

# USS Valuation – Questions and Answers

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## Understanding USS

### What kind of pension scheme is USS?

USS is an occupational pension scheme, which is offered by all pre-92 universities and related institutions, some post-92 universities (on a specific, limited basis) and several other organisations associated with the higher education sector. It is a private pension scheme. This means that the scheme is not underwritten by the government, and is supported instead by over 350 employers backing it.

### USS currently offers “defined benefit” pensions, what does this mean?

USS is a hybrid scheme, meaning that it offers both defined benefit and defined contribution benefits. Members earn a defined benefit pension on salary up to £55,550 and defined contribution benefits on salaries above this threshold.

USS is the largest private pension scheme in the UK (by fund value) still allowing new defined benefits to be built-up. ‘Defined benefit’ is a type of pension offer whereby an employer promises a specified pension payment and/or lump sum at retirement, which is calculated through a formula based on a member’s salary and length of service.

Defined benefit is distinct from ‘defined contribution’. In a defined contribution scheme, members have individual saving pots that both they and their employer pay into. At retirement, members draw their pension savings from their fund which consists of all of the contributions paid in plus the investment returns that have been earned. They can then choose whether they wish to take out all their retirement savings as a lump sum, or to opt for alternative options such as an annuity or drawdown.

### Who funds USS?

USS pensions are funded by employer and member contributions, and by investment returns. Employers pay the equivalent of 18% of your salary towards USS, and you currently pay 8%. Your own contributions to USS are deducted from your gross earnings, meaning that you do not pay tax on your pension contributions.

As mentioned, contributions alone are not enough to pay the benefits promised. Your benefits are also funded through investment returns. The USS trustee holds assets

valued at over £60 billion, and has an in-house investment team to seek a return on these assets. If contributions and investment returns prove insufficient to pay out defined benefit pensions when they fall due, employers must make up any difference. Employers offering defined benefit pensions therefore carry a significant level of risk.

### Who runs USS?

The USS trustee, supported by its supporting committees, directs and controls the scheme. The day-to-day job of running the scheme is delegated to the group executive. More information on the trustee board and its committees can be found on the [USS website](#).

### How are members and employers represented in USS?

The University and College Union (UCU) is the member representative in USS, and Universities UK represents all employers.

UCU nominates three of the twelve people on the USS trustee board, Universities UK nominates four, and there are five independent trustees. This structure ensures that all parties are represented on the USS trustee board. Member and employer representatives also have an equal opportunity to propose and negotiate changes to scheme rules through the Joint Negotiating Committee (JNC).

### How does the Joint Negotiating Committee (JNC) work?

USS is governed by a clear set of scheme rules. Any changes to these rules need to be decided on through the JNC. The JNC brings together an equal number of representatives from Universities UK and the University and College Union. The JNC has an independent chair who oversees discussions between employer and member representatives, and can choose to cast a deciding vote if agreement between both parties cannot be reached. Both Universities UK and UCU have to agree to the appointment of the independent chair.

### What is the difference between USS and the Teachers' Pension Scheme?

Academics at some universities (particularly post-92 universities) are in the Teachers' Pension Scheme rather than USS. This scheme is very different from USS.

TPS is a statutory, unfunded scheme backed by the UK tax payer. In contrast, USS is a private sector (non-statutory) scheme directly backed by higher education institutions with a fund set aside (from employer and member contributions, plus investment return) to pay benefits. This means that USS employers carry the risk that the fund is insufficient to deliver the promised benefits, whereas TPS benefits are ultimately underwritten by HM Treasury. Unlike USS, TPS is not reliant on investment performance. TPS also has different valuation requirements and is not subject to the approach that the USS trustee must follow.

## USS's valuation

### How does the valuation affect my pension?

Every three years USS is required to carry out an actuarial valuation. During a valuation, the USS trustee assesses the fund's assets and liabilities to ensure it has sufficient funds to pay the defined benefits already earned, and also that contributions into the scheme cover the cost of the planned future service benefits.

The last two USS valuations (in 2011 and 2014) have been challenging. Both valuations revealed a funding deficit and rise in the cost of future defined benefits. In 2014, Universities UK and member representatives (UCU) agreed a package of reforms to address these funding challenges. As part of the reform, both members and employers agreed to pay more towards USS and changes were introduced to benefits from April 2016. USS became a hybrid scheme, offering defined benefits (currently on salary up to £55,550) through the USS Retirement Income Builder and defined contribution-type benefits on salary above the threshold through the USS Investment Builder.

Since the 2014 valuation, economic conditions for defined benefit pensions have worsened. As a result, the position at the 2017 valuation is much more difficult than expected. The greatest challenge at this valuation is the significant rise in the cost of future defined benefits, which have risen by over a third since the last valuation. The funding deficit has also increased to approximately £7.5bn (89% funded) on the assumptions adopted by the trustee. The deficit was £5.3bn (89% funded) in 2014 and the plan at that time was to recover that deficit over a 17-year period.

As a result of the increased cost of defined benefit pensions, employers put forward a proposal for benefit reform to ensure that USS remains sustainable. Following negotiations with UCU, employers revised their proposal. This revised proposal has now been decided on as the proposal of the JNC. Importantly, it should be noted that benefits already built up in the scheme are protected by law and cannot be changed retrospectively. In addition, any proposed changes are subject to full consultation with affected members and their representatives, which is scheduled to run for at least 60 days from 19 March 2018.

### Why has the cost of future defined benefits increased so much since the last valuation?

Future defined benefits in USS have increased by more than a third since the last valuation. This is primarily due to lower expectations for economic growth, and specifically lower expectations for future investment returns. This is a problem faced by the vast majority of UK funded defined benefit schemes. The increased cost of making new defined benefit promises is one of the main financial challenges at this valuation.

## Why is the scheme in deficit?

The deficit at the valuation date (31 March 2017) is estimated at £7.5bn and is similarly driven by exceptionally challenging economic conditions.

In 2014, Universities UK agreed a recovery plan to wipe out the deficit over 17 years through deficit recovery contributions paid by USS employers from 1 April 2016 (and some planned additional investment return). We did not expect the deficit to be fully addressed by March 2017 but the increased deficit is a sign of the higher level of risk involved in funding a much larger pension scheme by size of liabilities than was predicted three years ago.

## Have other schemes within the higher education sector also been affected?

Until relatively recently the higher education sector offered final salary pension benefits to the vast majority of employees. However recent reforms have seen increasing divergence in the pension schemes offered in the higher education sector. Most have been reformed in one way or another, though the scale and shape of that reform would have depended on the specific circumstances and status of the different schemes.

Comparisons have been drawn between USS (predominantly for pre-92 institutions) and the Teachers Pensions Scheme (TPS) (for post-92 institutions, amongst others). However, this comparison is misleading, without recognising that the TPS is underwritten by the Government.

TPS is a statutory, unfunded scheme backed by the UK tax payer. In contrast, USS is a private sector (non-statutory) scheme directly backed by higher education institutions with a fund set aside (from employer and member contributions, plus investment return) to pay benefits. USS employers bear the risk that the fund is insufficient to deliver the promised benefits. An unfunded scheme is not reliant on investment performance (as is the case within USS) and greater risk can be taken as benefits are ultimately underwritten by the Government. TPS also has different valuation requirements and is not subject to the approach that the USS trustee must follow. Any comparison must reflect those significant differences in structure and regulatory requirements.

## What is the timeline for the valuation process?

The valuation date is 31 March 2017 and the trustee is required to sign off the valuation and submit its report to the Pensions Regulator within 15 months of that date. The process began well before March 2017, with dialogue between the trustee, Universities UK and UCU at all stages.

## Is the scheme going to collapse?

No. USS is supported on a collective basis by over 350 employers that are committed to the scheme. The scheme is designed so that the risk being run by the USS trustee is monitored, and does not exceed the risk capacity of the sponsoring employers.

It is clear that the risk the USS trustee is running in the current economic environment is very high and that action must be taken to put scheme funding back onto a sustainable footing. This is why the JNC has agreed that a reform of benefits is needed in order to ensure the scheme is secure and sustainably funded, and to not put at risk the wish to provide excellent pension provision for employees for the long term. Universities can't afford to pay more into pensions without diverting money from other areas, such as teaching or research.

## How can I give my view on the valuation?

The JNC is responsible for deciding on changes to future benefits and employee contributions to the scheme. Now that the JNC has proposed benefit reform there will be a statutory consultation between employers and affected staff (and their representatives). This consultation will last 60 days and is expected to start on 19 March 2018, and will provide the opportunity for affected employees to comment on the proposals.

## Potential benefit reform

### Why are we discussing reform of USS pension benefits again?

The cost of providing the defined benefits (DB) component of the overall USS future service benefits has risen by over a third since the last valuation. This means that to maintain current benefits overall contributions towards USS would have to increase from 26% of salary presently to just over 37% of salaries, an increase of over 11% of salaries.

USS employers pay 18% of salaries towards USS. This is a high level of employer contribution and reflects a clear and continued commitment to offering high quality retirement benefits. Over the past three valuations, employer contributions to USS have risen by almost 30%. However, employers are not in a position to increase their regular contribution further, and it is clear that many employees would find an increase beyond the current member contribution of 8% challenging too.

The trustee (and indeed pensions law) requires the increased cost in future service benefits to be addressed at this valuation, and the Pensions Regulator and trustee will also need to agree a credible plan to address the deficit. Benefit reform is necessary to ensure the scheme is on a stable and sustainable footing for the long-term. It is not in employers' or in members' interests to increase cost or risk to an unsustainable level. Controlling cost and risk is important in order to ensure that accrued benefits are secure and to enable employers to continue to make substantial contributions towards future pension benefits.

## Why don't employers just pay more?

USS is designed to meet the retirement needs of the higher education sector, and many USS employers are universities and registered charities operating on a not-for-profit basis. Most universities can't afford to pay more into pensions without diverting money from other central activities, such as teaching or research, reducing universities' positive impact in the areas most central to their core mission and purpose. Increasing contributions could damage the high standards that students, research funders and others rightly expect, and could undermine the sustainability of some institutions.

Ultimately, increasing employer contributions to an unsustainable level could threaten the very security of the pension scheme. The USS trustee is able to take a certain level of risk in its investments because it knows that employers have the capacity to support the scheme if those risks do not pay off, although this capacity to take risk has its limits. If the cost of employer contributions exceeds its present level, employers will no longer have the same capacity to shoulder the level of risk being run in the scheme.

## Why can't the scheme just carry on as it is until the next valuation and see what happens with interest rates, bond yields and investment returns?

The trustee is required to sign off the valuation and submit its report to the Pensions Regulator within 15 months of the valuation date (i.e. by 30 June 2018). The valuation report must include how the trustee plans to tackle any deficit, and must also set the contribution rate for future benefits. The trustee is responsible for setting the contributions required for the current benefits and has concluded the cost must rise, substantially so. The option to simply carry on as now does not exist. Even if it was allowed, this approach would also constitute a multi-billion-pound gamble on the progress of the global economy over the next three years which could be catastrophic for the scheme and the university sector if assumptions were not borne out in practice, and appropriate measures had not been taken sooner.

## How might benefits be reformed at this valuation?

Any potential changes to member benefits or contributions are negotiated within the Joint Negotiating Committee (JNC). The JNC is made up of equal numbers of representatives from the employer representative body (Universities UK) and from the member representative body (UCU), together with an independent chair. The JNC has considered the outcome of the 2017 valuation, with Universities UK and UCU meeting over thirty times in 2017. On 23 January, the JNC decided on a proposal to reform benefits.

The JNC proposal is for the full flexibility of the current hybrid scheme to be used: modifying the salary threshold in order to offer market-leading defined contribution saving (through the USS Investment Builder) to all employees, on all salary. This is seen as the most effective way of managing USS risk, whilst simultaneously offering

high quality benefits to employees and maximising options for the future should the funding position materially change. The full JNC proposal is available on the UUK website.

### What would the proposed benefit changes mean to me?

The pension benefits that you have already accrued are protected by law and cannot be changed retrospectively. Potential benefit reform will only affect pensions saved after an agreed implementation date, expected to be 1 April 2019.

The JNC's proposal involves moving to DC benefits from 1 April 2019. There are unfortunately misconceptions regarding the comparison between defined benefits (DB) and DC benefits. Even if some DB was maintained at this valuation, the level of DB that could be afforded would be very low. DC does not offer the same guaranteed outcome that DB does but DC does have advantages to members, such as the greater flexibility and choice it offers. Maintaining even a small level of DB would restrict the ability to realise the benefits of DC, whilst accruing only a very small amount of guaranteed pension. For this reason, employers suggested that within the current solution space, a DC only offer is the best offer for members, maximising the contributions towards future service and giving additional flexibility.

A full employee consultation on benefit reform is scheduled to start on 19 March 2018. This consultation will include modelling on your projected pension benefits, taking into account your specific circumstances.

### What happens to the benefits I have already built up?

Benefits for past service are protected by law and cannot be changed retrospectively. The benefit changes will therefore not affect the benefits that you have earned up to an agreed implementation date (expected to be 1 April 2019).

### Are employers proposing paying less towards pensions?

No, the overall amount employers have committed to pay towards USS benefits is 18% of salaries. This is unchanged.

### Can I pay more to continue my current benefits?

Member contributions only meet a proportion of the cost of current benefits. If the current level of defined benefits continued to be available this would constitute an additional cost of at least 11% of salaries (in addition to the current 8%). Universities UK does not see a way in which employers or employees could afford that level of increase in cost, particularly as some members are indicating that they have affordability concerns at the current contribution rates. In addition, even if members could afford higher contributions to provide defined benefits, the benefits that are provided are still ultimately underwritten by employers and the risk exposure at the moment is too high.

If the scheme goes to DC and the funding position improves will it ever go back to DB in the future?

The proposed changes are designed so that the DB section of the scheme is 'dormant' rather than closed. This means that, if the economic conditions were favourable, defined benefits could be reconsidered. Universities UK and UCU would review the situation at the next scheme valuation in 2020.

## Valuation methodology

Employers say that they want to control risk – what exactly are these risks?

Pension risk is a serious concern for both employers and scheme members (both current and future). Benefits that have already been built up are protected by law, it is therefore inherent that employers must meet the costs of providing these benefits. However, in the case of defined benefits it can be challenging to determine just how much they will ultimately cost once they fall due. A large number of variables affect the cost of defined benefits, including future investment returns, inflation rates and how long members live.

The key risk for employers is therefore that promised benefits will cost more to provide than expected, which would lead to a substantial and unexpected financial burden on employers in the future. This affects members, as – given that employers have a limited budget for pensions – an increased cost towards the past will preclude employers from offering the same high contribution rate towards future pension savings. It also has implications for the future sustainability of institutions.

Taking no action to change USS would be an irresponsible gamble with the future of the higher education sector at stake. Some institutions could even be forced to close if faced with an unaffordable bill to pay pension obligations.

Why can't the trustees take more investment risk and aim for higher returns to avoid having to pay extra contributions or make benefit changes?

Targeting higher returns increases the risk of unsustainable losses in adverse markets. This would result in the Trustee having to call on employers for even higher contributions – potentially including large one-off payments – threatening the future of some institutions as well as the scheme.

Why has the trustee changed its assumptions since September?

In September 2017, the USS trustee proposed a set of assumptions upon which to calculate the scheme's assets and liabilities. Due to the size of USS, small changes to assumptions can have a big impact on the valuation outcome.

The initial assumptions proposed by the USS Trustee required taking more risk than at the previous valuation. Based on the valuation assumptions developed at the last valuation in 2014, the USS deficit at March 2017 would have been £12.7 billion. The revised assumptions that USS consulted on in September 2017 would have brought this all the way down to £5.1 billion.

The USS Trustee already takes considerably more risk than almost all other trustees do because it is supported by over 350 strong and committed employers. However, many employers felt that the additional risk proposed by the trustee by weakening its valuation assumptions went too far. That was also the view of the independent Pensions Regulator and USS's covenant advisors, PWC.

Based on the feedback received to its consultation, the USS trustee revised its approach to incorporate a marginal level of investment derisking over the next ten years. This derisking would provide greater protection should another adverse event occur, but also slightly reduces expected future investment returns. This results in an increase in the scheme deficit and cost of future service benefits. The deficit now stands at £7.5 billion based on the trustee's latest position.

I've heard that increases in life expectancy have slowed down – has this been taken into consideration?

Yes – the USS trustee has reviewed its mortality assumptions in detail for the 2017 valuation based on scheme experience and the latest views on life expectancy. Overall, this has reduced the liabilities, but only marginally so.

I have seen different approaches put forward by UCU's actuary First Actuarial which say that rather than there being a deficit the scheme is in surplus, please explain?

The Trustee must make a professional, informed judgement of the assumptions used to value the scheme, and the level of risk that can be run. If the valuation could be carried out on what is known as a 'best estimate' basis, the scheme would have a surplus and be affordable within the current combined employer and employee contribution rate. However, the Trustee has a legal duty to take a "prudent" approach – that is set down in legislation – taking into consideration the possible risk exposure to employers if an adverse scenario occurs. These adverse scenarios are not remote possibilities. In fact, the scheme has faced a series of serious, unexpected adverse scenarios in recent years. Interest rates remain persistently low, and for example the UK's withdrawal from the EU has created significant economic uncertainty.

Even if it were lawful, the approach proposed by First Actuarial would place much too great a risk on employers and would not provide sufficient evidence that accrued benefits are secure. The approach would not be acceptable to the USS trustee and scheme actuary, employers or the Pensions Regulator, and would not be in the best interests of scheme members.

Because USS is a very large scheme, a proportionate level of prudence results in a high monetary value. Actuarial advice provided to the USS Trustee and Universities UK must take account of the risks inherent in a proposed approach.

With different actuaries making different assumptions that reach significantly different conclusions why doesn't USS take a second opinion?

There are different methods of valuing pension schemes, and there are also a large number of variables that the trustee needs to make reasonable assumptions about. It is therefore understandable that differences of view exist. However, this should not lead to doubt that USS faces a significant funding challenge.

In reaching the final valuation assumptions the Trustee and its actuaries have considered and modelled the potential impact of a huge range of possible outcomes, and called upon the expertise of independent advisors as required. The Trustee's valuation work has been comprehensively resourced. There has also been a detailed, formal consultation on the assumptions with Universities UK, which was reviewed thoroughly by Universities UK's actuary Aon and by actuarial advisors hired by individual institutions. It is unlikely that another firm of actuaries could reach a different conclusion (that pension costs have risen significantly) without introducing significant additional risk which would not be acceptable to the Trustee or the employers.

UCU have raised a number of concerns regarding the USS valuation methodology since 2014. As a result, Universities UK and UCU worked together over a significant period to better understand the valuation methodology, and raised a number of questions for the trustee, which received a full response. No alternative methodology was proposed.