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Universities Superannuation Scheme

DWP consultation on the draft Occupational Pension Schemes (Funding and Investment Strategy and Amendment) Regulations 2023

Detailed response

Scheme Maturity

Question 1:

Draft regulation 4(1)(b) provides that a scheme reaches significant maturity on the date it reaches the duration of liabilities in years specified by the Pensions Regulator's revised Defined Benefit Funding Code of Practice.

The consultation asks two specific questions relating to significant maturity and we have addressed these below. However it is worth setting out here our concerns with significant maturity in relation to open schemes like our own.

The draft Regulations appear to indicate that the scheme's funding strategies and technical provisions should plan for the scheme reaching 'significant maturity' on the basis of the accrual and scheme membership at the valuation date.

Whilst the consultation recognises that the time to 'significant maturity' may continue to be moved into the future at subsequent valuations, the effect of this approach would be to push up the level of technical provisions required and the cost of providing benefits. In the case of USS, where our sponsoring employer base is in the not-for-profit HE sector, this in turn will likely affect the sector's capacity for investment in education and research. For the USS we estimate this would increase our technical provision and future service contribution requirements by 10% and 25% respectively. Based on the position as at 31 March 2022 technical provisions would rise by £10bn and annual contributions by £0.6bn.

Further, the requirements will also impact the Scheme's investment policy. USS is a long-term responsible investor. It wishes to continue to invest in growth assets, which would be expected to provide employment, increase tax receipts and boost GDP, all ambitions which chime with the Government's aim to deliver economic growth and high-quality public services. The requirement to reduce investment in such assets in order to unnecessarily reduce risk works against that agenda.

For open DB schemes where new members are still being admitted, the funding and investment strategy requirements should be drafted to clearly allow both for the provision for future accrual and new joiners and for the strength of the covenant provided by the sponsoring employers. It should not be driven by a mechanistic assumption of an artificial time horizon to scheme maturity.

We would suggest that the Regulations clearly set out that open DB schemes can allow for the effect of ongoing new entrants and accrual within their own duration calculation.

i) Do you think that it would be better for the duration of liabilities at which the scheme reaches significant maturity to be set out in the Regulations rather than the Code of Practice?

Setting out the duration in the Regulations would be preferable, subject to it being defined in a sensible manner (see our comments in (ii) below), as it increases certainty for schemes, compared to a later Code which (presumably) will be subject to ongoing review and update by the Regulator. We also have concerns regarding TPR setting the law, which would be inconsistent with the usual status of Codes of Practice.

As noted above, we believe more consideration needs to be given to how schemes calculate their own duration, particularly open DB schemes where we believe allowance should be made for new entrants and future accrual in calculating the duration. It is worth noting at this point also that it is less than ideal to be providing views on the Regulations without being able to also review a draft Code, especially when the former states in a number of places that key requirements or limitations will be set out in the latter.

ii) If you think that the point of significant maturity should be specified in Regulations, do you agree that a duration of 12 years is an appropriate duration at which schemes reach significant maturity?

Duration is a function of the discount rate used: as the rate of discount increases the duration decreases. The swings which have been experienced in gilts yields in the last few weeks will have had a significant impact on the duration of schemes' liabilities. Given this, a single time period of 12 years will not be appropriate for all market conditions. As such we would suggest either the duration should depend on market conditions or the calculation to establish "significant maturity" should be independent of market conditions.

Low dependency investment allocation

Question 2: Do you think that the definition of low dependency investment allocation provided by draft regulation 5 is appropriate and will it be effective?

We believe more clarity is needed on what "low dependency" actually means, in the context of both investment strategy and funding approach.

We understand it does not necessarily mean "self sufficiency" as has been traditionally understood by pension scheme trustees, but at the same time the draft Regulation states that it must acknowledge that "further contributions are not expected to be required" from employers.

Also, it could be clearer whether it is intended that trustees must strictly comply with having a low dependency investment allocation once their scheme has reached its relevant date (and work towards this before the relevant date) or whether the intent is only that the Regulations affect the setting of technical provisions at each valuation. We would assume the latter given trustees' wide ranging investment powers under existing legislation.

Low dependency funding basis

Question 3: Do you think that the definition of low dependency funding basis provided by draft regulation 6 is appropriate and will it be effective?

As noted above, the draft Regulations require an assumption of no further contributions from employers. Therefore, the low dependency basis appears to require that trustees give no credit to the covenant that is still available from the sponsors, which may in reality be significant and valuable. This will have the effect of driving up the cash costs of accrued benefits unnecessarily when they could be maintained at a more reasonable level as a result of the covenant actually available.

It would be possible to have a low-risk funding approach whilst still relying on a reasonable level of covenant support.

Strength of the employer covenant

Question 4:

i) Do you agree with the way that the strength of employer covenant is defined?

We consider the proposed definition of covenant strength (Regulation 7(2)) to be reasonable and consistent with current practice.

However, we note that Regulation 7(3) - setting out that the strength of the covenant is to be assessed (solely) in relation to an assessment of the difference between the value of scheme assets and scheme liabilities (where liabilities are measured on an appropriate “low dependency” basis as set out in regulation 7(5)) – has the potential to introduce some volatility into the assessment of covenant strength, since the size of the deficit is sensitive to interest rates which vary independently of the robustness of the support provided by scheme sponsor(s). We have some concerns that such volatility in assessed covenant strength may not aid stakeholder understanding of the underlying strength of support provided by sponsor(s) and of its significance in the scheme valuation and monitoring processes.

ii) Are the matters which trustees or managers must take into account when assessing it, as provided by draft regulation 7, the right ones?

We have several issues with the definition provided by regulation 7(4) of the matters which trustees are to consider when assessing covenant strength:

- Draft regulation 7(4)(c) refers to “a Code” (which we understand as the Code from TPR planned to be released in draft later in 2022) that will set out “other” relevant characteristics of covenant. No copy of this Code is available at this time. It is therefore not possible to determine whether 7(4) represents an adequate basis for assessing covenant strength or includes the “right” matters.

- We believe the approach taken, whereby a limited number of matters to be considered are specified in the draft Regulations themselves, while other relevant factors are left to be specified in a separate guidance document, is inappropriate. It has the effect of creating a two-tier structure in which the matters explicitly included in the draft Regulations themselves could come to be seen as more important than the matters which are included only in the Code. Unless there is a specific intention that the matters specified in the Regulations are indeed deemed to be more important than the matters set out in the Code, it would be better to leave all such matters to be specified in the Code. Alternatively, all relevant matters should be specified explicitly in the draft Regulations, although this would be impractical and likely to result in unmanageably long regulations.
- We do not agree that the matters explicitly included in the draft Regulations themselves (namely employer cash flow and the likelihood of an insolvency event) are more important than other matters that are relevant to the assessment of covenant strength, which are not included. We believe there may often be other matters that are of equal or greater significance to those specified in 7(4) and it would be inappropriate to accord them lesser status than those that are currently listed explicitly. In the case of USS, these would include:
 - Institutional and structural factors reinforcing the commitment of the employer(s) to the scheme, including restrictions on exiting the scheme, the joint-and-several “last-man-standing” nature of liabilities, and the robustness of scheme rules.
 - The Higher Education sector-wide employer membership of the scheme that reduces the relevance of competition between employers and also effectively means that an insolvency event, as it would usually be understood in the sense of insolvency of a single sponsoring employer, would actually arise only as part of the collapse of a strategically important sector of the economy, an extremely unlikely event (and therefore less relevant for covenant assessment purposes).
- We expect the inclusion of employer “cash flow” in draft Regulation 7(4)(a) without further definition or explanation to be problematic for any scheme with a sponsoring employer in the not-for-profit (NFP) sector. NFP employers typically report little or no annual surplus / net cash flow, since they are required to devote all their resources to their charitable objectives. A backward-looking assessment would likely conclude therefore that “cash flow” of such an employer was limited. However, this would not take into account the often-considerable flexibility that such employers may have to reduce discretionary spending in order to generate cash flow when required. An appropriate assessment of covenant would need to take this into account. If they are to be relevant and “fit-for-purpose” in the NFP sector, the draft Regulations need also explicitly to take this into account. They currently do not do so. Reference is made in 7(4)(a) to “a Code” which might incorporate such considerations, but a copy of the Code is not available and it is therefore impossible to be sure that this is the case.

iii) Does draft regulation 7(4)(c) effectively capture the employer’s broader business prospects?

This is difficult to answer because 7(4)(c) refers to factors being set out in “a Code” which is not yet available, even in draft form. “Other factors which are likely to affect the performance or development of the employer’s business” is a suitably broad description for what must inevitably be a wide range of relevant matters. However, as noted above, we do not believe it is appropriate to

establish a two-tier structure for “matters” whereby some are explicitly listed in the Regulations and some are not.

Relevant date

Question 5: Does it work in practice to set a minimum requirement for the relevant date to be no later than the end of the scheme year that the scheme is estimated to reach significant maturity?

We do not believe there are any issues with the suggested approach specifically in relation to having flexibility to determine the relevant date within the applicable scheme year, although as indicated above we have concerns about how the relevant date for open schemes is determined. The USS Trustee currently has no expectation of the scheme reaching significant maturity whilst the scheme remains open to new entrants and accrual.

We are however concerned that there may be unintended consequences of the way in which the relevant date is expected to be revised between valuations in certain circumstances and the potential inflexibility of the regime as schemes approach or pass their “relevant date”. For example, if there were significant market movements, that could cause schemes who have not yet reached significant maturity to be required to review and, if applicable, revise their funding and investment strategy, due to changes in schemes’ funding ratios. Should those market movements also materially bring forward those schemes’ “relevant date”, they may unexpectedly be required to move to a low dependency investment allocation under their funding and investment strategy. If the intent is that trustees are bound to follow a low dependency investment allocation in those circumstances (rather than only needing to apply these principles when setting TPs – see above) this might precipitate a rapid change in investment strategy by pension schemes at a time of market volatility, which could be detrimental to members’ interests and exacerbate any wider market problems.

Question 6: Does your scheme already have a long-term date and how is it calculated?

No we are an open scheme, although we do use a dual discount rate approach which means we will gradually reflect the evolving maturity of the scheme in our technical provisions.

Question 7: Where the funding and investment strategy is being reviewed out of cycle with the actuarial valuation, would it be more helpful to require it to align with the most recent actuarial report?

This is one option which should be available, along with the option to be aligned with any subsequent actuarial advice.

Minimum requirements on and after the relevant date

Question 8: Do you think that these minimum requirements are sensible and will provide additional protection for the accrued pension rights of scheme members?

Where a scheme does not have a risk management framework that attempts to identify and mitigate funding risk as it matures, then the minimum requirements may well provide additional security for accrued benefits for schemes where employers are not providing a substantial covenant.

However where a scheme does have such a plan and has available to it a substantial covenant then these minimum requirements are overly prudent and cause unnecessary increased costs for scheme sponsors (and potentially members).

As indicated above requiring open schemes to determine the relevant date on an artificial construct and ignoring new entrants / future accrual results in these minimum requirements causing significant issues for continuing accrual of benefits by causing unnecessary increases in scheme contribution rates.

Question 9:

i. Should such limited additional risk at and after significant maturity be permitted, if supported by contingent assets? If so, to what percentage of total liabilities should this be limited?

Schemes should be permitted to take appropriate additional risk after significant maturity but this should not be limited to risk supported by contingent assets. In particular, in our view additional risk should be allowed based on the strength of the employer covenant.

We note that trustees will be required to have a clear detailed risk management framework (which it will be required to disclose in the proposed Statement of Strategy) which will set out the level of those risks, the strategic reasons for them, and the appropriate mitigations. This would give structure and transparency to the risks being taken by schemes without the need for an overly prescriptive investment/funding regime.

ii. What additional risks to members' benefits might be posed as a result, and what safeguards should apply to protect members?

Any additional risk should only be taken to the extent that it can be mitigated, for example via the covenant. Therefore there should be no additional risk to members' benefits overall and no additional safeguards required.

Investment risks on journey plan

Question 10: Do you think that the provisions of paragraph 4 of Schedule 1 will allow appropriate open schemes to continue to invest in growth assets as long as that risk is appropriately supported?

To a degree, but the provisions of paragraph 4 of Schedule 1 still reference the relevant date: as noted above the Regulations should be clearer that an open scheme can take into account new entrants and future accrual when determining its significant maturity timescale and therefore the relevant date.

As currently drafted the Regulations could result in considerable time being devoted to developing investment strategies which will never be implemented as the relevant date will move out at each valuation. As such we support the Regulation explicitly allowing for new entrants and future accrual to be allowed for in determining the relevant date for open schemes.

Risk in relation to calculation of liabilities on journey plan

Question 11: Do you think that the principles in paragraphs 4 and 5 of Schedule 1, requiring funding risks and investment risks to be linked primarily to the strength of the employer covenant, are sensible?

Employer covenant is a major factor trustees consider when deciding their risk budgets, as ultimately the employers underwrite the costs of the scheme. However if this is to be the case then trustees should not be restricted to only those considerations the Regulations and Code identify as appropriate for taking into account when evaluating the covenant – see our response to question 4 above.

Liquidity

Question 12: Do you think that the new liquidity principle set out in paragraph 6 of Schedule 1 is a sensible addition to the existing liquidity requirement of regulation 4(3) of the Occupational Pension Schemes (Investment) Regulations 2005?

Whilst we may have no objection to a liquidity requirement in principle, there is no definition in the draft legislation of “reasonable” in relation to the allowance to be made for unexpected cash flow requirements, and no reference to there being any supporting guidance included in the Code. Therefore it is difficult to understand exactly what the principle will require and how schemes might be expected to demonstrate adherence to it.

Question 13: Will the matters and principles set out in Schedule 1 enable the scheme specific funding regime to continue to apply flexibly to the circumstances of different schemes and employers, including those schemes that remain open to new members?

We have given our comments above, and particularly in relation to open schemes. We believe that Schedule 1 could allow sufficient flexibility for schemes but only if the matters relating to significant maturity for open schemes, the factors trustees can consider in evaluating employer covenant, and the ability to rely on employer covenant (where appropriate) even after the relevant date are addressed.

Funding and investment strategy – level of detail

Question 14: Is the level of detail required for the funding and investment strategy by draft regulation 12 reasonable and proportionate?

The level of detail required is probably reasonable and proportionate, for a scheme where the transition to low dependency is a real and imminent (if not ongoing) scenario.

However for an open scheme where a transition to low dependency, buy-out etc is not a realistic scenario at the current time, the information and level of detail required is unnecessarily excessive. It will also likely incur unnecessary additional time and resource costs.

Therefore again some form of exclusion or simplified requirements would likely be more reasonable and proportionate for open schemes.

Question 15: Do you think the requirement for high level information on expected categories of investments will impact trustees' independence in making investment decisions in the interests of scheme members?

As noted above, it is unclear whether the policy intent is that trustees will be bound to invest in accordance with their funding and investment strategy or whether the funding and investment strategy is only relevant to the setting of technical provisions. We are concerned that the Regulations will require employers to agree the funding and investment strategy (which in the case of USS is modified to a requirement to consult). Ultimate responsibility for investment strategy under existing legislation sits with scheme trustees and therefore to the extent that trustees must seek agreement regarding the funding and investment strategy that will alter the balance of power between trustees and employers in relation to investments.

Additionally, TPR currently has no power in s.231 of the Pensions Act 2004 over trustees' investment decision-making powers under the Pensions Act 1995, and the scope of TPR's ability to challenge trustees' investment decisions via the proposed Regulations is unclear.

Determination, review and revision of funding and investment strategy

Question 16: Are the requirements and timescales for determining, reviewing and revising the funding and investment strategy in draft regulation 13 realistic?

Whilst we believe these timescales are reasonable, we also believe they could be challenging in certain circumstances, for example where there are broader requirements to consult and/or where changes in the scheme design resulting from a valuation may impact on the appropriate investment strategy, and therefore there should be some additional flexibility in the timescales to allow for scheme specific circumstances to be taken into account.

Statement of strategy

Question 17: Are there any other assessments or explanations that trustees should evidence in Part 2 of the statement of strategy?

We are concerned that a not-insignificant amount of content of the statement of strategy will duplicate content already required for the Statement of Funding Principles, the Statement of Investment Principles and so on. Covering the same information again but in a different place may be confusing for the reader, and therefore not add any value whilst requiring additional work and expense for trustees.

Requirements for chair of trustees

Question 18: Do you agree that these are the appropriate requirements for the scheme trustee board when appointing a chair? Are there any other conditions that should be applied?

These requirements appear to be appropriate.

Actuarial valuations and reports

Question 19: We would like to know if you think these requirements will work in practice?

Our initial view is that these requirements, in isolation, should work in practice. However, given these additional requirements consideration should be given to removing other information that is required within the valuation report that the low dependency measure information would appear to replace.

In addition, we have already highlighted some of the issues around calculating and determining significant maturity for open schemes, and the required removal of ongoing covenant support in relation to the low dependency funding basis, and therefore there appear to be potential difficulties with interpreting and applying the Regulations in practice.

Recovery plan

Question 20: Do you consider that the matters prescribed by regulation 8(2) of the Occupational Pension Schemes (Scheme Funding) Regulations 2005 remain relevant for trustees or managers to take account of when determining or revising recovery plans? If so, why and how are they relevant to the setting of appropriate recovery plans?

In our view many of the matters prescribed by regulation 8(2) are now not relevant in the generality of determining recovery plans, although they may have some relevance in particular cases. Over the years, the Regulator has developed principles based on reasonable affordability, fairness between stakeholders and sustainable growth that work well as the primary drivers for setting recovery plans. However, if any of these are to be coded in law then this should be done very carefully, ensuring they are balanced with the others, considered in the round, and that the risk of unintended consequences is as low as possible.

Question 21: Do you consider that the new affordability principle at draft regulation 20(8) should have primacy over the existing matters, if they do remain relevant?

Affordability is one of many factors trustees should weigh and consider when constructing their recovery plans. Whilst calling it out explicitly in the Regulations may be helpful, we do not believe it should have primacy.

We also are concerned as to how “as soon as the employer can reasonably afford” may be interpreted, especially where the scheme is open to accrual of benefits. The Regulations should make clear that it is not an intention of the draft Regulations that employers should pay the maximum deficit contribution possible to the exclusion of all other pension and business considerations.

We believe it should be made clear under the Regulations that trustees may take into account other relevant matters such as (but not limited to) the ability of the employer’s need to invest in and fund its business and commitments, and to fund other pension benefits including contributions for accrual of future benefits where the scheme is open to accrual.

Moreover, where a scheme is backed by a sufficiently robust, long-lived and well-evidenced covenant, we see no logical reason why trustees should not have flexibility to allow employers to spread deficit repair payments over an appropriate corresponding time period.

This would also be consistent with TPR’s objective under the Pensions Act 2004 Section 5(1)(cza) to “minimise any adverse impact on the sustainable growth of an employer” in the exercise of its functions.

Multi-employer schemes

Question 22: Will the requirements in draft regulations 20(9) work in practice for all multi-employer pension schemes?

We do not have a view on this, as USS is a non-sectionalised multi-employer scheme.

Business burdens and regulatory impacts

Question 23: Do you agree with the information presented in the impact assessment for the funding and investment strategy?

The impact assessment is, by DWP's own admission, limited. The reasons for this include that true costs/impacts cannot be determined until the final Regulations are known but also because, as we have called out as an issue elsewhere, TPR's Code will play a big part in driving what schemes have to do and it is also still an unknown.

However, the impact assessment at present is, in our view, incomplete for further reasons. In particular it does not include:

- The true impact and costs for schemes of understanding the legislation and Code guidance: whilst the impact assessment estimates a cost for trustees to read and digest the requirements, they will also need detailed advice from their legal, actuarial, investment and covenant advisers on exactly what the legislation means for them and regarding any changes required;
- The costs of implementation: making any necessary changes to funding and investment strategies, documenting those changes in the required way, time spent negotiating and agreeing strategies with employers and so on. For USS employers and members we estimate the impact of the draft Regulations could mean a £10bn increase in technical provisions and an increase in future contribution requirements of £0.6bn a year.
- The ongoing costs of complying with the Regulations and requirements on an ongoing basis;
- And of course, for schemes still accepting new entrants, the increased costs of having to move to a low dependency position where contribution rates for employers (and members, in a shared cost scheme like USS) will be required to increase artificially.

The increased costs for employers who are in a scheme which has to move towards low dependency earlier than would otherwise be the case will have knock-on effects for their own costs, their ability to invest in their own business and the economy, and their recruitment/employment plans.

And finally members of shared cost schemes may see their own contributions increasing (and thus take-home pay decreasing), which in turn will have effects on opt-out rates and retirement provision levels.

It is worth also highlighting that in schemes like USS where administration and management expenses are paid from scheme assets, increased costs will also serve to reduce asset values.

Question 24: Do you expect the level of detail required for the funding and investment strategy to increase administrative burdens significantly?

Many schemes will already have in place some form of risk management plan, which will include funding and investment – for example USS has its Integrated Risk Management Framework which details when and how it will move towards a lower risk strategy.

Therefore having to draw up these statements on top of such a scheme running its own detailed risk framework, with the input of the relevant advisers, and with the proposed requirement to have to agree the statement with employers, will add significant time, work and cost requirements.

We are also concerned that it is proposed that the funding and investment strategy must be completed within the actuarial valuation 15 month timescale. For a scheme like USS which has to complete the valuation calculations, discuss and consult with stakeholders, potentially support an employer consultation, and finalise any changes and implement them within that 15 month period, this is likely to be a significant extra demand on resources.

Question 25: Do you agree with information presented in the impact assessment for the statement of strategy, referenced in paragraph 6.1?

The impact assessment completed as part of the enactment of the relevant parts of the Pension Schemes Act 2021 evaluated the costs of appointing a Chair for those schemes that didn't already have one, for that Chair to understand and sign the statement, and for schemes to submit valuations to TPR (with the statement) even when finding a funding surplus.

The impact assessment is therefore very limited in scope, but we believe is largely correct in identifying the key cost areas for simply signing and submitting a statement of strategy.

It does not cover the largest amount of work that will be needed for a statement of strategy, namely the work required to obtain and draw up the statement which is likely to be significant. It is worth remembering that the statement will be a significant undertaking and will require trustees to:

- Explain the main risks in implementing the funding and investment strategy;
- Set out how they intend to mitigate those;
- Set out what action they intend to take if those risks do materialise;
- Set out the proportions of scheme assets allocated to different categories of investment (including, before the relevant date, the proportions as the scheme moves along its journey plan) and the level of risk of each; and
- Evidence various other matters required to be included in the statement.