

University and College Union Higher Education

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To	FAO pre-92 LA and branches.
Topic	Universities Superannuation Scheme (USS) Dispute
Action	To note the latest correspondence to employers and UCU proposals for benefit reform.
Summary	This circular provides branches with a copy a letter sent to USS employers in which UCU again rejects the flawed approach to USS reform adopted by UUK, asks employers to consider carefully their approach to deductions and not to escalate the dispute and provides details of UCU's negotiating proposals.
Contact	Michael MacNeil, National Head of Bargaining and Negotiations

In line with the decisions made at the pre-92 decision-making meeting on 19 September, reported in UCUHE/231, the decisions made at the HEC on 24 October, I write to report the outcome of the meeting of branch officers and pension's officers on Tuesday 4 November.

As discussed at the meeting, please find attached;

1. A copy of a letter sent to your Head of Institution (Appendix 1)
2. A copy of UCU proposals for benefit reform (Appendix 2)

You will note that the letter to Heads of Institution asks them to consider carefully their approach to deductions. We are closely monitoring the approach adopted by institutions and, as I write this there, are many different approaches being taken. An increasing number are coalescing around a 25% deduction; some are reserving the right to deduct 100% of pay but are not clear from what point and, at present, a small minority are saying they take a hard line of 100% deduction from the date of participation.

As reported, the University of York have threatened 100% deduction from today but, after interventions, are reconsidering their position.

A report will be made to HE Officers as soon as a fuller picture emerges. Decision will be made in line with agreed policy.

Michael MacNeil
National Head of Bargaining and Negotiations



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BY EMAIL

6 November 2014

Dear Head of Institution

USS AND PENSION DISPUTE UPDATE

On 21 October I wrote to you indicating that a number of employers had expressed concerns about the current UUK proposals for benefit reform. A significant number of institutions responded to the questions posed providing their view of UUK's current proposals. If your institution has not responded then please do feel free to let me know if your institution supports the UUK reform package and the £50,000 threshold for the defined benefit scheme.

In my letter, I also reiterated UCU's desire to explore all areas for a possible agreement but indicated that, at present, UUK seemed to be unable to consider movement from their current proposal.

You will be aware that USS has circulated its consultation paper on the scheme's technical provisions and recovery plan. I must impress on you, once again, that the current approach under active consideration by the UUK representatives on the Trustee Board unnecessarily restrict the ability to agree an attractive, affordable and sustainable scheme for members and employers in the future.

UCU is of the clear view, backed by actuarial opinion, that the USS Board is adopting a flawed methodology when valuing the fund. However, we remain committed to genuine negotiations with the intention of reaching agreement. With this in mind, I thought you would be interested in our proposals for benefit reform (attached to this letter). These have been sent to the UUK negotiators and will be discussed at a meeting at the USS offices tomorrow.

From the content, it is I hope clear that we are seriously trying to find an agreed solution to the, albeit contested, funding situation USS are reporting.

You will, of course, be aware that our members have genuine grievances around the proposals to cut their pension benefits. We have seen overwhelming support in industrial action ballots. You are aware of the action we have called to date.

I ask you to consider your approach to deductions for this action. Considering that work related to assessment and marking constitutes a minority of work for most academic and professional staff, it is manifestly unjust to fine members 100% of their wages. Implementing such a draconian policy will only serve to exacerbate and prolong what is already a bitter dispute over your representatives' proposals to introduce changes to pension provisions which would cut the pension of our members by tens of thousands of pounds. Our members' grievances are real and understandable. Taking such a punitive approach to their legitimate and limited industrial action will cause long-lasting and deep-seated, harm to industrial relations at your institution.

If you have not already done so, I urge all employers to think carefully before escalating the dispute so that students will face complete days of disruption

I should be grateful if you could confirm to me the position you are adopting on deductions by 13 November.

Yours sincerely

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UCU PROPOSALS FOR BENEFIT REFORM

1. INTRODUCTION

At the outset, it is vitally important to state that UCU contends that nothing in this paper should be read as indicating the UCU accepts the flawed methodology adopted by USS when valuing the fund.

Notwithstanding, the joint aim agreed by the employers and UCU for the Funding and Benefits Working Group was to facilitate agreement through constructive dialogue and a programme of work that will inform and equip the group to assess the scheme's attractiveness to current and future employees and support the long-term financial health of the scheme.

This paper provides:

- A brief critique of the UUK proposals submitted to the USS JNC on 22 October;
- A summary note on the financial health of the pre-92 sector;
- An outline of our counter-proposals for negotiation;
- A reiteration our concerns on the valuation methodology adopted by the Trustee Board
- A note on the additional tests adopted by the USS Board

2. CRITIQUE OF EMPLOYERS' PROPOSALS

Under the UUK proposals, defined benefit provision would operate only on salary up to £50,000, and defined contribution provision above this level, with an additional voluntary 1% (employee) plus 1% (employer) scheme of entire salary paid into the defined contribution scheme.

No comments have been made about how the current cost sharing arrangement would work within this new framework. Currently, any increase in the costs of the scheme above 23.5% triggers rules 61.10 and 73.4 on cost sharing which state that *"if the JNC does not agree...how that cost...is to be addressed...that cost shall be shared in the ratio 35:65 between members and employers"*.

The cost sharing trigger applies to all salary. The position could, in the future, be that members accrue defined benefits only on salary up to £50,000pa but are required to pay cost sharing contributions on all salary. We believe a critical re-examination of cost sharing and the mechanism by which this is employed in USS needs to be carried out before any changes are made to the current scheme design.

Of particular concern is the fact that a number of scheme design features and technical issues are yet to be resolved and/or decided on. Some of these are set out in the *"Universities UK's proposals for modifications to USS benefits"* submitted to the USS JNC on 22 October 2014.

Additionally, there is no mention of a number of other issues that will need to be addressed. For example, how the new defined contribution scheme will deal with the

new flexibilities introduced in the 2014 budget, or of what will be the scheme’s investment strategy? And, what investment choices will be available to members?

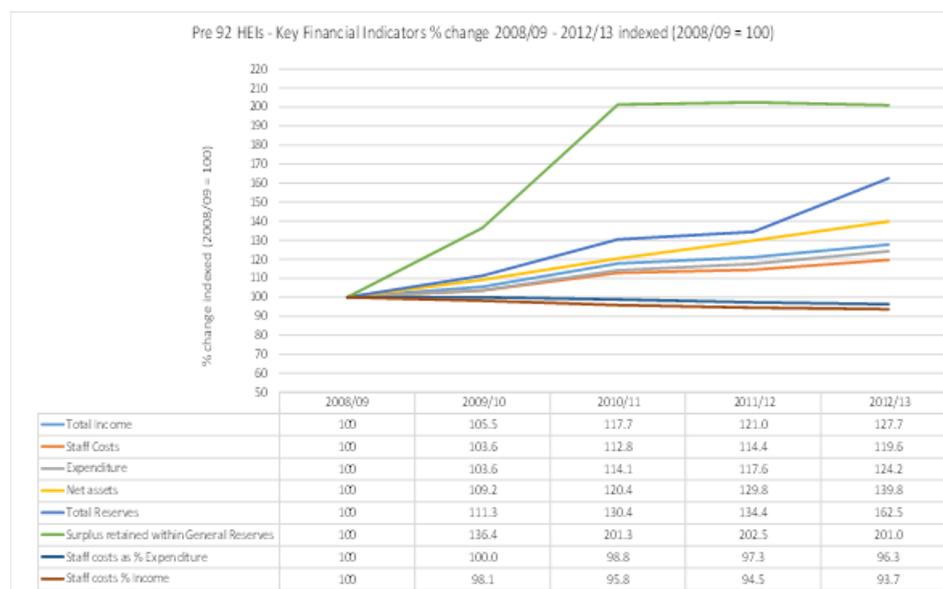
It is also not clear what earnings would count towards the threshold, the treatment of members on variable hours contracts, the treatment of earnings by partially retired members, staff with multiple appointments and even whether USS could still be part of the public sector pension fund - particularly important in our sector with members from the NHS and crossing between pre- and post-92 institutions. It is unclear how additional voluntary money purchase or added years contributions will be treated. There are also many questions that still require to be answered on the administration of the hybrid scheme.

The current UUK proposals regularly refer to “an improved new package for new and existing members”, but this fails to acknowledge the fact that members of the Final Salary section of USS will lose the link to final salary on any benefits accrued prior to the introduction of the new scheme.

3. FINANCIAL POSITION OF THE PRE-92 SECTOR

The chart below shows the percentage change for eight key measures of HEI financial health over five years (2008/09 – 2012/13) indexed to 2008/09 as the baseline year.

All figures are taken from HESA financial returns and are for the 66 Pre 92 Universities currently reporting individual institutional accounts to HESA.



This chart shows that over a five year period Pre 92 institutions have significantly increased their income, surplus, reserve and asset levels and at the same time are continually reducing expenditure on staff.

- The annual total income for Pre 92 HEIs has increased by more than 27.7% over the last five years. This is significantly higher than increases in income reported by Post 92 institutions.
- Whilst there has been significant growth in Expenditure at Pre 92 institutions (24.2% over five years) this growth does not account for the entirety of the

increase in income reported by Pre 92 institutions. The average Pre 92 HEI now receives £14.2 million more than it spends each year.

- The amount of Surplus Retained within Reserves each year doubled between 2008/09 and 2010/11 and has remained consistently high since then. On average, £11.2 million (78.9%) of the additional income received by Pre 92 HEIs is retained within reserves each year.
- Total Reserves held by Pre 92 institutions have increased significantly over the past five years, and in 2012/13 Total Reserves were 62.5% higher than they were in 2008/09.
- The Net Assets^[1] of Pre 92 HEIs have grown by 39.8% over the last five years
- Staff costs have not kept pace with increases in income and expenditure, and have consistently fallen over the last five years, despite previous increases in USS contributions. Measured both as percentages of income and of expenditure, staff costs are proportionately lower than in 2008/09. In 2012/13 staff costs as a % of income were 93.7% of the 2008/09 total and staff costs as a % of expenditure were 96.3% of the 2008/09 total.

4. OUR COUNTER-PROPOSALS

We note that the UUK proposed changes are “designed to create a structure for USS which is sustainable and affordable over the long term” and that the employers are willing to **increase** their contributions under the new design. However, an important factor in the UUK proposals is the introduction of a defined contribution (“DC”) element. Essentially, this is an attempt to transfer risks from the employers to the members. Members take on all investment risk for their DC fund and it is their responsibility to decide how to use their fund in retirement. We disagree with this approach.

The JNC paper *“Universities UK’s proposals for modifications to USS benefits”* acknowledges the fact that in a DC scheme, risk is borne fully by members. It then goes on to state that *“As such, the Trustees exhibit a marked preference for DC over DB benefits”*. UCU restates that it is not the role of the Trustee to have any view on or preference for any particular set of benefits. Their role is to administer the benefits set out in the Deed.

There are also differences in the efficiency of pension provision arising from DB and DC schemes. One study, for example, considering pension as an income for life in retirement and using the basic ratio of inputs to outputs as the measure of efficiency, found clear differences between DB and DC provision. The results showed that if under current circumstances it costs £2 to produce one unit of pension using the conventional UK funded DB arrangement, then this same pension unit under an individual defined contribution (DC) system costs £4. DC has a number of other weaknesses which make it a costly and inefficient form of provision; in particular, the absence of risk-pooling and risk sharing among members and economies of scale and scope.

As an example, in a DB scheme, investment risks are spread across all members through the use of a single pooled investment fund meaning that volatility is reduced. Trustees, taking professional advice, manage the investments of the fund and remove

^[1] Net Assets excluding pension assets and/or liabilities. This measure does not currently include USS liabilities.

the requirement for members to make investment decisions, as is the case for DC pensions. By investing collectively, a broader spectrum of investments is available, costs are reduced and a longer time horizon can be used in the investment strategy, allowing all members to benefit from superior investment choice and performance. At retirement, pensions are paid out regularly from the scheme's assets. Because assets are pooled, the trustees are free to invest in growth assets for longer, which should in the long term give higher returns.

But a much greater advantage is the benefit that arises from mortality pooling. To illustrate this, assume a member "Ashley" retires at age 65 and expects to live to 85. Ignoring complexities like interest rates for simplicity, if Ashley wants a pension of £10,000 per annum, a pot of £200,000 at retirement will be needed. After drawing down their first £10,000, Ashley has a pot of £190,000. Unfortunately, this is no longer enough to provide an income of £10,000 pa as having survived the year from 65 to 66, Ashley now has a longer life expectancy and can be expected to live to say 85 years 2 months. This effect is called mortality drag. In fact, if Ashley will essentially need to assume immortality to make sure the pot is large enough not to run out before death.

But now imagine 100 Ashleys with a combined pot of £20 million. After a year, we find we have only 99 Ashleys left as one has sadly passed away. But happily the remaining pot of £19 million is now sufficient to pay £10,000 pa over the longer life expectancy of our remaining Ashleys. It is this pooling of mortality risk that is a big driver of the higher benefits levels and efficiency available from DB schemes.

**WITHOUT PREJUDICE PROPOSALS TO THE FUNDING AND BENEFITS
WORKING GROUP ON 7 NOVEMBER 2014**

Our counter-proposals are formed with the intention of maintaining an entirely DB benefit structure to USS pension. They are:

1. All future service on the basis of CRB 1/70th with an automatic lump sum (3x) and CPI revaluation.

	15 years	20 years
<i>Employer future service contributions</i>	18.1%	18.1%
<i>Past service deficit contributions</i>	4.3%	2.8%
<i>Total employer contributions required if employee contributions were 6.5%</i>	22.4%	20.9%

2. In order to fund these changes, UCU are willing to enter negotiations around:

- a) No DC element in the scheme
- b) Final salary link to be replaced by another index
- c) Movement in employee contributions, possibly on a 2:1 ratio (i.e. 18%:9%)

- d) Money intended by employers for the DC element to be used to enhance DB pensions for the maximum number of members
- e) The potential for an absolute cap on pensionable salary
- f) Cap on the pensionable salary to be revalued according to the 85th percentile of members earnings, so that for 85% of members all salary would be pensionable in the DB scheme

3. Should the funding position of the scheme improve then the employers agree not to reduce their contributions below a floor of 18%. Further, that should scheme funding improve, any additional funds are to be used to improve defined benefits and to create a “buffer fund”.

THE BUSINESS CASE FOR OUR PROPOSALS

We have used the three principles of affordability, sustainability and attractiveness as a framework for this section.

Affordable

Depending on the approach adopted by the scheme actuary, we acknowledge that our counter-proposal may appear to breach what the employers consider as an acceptable level of contributions. However, the independent work undertaken on the employers' covenant indicated levels of affordability in excess of the arbitrary 18% adopted by the employers as their baseline for negotiations. In addition, as shown earlier, the pre-92 sector is in a healthy financial position. However, we have produced a proposal that recognises the constraints on the employers' negotiators. It acknowledges the possibility of reaching agreements for current and future employees to contribute to the continuing financial health of the fund by accepting changes to benefit structures and increasing levels of contribution. We believe that our proposals are affordable for both employers and employees

Sustainable

As outlined later, a different approach to valuation methodology could lead to a dramatic improvement in the scheme's funding position. In the event of a positive funding ratio, we propose the creation of a separate fund which could be used as a smoothing mechanism should deficit contributions be required in the future. This fund could be used to deal with contribution volatility should deficits grow in the future.

Attractive

The pension scheme needs to be attractive for both members and employers. The current scheme with the two-tier structure is unattractive and divisive, particularly for current CRB members when the deficit contribution burden is considered against the benefits to be received. The UUK proposal is unattractive to members as it reduces significantly the benefits which members will gain for similar contribution levels to those being made now.

Our proposal for members, accepts a reduction in benefits and removes the inequality of the two-tier system as well as providing an improvement to the benefits proposed by UUK. For employers, the UUK proposals provide poor value for money, particularly when viewed against the superior benefit structure of the Teachers' Pension Scheme (TPS). In particular, USS pensions will cost more but provide inferior benefits and employers wishing to attract staff from post-92 institutions will be forced to find other ways of compensating members to ensure comparability in the total remuneration package.

Our proposals, while not immediately matching TPS benefits are considerably more attractive for members and provide better value for money for employers.

5. VALUATION METHODOLOGY ADOPTED BY THE TRUSTEE BOARD

UCU contends that there is a major problem with USS' de-risking approach. It starts from an unhelpful valuation methodology from which it derives an investment strategy.

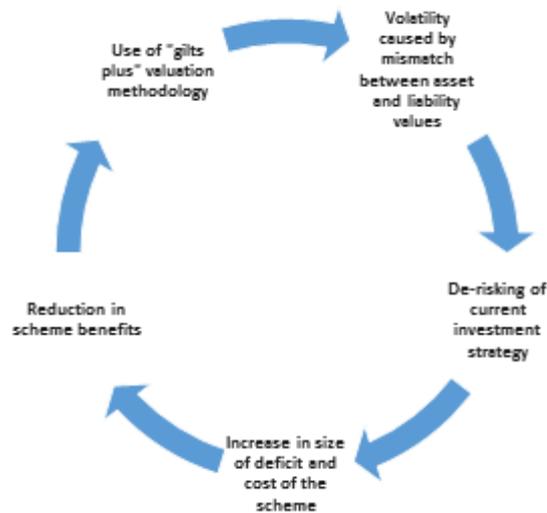
The USS Statement of Funding Principles sets the discount rates used for valuations with reference to the return on gilts, with an allowance for additional outperformance for other assets held by the Scheme which are expected to outperform gilts in the long term. The USS valuation methodology is termed a "gilts plus" method.

The current investment strategy combined with the current valuation methodology produce volatile valuation results. The volatility arises because the current "gilts plus" methodology sets the value of the liabilities using gilt returns and compares this to the market value of assets. If, as is the case for USS, most of the assets are not in gilts but the liabilities are calculated with reference to gilt yields, this creates a fundamental mismatch between the asset and liability values in the balance sheet.

The solution proposed by the Trustee for this volatility is to invest more of the assets in gilts so the assets move in line with the liabilities, also assessed on a gilts basis. In other words, the Trustee's approach has the valuation methodology driving the investment strategy – into lower yielding assets, which increases the reported deficit and increases the predicted cost of benefits.

The current approach being taken by USS sets the valuation methodology then forces a change in the investment of the assets to fit the valuation methodology. The change in assets (into more bonds) automatically increases the cost of benefits so making benefit cuts seem increasingly necessary. Our view, is that it would be more sensible and efficient to agree on an appropriate mix of assets and then set the valuation methodology in a way that reduces volatility and also takes into account the actual investments held by the scheme.

By allowing the valuation methodology to drive the investment strategy, the Trustee is introducing a cyclical process, leading to increased costs and further benefit cuts, as shown in the diagram below.



The USS engagement paper identified contribution volatility as a major issue for the scheme and the sponsoring employers. If the Trustees still see volatility as a key factor for the scheme then an important piece of analysis for USS would be to assess whether an alternative methodology would have produced less volatile results in the past. A request for this piece of work was made in June 2014 but has yet to be undertaken. The matter was raised again at the USS Joint Negotiating Committee on 22 October.

However, and in addition, UCU have presented a number of arguments to USS about alternative ways in which the volatility of the valuation result could be controlled without moving more assets into low yielding bonds.

For example, basing the USS funding assumptions on the membership data available at the last valuation, 31 March 2011, and assuming that the split of active members, deferred members and pensioner members has not changed since this date, it is estimated that applying an alternative, prudent “build up” valuation methodology would reduce the deficit in the USS by approximately £8.6bn as at 31 March 2013.

However, UCU is not proposing an alternative methodology simply because it has, on this occasion, a better outcome. Rather we are suggesting that the current gilts plus methodology has produced and will continue to produce volatile outcomes. Given that volatility was identified by the USS engagement paper as a major problem for the scheme and the sponsoring employers, changing the valuation methodology would, in our view, be a far more rational response to the problem of volatility than changing the investment strategy to fit the valuation methodology and by doing so increasing the expected costs of the scheme to all stakeholders.

The Pension Regulator

The hidden-hand of the Pension Regulator (tPR) is often referred to in discussions on what is possible to agree. We feel it necessary to state our understanding of the process for making changes to the scheme.

The UUK document states that “A salary threshold of £50,000 is subject to the USS Trustees (and the Pensions Regulator) agreeing to an extension of the period over which the current deficit is to be repaid”. In our view, this is a slight misrepresentation of the role of the different parties and the process followed in negotiations.

Whilst the powers of different parties are set out in different parts of the Trust Deed and Rules, it is clear that the Trustee and the scheme actuary determine the valuation results and the contributions required to cover the benefits (under rule 73). If the valuation indicates that benefits need to change, decision making passes from the Trustee to the JNC.

The process followed is then for the JNC to instruct the Trustee on the benefit changes to be made:

“Where the JNC recommends to the trustee company any amendment of the rules, the trustee company shall, in accordance with this rule, take steps to implement the recommendation, unless it appears to the trustee company, acting on actuarial advice, toprejudice unfairly any one or more groups of members or former members when compared with another or other groups;”

The Trustee is not able to refuse to make changes specified by the JNC except in circumstances where the scheme actuary indicates this will unfairly prejudice one or more groups of members.

It is only in the position where contribution increases are required and the JNC cannot reach agreement that the Trustee takes back the power to increase contributions – and in these circumstances, they must follow the 35%/65% cost sharing approach agreed after the previous valuation.

It is also important to note that neither the Trustee nor the Employers require the agreement of the Pensions Regulator to any settlement. Under legislative requirements and the scheme rules, it is for the Trustee and the Employer to agree how deficit contributions will be paid. Whilst the Pensions Regulator might subsequently take action, they are NOT a party to the agreement on contributions.

6. THE TRUSTEE’S THREE TESTS

As part of its engagement with Universities UK (UUK), the USS trustee board published the paper “*Integrated approach to scheme funding*” in July 2014 which sets out three guiding principles for scheme funding, and addresses the interaction of covenant, investments, contributions and benefits. The principles have been codified into **three Tests** that influence the degree of investment de-risking that the USS Trustee believes is appropriate.

Test 1 focuses on benefit security, and **Test 2** is about the volatility of the employers’ contributions. Both tests rely on stochastic modelling of the future: the first to determine whether the Trustee is comfortable with a particular level of technical provision (based on the likely time to transition to a self-sufficiency position), the

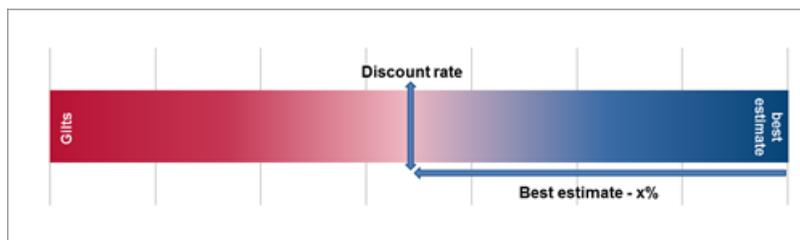
second to assess the likelihood of employer contributions exceeding certain pre-specified thresholds as set out in the Trustee’s paper “Scheme Funding within USS – an engagement with Universities UK”, December 2013.

The tests are designed to determine the level of investment de-risking required, and will therefore influence the cost of the scheme, and the need for future changes to the benefit structure. However, there are some significant problems associated with using stochastic modelling to determine the need for changes to, or appropriate level of, future benefits. The output and results of stochastic models are highly dependent on the model itself, the assumptions chosen, and the level of correlation allowed for between the key variables and inputs.

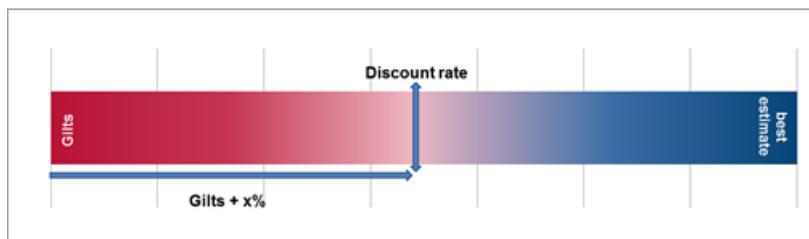
These tests also rely on gilt yields for determining the value of the liabilities and are therefore likely to produce more volatile results than if the liabilities were calculated with reference to the return on the assets held by the scheme.

Test 3 focuses on the reliance on the employers’ covenant, and the Trustee’s principle that this level of reliance should not increase over time. In test 3, the level of reliance on the employer covenant is calculated by comparing the net asset value of the sector to the USS deficit (calculated on a “self-sufficiency” basis, using discount rates equal to the yields on gilts) and allowing for an amount required to meet a tail risk (calculated in probabilistic terms). As mentioned above, in USS most of the assets are not invested in gilts. Basing the decision on the degree of investment de-risking that is appropriate on a deficit calculated with reference to the yield on gilts creates a fundamental mismatch – the deficit as measured using a gilts-based discount rate is irrelevant for a scheme where the majority of assets are not invested in gilts.

There are two ways of measuring employer covenant. The first approach is to take a best estimate return on the asset portfolio and deduct an amount to allow for prudence. We might term this a “best estimate minus” approach to discount rates. Here the distance moved **from right to left** indicates the reliance on the employer covenant.



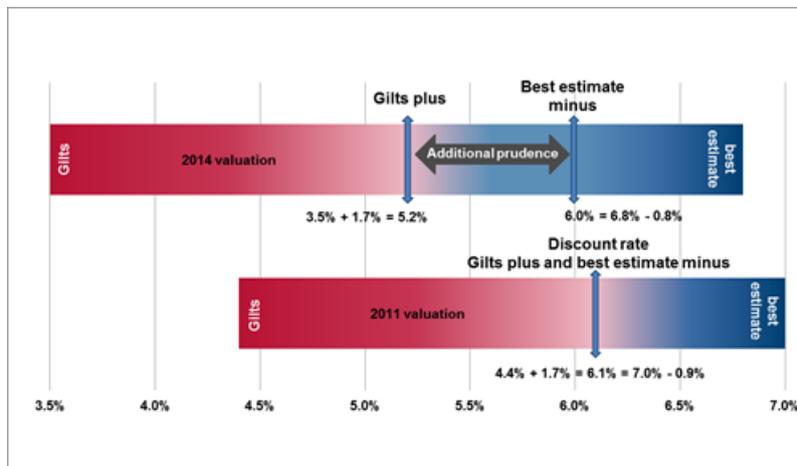
The alternative approach, and the one favoured by the USS Trustee, is to set the starting point as the position USS would be in if it were to exist with no employer support (gilt discount rate) and to move away from this – a “gilts plus” approach. Here the distance moved **from left to right** indicates the reliance on the employer covenant.



The Trustee’s favoured approach is the second one, but the first method is also supported. The Financial Reporting Council which sets the Technical Actuarial Standards (“TASs”) which apply to actuarial work and advice state that they “do not consider that the solvency position indicates the level of prudence in the technical provisions”^[2]. The solvency and self-sufficiency (gilt based) measures are generally taken to be near equivalents (especially for very large schemes whose opportunities to buy out will be limited) and so the FRC favour the first approach as a measure of employer covenant.

Depending on the method used to set the discount rate for use in valuations of the USS, a change in market conditions will change the reliance on the employer covenant in different ways.

As an example, over the course of USS’ inter-valuation period, gilt yields have fallen but equity dividend yields have risen slightly so the gap between a gilts basis and best estimate basis has widened. This is shown in the chart below.



If the USS valuation methodology follows an FRC type “best estimate minus” approach, the change in basis from 2011 to 2014 would reflect the change in yield on the actual assets held by the scheme (such as the change in UK equity dividend yield, and other data considered relevant by the internal investment team) since the previous valuation, and this would represent an unchanged margin of prudence relative to an ongoing best estimate value of the liabilities calculated using a best estimate minus approach, and therefore no change in reliance on the employers’ covenant **in an ongoing scheme context**. In fact, since 2011 the reliance has fallen a little due to the lower proportion of growth assets in the portfolio.

It is important to note that with a multi-employer last person standing scheme like USS, the chances of involuntary termination are very remote and it would seem sensible to follow an **ongoing** FRC type approach. Maintaining a sensible margin of prudence relative to an ongoing best estimate value of the liabilities calculated using an internal rate of return approach is one way of ensuring that the reliance placed on the employers’ covenant does not increase over time, as specified by the Trustee.

^[2] FRC TAS P Significant Considerations 7.11

7. CONCLUSION

UCU submits this paper for consideration by the Funding and Benefits Working Group of the USS JNC and the JNC as a whole. While we do not accept USS' approach to valuation and derisking, we note that significant other actors consider there is a case for change. We believe this proposal has the benefit of maintaining the character of USS as a defined benefit scheme which is affordable, sustainable and attractive. It also carries the key benefit of not changing the nature of the scheme beyond recognition so that when economic circumstances change, the damage is not irreparable.