THE POLICY INSTITUTE

KING'S College LONDON

Is the Universities Superannuation Scheme still fit for purpose?

An approach to reforming the USS pension scheme

Introduction

The Universities Superannuation Scheme (USS) was established in 1975 to provide pensions for academics and other senior employees working in the Higher Education and related sectors. Since its establishment, the scheme has grown rapidly, expanding from 13,000 members in 1975, to more than 375,000 today. With assets of more than £63 billion, USS is funded by contributions from both members and employers, which are then invested to ensure there is enough money to pay the benefits as they fall due. These contributions are shared between members (35%) and employers (65%) – in what has become known as the 35:65 rule. Ensuring that the fund has sufficient assets to pay benefits to members is a key role for the Trustees, who conduct an actuarial valuation of the scheme at least every three years to determine the level of contributions required to pay the benefits.

The last two years have seen turbulent and rocky times for USS. The 2017 actuarial valuation stated that the scheme was £7.5 billion underfunded or, put another way, "the schemes assets were sufficient to cover 89% of its liabilities".[1] The valuation resulted in proposed changes to the scheme, which then led to a deadlock two times within the Joint Negotiating Committee (JNC) – the part of the USS governance structure where the main employer and employee representatives come together to vote on proposals for changes. Ultimately, the deadlock, as well as controversy over the valuation and valuation methodology, led to strikes within Higher Education Institutions across the country. Subsequent dialogue with striking staff and other relevant parties, has revealed that various stakeholders have different aspects they want to change when it comes to the running of USS. This is especially the case in respect of the perceived divergences in interests between employers, employees, USS and the Pensions Regulator (tPR).

The Policy Institute, King's College London, was keen to explore different perspectives on USS, as well as to identify areas where there may be consensus for making progress, or even an agreed starting point for change. We therefore ran a Policy Lab with key stakeholders from King's College and the Pensions Sector, including a number of

1 https://www.uss.co.uk/~/media/document-libraries/uss/how-uss-is-run/av-archive/actuarialreportasatmarch2017.pdf

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external organisations. Our guiding question was: "*How can we improve the governance and regulation of USS in the interests of all stakeholders?*". The Policy Lab discussion was informed by an evidence pack, researched and written up by the Pensions Policy Institute.

Whare are Policy Labs?

Policy labs are a tried-and-tested model (see for example, this testimony in the The British Dental Journal) for delivering sessions that bring together research, policy and practitioner expertise to make progress on complex challenges. We have previously worked on reducing the costs associated with rising levels of type 2 diabetes, on improving access to and use of effective land de-mining techniques, on rising rates of detention and the Mental Health Act, and many other 'wicked' problems. Policy Labs work by drawing out a wide range of perspectives from as broad a range of stakeholders as possible. In so doing, they attempt to ensure that multiple views, options and ideas are considered and deliberated, and that potential barriers are identified, understood and addressed. Convening wide stakeholder groups and drawing on robust evidence facilitates a multifaceted assessment of challenges and ways of navigating those challenges through possible next steps.

The headline finding from the lab was that both structural and cultural changes are needed to enable USS to have the necessary influence with the regulator, and to improve the way the scheme is run, especially in terms of the dialogue with its employers and members. What makes USS different from other pension schemes is that it is both a Defined Benefit (DB) scheme and a Defined Contribution (DC) scheme. The core pension is Defined Benefit – the USS Retirement Income Builder, which guarantees a certain level of retirement income. This is topped with a Defined Contribution element – the USS Investment Builder, for income accrued over £55,000. Participants were clear that tPR needs to take a more active, even bespoke, role in regulating USS, because of the unique nature of the scheme. There was recognition that calculating risk is complex and difficult, but there was also agreement that valuation methodologies had become too complex. Equally, there was consistent agreement that communication needed to be improved, including by USS representatives actively and valuably engaging with employers, and recognising the impact of their decisions in the Higher Education context.

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Headline Findings

- The Pensions Regulator (tPR) needs to regulate USS more actively and in a way that reflects USS' unique features.
- The difficult process of calculating risk for an open scheme like USS may have resulted in an overly complex and flawed valuation methodology which now drives decision-making.
- Trustees and USS management need to engage with employers and staff to better understand the impact of their decisions and actions in the context of the sector.
- A more deliberative process in reaching consensus is desirable but is likely to be difficult to deliver.
- It will be important to increase both accountability and transparency if USS is to avoid further conflict between itself, employers and the membership.
- Consideration should be given to sectionalising the scheme to enable it to better meet the specific situations of certain employers.
- Communications should be much more timely and designed for the well-informed academic.

The Pensions Regulator needs to regulate USS in a way that reflects its unique features

Most other DB schemes are closing. The total number of DB schemes is down from 7000 to 5500; 95% are now closed to new members and 50% are closed to all new accruals. Against the backdrop of declining DB Schemes, tPR is increasingly becoming a "watchdog" regulator which ensures that schemes are being managed appropriately, rather than the more advisory role it has previously tended to adopt, providing guidance on how schemes might approach different issues.

As tPR moves more towards an enforcement role, it needs to build a specific and bespoke approach for USS, which increasingly looks like a scheme with unique features and characteristics. A bespoke approach needs to factor in different appetites for risk. tPR currently takes a relatively "risk-averse" approach to scheme valuation and the ability to meet obligations. A lot of emphasis is put on the assessment of the strength of the employer covenant. The perception of tPR is that it is a gilts-based regulator, even when it denies this, with the asset returns tending to be measured relative to gilts (a "gilts plus" approach) and statistics of returns published relative to gilts. This drives behaviour in taking a risk-averse approach to valuations.

In addition to factoring in different appetites for risk across stakeholders, tPR also needs to be wary of becoming too "mechanistic" in applying rules-based criteria. The actuarial profession used to have considerable flexibility in taking into account the specific circumstances of a scheme. Lots of assumptions were used, some rather more subjective (such as the impact of the employer's environment) versus those more clearly objective. Now the tPR is taking a much more mechanistic, rigid, internal rules-based approach, it needs to establish ways of retaining some flexibility in the application of rules-based criteria to reflect the unique aspects of USS.

The difficult process of calculating risk for an open scheme like USS may have resulted in an overly complex and flawed valuation methodology which now drives decision-making

Defining and calculating risk for an open scheme like USS is difficult. Adopting valuation practices that are more appropriate to a closed scheme will almost certainly result in an unduly conservative valuation. For example, the absolute level of risk for a closed scheme is equivalent to getting the money from Legal & General (L&G) – the risk has been fully crystallised and handed off. What is the risk for an open scheme? There is no intent to pass this to L&G, instead the intent is to keep the scheme running and provide benefits to all members. This is a very different concept of risk and it is not clear how to achieve a coherent assessment of risk for a scheme such as USS which could run indefinitely. Beyond this there is also “uncertainty” or the “unknown unknowns”. It is only possible to say that the assessment is the “best understanding of risk”. But it can’t be complete and comprehensive, since this is not actually possible given the long-run nature of the time horizons. So, the valuation answers the question: If I hold this amount of money, in these types of assets, what’s my chance of paying those benefits? This is like an insurance company which has to ask: “Have I sufficient funds to cover a one in 200 chance of paying out all the money for policy holders?”

While clever, the valuation methodology could be seen as overly complex and aiming to be spuriously accurate about future assumptions. The current methodology to tie together the “Holy Grail” of risk management, namely the employer covenant, contribution level and investment policy. As a result, it is complex to explain (for example, requiring three Youtube videos of 20 minutes each). There are many assumptions in the modelling that are focused on making things spuriously accurate (for example, around the timing of events in the future). This, coupled with the fact that the methodology “hasn’t been exposed to market testing” means that it could have some “fundamental flaws”.

The valuation test was originally used as a check but has now become part of working out the final answer for the required contributions. Test 1 – the risk management tool that measured whether the risk which employers and trustees had consented was matched in the DB section of the scheme – forced a view to be taken on how long the university sector can be reliably expected to continue. So, the Trustees end up making a judgement along the lines of “we believe the sector is strong but we have to be mindful that the sector may not continue indefinitely and PwC [PricewaterhouseCoopers] says that they can see the sector looking forward say 20-30 years.” On this basis, the Trustees feel they have to be within a certain distance (eg £20bn) of what is needed to “run for cover” (ie safety) by that date. That drives the calculation of the potential deficit. In purely theoretical terms, this probably makes sense; but in practical terms it is a strange way of calculating risk – the assumption that “the sector looks forward say 20-30 years” is historically, and therefore factually, flawed. “The sector”, in its modern incarnation alone, stems from fundamental educational reforms in the late nineteenth century and “looks forward” to expansion on an unprecedented global scale, provided that adequate support for the world-leading scholars it attracts is not eroded by short-sighted policy.

Trustees and USS management need to engage with employers and staff to better understand the impact of their decisions and actions in the context of the sector

In most schemes, the consideration of what is needed to pay the benefits is negotiated between the scheme and the employer. The outcome of this initial dialogue, which a valuation will inform, is then taken to wider consultation with the membership. As part of this, an early agreement is often reached on what the split will be between employers picking up any additional contribution and what will be asked for from members. In the rail scheme, for example, there is a 60:40 cost sharing rule which employers and employees agree before consultation, and the Trustees cannot impose a valuation without there always being room for manoeuvre in determining what additional contributions will be required.

“Forced to work with the level of increased contribution dictated by the valuation, the result is an outcome which does not satisfy either employers or employees.”

With USS, the Trustees consult with employers but don’t have to negotiate or agree with them in coming to a final recommendation on what is needed to fund the scheme. Instead, it passes a fixed valuation estimate over to the JNC and puts the onus on it to agree a spilt of contributions based on that. The key thing with this dynamic, is that the ultimate power in determining the overall additional contributions required, lies solely with the Trustees and is not shared with the employers. In essence, USS is only interested in the pension scheme and does not have to consider the other interests that employers might have (eg staff relations, competing calls on their spending, etc). This is different to most other schemes where the Trustees have to appreciate that employers are balancing an interest in other factors as well as their appetite for risk in funding the pension covenant.

This can be viewed as a very rules-based approach, but it also begs the question of how appropriate it is to ask Vice Chancellors and Chief Financial Officers (CFOs) what they think is a reasonable level of risk, not least because it is a hard question to answer in the abstract. This was, in practice, exacerbated by the questionnaire sent to employers which was “bizarre” and contained “a leading set of questions” such as “do you want to take on more risk?”. Instead of pushing the question of risk appetite onto employers, USS should be thinking about how to collect information that more accurately captures the preferences of employers (eg explaining the consequences of carrying more or less risk and the costs that results in). The process has become quite mechanised, with questionnaires to particular types of people (CFOs), with the responses plugged into the test, resulting in a valuation which then drives a demand for greater contributions. There is no iteration with key stakeholders, for example explaining what the risk tolerance would lead to.

Relatedly, it is likely that the role of the JNC is now broken. The JNC has operated for 40 years, and during that period it has never required a casting vote. As recent valuations have required significant increases in contributions, this has, inevitably, led to a split in the JNC along employer-employee lines. Now it has been deadlocked twice and required a casting vote twice in the last few years. This suggests that the JNC is no longer fit for purpose; in part, it is having to do “the heavy lifting” in the overall structure by attempting to resolve the trade-off flowing from a conservative valuation between higher contributions and employers wanting to limit pensions as a proportion of salary. Since the JNC is now deadlocked, it would seem that the USS structure is one that can deal with consensus but not conflict. Faced with this, compromise recommendations emerge. In the current case there is a move to Defined Contributions (DC), an aim to freeze pension costs at 18% of salary, putting some money into reducing the deficit and placing the remainder of additional contributions into employees’ DC accounts.

Forced to work with the level of increased contribution dictated by the valuation, the result is an outcome which does not satisfy either employers or employees. For employers, they are faced with a significantly increased cost of pensions. For current staff, the increased contributions and shift to DC are seen as counter to the culture of universities as a not-for-profit “public service” sector and the implicit contract on how staff in such a context are rewarded. So unlike in a private sector company, where there is a very clear link between performance and reward (for example, employees get bonuses, performance payments, share of profits) in universities the link is much more tenuous. Consequently, any changes to pension contributions and benefits that are perceived as detrimental, cannot be compensated for by more performance-related rewards. Furthermore, as universities are not-for-profit, it could be argued that, over the long-run, it is effectively the staff who pay the employer contributions. There could therefore be a conflict of interest in protecting the interests of current employees relative to future employees, who would expect access to a "high quality pension arrangement" (as currently defined, that is the current scheme). If the choice is made to spend a lot of money financing the deficit, there is likely to be less money to pay for future benefits or, if the choice is not to pay off the deficit, this could expose future members to additional risk.

A more deliberative process in reaching consensus is needed

The deliberative dialogues process used at King's College in response to the strike action, as part of the engagement with staff, has worked well. While this process could, to some extent, be "seen as stepping over the UCU/UUK structure", it has resulted in a constructive approach to tackling some of the perceived problems with the USS scheme. Both employers and employees would value the ability to engage with each other in an iterative process of considering the assumptions going into the valuation, the choices for how much of the additional contribution to go with, and the share of costs between employers and employees.

This could be the model for the start of a deliberative dialogue process, but it is not the final answer. Another option to introduce a more deliberative process, would be to embed the Joint Expert Panel (JEP) as a concept within the governance structure. In other words, bringing something JEP-like, such as an independent review panel, into the structure of USS. As an expert panel, such a structure would be different to the JNC (which is a representative committee) and could therefore contribute as part of the wider governance or negotiation process.

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Clearly, there are challenges. First, where would the JEP sit in the hierarchy (ie who talks to who and in what order)? Second, which elements of the JEP could be usefully suffused into USS? Thirdly, how would trust in the JEP-like expert panel be maintained? And fourth and perhaps most importantly, the JEP has no formalised basis: it is not mandatory for USS to take any notice of the JEP's findings, which it sees as "just a way to resolve a dispute between employers and employees" and does not like being told what recommendations to adopt.

Any move to a more deliberative process involving employers and employees is likely to be met with resistance from USS Trustees and Management, who view their role as centred on running the scheme, rather than focusing on the intricacies of the wider context, such as the relationship between employers and employees. Nonetheless, the JEP process suggests there are ways forward to be found in more deliberative approaches to the scheme valuations.

Accountability and transparency are paramount if USS is to avoid further conflict

There are questions about why USS has such a large number of committees. Is this governance for governance's sake? Is there a belief that having a committee for each function leads to governing well? Or is it that Trustees are not confident in their duties and so delegate to committees to fulfil functions that they should be capable of? USS should be clear about what the reason is for having each committee. Conversely, it is not clear why there is no Communications committee (or at least a senior accountable figure for communication and engagement with members) and where the responsibility for developing the scheme lies, in particular most recently, who was behind the contentious plans to make the scheme fully DC. If this continues to be the direction of travel, there should be transparency and accountability over these decisions and who is making them.

The role of "chief risk officer" should be more pronounced in the structure, given that the assessment of risk is the biggest challenge for the scheme. The current regulatory environment can be seen as leading to a risk appetite which has become too cautious on the part of USS. Against this backdrop, and because risk is so long-term, it is critical to argue clearly why a different view of risk should be taken given what might happen over a very long period of time. While there is a Chief Risk Officer in USS, it is someone "buried in the structure" and they do not report directly to the Trustees; they are part of USS Investment Management Limited (USSIM), under the CEO, probably chairing the Risk Committee. This role should be elevated to strengthen the voice and give a clear line of reporting to the Trustees to help them "push back" against the mechanistic rules-based approach of the regulator.

There should be more transparency on key issues such as the valuation technique and cost of the deficit as a proportion of pay. Given its importance, there should be regular reporting of the valuation technique "so that everyone can understand how arbitrary it is". Publishing pages of assumptions tends to hide the most important points (eg, that the discount rate and inflation assumptions make the biggest impact). The valuation "is just a budget exercise – it's always wrong", so there should be transparency about this and space to challenge and discuss, taking into account the context of the sector. The language should be accessible to an informed lay person (academia is really different in that) and not deliberately confusing. This is not a typical scheme as it has a very vocal and informed group within the membership that USS has to engage with. In a similar way, there has been a lack of transparency over how the size of the deficit equates to costs to employers. The initial calculation of the deficit saw it rise from 2.1% to 6% of pay. Once the deficit was recalculated to come out only half as large (£3.5bn rather than £7bn) it would have been expected that the deficit as a proportion of pay would have fallen an equivalent amount, (to 3%) but in fact it ended up at 5%. There was no transparency or accountability in how that figure was reached.

The value for money of the scheme should be tested regularly beyond the forms of benchmarking that regularly appear in the annual report. While value for money is generally a concept applicable to DC schemes, it is appropriate to consider value for money issues in running USS. While notionally costs are paid by employers (there are no direct deductions from members' accounts), for a non-profit sector such as universities, the cost over the long-run is effectively borne by staff. So, for example, how much cost are members bearing and what is the quality of services like communications provided to members? The rail scheme did a forensic analysis of investment costs and where it had been claimed that £80 million was being spent, in fact £300 million was identified. This resulted in changes to the investment policy, saving £100 million a year. If we take this sort of approach, it is almost certainly true that the £126 million costs reported by USSIM are "just the tip of the iceberg" and the total investment costs are "probably in excess £500m" including the money lost in the net return from investments. USSIM is a big organisation with 80 people paid over £100,000 per year. At the moment, it is not clear who makes decisions on value for money and pays proper attention to scrutinising cost (or indeed if this happens much at all given that the headline £126 million figure is a small proportion of costs). Questions have to be asked, including whether the scale of the USSIM operation is a "self-fulfilling oligarchy" operating independently of what employers or employees want (eg having teams going around the world to look at private investments). One way to do this would be to explore how it is done relative to other schemes such as rail. This is a reasonable question to ask. While the costs are marginal given the overall asset base, there should still be scrutiny of this, including being clear on whether costs are rising or falling and ideas as to how it can be done better.

The number and role of the professional advisors within USS should be examined. The Vice Chancellors should be bringing in more of the sector context to decision-making, but this may not be accepted by the professional Trustees. It is not known how effective they are as a group and, as "high-powered individuals", their voice and opinions are thought to carry a lot of weight. Whether this serves the interests of members should be open to scrutiny (although the advisors would say that members interests are to pay the benefits, regardless of sector context). They may also view the JEP as "an industrial relations/public policy dressed up as pensions".

The Trustees should be seen to hold the Executive to account. USS has effectively been the subject of a "humungous disaster" following which a CEO would normally have been sacked and replaced. However, the current CEO still has the confidence of the Trustees. It could be concluded therefore that that either the Trustees are ineffective or the culture is wrong and the standard rules of accountability have not been adhered to. The Board would state that the problems that arose from the valuation and proposed changes to the scheme "are not our responsibility" and that "there is nothing we could have done – it's all down to UUK or UCU to resolve". In contrast, employees would likely say there needs to be acknowledgement of the failures over the last year and that, in any other organisation, challenges and strikes such as we have seen would have repercussions.

The Trustees should also be more accountable and open to challenge. It could be argued that USS should be operating on behalf of UCU and UUK, determining how they serve them. At the moment, both the Trustees and the Executive seem aloof or arrogant in the way they are not being held to account. While scheme members have lost one and a half months' salary from strike action, "who has paid" in the Executive or Trustees? As the current structure has four very highly paid "big figures" in the sector, no one wants to criticise them and

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it has become hard for senior leaders in the sector to "rock the boat" in challenging the Trustees on their performance. How to disrupt this is a challenging question. This is not usual in the private sector where Trustee Boards don't tend to have CEOs or CFOs on them. This perhaps underlines why the tPR talks about "putting billions in the hands of amateurs" and is setting the agenda to raise the quality of trusteeship so that individuals won't be able to be a trustee unless they can demonstrate a certain level of professional competence.

Increasing the accountability of USS is likely to need changes to the composition and culture of the Trustees. Some changes to the Trustees would seem to be needed if the Board takes a more robust stance with the CEO and the regulator. One option would be to mirror the approach in the Netherlands, where employees, employers and government (or Trustees in the case of USS) all have an equal footing in dialogue rather than having one above the other two. The USS Trust articles may point to how this change could be made (eg for UCU and UUK to drive this if there is agreement that the current approach is not fit for purpose). Another option would be to work within the existing structure, but that depends on whether there are the people in place who want to make changes to the culture (rather than saying "we've done what we need to do"). When will USS and the Executive team hold a mirror up to themselves? It would also be desirable to have more diversity amongst the Trustees, especially as, if it happens, moving into the world of DC would involve a cohort of younger members. This could be complemented by making the interests of members more prominent in the structure, for example through having the democratic election of Trustees (eg via UCU or standing as independents).

Consideration should be given to sectionalising the scheme to enable it to better meet the specific situations of certain employers

The employer universities are very diverse in their characteristics but are treated exactly the same in a common scheme. Some universities are very well-established and some are more recent. The financial strength of the employers also varies substantially, A small college with six people in the scheme is treated the same as large Oxbridge college. For the small college, if contributions go up 20%, that is frightening. An Oxbridge college, on the other hand, will have a very different view on the capability to pay the employer covenant (one of the three legs of risk) and "it is ridiculous" to challenge their ability to do this. As a result, there is a challenge to persuade all universities to remain within the scheme and, for example, some Oxbridge colleges have indicated they may leave, despite the very high costs of doing this. [Note: USS only covers pre-1992 universities and the universities in immediate financial difficulty are covered by the teachers pension scheme.]

Sectionalisation of the scheme would give more flexibility to tailor the scheme to employer situations. A scheme can be split into sections with either one section for each employer or sections that cover groups of employers with similar characteristics/situations. National Grid did this a number of years ago when breaking up the company by looking at past benefits and allocating this to individual sections with the new employers. Each employer in rail also has its own section. Having different sections would allow the funding of those sections to be different, reflecting the characteristics of the employer organisation. The differences between sections could also go further in allowing employers to define their own benefits. On moving employer within the scheme, individuals can still transfer to different sections without costs to the member.

USS could choose to amend the Trustee rules to break the scheme up into sections with one per employer or groups of universities (eg Russell group universities). While sectionalisation of the scheme would lose the strength of "last man standing", it might encourage Oxbridge colleges to remain. However, breaking a scheme up into sections is much easier to do if reallocating surpluses rather than deficits.

Communications should be much more timely and designed for the well-informed academic

While USS puts out a lot of information, this has not prevented trust being lost between Trustees and the membership as a result of poor communications. In the round, the recent events are a massive failure in communications. It could be argued that the Trustees measure communications in terms of input (number of words in comms, etc) and not output (what people understand, how effectively things get agreed, etc). USS published 84 pages of technical information as part of its consultation and, not surprisingly, it is hard for all but the most dedicated of readers to find the really important information. While the Trustees still insist they communicate very well, they seem "miles behind the curve" in managing public perception (eg the Trustees are not visible on social media). The "channels" used by USS to distribute information, do not enable effective communication of messages to the membership (eg initially going via CFOs such that there was a long delay in getting professional comms people involved). It is not clear who within the USS structure has authority on comms. Trustees have not held the CEO to account for failure in communications and engagement.

Members should be treated as intelligent and well-informed. The university sector membership is different from other schemes – in terms of language, tones and styles – and that is not always reflected in communications from USS. Communication from USS should be appropriate to the membership which has a significant group of well-informed individuals who are interested in a higher level of information, than for many schemes (including aspects such as rates of return, underlying assumptions, etc). While most schemes generally don't put out actuarial thinking to their memberships, USS should consider sharing more on this because of the particular characteristics of an important group of its members. Timeliness of communication is critical, allowing sufficient time for people to process the information being provided and use this to have their say and/or influence others as appropriate.

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