The Policy Institute

Policy lab: How to Improve the Governance and Regulatory Structure of USS pensions.

The purpose of the Evidence Pack

This document has been created by bringing together data and information about the governance and regulation of the Defined Benefit pensions market and the Universities Superannuation Scheme (USS).

It is to be used as a platform for discussion and debate at the Policy Lab.

1. Defined Benefit and Defined Contribution Pensions.
2. What is the Universities Superannuation Scheme (USS)?
3. What is the current position of the USS?
4. UK regulation of Defined Benefit schemes.
5. The structure of USS and the role of governance.

Defined Benefit and Defined Contribution Schemes: the changing pensions landscape

The Pensions Landscape

There are currently two main models of private or workplace pension scheme in the UK. They can be seen as existing on a continuum.

Defined Benefit

Defined Contribution

Increased risk for employers

Increased risk for members

Low flexibility

High degree of flexibility

Low member engagement

High member engagement

As a possible third option, the Government is currently consulting on the introduction of Collective Defined Contribution (CDC) pensions in the UK.

What are Defined Benefit (DB) pensions?

- Defined Benefit (DB) is a type of private workplace pension scheme (into which employees and employers make contributions) which is designed to provide members with an constant income throughout retirement.

- The income that members will receive in retirement is determined in advance as a proportion of working life salary (typically 1/60th or 1/80th per year).

- Contributions are variable because employers and/or employees may need to make increased contributions in order to ensure there is enough money within the scheme to pay the guaranteed benefits.

What are Defined Contribution (DC) pensions?

- Defined Contribution (DC) pension schemes (the other main type of workplace pension scheme in the UK) provide members with a pot of money at retirement rather than an income.

- Savers can access this money flexibly from age 55 by:
  - Withdrawing it fully
  - Withdrawing it gradually
  - Converting it into an annuity which will provide them with an income for life similar to that provided by a DB pension scheme
  - A combination of the above

What are Collective Defined Contribution (CDC) Pensions?

- CDC schemes are similar to DC, but members pool their money into one "collective" fund, rather than having their own individual accounts, meaning that risk is shared by all members of the scheme, rather than shouldered by each saver individually.

- Upon retirement, the scheme pays out a pension, but the crucial difference between this and normal DB and DC schemes is that a CDC scheme offers a "target" income rather than a hard promise of a specific sum for life. That sum can fall depending on investment performance.

Defined Benefit and Defined Contribution Pensions – comparison.

	Defined Benefit	Defined Contribution
Contributions	Contributions may be adjusted to meet guaranteed benefit levels	Contributions are fixed
Withdrawals	The size of the final pension pot is predetermined	The size of the pot will vary depending on contributions and investment performance during accrual
Flexibility	Few options for flexibility in either accumulation or decumulation	Members can choose different investment strategies and options in withdrawal
Risk	Risk resides with the sponsor, which must meet the guaranteed benefits	Risk resides with the member to ensure they have enough money in retirement

How are DB benefits calculated?

Defined benefit pension income is calculated based on:

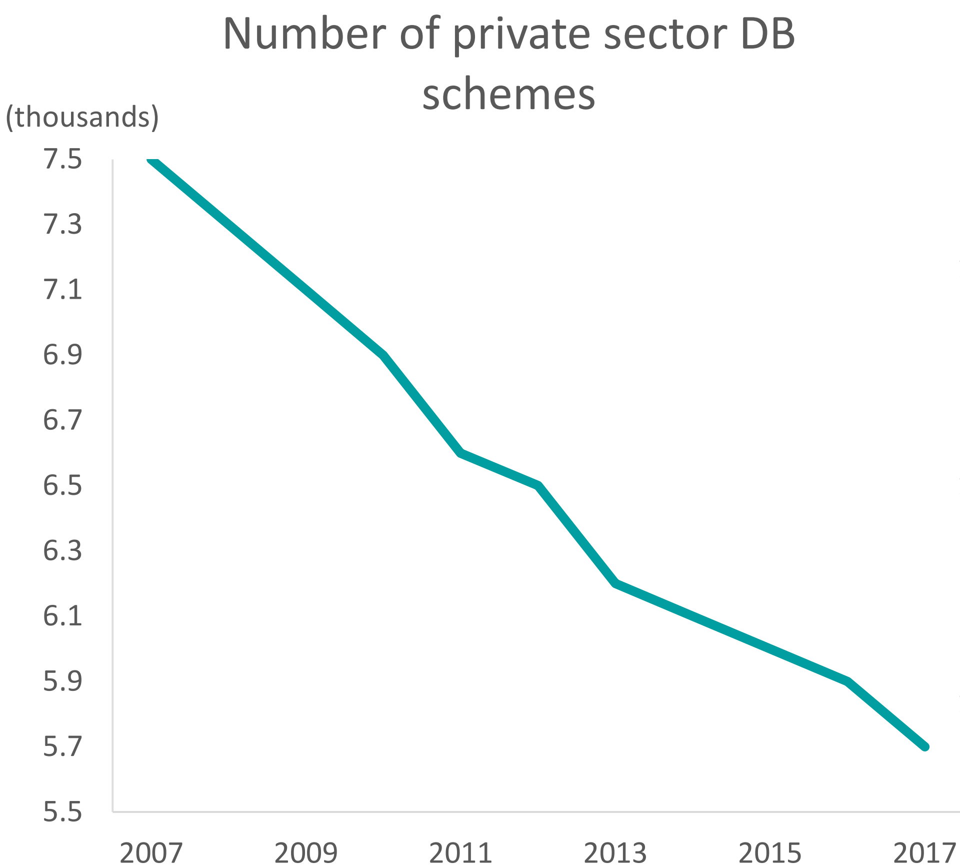
- Pensionable service: the number of years an individual has been contributing to the scheme
- Pensionable earnings: this could either be ‘final salary’ (salary at retirement) or ‘career average’ (salary averaged over career)
- Accrual rate: the proportion of salary an individual will get for each year in the scheme (often 1/60th or 1/80th)
- As an example, someone who has been an active member who makes contributions to a final salary DB scheme with a 1/60th accrual rate for 15 years and has a final salary of £30,000 would receive an income of £7,500 each year for the rest of their life (£30,000 x (15/60)

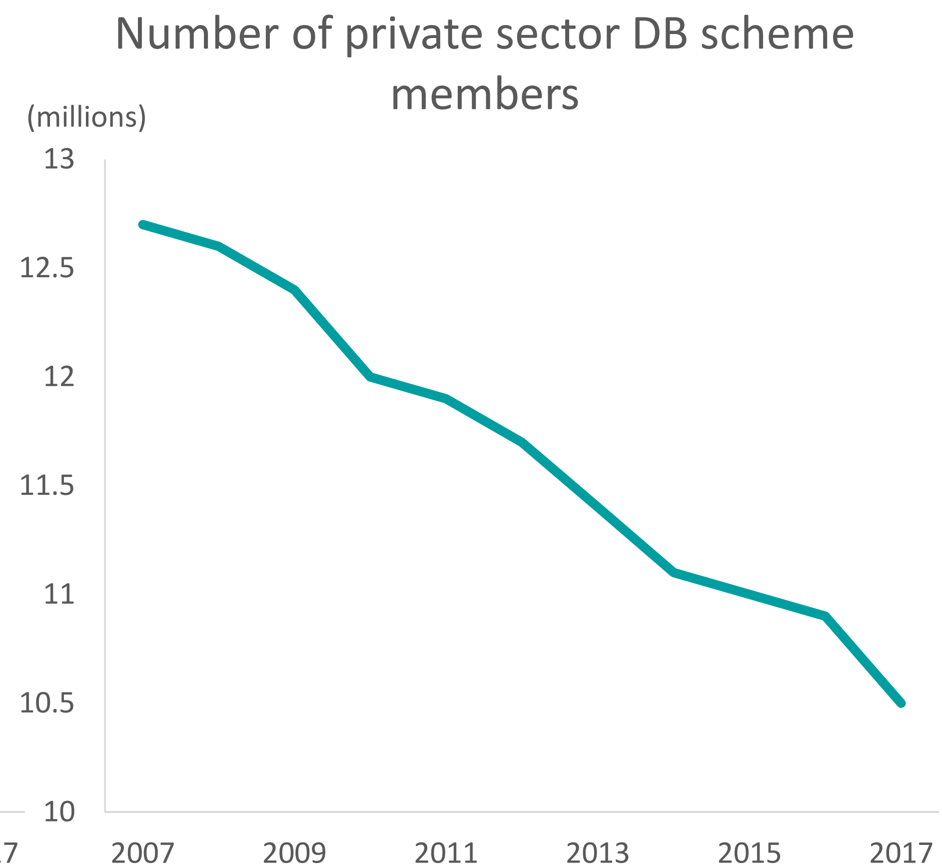
It is the sponsoring employer’s responsibility to ensure that the scheme is able to pay these pensions, irrespective of contributions made by scheme members and the quality of investment returns.

Defined Benefit schemes have been in decline for some time

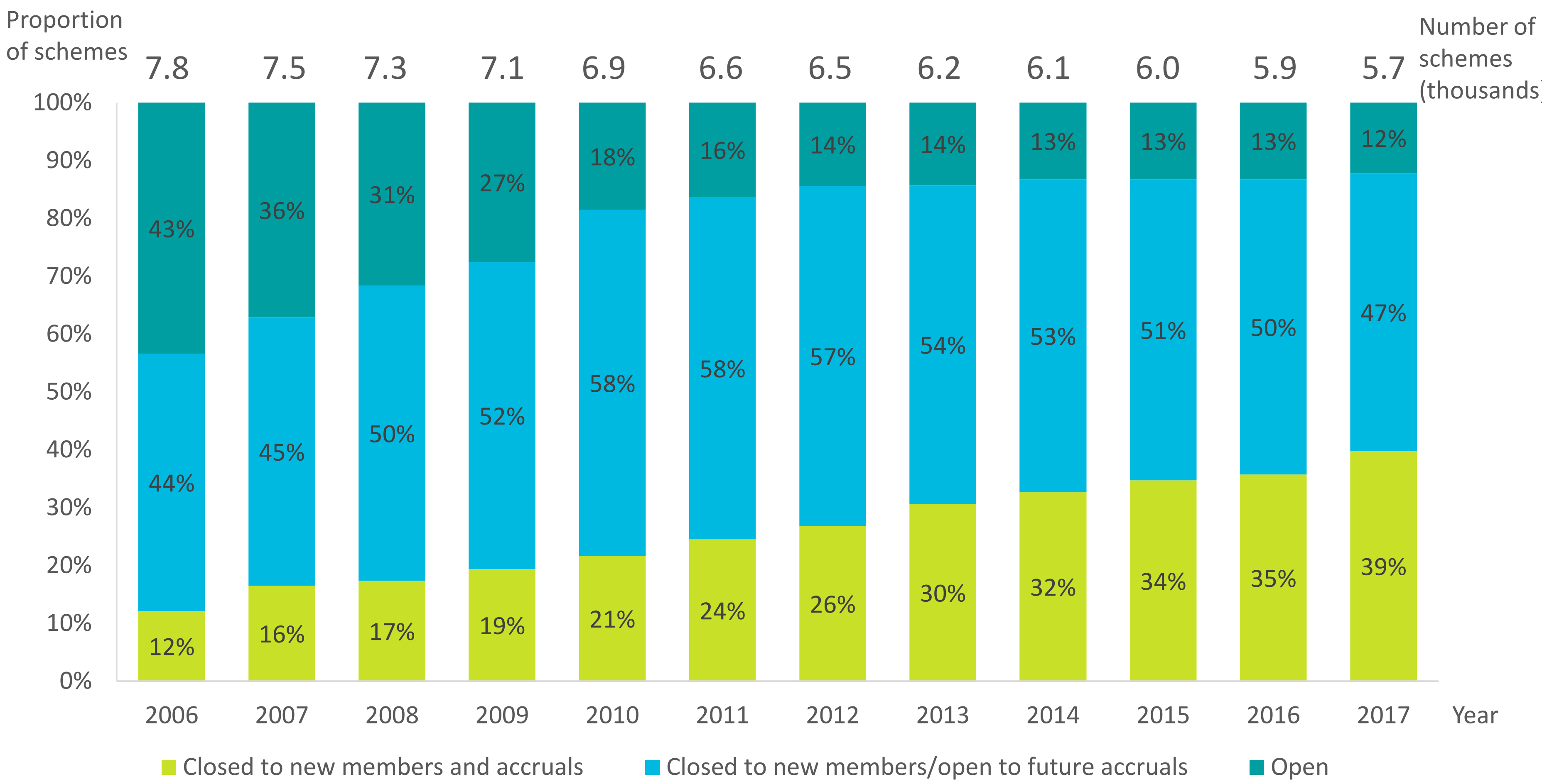
- Membership in private sector DB schemes peaked in 1967, with around 8 million active members.
- From the early 1970s onwards the number of active members and the proportion of the workforce in DB schemes has been falling.
- By 1991, active membership in private sector DB schemes had declined to 5.6 million.
- This decline has continued steadily since then, and there are now less than 1.3 million active members in private sector DB.
- The number of private sector DB schemes has also shrunk.
- Many small and some larger schemes have been wound up, and around 940 schemes have been transferred to the Pension Protection Fund (PPF).
- Fewer than 6,000 DB schemes remain in the private sector (5,671).

Both the number of schemes and the number of members in private sector DB have declined steadily

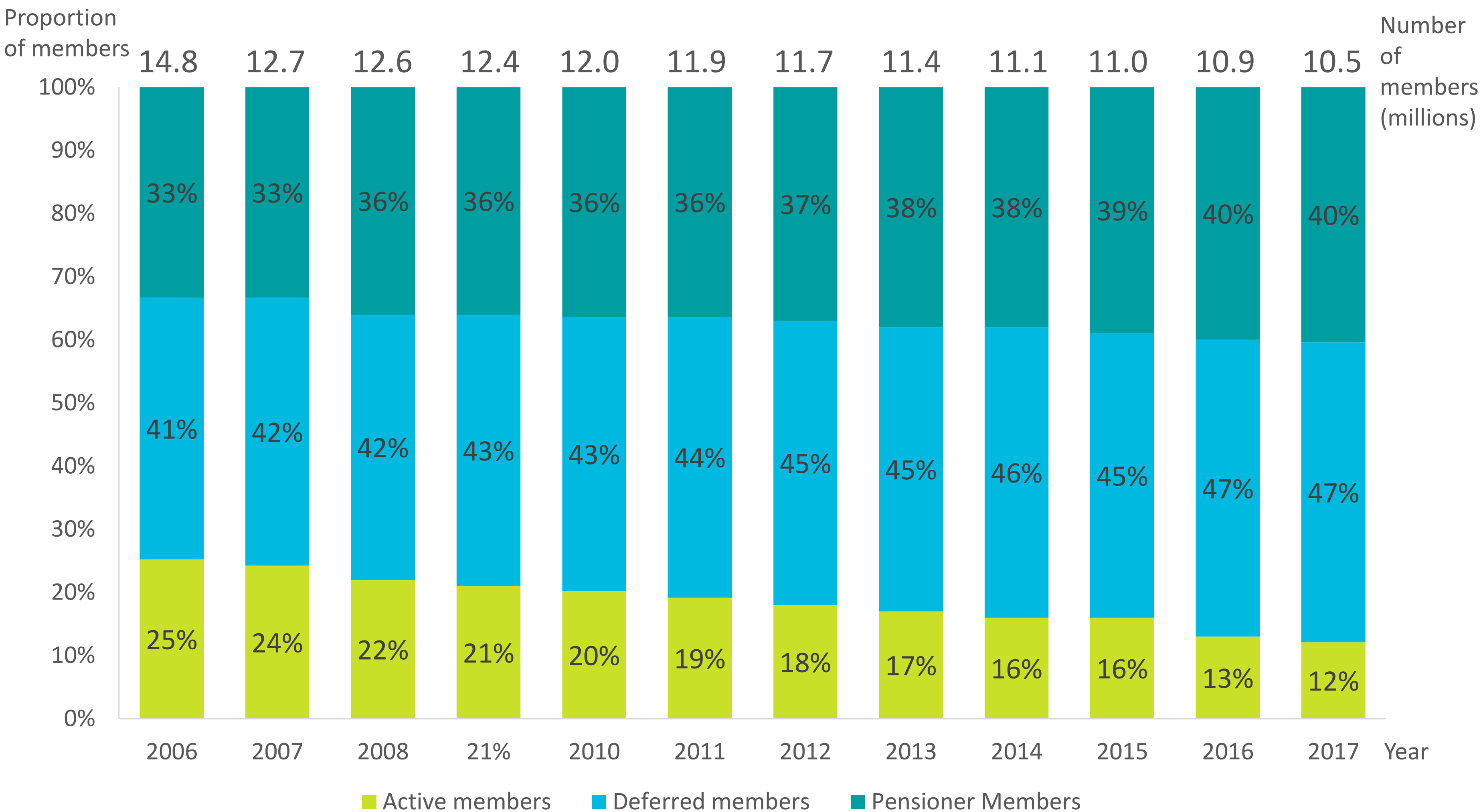




Less than 12% of private sector DB schemes remain open to both future accruals and new members; source PPF Purple Book 2017



The number of active members in private sector DB schemes has declined relative to the number of deferred and pensioner members



Several factors have increased the cost of DB provision

The main factors are:

- Economic change
- The decline and volatility in asset growth
- Quantitative easing
- Increasing longevity
- Increases in retirement age
- The provision of benefits became non-discretionary
- Dividend tax credits and contracting out were abolished
- Regulatory requirements placed further pressure on DB schemes

Factors that have increased the cost of DB provision - I

- Economic change: Changes in the UK and global economy during the second half of the 20th century and into the 21st have contributed significantly to the decline of DB pensions. Structural change in the nature of UK industry and employers, as well as changes in patterns of employment, have affected provision and membership. The low investment returns and sustained low gilt yields experienced more recently have compounded the problems facing schemes.
- Decline and volatility in asset growth: Investment markets are volatile by nature and this can have significant impacts on the investment returns of DB schemes, and, as a result, the level of contributions required to provide promised benefits. Until the latter half of the 1990s, high rates of stock market return made DB provision more affordable. Between 1974 and 2000, the average real return on UK equities was 13%, compared with an average of about 5.5% for the whole of the 20th century. The decline since the turn of the century has hit some DB schemes hard.

Factors that have increased the cost of DB provision - II

- Quantitative easing: In more recent years, scheme funding has also been affected by sustained low interest rates and quantitative easing (QE). QE can lead to increases in a scheme's assets as the value of any gilts it holds goes up, but this increase is relatively small compared with the decrease in discount rates used for calculating pension scheme liabilities that results from QE. Estimates suggest that for every £1 increase in assets resulting from falling gilt yields, there is a £5 increase in liabilities. A 0.25% fall in gilt yields could increase DB scheme deficits by as much as £45 billion. The first round of QE, in 2009-10, increased pension deficits by an estimated £74 billion, even after adding the corresponding investment gains.

Factors that have increased the cost of DB provision - III

- **Increasing longevity:** In 1981, the average male life expectancy at age 65 was estimated to be 14 years. This has since increased to almost 22 years. Women's life expectancy at age 65 increased from 18 to 22 and a half years over the same period. While the amount that will be paid to pensioner members per annum remains the same, the effect of increased longevity means that most people will receive payments for longer. This means that the value of benefits provided by a DB scheme are generally much higher than previously anticipated. A one year rise in longevity is estimated to result in a 4.5% increase on the liabilities of a DB scheme.

- **Increases in retirement age**, both in state and private pensions, which were introduced largely as a means to reduce the impact of increased longevity, have not mitigated increased life expectancy and the amount of time spent in retirement, although they have somewhat mitigated the speed at which this has been increasing.

Provision of benefits became non-discretionary:

- During the peak of DB provision, employees' entitlement to promised benefits was discretionary, meaning that, depending on its rules, a scheme could be wound-up without the sponsor necessarily having to secure all member benefits with an insurer, even if the sponsor was solvent.
- It is now mandatory that benefits are delivered so long as the sponsor is solvent, including increases in line with mandatory inflation measures introduced in the 1990s.
- It is also mandatory that 'early leavers' (scheme members with more than three months of contributions, but less than two years) have benefits they have accrued within the scheme preserved, which was also previously at the discretion of scheme specific rules.

Factors that have increased the cost of DB provision - V

Dividend tax credits and contracting out were abolished:

- Prior to 1997, dividend payments received tax relief in order to offset the corporation tax already paid by companies on their profits. However, as pension funds were tax-exempt, they received a tax-credit of 20% on dividends in place of tax relief. It was estimated that schemes would have to increase contributions by around 30% in order to offset the abolition of dividend tax credits.
- With the introduction of the new State Pension in 2016, contracting out for DB scheme members came to an end. With the abolition of the State Second Pension (S2P) in favour of the single-tier new State Pension, contracting out is no longer an option. When this change occurred, schemes had to ensure that the guaranteed minimum amount that pension schemes had to provide to members in exchange for paying reduced levels of national insurance contributions held within the fund matched up with the amount HMRC expected to be held. For many schemes, this exercise led to an increase in funding costs.

Factors that have increased the cost of DB provision - VI

Regulatory requirements around funding and reporting put further pressure on DB schemes:

- The Finance Act 1986 introduced restrictions on surplus levels. The maximum acceptable funding level was set at 105% of present liabilities. This was introduced to prevent companies from using pension funds to hold profits tax-free until they could take advantage of lower levels of corporation tax. The main result was that employers reduced and sometimes stopped paying contributions in an effort to reduce surpluses during times of high funding.
- The introduction of FRS17 in 2002 established tighter restrictions on accounting standards and transparency in pension funds. Surpluses and deficits in pension schemes must be reported on sponsoring employers' balance sheets. This fundamentally changed the way that pension liabilities are viewed, making them more transparent to shareholders, as well as shortening the investment horizon for DB schemes in cases where trustees agree to invest in such a way that would help sponsors to meet their broader accounting objective.

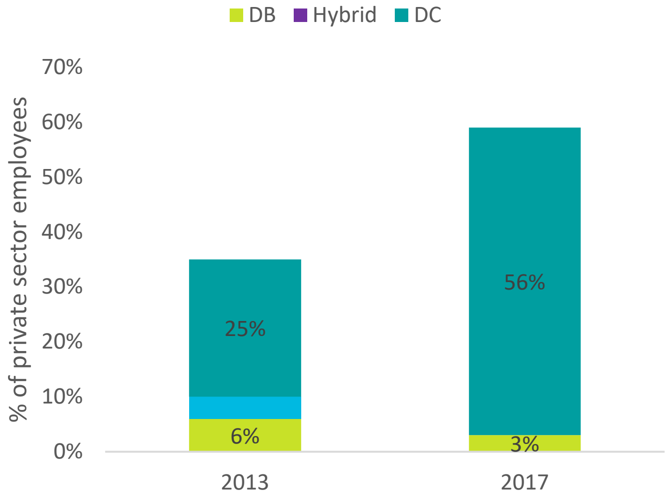
The increasing cost of DB provision presents challenges for employers, trustees and members

- The rising cost of provision and uncertainty about benefits are the central concern for sponsors and members respectively. However, wider concerns include the impact of growing deficits on other stakeholders.
- Employers are faced with balancing the needs and interests of many, often competing, stakeholders**.** The financial needs of the DB scheme must be balanced against the needs of current employees, investment in the business, and shareholder dividends. While it is important that the sponsor upholds its commitment to DB scheme members, it must also ensure the continued success of the company.
- tPR's Code of Practice on funding states that a 'strong, ongoing employer alongside an appropriate funding plan is the best support for a well-governed scheme.'
- Funding of a DB scheme should not threaten the ongoing survival of the sponsoring company, making it insolvent or unprofitable, nor should it lead to poor compensation for current employees, most of whom are unlikely to be members of the DB scheme.

Meanwhile, Defined Contribution (DC) schemes are growing

- As DB pension schemes have fallen, and in many cases been closed to new members, so DC schemes have risen. This is due largely to the introduction of Auto Enrolment of people into workplace pensions.
- As DC contribution rates are fixed, but the benefits undefined, there is a transfer of risk from the employer (who would have to meet the cost of DB payments in perpetuity) to the employee (whose retirement pot is subject to the fluctuations of investment, inflation and longevity).
- There are currently around 33,500 DC schemes operating in the UK,.
- In 2012, there were 1 million active members in workplace DC schemes. By 2017, this had grown to 7.7 million.

Active members as a % of all private sector employees



Source: Employers' Pension Provision Survey 2017, DWP, June 2018

Both DB and DC offer advantages and disadvantages

Type of scheme	Defined Benefit	Defined Contribution
Pros	Provides members with a high level of certainty of the income they will receive throughout their retirement	Sponsors know how much they will need to pay into the scheme as the contribution rate is fixed
		Members can use pension freedoms to access their savings flexibly at and during retirement (although people who have been members of DB schemes throughout working life are able to transfer out in exchange for a lump sum in order to access these freedoms)
	Provides the member with an income for life so there is no risk of running out of money based during retirement	Members with DC savings are able to leave bequests with their remaining pension savings
		More portable and therefore may suit some people more in the evolving employment landscape in which most people will have a number of jobs over the course of their working life
Cons	Less certainty for scheme sponsors as to how much will need to be paid into the scheme in order to be able to provide this income	Does not provide certainty about how much money members will have to fund their retirement
	Members cannot leave bequests, although schemes generally provide benefits for surviving dependents	It is the responsibility of members to decide what to do with their savings when they reach retirement, and this exposes them to several risks, the most significant being the risk of running out of money during retirement
	There is a risk that members will receive a reduced income if the sponsoring employer becomes insolvent	

DB schemes are increasingly looking for ways of reducing their deficit and the uncertainty surrounding it

- Deficit repair contributions: As part of a recovery plan agreed with trustees, sponsors may make additional contributions to the scheme in order to reduce deficits.
- Improved investment returns: Schemes may try to invest their way out of difficulty. The erosion of the yield on long-dated gilts has increased the value of future pension promises. One option for trustees is to look for better investment returns elsewhere.
- Changing benefit structures: Under current legislation, scheme sponsors have very little scope for modifying benefits which have already been accrued. They can, however, limit future liabilities by modifying the way in which benefits are accrued in future, for example by:
  - moving from final salary to career average,
  - reducing the accrual rate (e.g. from 1/60th per year to 1/80th) or
  - reducing the way that accrued benefits are increased annually.
- Buy-outs and buy-ins: Scheme sponsors wishing to reduce the uncertainty of liabilities and deficits and trustees wishing to secure member benefits, may opt to transfer the payment of the pension benefits to an insurance company. In a similar way, schemes can insure the payments of some or all of their members through a buy-in where the trustees purchase an annuity.

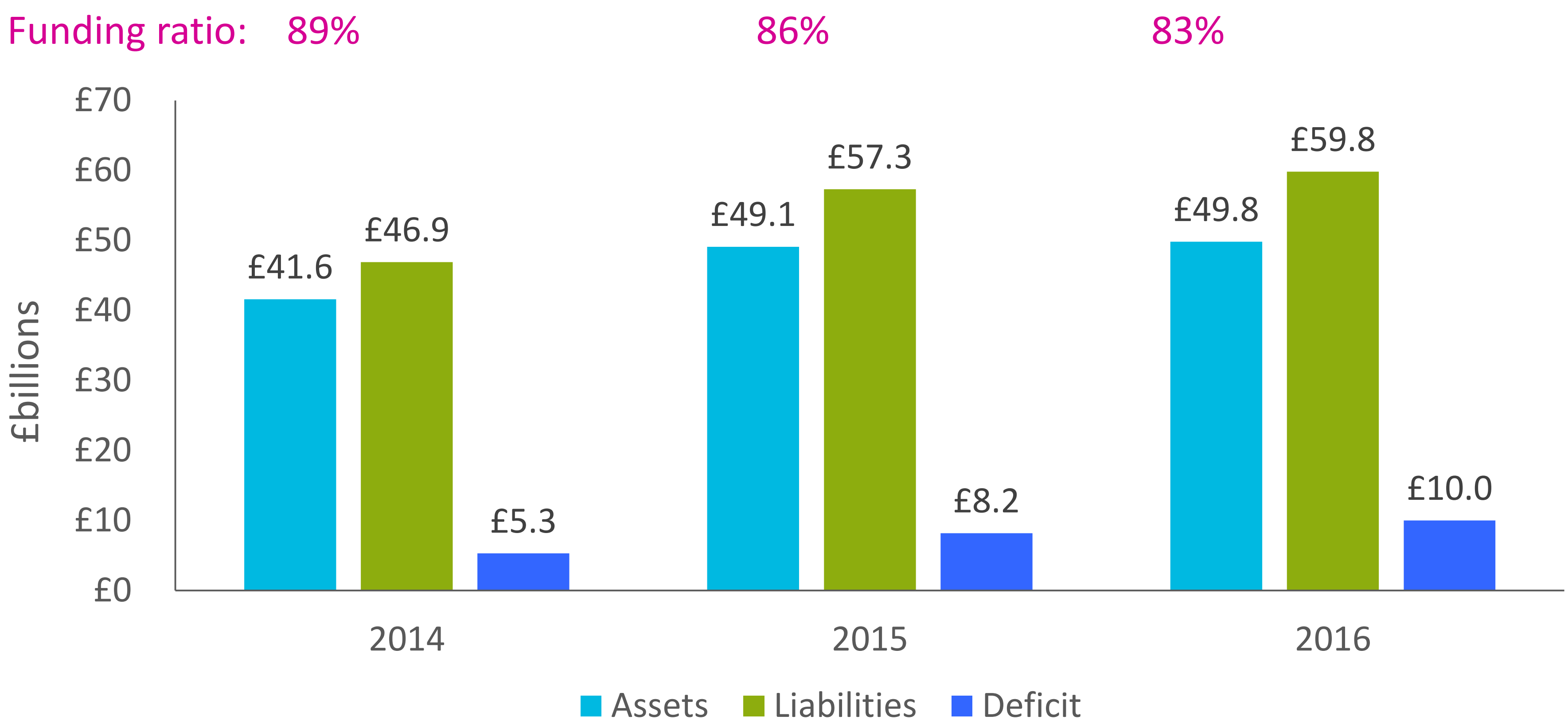
None of these options are simple or without significant cost.

The Universities Superannuation Scheme

What is the Universities Superannuation Scheme (USS)?

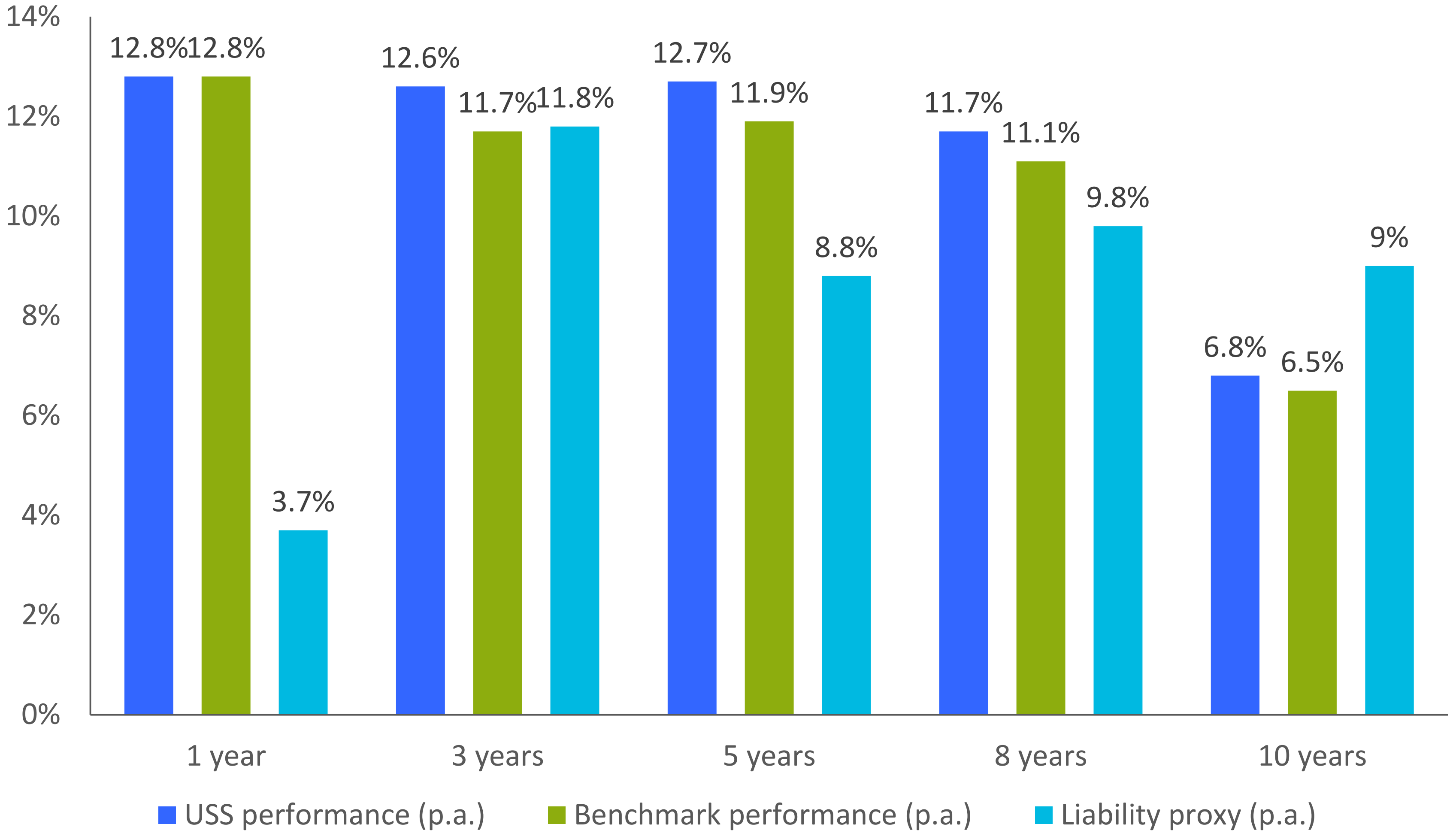
- Universities Superannuation Scheme (USS) was established in 1975 to provide pension provision for academics and other senior employees working in higher education and related sectors.
- The scheme has grown from 13,000 members in 1975, to more than 375,000 today, with the value of assets increasing from just over £10 million to more than £63 billion.
- USS is funded by contributions from both members and employers. These contributions are invested by the Trustee to ensure there is enough money to pay the benefits as they fall due. These contributions are shared with 35% from members and 65% from employers (the USS 35:65 rule).
- The Trustee conducts an actuarial valuation of the scheme at least every three years to determine the level of contributions required to pay the benefits.
- Depending on the outcome of the valuation, there may need to be changes to the level of contributions and/or benefits in order to ensure that the scheme has sufficient assets to meet the promised benefits.

USS funding ratios have declined in recent years
Scheme funding position (As at 31 March each year)

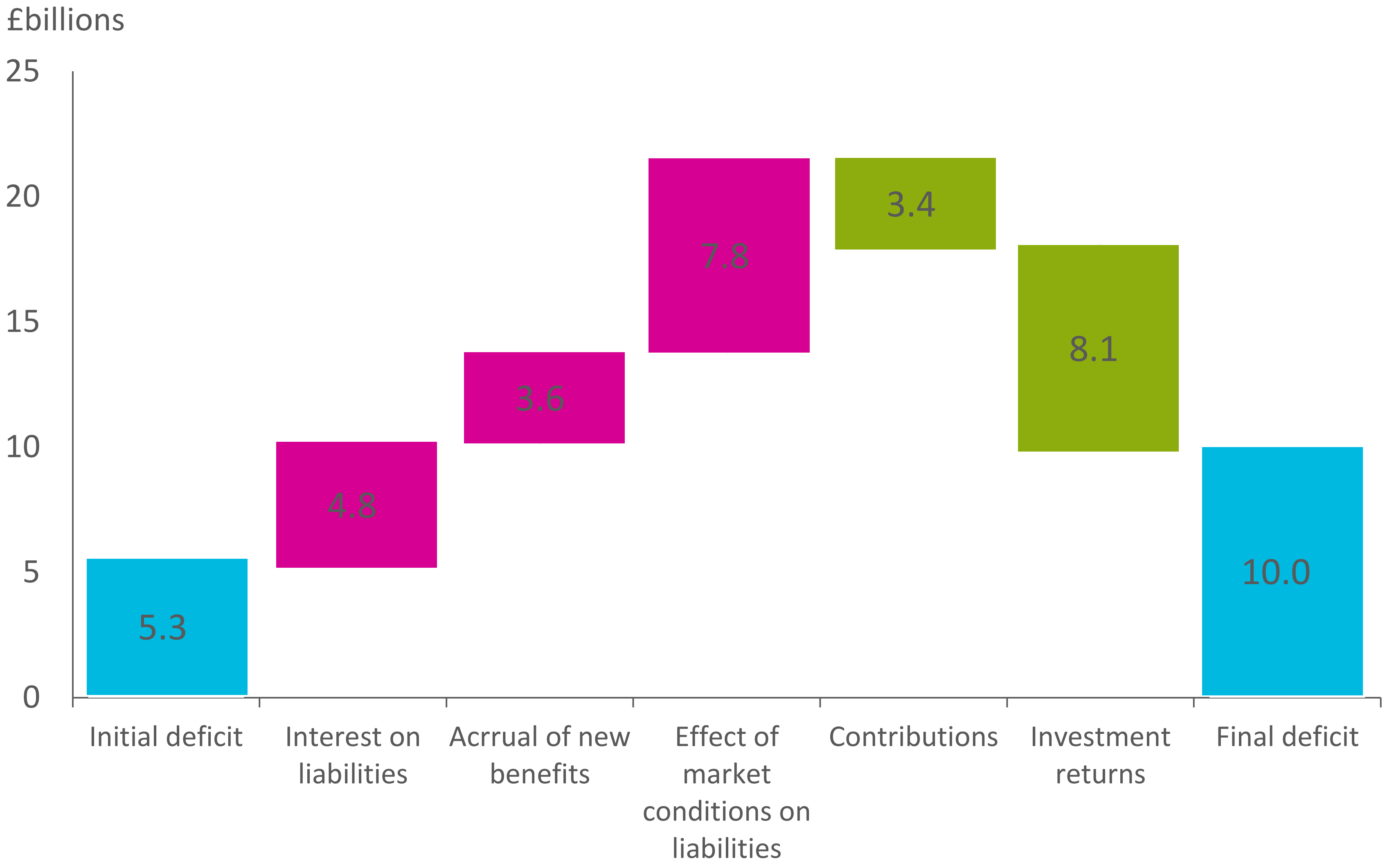


Although the funding ratio is estimated to have increased to 89% in 2017 as the deficit decreased to £7.5bn. Source: USS Members' annual report, 2016.

USS deficits have grown despite reasonable investment performance - USS investment performance compared to benchmark returns and liabilities



There are a number of factors which have driven the increase in deficit for USS between 2014 and 2016



What is the current position of the USS?

USS made significant modifications to the scheme in 2016

From April 2016, the benefits provided by USS changed, as did the contribution levels payable by employers and members.

These changes included:

- Career Revalued Benefits (CRB) for all members on salary up to £55,000 pa, benefits accrued at a different rate to that used previously (the new accrual rate being 1/75th of salary per year as pension income, 3/75th of salary as a lump sum.
- Defined contribution section was introduced for members on salaries above £55,000 pa.
- An option for all members to make additional contributions to the DC section of the scheme 'matched' by the employer contributions (if the member contributes an additional 1% of salary, the employer does likewise).

Since 2016 there have been two sections of the scheme

- The USS Retirement Income Builder: This is the Defined Benefit element of the scheme. It guarantees a certain level of retirement income. The trustee achieves this by investing the contributions employee and employer pay in a range of different types of assets. The money made from those investments contributes to the fund used to pay pension.

- The USS Investment Builder: This is the Defined Contribution element of the scheme. It provides a different way to save for retirement. Both employee and employer pay into the scheme and that money is invested into a range of funds which the employee can choose from. The USS Investment Builder benefits from the economies of scale available as a result of being part of the trust, meaning that all but one of the USS Investment Builder funds is provided at no cost to members.

- Members can be part of both elements simultaneously.

Original proposed changes January 2018

USS announced that from April 2019 (at the earliest):

- The salary threshold (the salary up to which defined benefits currently build up) would be reduced to zero from £55,000 pa., effectively closing the scheme.
- All future benefits, until further review, would be built up in the USS Investment Builder (the DC part of the scheme), except death in service and ill health retirement benefits which would remain based on full salary.
- The employer contribution would remain at 18% of salary, with 13.25% of their overall contribution going into members’ USS Investment Builder funds.
- Members would continue to contribute 8% of pay, but would have access to a lower cost option of contributing 4% while still receiving the full employer contribution into the USS Investment Builder.
- The ‘match’ – the additional 1% employer contribution currently available when members contribute an additional 1% to the USS Investment Builder [illegible] discontinued.

Additional proposed changes May 2018

In May 2018 USS announced a cost sharing update. This will mean an increase in contributions for everyone that pays into USS (both employee and employer).

The proposed changes included:

- Current defined benefits to remain the same, but contributions to increase
- Member contributions to increase from 8% to 8.8% of salary from 1 April 2019
- Further increases to member contributions to be phased in at 1 October 2019 (10.4%) and 1 April 2020 (11.7%)
- Employer contributions to increase to 19.5% of salary from 1 April 2019, then to 22.5% from 1 October 2019 and 24.9% from 1 April 2020
- 8% of member contributions from salary above the defined benefit threshold (2018/19: £57,216.50) to continue to be saved in the USS Investment Builder, with the excess of these member contributions supporting defined benefits in the USS Retirement Income Builder
- rs’ contributions to the USS Investment Builder on salary above shold to remain at 12%

Additional factors

*"Current USS contributions of 26% of payroll amount to around £2.1bn a year, so an increase of 11.4% of payroll represents around £900m. The longer such a sizeable deficit is left unaddressed, the greater the potential funding challenge could be for employers and members in the future."**

- USS is required by law to demonstrate every three years that the scheme is sustainable – that its contributions, investments and benefits are in balance with the financial support its sponsoring employers can provide. It is also required by law to address changes in the scheme's funding position.

* Source:ht co.uk/how-uss-is-run/valuation/cost-sharing-update-proposed-changes-to-contribution-rates/the-background

The Joint Expert Panel (JEP)

- The Joint Expert Panel (JEP) was established as part of an agreement between UCU and UUK in March 2018, bringing an end to industrial action that started as a result of the proposed changes to USS.

- The JEP was tasked with agreeing the key principles to underpin the future approach to the scheme's valuation. It reported in September 2018.

- Because the Trustee must demonstrate to the Pensions Regulator that the scheme is sustainable and has sufficient funds to pay the pensions promised or a credible plan to recover any shortfall, increases to contributions under the 35:65 cost sharing rule were used to complete the 2017 and 2018 valuations at the same time as the JEP consultation.

- Following the JEP's recommendations in September 2018, USS has agreed to revisit the scheme's valuation for the purposes of the 2019 valuation.

- The JEP's work on USS remains ongoing.

The Regulatory Framework for DB pensions and the USS

Pensions Regulation in the UK – an overview
There are two regulatory bodies for UK pensions; this is how they differ

The Pensions Regulator (tPR)	Financial Conduct Authority (FCA)
Reactive policing of DB pensions during accrual stage. Regulation of Master Trusts.	Proactive regulation of financial products accessed by pension holders post-accrual.
Responds to triennial scheme reviews.	Active in seeking evidence through ongoing supervision.
Promotes good administration and governance through guidance and advice.	Authorises financial services and their ability to meet statutory regulation.
Protects members by stopping pension schemes from falling into the Pensions Protection Fund.	Protects members by direct intervention in financial markets.

The Pensions Regulator

The Pensions Regulator (tPR) was set up following the Pensions Act (2004) to provide clearer and more robust regulation and investigation of the pensions industry. It succeeded the Occupational Pensions Board. Its statutory duties are;

- To protect members' benefits.
- To reduce the risk of calls on the Pensions Protection Fund (PPF).
- To promote, and to improve understanding of, the good administration of work-based pension schemes.
- To maximise employer compliance with automatic enrolment duties.
- To minimise any adverse impact on the sustainable growth of an employer.

The Pensions Regulator – strategy and policy

- TPR adopts a risk-avoidance strategy for regulation, specifically seeking to ensure that schemes are not in a position whereby they are referred to the PPF. Currently, tPR;
  - Educates and enables – The main focus of its work is on sharing and promoting best practice in governance and management of work-based pensions.
  - Investigates – All schemes must complete a triennial review providing oversight of membership, funding and investment. TPR also expects to receive reports in specific circumstances, such as an apparent funding shortfall. Upon receipt of reports, tPR will carry out comprehensive risk assessments and engage where appropriate with individual schemes.
  - Rectifies – tPR can issue notices mandating specific action. These include taking action to recover unpaid employer contributions, prohibiting trustees, issuing fines and initiating criminal proceedings.
  - Acts against avoidance – tPR can issue mandatory contribution notices, financial support directives and restoration orders to ensure that pension schemes do not fail.

A stronger regulator

TPR's own annual perceptions reports show that while it is seen as being 'respected', 'fair' and 'clear', fewer people see it as 'decisive' 'efficient' or 'tough' However, following an internal review in 2017, the Regulator has introduced Key Performamce Indicators (KPIs) that encourage more proactive engagement and greater use of powers. Additionally, in March 2018, the Government published a White Paper outlining proposals to strengthen tPR including:

- The ability to issue punitive fines.
- The creation of a criminal offence for wilful and grossly reckless behaviour in relation to a pension scheme.
- Improving anti-avoidance powers.
- Using civil sanctions as an alternative to criminal in the form of fixed and escalating penalties.
- Increased powers of inspection and investigation.

The Pensions Protection Fund

- The government established the Pension Protection Fund (PPF) in 2005 to provide benefits in the event that a pension scheme's sponsoring employer or employers become insolvent without there being sufficient funds available in the scheme.
- Schemes such as USS are identified by the PPF as multi-employer schemes with a joint, or shared liability.
- This joint liability is based on the 'last man standing' concept, which means that they would only become eligible to enter the PPF in the extremely unlikely event that the vast majority (if not all) of the scheme's employers were to become insolvent. This would mean that all of the 350 employers covered by the USS would need to face insolvency.
- If such circumstances were to occur, the PPF would take over the payment of pension benefits to members, but the benefits received might be less than the full benefits earned under a scheme. The precise amount that the PPF would pay to each member would depend on the member's age, the period over which the benefits were earned and the total value of benefits.

The Financial Conduct Authority

- The Financial Conduct Authority (FCA) is responsible for regulating the areas of the pensions industry where people access their pensions and retirement income directly, rather than through an employer.
- The FCA, having oversight of the wider financial sector, also has the responsibility of regulating financial advisors and asset managers who may be working with occupational pension schemes.
- With the move from DB to DC, the FCA will have a greater role to play in providing regulation that impacts directly on people with occupational pensions, especially when people decide to take advantage of the greater flexibility they have to purchase financial products in retirement. To this end, tPR and FCA published a joint regulation strategy in October 2018.
- The FCA has generally been more proactive than tPR, with a default response of opening an official investigation into any identified potential or alleged wrongdoing.

Regulation and risk-aversion

- As well as providing regulation, tPR's strategic aims are also viewed as having an effect on the wider pensions landscape.

- Some commentators believe that while the institution of tPR has increased the security of pensions in the UK through its risk-avoidance approach, it has also had the effect of sponsoring a culture of minimal risk, distorting the pensions industry, leading to Trustees and sponsors seeking a more cautious approach to investment and valuation in order to comply with the regulations.

"In essence, regulators are requiring the USS to behave as if the fund could be closed down at any moment while still meeting its obligations with as much certainty as possible. To do that is inordinately expensive. And the irony is that the realisation of the cost of behaving in this way has inevitably led the trustees to propose closing the Defined Benefit scheme altogether. Regulation to protect pensioners in the event of a Defined Benefit scheme closure has resulted in the closure of virtually all such schemes."

Mervyn King & John Kay, THE, 6 September 2018

tPR and USS

- In the USS case, tPR intervened early in the triennial valuation process, with resulting advantages and disadvantages, according to the Joint Expert Panel report.

"On the one hand the TPR's early involvement can be seen as providing evidence to the Trustees and stakeholders around the 'envelope' of outcomes acceptable to the Regulator."

"On the other hand, their early intervention can be seen as closing down options for discussion and negotiation, and unduly influencing the outcome of consultations with employers"

"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 cash flow positive status, and the fact that it is a 'last man standing' scheme."

- JEP went on to say that

"…the Regulator's influence has been disproportionate. Some of those giving evidence to the Panel have suggested that the Regulator's views have steered employers' decisions."

Analysis

- The Pensions Regulator is currently taking on more proactive supervisory and investigatory work, and increasing its use of its existing powers.
- It will also likely see a further increase in both its investigatory role and in the type and severity of the sanctions it can impose.
- tPR will be working more closely with the Financial Conduct Authority.
- Early intervention can have unintended consequences regarding valuation and future planning.

The structure of USS and the role of governance

Governance and Defined Benefit Schemes I

- Good governance in DB schemes is vital to their success, and according to tPR, should result in;

  - Better assessment of risks and risk management strategies.
  - Better value operational and investment costs.
  - Better data on members and liabilities.
  - Lower deficits and recovery times.
  - More security for members and full payment of accrued benefits.

- Evidence from tPR suggests that larger schemes, such as USS, are much more able to deliver good governance and are more likely to be able to draw upon a larger pool of experience and expertise.



Governance and Defined Benefit Schemes II

- The Pensions Regulator also suggests what good governance looks like. It should be characterised by;

  - Diverse membership.
  - Regular and effectively chaired meetings.
  - Evaluation of competence and performance.
  - High standards of investment knowledge and regular training and development opportunities for individual trustees.
  - Strong engagement with the scheme sponsor.
  - Structured risk assessment policies and processes.
  - Regular monitoring and reviews of agents (such as administrators, consultants, investment managers).

Governance and value for money

- PPI has identified three areas of value for money outcomes in DC schemes that are likely to be seen as positive for members of DB schemes.

  1. The value of the pension pot.
  2. The security of the pension pot.
  3. Trust in the pension scheme.

- While charges, contribution levels and investments have an impact in monetary terms, governance, administration and communication are vital in sustaining members' trust and ensuring positive outcomes.

The role of governance in driving better value for money

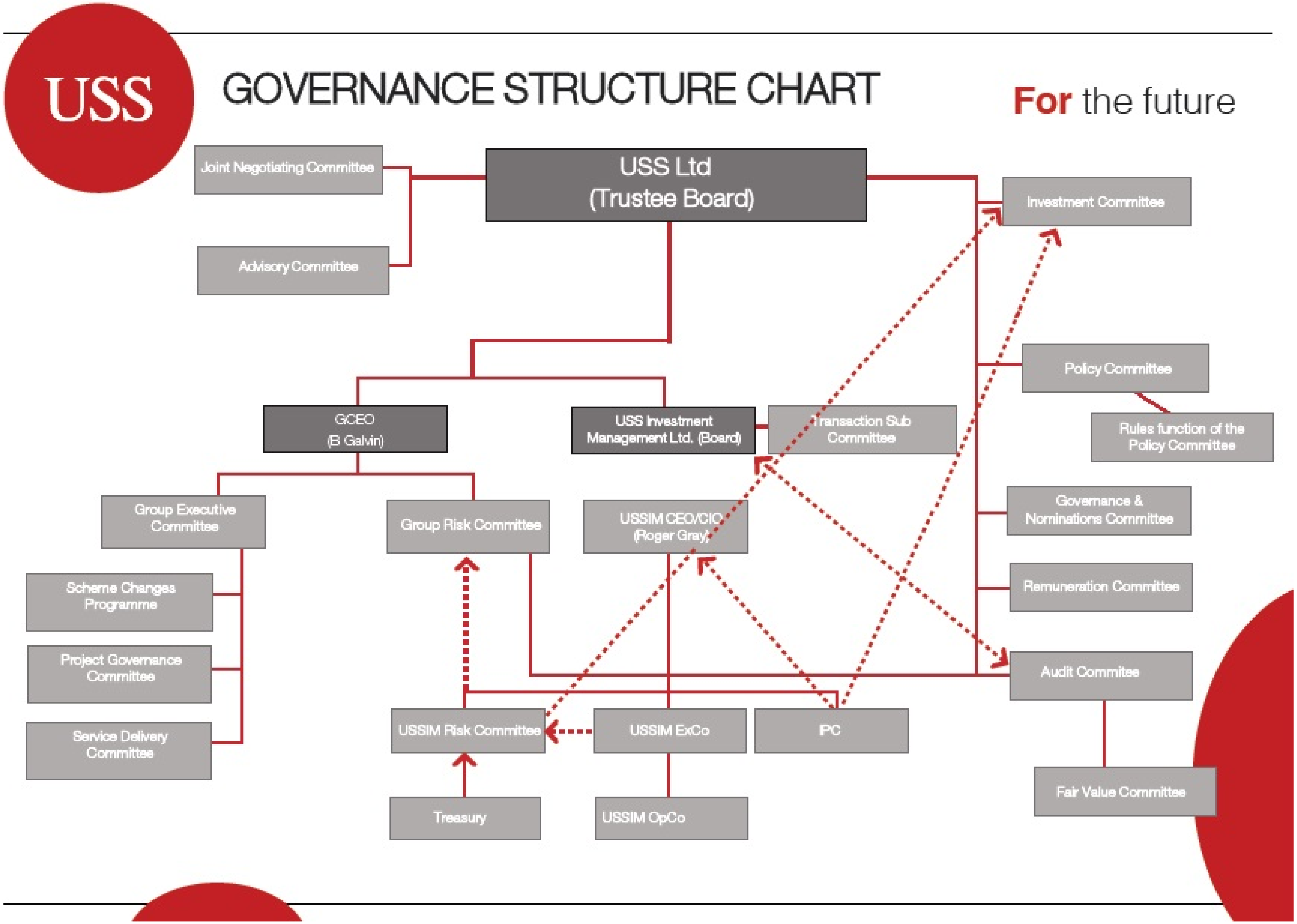
In order to ensure value for money for members and sponsors alike, good governance should;

- Communicate effectively about contribution rates and charges.
- Ensure clear, effective and transparent administration.
- Set a clear default investment strategy, monitorit, and take action to change it if necessary.
- Ensure communication with members is timely and appropriate, serving to increase member engagement and understanding and drive good member decision-making.
- Drive up active participation and increase contribution levels.

The USS - complex and multi-layered

- The sheer size of the USS means that it has a complex structure.
- USS itself is a separate entity from the Higher Education sector, and is a privately-run not-for-profit trust.
- As such, many of the investment and advisory functions that smaller schemes will outsource to external agents are handled by the wholly-owned subsidiary company USS Investment Management Ltd (USSIM).
- The day-to-day running of USS is handled by an Executive Committee, led by a Group Chief Executive Officer, appointed by the Trustee Board. This exists to implement the Board's strategy and deliver its business plan through the management of the scheme and trustee company.
- Annual running costs for USS total £124.9M, with £61M going to staff costs.

USS Governance structure (taken from USS website)



Trustee Board

- The Trustee Board (USS Ltd) is responsible for strategic decision-making, and overseeing and supporting the work of the Executive Committee and ensuring that promised benefits are paid in accordance with relevant rules and regulations.
- It consists of between 10 and 12 non-executive members (currently 12). These are;
  - Four directors appointed by Universities UK.
  - Three directors appointed by the University and College Union (UCU).
  - Between three and five independent directors, all of whom have significant experience in the pensions and asset management sectors.
- Key responsibilities are to ensure that;
  - The scheme is adequately funded.
  - The investment strategy adopted by the trustee company is appropriate.
  - Scheme management, administration and investments are delivered appropriately and at a cost that represents value for money.
- In order to ensure that the Trustee meets its obligation to good governance, there are various subcommittees that report throughout the year.

Subcommittees

- Advisory Committee: Advises the Board on the exercise of powers and discretions, on technical aspects of applying rules and acts on complaints received.
- Audit Committee: Evaluates and reports on financial reporting, control and governance in respect of the requirements of relevant regulatory systems.
- Governance and Nominations Committee: Oversees implementation of policy and practice regarding governance arrangements, board and committee effectiveness.
- Investment Committee: Advises Board on strategic and regulatory investment matters and oversees investment of assets.
- Policy Committee: Advises the Board on strategy and policy, reviewing scheme rules and providing advice on amendments to these rules.
- Remuneration Committee: Ensures that remuneration policy complies with regulatory requirements, and is fit for purpose regarding recruitment and retention.
- In addition, USSIM also has a number of internal committees to ensure its own integrity.

Joint Negotiating Committee

- Joint Negotiating Committee (JNC) is a unique feature of USS and was introduced at a time of greater trades union influence to give equal input into scheme rules for representatives of both the employer (UUK) and employee (UCU).
- JNC consists of 10 members, five from each body. It has an independent Chair who has a casting vote in the event of a negotiated agreement not being reached.
- The JNC approves amendments to scheme rules proposed by the Board, and can initiate and consider alterations proposed by other committees.
- The JNC is also responsible for deciding how contribution increases will be borne and / or what benefit changes should apply where changes to the cost sharing provisions have been invoked.
- In recent JNC discussions over the future of USS, JNC was split evenly on the proposals. Although the Chair used his casting vote powers, neither UUK nor UCU were happy with the USS proposals, so no agreement was possible.

Comparison – The Teachers' Pension Scheme

As a current DB scheme of similar size, the Teachers' Pensions Scheme (TPS) is examined for governance comparison purposes only. As it is a public sector scheme which is underwritten by the Government, it does not represent a viable alternative scheme to that of the USS.

- The TPS is the scheme generally recognised by post-1992 universities, and is the second largest public sector scheme in the UK, with almost 2 million members and nearly 9000 employers.
- It remains as a DB scheme, though in 2015 it changed from being a final salary scheme to a career average scheme.
- It is administered by Capita on behalf of the Department of Education in a contract worth £10.76M per annum.
- In September 2018, it was announced that employer contributions would increase from 16.4% to 23.6% following a valuation of public sector schemes by the Treasury.

The Teachers' Pension Scheme – governance I

- The TPS also has a very complex structure, due in part to the outsourcing of administration.
- TPS is run by the Department of Education, ultimate responsibility lies with the Secretary of State acting under advice from the Departmental Board, scheme manager (DfE Principal Accounting Officer) and the Teachers' Pension Scheme Pensions Board (TPSPB).
- Strategic and Service Delivery Boards comprise DfE and Capita members, and oversee operational and strategic issues, reporting to scheme management DfE Committees, and the Departmental Board.

Teachers’ Pension Scheme – governance II

- The equivalent of a Board of Trustees within the TPS is the Teachers’ Pension Scheme Pensions Board.

- This consists of five members each from employers and members, with 2 from DfE, an independent chair and one independent pensions specialist.

- There are four subcommittees which provide oversight of key areas of the scheme and further advise scheme management and the Secretary of State.

  1. Commercial (ensuring that employer and employee views are reflected in future delivery of the scheme.
  2. Management Risk and Internal Controls
  3. Service Delivery and Maintenance of Data
  4. Information for Members and Communication



Analysis

There are a number of unique or rare characteristics of USS.

- The profusion of subcommittees. Reflecting the size and large asset holdings of USS, there are seven committees reporting to or advising the Board.
- The large number of professional and corporate trustees. Research conducted by the Pensions Regulator suggests that even among larger Trust-based schemes, the mean number of professional trustees on boards is two, and TPS has just one.
- The placement of professional trustees on subcommittees. All five current independent trustees also have seats on various subcommittees.
- The JNC and its role in deciding on changes to contribution rates.
- The role of the independent Chair of JNC.
- The fact that there is a default position on contribution arrangements and cost sharing (65/35) that can be invoked in the event of the JNC not agreeing on changes to contribution rates.

Pros and Cons of the USS structure

Pros	Cons
Great deal of financial expertise and experience within the scheme.	There is a highly bureaucratic structure with significant running costs.
There is a clear and defined division of labour between different committees with expertise appointed accordingly.	The JNC can be a sticking point if deadlocked.
There is close involvement of stakeholders (UUK and UCU) throughout the decision-making process.	Stakeholders' interests can prove secondary in comparison to the influence of professional trustees and the Chair of JNC.



Communication and transparency

- The size and complexity of the USS (over 350 employers are in the scheme) can make for difficulties in effective and timely communication and consultation.
- Responses to DWP's consultation 'Security and Sustainability in Defined Benefit Pension Schemes' suggested that schemes could do more to communicate more simply with their members. For the most part, it was felt that clear communication would help members understand their scheme's funding position and the potential risks, and also what the impact would be in the highly unlikely event that the scheme were to enter the Pension Protection Fund.
- However, some respondents, predominantly from within the pensions industry expressed concern that communicating more information to members of scheme funding levels could in fact cause unnecessary panic for individual members, and in a worst-case scenario, poorly communicated information could potentially lead to rush reactions such as mass transfers out of the scheme as a result of concern about scheme deficits, which could in the long-term be more detrimental for the member.
- In order to avoid this while improving member knowledge of scheme funding, there would need to be a clear way of sharing this information and what it means.

Questions

[These suggestions are for guidance only]

- How appropriate is the USS structure for the size of the scheme?
- What is the role for professional trustees, and what influence do they have?
- What are the roles and responsibilities of UUK and UCU in the scheme?
- What is the function of the JNC in the scheme?
- How might communication and consultation processes be improved?

Glossary

Glossary

- Active member: Current employee who is contributing (or have contributions made on their behalf) to an organisation's occupational pension scheme.
- Career average scheme: A Defined Benefit scheme that provides a pension based on the number of years of pensionable service, the accrual rate and average earnings over the period of active membership.
- Consumer price index (CPI): Index issued by the Office for National Statistics which measures changes in the price level of a market basket of consumer goods and services purchased by households.
- Deferred member: A member of an occupational pension scheme who has accrued rights or assets in the scheme but is no longer actively contributing (or having contributions paid on their behalf) into the scheme and hasn't reached pension age yet.
- Deficit repair contributions (DRCs): Contributions made by sponsors to make up the deficit in an underfunded scheme over a specific period of time.
- Defined benefit (DB): A pension benefit related to a member's salary or some other value fixed in advance, and independent of investment returns.

Glossary

- Defined Contribution (DC): A pension benefit where the individual and (often) their employer contribute into a pension pot, and the benefit received by members depends on the totality of contributions and its investment returns.
- Discount rate: An interest rate used to reduce an amount of money at a date in the future to an equivalent value at the present date. Discount rates are at the heart of most actuarial calculations and this especially applies to calculating the liabilities of DB schemes no matter the valuation method.
- Employer covenant: Ability and willingness of the employer to support the scheme.
- Final salary scheme: A Defined Benefit scheme that provides a pension based on the number of years of pensionable service, the accrual rate and final earnings as defined by the scheme.
- Funding ratio: Calculated by dividing a scheme's assets by its liabilities. Identifies a scheme's ability to pay future liabilities.
- Liabilities: The projected amount that a scheme will have to pay in the

Glossary

- Pension accrual: The build-up of pension rights. In a Defined Benefit scheme this may be based on the number of years of contributions.
- Pension Protection Fund (PPF): Established in April 2005 to pay compensation to members of eligible DB pension schemes, when there is a qualifying insolvency event in relation to the employer and where there are insufficient assets in the pension scheme to cover PPF levels of compensation.
- Retail price index (RPI): Index issued by the Office for National Statistics. An average measure of the change in the prices of various goods and services, including housing costs, bought for consumption by the majority of households in the UK.
- Scheme pension age: The minimum age at which scheme members are allowed to begin drawing an income from the scheme.
- Volatility: The level of variation in investment returns over a period of time.

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