Dear Sirs

In response to the invitation to comment on the consultation document provided by USS relating to the proposed assumptions for the scheme’s technical provisions and Statement of Funding Principles, the University of Sheffield wishes to make the following points.

**Level of USS pensions risk**

Pension risk is not only a matter of interest for employers but also for scheme members and future employees. Increasing the level or risk borne by employers today to such a level that, should the risk not pay off, employers are not able to afford appropriate benefits in the future would make the scheme unsustainable. A balance needs to be struck between prudence and risk.

A level of prudence in assumptions is required in law as part of a valuation process. In previous consultations we have sought to encourage the USS Trustee to adopt a reasonable level of prudence in its valuation assumptions rather than an excessive level. The proposed assumptions appear to offer a more balanced approach to prudence.

Most of the assumptions which inform the technical provisions are now based on a “best estimate” basis which in effect gives a 50/50 chance of the outcome being more or less favourable than that selected as the best estimate. Where prudence has been applied explicitly, for example in the discount rate (the rate of return used in the assumptions to state future liabilities in terms of “today’s money”), this has increased marginally from that applied in 2014 but this increase does not off-set the increased risk caused by the overall approach proposed by the Trustee.

A key part of this additional risk built into the assumptions is the Trustee’s view that interest rates will rise materially in future and above what is expected by the markets. Whilst the economic conditions prevailing are exceptional, there are mixed views as to whether they continue to represent an anomalous period or whether they are more representative of a new reality in the medium term. As such, the USS view may be considered bold.
The University notes that the assumptions proposed by the USS Trustee are considered to be at the extreme end of the level of prudence that would be deemed acceptable both to the Scheme Actuary and the Pensions Regulator. In other words, it is highly unlikely, given the legislative power of the Pensions Regulator, that further relaxation of the level of prudence in the assumptions would be acceptable even if it were desirable to employers.

Whilst the reduction in the level of prudence has a beneficial impact on the 2017 deficit position (reducing it from an estimated £12.6bn to £5.1bn) it does increase the likelihood that contributions in future will be insufficient to pay for promised benefits. As such it places a higher possibility on employers having to pay more into the scheme – up to an additional 7% of USS pensionable payroll at the extreme (noting that each 1% increase in USS employer contributions costs this University c£2m per year based on current staffing levels and costs).

The University notes the Pensions Regulator’s views on the USS Trustees assessment of the sector covenant and is keen to understand the impact of this on the valuation assumptions currently proposed. The strength of the covenant is a significant factor in the valuation as it is an indicator of the reliance that the Trustee can place on employers to pay more into the scheme in an extreme event. This University is not in a position to influence the assessment of strength of covenant for the sector as a whole.

The intervention at this late stage of the consultation is potentially unhelpful given the covenant review was undertaken a while ago and therefore the position USS were intending to rely on was known before this part started. However, it is only one factor amongst many assumptions that drive the valuation outcome and hence we are unclear whether the Pensions Regulator intends to provide further specific commentary on those other factors as well as its view on the strength of the covenant.

Given that this University has expressed a view, along with most other USS employers, that the current 18% employer contribution rates is at the limit of what is acceptable and affordable without requiring significant changes to our strategy and diversion of funds from other business critical activity, increasing the level of risk that the employers could be called on to further fund the scheme is not something to be entered into lightly.

A key part of the USS Trustee valuation process is the so-called “Test 1”. This is a rather technical, self-imposed test introduced by the USS Trustee at the 2014 valuation. Test 1 is designed to ensure that the gap between the ongoing funding basis for the scheme, and self-sufficiency, is maintained within some limits – this ensures that reliance on employers doesn’t grow beyond acceptable levels.

The principle that the exposure to USS should not be allowed to extend beyond certain limits, or indeed simply increase gradually over time is one which this University supports.

However due to its complexity Test 1 has been characterised by some as meaning that USS is seeking to move to a self-sufficiency basis. We do not believe this to be the case but the complexity over the interplay between various factors within Test 1 and the actions it drives is not well understood.

There remains significant challenge to lack of clarity surrounding Test 1 and the impact on the valuation and the behaviours it drives. The University urges UUK to seek from USS clarity over the following:

- The actual impact of Test 1 on the deficit position – i.e. if Test 1 were removed (and any other assumptions had a level of prudence to be line with the expectations of the Pensions

1 “Self sufficiency” in this context would be where the USS could afford to pay all pension benefits promised from only its own investments and the investment income return and not rely on any future employer or employee contributions
Regulator) what would the valuation position of the scheme look like? This would help stakeholders see the “price” of using Test 1 to achieve the objectives outlined above.

- What other options are available to the USS Trustee to limit the reliance on employer covenant over time and why are they not used to achieve this?
- The projected cash flow position over the coming 20 year horizon. It is acknowledged that increased membership creates not just increased inward cash flow but also additional liabilities in the scheme, however understanding the expected cash flow position in this time horizon will give an indication of the pressures on the scheme to “cash in” its investments to pay benefits or ability to take a longer term view of its investments.

Whilst these matters may not materially change the outcome of the valuation, given the potential impact on benefits it is important that we are able to fully understand the rationale behind these key assumptions and to demonstrate openness and transparency to our staff on the valuation process. It would be extremely helpful if USS were to release this information and to really engage in the debate about Test 1 and help the broader membership understand why it is in place, what it will drive in terms of future investment strategy and the impact on the scheme of that strategy. To date we do not consider that there has been a fully understandable and justifiable rationale to the adoption of Test 1 and the outcomes it drives.

As such, on the matter of the detail of the assumptions we would wish to go no further at this stage than to reiterate that the University wishes the USS Trustee to apply a reasonable, but not excessive level of prudence to the assumptions bearing in mind that this University supports the principle that the exposure to USS should not be allowed to extend beyond certain limits, or indeed simply increase gradually over time.

Cost/contributions

The University sees the current level of employer contributions of 18% of USS member’s payroll as at the limits of what is affordable and acceptable. Each 1% of employer contributions currently costs c£2m per year for this University.

We acknowledge the view of the USS Trustee following its employer covenant assessment that employers could afford up to 25% contributions over a 20-year horizon in extremis. This view of “affordability” needs to be differentiated from our willingness to pay contributions at such levels and the impact of having to do so. Were such a situation to arise which required those additional 7% of employer contributions (the difference between the 25% in extremis levels and current 18% contributions) there would need to be a considerable and strategic shift in our operations to accommodate this which would severely inhibit our ability to thrive and continue our on-going success.

As such, any outcome from the current valuation which indicates an increase in future costs for the employers is not welcomed and, all other avenues having been explored, would inevitably lead to a discussion around future pension benefit structures in USS.

It is noted that, based on the assumptions proposed (which the scheme actuary has indicated are at the extreme end of the scale of optimism which he can accept in signing off the valuation), the cost of future benefits is placed at 30.5% - considerably above the current total contribution levels of 26% (which includes 2.1% for deficit recovery payments following the 2014 valuation).
Future benefits
In light of the comments above, unless there is a fundamental shift in the USS Trustee’s view on the parameters it can and is prepared to use for this valuation, there will need to be a discussion about the future benefits offered by the scheme.

In looking at a future benefit design, the University would seek to balance the risks inherent in USS and therefore the pressures placed on sponsoring employers with offering an attractive and high value pension scheme to our staff. Clearly there is likely to be tension in this balancing act.

Any change in benefit structure in future is a matter for negotiation between UUK, representing the collective employers and UCU representing the USS members via the Joint Negotiating Committee (JNC) along with an independent Chair.

Key aims of any future benefit structure for this University include:

- Offer value for money for both employers and members
- Be an attractive part of the overall total reward package
- Be fair across the workforce and between generations
- Be affordable for employers and members
- Be sustainable in the long term
- Offer sufficient flexibility to suit a varied and complex membership
- Provide good value “ancillary benefits” including death in service cover, incapacity retirement arrangements etc to support members when at their most vulnerable

Notwithstanding the desire to better understand the application and impact of Test 1 on the valuation outcomes, if the outcome is that benefit changes are required the University would question the merits of maintaining a trivial level of defined benefits within the scheme structure where it does not meet the aims outlined above, notably in terms of value for money. Given the particular economic circumstances in which this valuation is occurring, if it is determined that benefit reform is necessary, there is a strong argument for building in flexibility in any future benefit design to allow them to respond positively if, in future, the economic position allows an amelioration of the funding position.

The University would welcome further discussion on this matter once the valuation position is clearer and/or confirmed by the USS Trustee following the consultation period.

Summary
The University acknowledges the challenges of determining an appropriate means of valuing and managing assets and liabilities within a large complex defined benefit/defined contribution scheme such as USS and the USS Trustee’s role in protecting accrued member benefits.

It is important that the limitations in terms of affordability of the scheme for sector employers is recognised as having reached its limit on an on-going basis.

The University is also not willing to carry a level of risk in the scheme that could expose it to a greater likelihood of increasing costs in future, noting the potential impact on core strategic activity in such eventualities.

To properly understand the extent of the problem that needs to be solved and the level of risk being carried by the employers under the proposals the University requests that the lack of clarity over the application and impact of Test 1 should be seen as a matter of urgency to address by the USS Trustee in the interests of engaging stakeholders openly and transparently in the valuation process. The University would welcome UUK’s support in achieving this on behalf of employers.
Yours sincerely, on behalf of the University of Sheffield.

[Signature]

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