Bill Galvin
Chief Executive Officer
USS Limited
Royal Liver Building
Liverpool
L3 1PY

Universities UK

11 May 2020

Dear Bill

The USS Trustee's Methodology and Risk Appetite, Technical Discussion Document for USS sponsoring employers for the 2020 actuarial valuation

Thank you for the Trustee's discussion document on the 31 March 2020 actuarial valuation, set out in a document dated 9 March 2020 published to employers.

The Trustee's discussion document is an opening contribution to what is likely to be extensive dialogue over the coming months regarding the funding of USS, and on the potential outcomes for the 2020 valuation taking into consideration the recommendations of the Joint Expert Panel's (JEP's) second report. We note that the Trustee has made clear that no decisions have yet been reached in its planned approach to the 2020 valuation. It is important and necessary that other strands of work, notably from the Valuation Methodology Discussion Forum (VMDF), are concluded before the full valuation picture starts to take shape and any formal consultations are published.

Whilst it is helpful for the key issues to be aired at this early stage, it is apparent in the responses provided by employers that fuller information will be needed in due course in order for employers to provide formal, considered views. Indeed, this seems to be a point acknowledged by the Trustee in the way it has asked for initial views in the feedback questions. We welcome that throughout the document the Trustee confirms that further work continues through, and in collaboration with, the VMDF, with formal views sought in due course through the statutory Technical Provisions, Schedule of Contributions and Recovery Plan consultations with employers (through UUK) currently planned for later this year. We emphasise just how important it is for employers that it is clear in the consultation material how the various components of the funding approach, including covenant, risk and individual assumptions – and the various positions which might be taken on each of them – interact.

I am grateful to the Trustee for the extension to the discussion deadline and – especially during these unprecedented times – would want to recognise the continued dedication of the trustee board and its team to the valuation and its related workstreams and processes, to communication and explanation, and to maintaining constructive and frequent dialogue with the Pensions Regulator. I would also express my thanks to employers for giving such

Chief Executive
Alistair Jarvis

Universities UK
Woburn House
20 Tavistock Square
London
WC1H 9HQ

telephone
+44 (0)20 7419 4111

twitter
@ universitiesuk

email
info@ universitiesuk.ac.uk

website
www.universitiesuk.ac.uk

careful and thorough analysis of the issues; which is especially appreciated during these challenging times for us all.

It is clear that through this 2020 valuation we are at a pivotal point in the scheme's evolution. This was true even before the impact of Covid-19 (which at the time of writing presents a challenging and somewhat uncertain time for both USS participating employers, and in the financial markets affecting the fund), as stakeholders – through the establishment of the JEP – have looked to find a path to a sustainable scheme for the future. We believe that through continued collaboration, all stakeholders can find a solution.

I do not intend in this response to give a detailed analysis of the responses provided by employers; indeed, on this occasion you invited the responses from employers to be also provided to the Trustee so you will have immediate access to them and to the considered thoughts provided. However, recognising that you seek comments ahead of your next Trustee board meeting (which I understand is on 20 May), I set out below the headline views from UUK:

1	**What are your comments on the proposed new methodology?**
	In broad terms employers appear collectively supportive of the Dual Discount Rate approach, but acknowledge that *how* this approach is utilised is of paramount importance. Employers look forward to seeing a report of the fruits of the work of the VMDF and matters relating to the investment approach for the fund. It is expected that this will include the extent and nature of any de-risking, and how this analysis informs the anticipated investment return and is then utilised in the discount rate used in the valuation. It is important for employers to see how this would translate into contribution rates, with modelling to show different possible outcomes and how this might influence the contribution rate over time. In short, the structure in encouraging, but deciding on the assumptions to be used within this structure is crucial. Some employers were concerned that the illustrative figures shown in the Discussion Document meant that little appeared to have changed. Others commented to question why the Trustee had only shown the most prudent of the JEP's example discount rates without any explanation as to why.
2	**Do you support the measures to ensure the covenant is "Strong" agreed as part of the 2018 valuation on: i) the permanent rule change on employers exiting the Scheme to underpin a 30-year covenant horizon, ii) debt monitoring arrangements; and iii) pari passu security on new secured debt?**
	This question produced some of the strongest, and also the widest range of, views from employers, and again, we expect the Trustee will wish to address the important and detailed questions raised by employers (in addition to those raised separately by UUK). What is clear from the responses received is that employers continue to be committed to the scheme, and are not looking to leave (not withstanding that section 75 debt costs make this unpractical for most in any event). They remain engaged and supportive for the long-term, but importantly this is predicated on USS being sustainable in terms of cost and risk. Employers are also willing to consider further detail in relation to the proposed supplementary covenant measures. But, as mentioned, they think it necessary to do

	this in the context of a fuller proposition, so that these covenant steps can be considered alongside the other component parts of the valuation. Employers would welcome further information on the rationale for the rule change, and in particular for the Trustee to set out the circumstances, through scenarios, in which it would seek further funding from an employer which has paid its section 75 debt. Employers consider that an extended moratorium might present a more appropriate framing of any provision rather than a permanent change – something PwC seemed to support in the recent webinar for employers on these issues. Again, on debt monitoring, and on pari passu arrangements (relating to secured debt), the detail matters and the Trustee's proposals need to be proportionate, thought through in the context of the prevailing conditions, adaptive, and work for the variety of employers participating in the scheme. On this latter point, work has already progressed in relation to debt monitoring and pari passu, and we are grateful for the work of employer colleagues bringing their expertise to the working group. At the time of writing it seems we might have proportionate arrangements which could be taken to employers and be consulted upon; we are appreciative of the constructive work of the USS Team and their advisors on what we feel could be a balanced solution. In terms of the proposed rule change, it is clear from employer responses there is more work to do in this regard before any proposal can be consulted upon with employers. I hope that the Trustee acknowledges the constructive responses from employers at this stage, and is something that can be discussed further at the JNC.
3	**Do you wish to consider tangible covenant support measures to further strengthen the covenant and potentially support additional risk?**
	Employers were generally sceptical of how such approaches could work collectively and alongside the cost-sharing aspects of the Scheme. As such, there was limited appetite to explore this option at this time, but should the Trustee have a particular proposition that they felt could operate effectively and for the benefit of all parties then employers would be pleased to hear more. In the absence of such a proposition from the Trustee, it is suggested that this part of a potential USS funding approach is paused for now.
4	**Do you have initial views on whether you would be comfortable with an investment strategy that took a moderately larger amount of risk in the long term?**
	Employers noted that the JEP's second report stated that a *slightly higher risk appetite* was needed to achieve a good resolution to the scheme valuation. In general terms employers are open to the idea of exploring what such an approach would look like in terms of options for either higher risk and/or taking risk for longer – and what this then means for valuation outcomes and contribution rates. Employers recognised that further work is needed by the Trustee to articulate pensions risk in terms that can be understood, analysed and then responded to. Employers look forward to seeing more on the work taking place in the VMDF in this area in due course. It is therefore important that the VMDF is provided with information to consider the options further and to reach a conclusion, before the Trustee consults on the Technical Provisions, Recovery Plan etc.

<table>
<tr><td>5</td><td>Based on the example approach to managing risk, as set out in this document, what is your risk appetite? In other words, do you have initial views as to how much of your risk capacity you are comfortable for us to rely on in supporting the Scheme, in the knowledge that there are adverse scenarios in which this may be called? (You may wish to express this as a contribution of x% of salary, or a monetary amount, paid over y years.)</td></tr>
<tr><td></td><td>The vast majority of employers did not feel it was possible to answer this question, or indeed to quantify the amount of risk they are willing to take in the manner in which the question was posed, and asked that more information is provided.

Employers stated that it is important for them to understand more clearly the Trustee’s definition of a significantly adverse scenario, and what actions it would take in such scenarios.

Employers noted that pensions risk can manifest itself in many ways and it is difficult to define a “risk appetite” in such definitive and specific terms, and certainly not without seeing a fuller picture of its practical implications.

Employers would be appreciative of the Trustee bringing a range of scenarios and options to employers for discussion. In particular, employers considered it would be beneficial if the Trustee could, in collaboration with the VMDF, develop a risk framework for further consultation, and in this show what specific positions on risk might mean for both immediate and future contributions. This would enable employers to review the range of proposed options and allow them to assess the long-term impact of specific decisions, and the trade-offs that would be required.</td></tr>
<tr><td colspan="2">In addition to questions 1-5 raised in the discussion document, UUK invited feedback from employers on the additional views and analysis expressed in its accompanying paper.</td></tr>
<tr><td>6</td><td>Do you agree that it would be helpful if an outline proposition is developed which shows how the various components – including risk appetite, investment strategy, covenant measures, contribution rates and volatility, and benefit design – might operate together under a particular strategy (or strategies)?</td></tr>
<tr><td></td><td>This question resulted in an almost unanimous response from employers as they strongly agreed that it would be helpful for an outline, overall proposition(s) to be developed to show how the various scheme components might operate together under a particular strategy or strategies. We are keen to engage further with the USS team on this issue, and note the important role of the VMDF here in helping ensure that, for the main consultation on the Technical Provisions, Recovery Plan etc., the Trustee presents the best information possible to help employers form their views.</td></tr>
<tr><td>7</td><td>Any other comments?</td></tr>
<tr><td></td><td>As expected within such thoughtful and rich responses there were numerous individual points not captured elsewhere, with the following being expressed a number of times or otherwise being notable:
Valuation timing – employers are understandably occupied by and concerned with the Covid-19 pandemic and, in relation to USS, there is concern about how the pandemic might impact the Scheme in both the short and long term. Some employers have questioned whether the original</td></tr>
</table>

	timetable for the valuation remains appropriate, especially with some of the flexibilities and accommodations the Pensions Regulator is affording scheme trustees through these difficult times. It would be helpful, in due course, for the Trustee to consider the responses from employers and set out its proposed route through the valuation timeframe, explaining why other options have been discounted, and allowing sufficient time for employers – and the Trustee itself – to both consider and analyse the effects of the pandemic which might not currently be apparent. • Sustainability of the core offering – a number of employers suggest in their responses that the contribution rate for both employers and members is on the cusp of (and perhaps beyond for some) sustainability at this time. Whilst it is right that the Trustee sets the price for current benefits, employers believe it would also be helpful – if the Trustee suggests that contributions would need to increase for current benefits – for the Trustee to also illustrate in broad terms the level of benefits which might be afforded for specific (lower) contribution rates. • Member options – employers again raised concerns about the member opt-out rate, and we have seen from the analysis in the JEP report that there are a variety of reasons why members seem to be opting out of the Scheme; affordability and suitability of the Scheme offering being two notable examples. Employers would like to see flexible options introduced for members and note that, perhaps, the one-size-fits-all offering is looking increasingly out of step with modern workplace pension provision.

It is clear from the responses to the USS Discussion Document that this has been a helpful start to the 2020 valuation and that employers can see positives in the Trustee's broad direction of travel. In particular, employers have welcomed the Dual-Discount rate approach and – potentially – exploring the option of taking a little more risk for longer if this ultimately provides a more sustainable funding approach. There is also a sense amongst employers that they might have made more of this particular exchange if a fuller picture had been presented. We see this when employers have expressed caution and raised queries in response to the Trustee's questions on covenant support, investment strategy and risk appetite – questions which are difficult to answer without seeing the fuller picture and in particular with a more comprehensive, and complete, analysis of the risk and reward trade-offs of individual decisions.

On behalf of employers, UUK would request that the Trustee, in collaboration, develops an outline, overall proposition for the valuation showing how the various components might operate together and which can be shared with employers for consultation either ahead of or alongside the statutory consultations. It will also be important for employers to understand how the impact of Covid-19 can be factored into these discussions. Let me be clear that the UUK Pensions Team, and its wider representatives, is ready and willing to work closely and constructively with the USS Team – and indeed with UCU colleagues – in developing a proposition for employers to consider.

I have included as annexes to this letter the UUK *Accompanying Paper for Employers* and the supporting Aon advice note *USS Initial Consultation for 31 March 2020 actuarial valuation,* which were shared with employers early in the Discussion Document timeframe, and which I hope will also support the Trustee in considering employer responses, many of which echo the views expressed in these two papers.

We look forward to hearing what the next steps will be as we work together to achieve a sustainable scheme through this 2020 valuation process, and more importantly through these challenging times for the country and its higher education sector.

Yours sincerely,

Stuart McLean
Head of Pensions

Annex: