REPORT OF THE JOINT EXPERT PANEL

September 2018

The Joint Expert Panel on the Universities Superannuation Scheme commissioned by the University and College Union and Universities UK.

2. EXECUTIVE SUMMARY

SCOPE OF THIS REPORT AND TERMS OF REFERENCE

- This report focuses on the first phase of the Joint Expert Panel's (JEP's) ToR, namely to review the basis for the Scheme's 2017 valuation, assumptions and associated tests. This has included:
  - a review of the 2017 valuation to date, including an assessment of the methodology, assumptions and process underpinning it; and
  - exploring the scope for possible revisions to the methodology and assumptions to allow the valuation to be completed without invoking cost-sharing through rule 76.4-8 of the Scheme Rules.

- In undertaking its work, the JEP has been asked to take into account:
  - the unique nature of the HE sector;
  - considerations of intergenerational fairness and equality;
  - the need to strike a fair balance between stability and risk; and
  - the current legal and regulatory framework.

- The JEP has not, in this phase of its work, considered valuations beyond the 2017 valuation. That would be the subject of a follow-up report. However, we have taken the opportunity in this report to suggest areas for future investigation and consideration.

JEP'S WORKING METHODS

- The JEP has held 11 day-long meetings between May and September 2018. The Panel has taken an evidence-based approach to developing its analysis of the Scheme and 2017 valuation. It has held 11 oral evidence sessions with a number of parties directly associated with the valuation – including the Trustee and its actuarial and covenant advisers – and has challenged those called to provide evidence. The Panel has also actively sought evidence from Scheme members and participating employers. Fifty-five submissions were received. These have all been reviewed and considered by the Panel.

- The JEP commissioned a joint report from UUK and UCU's actuarial advisers – AON and First Actuarial. This report was provided by the two firms working together using their intimate knowledge and understanding of the Scheme, but importantly without the input or involvement of UUK and UCU (i.e. it was produced independently for the Panel). In addition, new analysis was requested from the Trustee.

- Throughout the Panel's work, the Trustee and its Executive has engaged actively with the JEP and has provided the Panel with a considerable volume of information, much of which has not been in the public domain.

ABOUT USS

- USS is the UK's largest private occupational pension scheme by assets, with £63.6bn of assets under management as at 31 March 2018. The Scheme provides a mix of defined benefit (DB) and defined contribution (DC) benefits through a hybrid benefit structure introduced in 2016. Members accrue career average revalued earnings (CARE) defined benefits up to a 'salary threshold', which is currently £57,216.50 per annum. Above this threshold, members build up DC benefits with contributions based on their salary above the threshold. Approximately 80% of active Scheme members earn less than £55,000[3] meaning the vast majority are accruing DB on all their earnings.

- The Scheme has a number of unique features. Its relative immaturity means that it is cashflow positive (i.e. its current income exceeds its outgoings) and, all other things being equal, is projected to remain so for the next 50 years. Crucially, the strength and long-term nature of the higher education (HE) sector and its participating employers mean that, unlike the vast majority of occupational Scheme trustees, the USS Trustee can afford to take a very long-term view. This is particularly so given that, over the next 20 years, USS expect the size of the Scheme to fall relative to the size of the sector. This is mainly due to the changes made to Scheme benefits in 2016 which mean that final salary benefits will gradually fall away and be replaced by CARE benefits capped at CPI growth.

- The Scheme's governance arrangements also contain a number of unique features. The determination of benefits and how costs are shared falls to the Joint Negotiating Committee (JNC), which sits outside the remit of the Trustee. The Trustee has the sole power under the Scheme Rules to set the employer contribution rate (subject to consultation). A further feature of USS is that it shares risk with Scheme members though the cost-sharing rules which are applied when the Trustee determines that there should be an increase in the aggregate amount of contributions.

3 https://www.uss.co.uk/~/media/document-libraries/uss/Scheme/uss-investment-builder-a-summary-of-research.pdf

ASSESSMENT OF THE 2017 VALUATION – METHODOLOGY, ASSUMPTIONS AND TESTS

- In considering its approach to an actuarial valuation it is reasonable for any scheme to assess contribution affordability; investment return; and availability of employer assets to support the scheme in extremis. The Pensions Regulator (TPR) has encouraged trustees to adopt this approach. These considerations are reflected in the three Tests used by the Trustee: manageable distance to self-sufficiency in 20 years' time (Test 1); stability of contributions (and/ or benefit design) (Test 2) and the ability of the sector to underwrite the Scheme in a disaster scenario (Test 3).

- 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.

- Whilst the specificities of the Scheme and the strength and diversity of the HE sector appear to have been taken into account in some areas, this has not always been the case. In particular, the Panel believes that insufficient weight has been given to the fact that USS is a large, open, immature scheme which is cashflow positive and can adopt a very long time-horizon. By giving this strength and diversity a greater weight, the Panel believes that the Trustee and the employers may be able to agree a larger risk envelope.

- The Panel is of the view that **self-sufficiency** is a useful concept as an element in a test. It provides a reference point for judging whether a scheme is over-reliant on the sponsor covenant. However, the way in which the employers ' risk appetite has been applied through Test 1 has contributed to the adoption of strong risk aversion. The Panel's view is that adopting a time horizon of 20 years (used for assessing the gap between technical provisions and self-sufficiency) and the hypothetical move to a lowvolatility, low return portfolio is only one of many paths available for a scheme with the strong, long-term, prospects and unique characteristics of USS.

- Overall, this approach dampens perceptions of the outlook for the Scheme which, in the Panel's view, is strong.

- The Panel considers that in a scheme of USS's size and assets under management, it is appropriate for the Scheme to develop its own model for establishing **economic and investment outcomes**. The Panel has identified no concerns about the Fundamental Building Blocks (FBB) approach.

THE VALUATION PROCESS AND GOVERNANCE

- One of the unique features of USS is its governance structure. Amongst other things, this gives the Trustee unique powers through a unilateral right to set contributions (subject to consultation). It is beyond the scope of this report to examine whether this should change, but clearly the process does need to be managed more effectively in terms of interaction with, and gaining the support and confidence of, employers and members.

- It is reasonable in a scheme as large as USS that the Pensions Regulator (TPR) should be kept informed during the valuation process. This is consistent with TPR's risk-based approach to regulation. However, some of those giving evidence to the Panel have suggested that the Regulator's views have steered employers' decisions.

- TPR appears to have taken an approach to the valuation, especially in relation to the employer covenant, that does not fully take account of the specificities of USS. In particular: the very long-term nature of the Scheme; its relative immaturity and cashflow-positive status; and the fact that it is a 'last man standing' scheme.

- The excessive complexity of the valuation has raised a number of issues relating to the clarity of communication with employers and Scheme members as well as the process, content and timing of consultations with employers.

- With respect to assessing employer covenant, the Panel acknowledges it is not a simple task to consult with 350 different institutions or to ascertain their risk appetite – a consultation will inevitably generate a wide range of views and possible outcomes. However, the framing and context of the questions asked of employers have, in our view, produced misleading results. These results have been distilled into a single number which feeds into Test 1, and which in turn affects contribution requirements, future Scheme benefits, the investment strategy and the estimated deficit. These are outcomes which, on exploration, appear to be inconsistent with many employers' wishes.

- Employers have been asked questions in consultations and questionnaires that have not fully explored the consequences or trade-offs of the issues under investigation. It is debatable whether employers have been able to give fully informed answers to important questions. In addition, timeframes for consultations have sometimes been very short, with the result that it has not always been possible for employers to consider and debate thoroughly the issues under consultation, particularly in the many universities with complex governance structures.

- There has been a large volume of information relating to the valuation placed on the USS website. This has, in part, been in response to member requests and shows a desire on the Trustee's part to operate in an open and transparent way. However, much of this information is extremely technical and complex in both language and content. It is very unlikely, despite the high educational attainment levels of USS members, that this material has been well understood by Scheme members. Volume is not a substitute for good quality information that can be understood by all. The lack of understanding is likely to be a contributing factor to falling levels of member confidence in the Scheme.

- There is no formal mechanism for involving Scheme members in the valuation process or assessing their appetite for risk. This is of great relevance in the USS context given the existence of cost sharing when additional contributions are required. It is beyond the scope of this report to consider how member involvement could be achieved, but this is an unresolved issue for the management of the Scheme.

CONCLUDING THE 2017 VALUATION

- The 2017 valuation process commenced almost two years ago. Much has happened in the intervening period, not least a protracted period of negotiation, and an industrial dispute which led ultimately to the creation of the JEP.

- Our ToR restrict us to commenting on the 2017 valuation. The Panel has made a number of observations about the valuation assumptions and methodology which, if agreed, would mean that the outcome could be different, thereby enabling all parties to move forward quickly. In addition, there have been a number of post-valuation developments, including the availability of new data which, if applied, would influence the outcome of the valuation.

- The Panel has developed five principles against which adjustments could be considered:

    1. A re-evaluation of the employers' willingness and ability to bear risk – this would mean re-assessing the reliance on sponsor covenant.
    2. Adopting a greater consistency of approach between the 2014 and 2017 valuations – this would mean changing the approach to deficit recovery contributions.
    3. Achieving greater fairness and equality between generations of Scheme members – this would mean smoothing future service contributions.
    4. Ensuring the valuation uses the most recently available information – this would mean using latest available data and taking account of recent investment considerations and outcomes.
    5. Taking the uniqueness of the Scheme and the HE sector more fully into account.

- The Panel believes that making adjustments in each of these areas would have a material impact on the scale of the 2017 deficit and resulting contribution increases. We also believe this would create a space within which employer and members can find common ground so that the issues around the valuation can be reconciled. It is also our view that the adjustments proposed are consistent with the Trustee's fiduciary duties and the objectives of the Regulator.

- If agreed and implemented, these changes would avoid the need for the very steep contribution increases envisaged in the Scheme Rule 76.4-8 (cost-sharing) process. This would create the space for the stakeholders, through the JNC, to consider some of the longer-term issues facing the Scheme and establish a stable platform for a further review of the Scheme by the Panel.

LOOKING AHEAD

- In the time available to it, the JEP has undertaken a thorough examination of the methodology, tests and assumptions used in the 2017 valuation. We have provided commentary on their application and the overall approach to the valuation adopted by the Trustee. We have also made recommendations as to revisions to the 2017 approach that would enable the 2017 valuation to be concluded, whilst creating some space for the Trustee and JNC to consider the necessary short and longer term reforms to the Scheme.
- However, it is clear that there are a number of issues that remain to be resolved. Whilst the JEP has commented on the many elements of the valuation, we have not opined on

whether there is a different way of reaching a conclusion that could provide long-term stability to the valuation process and have the support and confidence of all parties. The Panel believes this should be a core element of the second phase of its work.

- The second phase of work should also include a wider review of the approach and involvement of UUK and UCU in future valuations so that a more collaborative approach can be adopted and industrial action, such as that witnessed earlier this year, can be avoided. This would require examining the interaction of the various bodies with a formal role in the valuation process; considering the potential for the involvement of Scheme members in the valuation process; and considering how more effective engagement with employers can be achieved.

- We have recommended that in view of the need to start to prepare for the 2020 valuation, work on Phase 2 should start as soon as possible. However, this work will require a firm foundation and cannot, therefore, be concluded until the 2017 valuation itself is concluded.

The Joint Expert Panel (JEP) is a panel of independent experts who have been examining the assumptions and methodology used for the 2017 Universities Superannuation Scheme (USS) valuation.

It is comprised of six actuarial and academic experts, nominated equally by Universities UK (UUK) and the University and College Union (UCU), with a jointly agreed chair, Joanne Segars OBE.

The findings in this report are expected to inform discussions for UCU and UUK to conclude the 2017 valuation.

For further information please visit:
www.ussjep.org.uk