THE UNIVERSITY *of* EDINBURGH

Technical Provision Consultation for the 2020 USS Valuation

University of Edinburgh Response, 30 October 2020

We would like to preface in the strongest possible terms that, in keeping with the Trustee's own observations (in para. 6 of Page 5 of the Technical Provisions consultation) current contribution rates are at the limit of affordability. The full range of illustrated outcomes indicated in the Technical Provisions consultation are therefore unaffordable both to employers and (we believe) to members. We believe that such increases would undermine the financial sustainability of many (if not all) of the employers within the scheme, adversely affecting institutions' ability to pursue current strategies and preventing essential investment in both staff and infrastructure / facilities. Moreover, higher pension costs put jobs at risk, both for USS members and those not eligible for membership of this scheme. In addition, already unacceptably high opt-out rates prevail within the scheme and will only increase should members be required to pay more. The lack of optionality and choice for our staff places a significant strain on our obligations as employers to provide affordable and sustainable choices regarding savings for retirement.

We intend to argue strongly, at the appropriate point in this valuation process, for long-term structural change, which will provide greater certainty around the future costs of the scheme and proposes a sensible approach to deficit recovery, which properly reflects the uniqueness and strength of the sector's covenant. Our responses to this consultation reflect our desire to develop a strong and appropriate basis from which the sector must grapple with benefit reform for the good of members and employers alike.

1. The inputs and assumptions

We support the use of a dual discount rate model and consider the post-retirement discount rate to be reasonable. However, the pre-retirement discount rate appears unduly cautious compared with the approach used for the 2018 valuation even if a continued "strong" employer covenant is assumed. There is a relatively high probability that a higher rate of return will be achieved by the portfolio, even allowing for some de-risking; the discount rate should therefore be aligned with the investment strategy (within the constraints of the employer covenant). This places too much emphasis on moving towards self-sufficiency.

We agree that the other assumptions are broadly reasonable. However, we are keen to understand the impact of COVID on the liability profile – both short-term and longer-term.

2. The methodology

We consider that the overall financial management strategy should first focus on the employer covenant and the appetite for risk. Once this is clear, the optimum investment strategy can be established. The approach used to value the liabilities is then linked to the expected return, with suitable prudence margins that link to the covenant.

We have no strong preference as to whether a discount rate is expressed as "gilts plus" or "CPI plus". The key issue is that the value placed on the liabilities represents a suitable provision to provide benefits for members when they fall due at an acceptable cost to both employers and members.

We require greater clarity around how the funding position will be monitored going forward and what actions might be taken at interim times. It is crucial that this recognises the very long-term nature of the Scheme liabilities and the associated investment strategy, together with the

resilience of the HE sector. Otherwise, short-term actions may be taken that damage the financial strategy and place undue burdens on the employers (and members).

We agree that it is crucial to consider intergenerational fairness. However, we believe that the methodology used to produce the illustrative figures has resulted in a strategy that has too much focus on short-term measures (additional contributions, potentially by both members and employers). The various contribution rate options quoted all result in a level well in excess of the 25% figure quoted as "a realistic long-run affordable maximum" in the consultation document.

We note in Section 5 that USS suggest a contribution of 9.3% of payroll over the next 30 years is sufficient to meet the shortfall relative to the self-sufficiency target. This contrasts with materially higher figures quoted as necessary to meet the Technical Provisions target (which are assumed to be paid over a much shorter time period). This does not appear consistent with the suggestion of considering intergenerational fairness, and should be revisited as a result.

3. The risk management framework

The Risk Metrics appear overly sensitive given the size of the Scheme, particularly to interest rate changes. We require greater clarity around how the metrics impact on the financial strategy going forward.

As USS recognises, the illustrative contribution rates that are shown in the consultation document are far beyond what has been previously been considered "affordable". This implies the metrics place too great a focus on achieving de-risking steps towards self-sufficiency over too short a period.

The focus of the consultation is too narrow to take account of all aspects of risk management. For example, there is a need to consider the continued build-up of risk as members accrue further elements of DB entitlement. It is crucial to consider future benefit reform when looking at both overall cost and the risk management framework. Greater long-term certainty of cost is vital for both employers and members.

4. The figures for the Technical Provisions

We have commented on the assumptions and methodology above. In order to assess whether the Technical Provisions are reasonable, we need to understand more about:

- The extent to which they are influenced by the Risk Metrics
- How they interact with the future benefit design
- How the valuation results translate into a Recovery Plan that is affordable and aligned with the sustainability of the HE sector

Our initial view is that the Technical Provisions are currently set at a level that exceeds what is appropriate based on the covenant of the HE sector (even if no actions are taken around debt monitoring etc.) and the current investment strategy. We also believe it is reasonable to recognise that the shortfall disclosed at March 2020 is expected to be met in part over the long-term by investment return in excess of the prudent discount rate.

Illustrative Recovery Plans reflect a period of either 8 or 10 years to achieve full funding on a Technical Provisions basis. This does not take account of affordability, nor does it support the sustainability of the HE sector (particularly given the extra short-term pressures on managing our cash position), which are also key considerations highlighted by the regulator.

Clarification on whether the basis used to determine the Technical Provisions will change at future valuations will also be helpful. In particular, as changes are made to reduce the growth element of the investment strategy will this impact on the pre-retirement discount rate?

5. **Willingness to adopt debt monitoring, pari passu arrangements and the long-term rule change**

This has been the subject of separate consultation and clear views have been expressed by the employers. Given the current economic conditions, it may be particularly damaging to the future viability of weaker employers within USS to be required to offer pari passu arrangements, since sources of capital to remain competitive may be unavailable. If employers subsequently fail, this will reduce the long-term covenant for the scheme and place undue pressure on the stronger employers.

6. **Additional contingent support for the scheme**

We cannot easily give a view on willingness to provide such support. In order to consider this further, we need clear guidance from USS as to how they will adjust the Technical Provisions and restructure the wider journey towards self-sufficiency.

Mechanisms such as contingent contributions are not really feasible currently given the pressure on managing cash positions and the challenges that even the existing level of contributions present to employers.

Given the multi-employer structure of USS and the mutual way in which it operates at present, we need clarity from USS as to how it sees a contingent structure operating in practice. Will the impact be the same on all employers, irrespective of the individual ability to make additional support available? Balance sheet strength varies significantly across the employers in USS.

7. **Levels of financial support employers can afford to give to the Scheme and affordable risk capacity**

a) **%age of Payroll available**

b) **Length of time over which that is available**

c) **Cost of future pension provision to employers acceptable to the section in an adverse scenario**

d) **The growth of the sector payroll over the longer term**

The consultation document appears to suggest that a long-term employer rate of up to 25% is envisaged (made up of 15% towards future benefits and up to 10% to rectify any past service shortfall). Whilst this may be affordable for some employers, there will be others where such a rate is not manageable. As a reminder, the Sector has already indicated that current contribution rates are at the top-end of affordability.

This will undermine the principle of mutuality that USS currently provides across the HE sector; contribution rates will need to reflect the lowest affordable rate for the sector employers, which may have other implications for the financial strategy that place undue burden on stronger employers.

Moreover, in order to achieve this long-term position, it appears that USS expects contributions to be materially higher under any Recovery Plan. In the consultation document, it is recognised that the proposals are “unlikely to be considered affordable or sustainable”. We consider this reflects too great a focus on the short-term for rectifying the financial position which is particularly inappropriate given the current financial climate (volatile financial markets, low bond yields etc.).

We believe it is important, both for employers and members, that the level of risk associated with benefit provision is reduced to establish a sustainable scheme in adverse scenarios. We also suggest that alternative benefit designs are offered within USS to encourage full employee participation whilst recognising the different objectives of our workforce across their careers.

Whilst the HE sector is under significant cost pressures at present, the clear expectation is that there will be a recovery. Universities are reacting dynamically to the COVID pandemic with the aim of remaining strong for the long-term. There is still an expectation of future recruitment etc. We consider that HE institutions can be expected to remain successful for many years into the future and it is vital that the financial strategy properly reflects this.

We have concerns that more employees will choose to opt out of USS if member contribution rates increase as part of the Recovery Plan. This will reduce the USS payroll but have no impact on the level of the deficit to be funded. Hence the contribution rate for the remaining members will increase. Moreover, we are unable to offer an alternative pension option to those employees who opt out of USS, due to the exclusivity provisions.

8. The determination of employers' collective risk appetite, and approaches if the proposed approach on affordable risk capacity is not felt to be reasonable

In deriving an acceptable level of risk for employers, we consider it is vital to consider past and future service separately. Our overall risk budget is spent on a combination of underwriting the benefits built up to date and financing benefits for future service.

The consultation needs to recognise this more explicitly. We need a more stable contribution rate in relation to benefits for future service, with a structure that does not add to the risk already borne by employers (and to a lesser extent by the employees). This will enable more of the risk budget to be allocated to managing the existing funding shortfall.

We question the general suitability of the Risk Metrics. From a structural angle, we question the need to consider both "affordable" and "available" risk capacity – should the focus not be purely on available capacity, representing how the employers can support the Scheme in an extreme situation? Affordable should be looked at more in the context of the employers ability to make cash contributions, which links to the assessment of employer covenant and the need to maintain a sustainable HE sector.

It will be helpful to see examples of how contribution rates might change in different future scenarios in order to better understand how the metrics might impact on the required level of contributions. This analysis needs also to consider the impact of reform to benefits for future service – as the consultation document confirms, the funding strategy will be affected by the risk implicit in the benefit design.

There may also be value in understanding better the extent the projected trend in reliance on the employers risk capacity over future years. Presumably, this will reduce over time as the funding position improves. Whilst the current position clearly imposes a lot of demands on employers, this may be more manageable if there is a clear expectation of how this will improve the positon over time. Is there any modelling that can give some clarity on this?

We are concerned that the current structure of USS does not treat different generations of members fairly. For example, only active members pay contributions and an element of the current rate is allocated to meeting the past service shortfall that relates to both current and former employees.