP. The work of JEP 2 is crucial in finding a long term solution but it is unfortunately evident that Universities Superannuation Scheme Limited needs to be reformed. We acknowledge that the USS board has a responsibility as Trustee and is doing its best based on the advice it receives from its Executive and its advisers, however the Executive continues to behave as if it is immune from the same budget constraints as the stakeholders who ultimately pay them, mainly because any costs are recovered from the pension scheme. For example, Personnel costs in the last five years to 31 March 2018 have doubled with the number of people earning more than £100,000 increasing from 58 to 128. Some of this might be explained by good investment performance and some needed changes but members and employers will find these figures difficult to square with calls for yet higher contributions and continued uncertainty over future benefits.

Questions from UUK to be answered

1. **Do you have any specific comments on the proposed assumptions for the 2018 Valuation, including views on the proposed upper bookend and lower bookend?**

   Answer

   We are disappointed that USS continues to use Test 1 (Self-Sufficiency) as the main driver of the valuation process and they have not accepted the JEP comments in the second paragraph of page 8 of their report, quoted in the second paragraph above.

In effect USS has replicated the same approach as per the 2017 valuation despite the fact that their approach sparked industrial action which prompted the stakeholders to commission the JEP. The first report of the JEP produced fresh insight into the valuation process.
We are also disappointed that USS does not make more use of the 2011 scheme changes to normal pension age, for example by use of a control period. Indeed it is not clear if the USS focus on Self Sufficiency (and so short term horizon) properly takes into account that over time the more generous benefits that have already accrued prior to the 2011 and 2016 scheme changes will eventually run off as the more modest benefits that now exist become more prevalent.

2. **Do you support UUK putting forward a proposal for a CCs arrangement to the USS Trustee as it requested? If not, would you prefer to pay at the upper bookend level? Or what would your preferred response be?**

We are prepared to support in principle the Contingent Contribution approach suggested by Aon but would like to make the following points:

i. It is frustrating to see a huge amount of work (not to mention expense) taking place to consider a framework to introduce contingent contributions when the power to levy extra contributions already exists within the scheme rules. This point is also noted by UUK in their 27 February 2019 paper, paragraph 3.1.

ii. Following on from this point, a fundamental question arises namely, why is a contingent contribution framework being pursued? Is it a fundamental lack of understanding by USS or the Pensions Regulator (tPR) as to how the scheme rules work? We know that USS is aware of its rules.

iii. It is clear that USS and the sector does not fit into the tPR model so this is something JEP 2 should explore.

iv. If the sector is to accept a contingent contributions framework then there needs to be an incentive. Therefore we need to have a contribution level at the lower bookend and a low likelihood that other than in exceptional circumstances would contingent contributions come into operation, noting the long term covenant of the sector.

v. It is clear from the correspondence that agreement needs to be obtained from UCU, otherwise employers would either have to shoulder the full burden or we would have a strange position where member rates are being levied at the higher bookend whilst employers benefited from the “rebate”. Given the UCU stance on no detriment and their hostility to USS use of Test 1 (which is largely behind the idea of contingent contributions) it is difficult to be confident of an agreement. It should be remembered that the stakeholders are working together on JEP 2 to provide a long term pension solution so it is critical that discussions around contingent contributions do not become a cause of division between employers and employees. We are concerned that any resulting dispute over contingent contributions could undermine the good work of the JEP

vi. There is no mention in the UUK material about the legal framework for CCs and what does this mean for bank covenants? This point is made to highlight the fact that whilst overall we have a financially strong sector, some employers will already have made plans and so have other commitments. Having said that we would want to ensure that contingent contributions (or the threat of them) does not result in unintended consequences by incentivising some employers from taking steps to avoid their share of the deficit.

vii. Para 4.4 (ix) of the 27 February UUK paper references a reset option at the end of each valuation period. Whilst this is welcome we need greater clarity because USS would make allowances for an “under paid/under-funded” situation at each valuation which is more reason why it would be impractical to adopt cost sharing without members, i.e. a lack of alignment with this and any future invocation of the normal cost sharing rule.

viii. If we proceed with a contingent contribution framework it is critical that there is not “back-door meddling” in the USS modelling, without the approval of the stakeholders. In other words we need full transparency of the investment model (fundamental building blocks-last published 22 March 2018) that underpins the valuation and agreement on the assumptions between valuation periods and this should be formalised into a mechanistic model that can drive day to day monitoring of the funding level of USS where any update to the model can be agreed between UUK and USS. We know that other pension providers make readily available on line funding models for clients and we understand that Mercer has one in operation. Making such information available will provide greater transparency for all stakeholders as it is critical that all stakeholders have confidence in the integrity of the model.

ix. The Aon framework seems to indicate Contingent Contributions being applied in steps with no or little “catch-up” but the 7 February USS document indicated that USS would be looking to be no worse off than had the upper bookend been applied from “Day 1”. Greater clarity is needed.

x. Aon make the point that actual agreement on the deficit recovery plan occurs later in the process but employers are being asked to consider bookend rates as if there was to be no further discussion around recovery periods or asset out performance assumptions? Incidentally it is not clear why Aon reference a zero out performance for the 5% deficit rate for the 2018 valuation whereas the Trustee agreed a very small outperformance for the 2017 valuation which reduced the deficit rate from 6% to 5% (bottom of page 3).

xi. As the deficit has halved it seems strange that we are not using a deficit rate of circa 3%. We understand that USS has explained that it is because of post valuation experience in relation to self-sufficiency but this explanation is not helpful when we are trying to build a framework based on Technical Provisions and so be more reflective of an open scheme and strong covenant with long term prospects.

xii. A key challenge by Aon is whether or not USS will accept a trigger metric using Technical Provisions and not Self-Sufficiency. Also they cite at least six months' notice of any change in rates. Can we be confident that the six month's notice is acceptable to all 350 employers' financial plans?

xiii. Has anyone prepared an analysis of the Contingent Contributions framework in a scenario where the pensionable payroll diminishes? This is important since in the coming months we are likely to see more withdrawals and as mentioned earlier it would not be surprising to see some employers reluctant to put new members into USS (despite their obligations) because of affordability issues.

xiv. The top of page 11 from the 27 February Aon report highlights a fundamental problem with these proposals namely that all that Contingent Contributions do is add to uncertainty whilst USS continue to focus on Test 1 (self-sufficiency) despite clear direction from JEP that this is a flaw in the USS valuation methodology, i.e. short term considerations are given too much importance.

3. Do you find the proposal for a CCs arrangement set out in the Aon note (attached to this paper) acceptable, taking all factors into account? If not, what aspects would you wish to change?

Please see the comments under 2 above.

In conclusion we would like to make the following points:

---

i. Whilst we do not believe that contingent contributions are necessary for the reasons outlined, we are prepared to support their introduction provided that the underlying basis is based on Technical Provisions and not Self Sufficiency since the latter would most likely lead to more volatility than is necessary given the long term nature of the scheme. .

ii. We would stress the need for a mechanistic model to monitor the performance of the fund so that extra contributions were not triggered by changes to assumptions that had not been agreed by stakeholders.

iii. We are supporting contingent contributions in order that the stakeholders can progress their work with JEP 2, and the intention to provide a long term solution for USS.

iv. It is critical that the stakeholders have confidence not only in the contingent contribution model but also the underlying valuation methodology that underpins it.

Yours sincerely

Professor Stuart Croft
Vice-Chancellor and President