Dame Kate Barker
Universities Superannuation Scheme

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Dear Dame Kate,

Universities Superannuation Scheme (the Scheme)
Actuarial valuation as at 31 March 2020 (the 2020 Valuation)
Rule 76.1 report

We appreciate the significant engagement we have had with the USS Trustee, the USS executive team and their advisers during recent months.

This letter sets out our views on the content of the final draft Rule 76.1 report which was provided to us on 18 February 2021 and on the Scheme's 2020 Valuation more generally. We understand that the Trustee approved the final draft Rule 76.1 report at its Board meeting on 19 February 2021.

1. Conclusions

The Rule 76.1 report contains three separate funding proposals, based on three distinct covenant scenarios. Our view is that under each of the three scenarios the strength of the employer covenant is 'Tending to Strong', as assessed against our 4-point covenant grading scale. However, we recognise that the covenant support measures envisaged under Scenarios 2 and 3 have value and that this value can be reflected in the respective funding strategy proposals.

Part 3 of the Pensions Act 2004 places responsibility on trustees to choose the assumptions on which the Scheme's liabilities will be calculated, and, where necessary, to prepare an appropriate recovery plan.[1] For schemes where we engage throughout their valuation process, we seek to provide our comments and set out our concerns as the valuation progresses. This is to aid the trustee's decision-making process and to make it more likely that we will regard their valuation as compliant when submitted to us and so will not wish to investigate the use of our regulatory powers.[2] We have adopted this approach here and understand that this is of value to the Trustee.

We are comfortable that the funding strategy proposals for Scenario 1 are compliant with Part 3 of the Pensions Act 2004. Our assessment of the proposals for Scenarios 2 and 3 is more marginal. These funding strategies are at the limit of what we consider to be compliant with the requirements of Part 3.

[1] Pensions Act 2004, ss 222, 226(3); Occupational Pension Schemes (Scheme Funding) Regulations 2005, reg 5(4).
[2] Pensions Act 2004, s231.

More detail on our position is set out below.

2. Covenant

Our view of the employer covenant remains ‘Tending to Strong’ for the reasons set out below:

a) **Affordability:** We recognise that the Higher Education sector is financially successful and generates significant levels of income. We are therefore of the view that, should the sector be required to make provisions to ensure that the Scheme’s funding requirements are sufficiently met, it has the capacity to do so. However, the employers in the sector, as with many not-for-profit institutions, seek to utilise most (if not all) of their income and capital resources to meet educational objectives and to retain their competitive position. How the Scheme’s funding needs sit within those competing calls on income and wider resources is a key issue.

   The clear capacity of the sector to support the Scheme has yet to be evidenced by a demonstrable commitment by the Scheme’s sponsors when the Scheme requires increased cash contributions to meet its funding needs. At the previous valuation, contributions were set at a lower level to be followed by stepped increases in contributions to allow for employers to adjust their plans and to ensure the subsequent increases were affordable. The initial lower level of contributions only included deficit repair contributions (DRCs) of 2% of salaries. There is now a stated concern that future agreed step-ups in contributions may not be affordable to all employers. This is at a time when, on any reasonable set of assumptions, the Scheme’s deficit has significantly increased since the previous valuation and higher DRCs would be required. This reinforces our view that the level of contributions for the 2020 Valuation should address the deficit over an appropriate recovery plan, and the Scheme should only take a level of investment risk which the sector has the capacity to underwrite with increased payments if necessary.

b) **Scheme size vs sector:** We recognise the resilience demonstrated by the sector as a whole to the challenges presented by the Covid-19 pandemic during 2020. Furthermore, as well as the significant and resilient market, we also recognise the Scheme has strong access to value in the employer group (by way of the last man standing provisions). Our ‘Tending to Strong’ conclusion is more heavily impacted by the significant size of the Scheme in the context of the sector. This view would appear to be supported by (for example) the Trustee covenant adviser’s recent opinion that the size of the Scheme relative to an estimated valuation for ‘Available Risk Capacity’ is considered ‘Tending to Strong’.

c) **Covenant support measures:** We recognise the value that the covenant support measures currently being negotiated could have to the Scheme. Taking into account our other concerns in relation to covenant as noted above, we consider the measures to be protective of the current covenant position. As such, adopting the measures will not change our view that the covenant strength is ‘Tending to Strong’. However, we have communicated our view to the Trustee that the measures do have value and allow some flexibility in relation to the valuation approach. This is particularly the case when considering across the three scenarios what discount rates are applicable, what levels of outperformance should be assumed over the recovery plan period and what length of recovery plans would be appropriate.

3. Valuation approach

Overarching methodology

We are generally supportive of the overarching methodology adopted for the 2020 Valuation:

- The approach follows integrated risk management (IRM) principles with both covenant strength and notional investment strategy being key inputs in developing an appropriate funding strategy;
- The use of a 'self-sufficiency' (or 'low dependency') measure of the liabilities as a benchmark for quantifying the reliance placed on future employer support and generally for informing discussions around risk is appropriate. This is both in relation to the 2020 Valuation and as part of subsequent monitoring and future contingency planning within the IRM framework;
- We see benefits in adopting a dual discount rate, with a different discount rate for the periods before each member retires (pre-retirement) and after each member retires (post-retirement). This approach reflects the current profile of the membership and can evolve automatically towards a lower risk position to the extent this profile changes in the future and the Scheme becomes more mature. Using dual discount rates also means the cost of future service accrual reflects the relatively younger age of those active members accruing new benefits.

The technical construct of the approach is largely a matter for the Trustee rather than us, with our focus being more on the aggregate outcome. At a high level, both the overall approach and some of the individual components are comparatively complex. We acknowledge there are reasons for this complexity given the Scheme's circumstances but there are implications that flow from it. For instance:

- The complexity necessitates a clear and extensive engagement and communication exercise with stakeholders, which we know is what the Trustee Board envisage and have indeed already started;
- We believe that it is more appropriate for the Trustee and stakeholders to adopt a holistic approach to the valuation process and output rather than focus too much on the individual elements.

Affordable Risk Capacity (ARC)

In principle, we support quantifying the employers' risk capacity using this type of metric and constructing tests around it as part of the IRM framework. As we have discussed with you though, we do have some reservations over how the ARC has been derived, in particular, the assumption of a lengthy period of covenant reliance. Our view is that while we understand the sector's long history and likely future prominence in the global education marketplace, we do not believe that this enables the level of financial support available to the Scheme, over a 30-year horizon, to be predicted with confidence.

More generally, the calculation of the ARC relies heavily on several long-term assumptions. Some of these long-term assumptions are individually very subjective meaning the overall outcome will be subject to considerable uncertainty. We acknowledge the Trustee recently sought independent advice to inform its approach to the ARC and we note that the Trustee's view on appropriate assumptions, and indeed on the calculation method itself, has developed as a consequence. Ultimately though, given the significant uncertainty attached to it, we consider that the ARC, and any risk metrics derived from it, should not be viewed in isolation when making key valuation decisions.

Market conditions at 31 March 2020

Setting discount rates for an actuarial valuation as at 31 March 2020 is a challenge because of the impact of Covid-19 on economic conditions and investment markets at that date.

When viewed solely through the lens of confidence intervals on the Fundamental Building Block (FBB) expected returns, it might appear that there is more prudence in the approach than was the case for the 2018 valuation. However, in his initial advice on discount rate assumptions (report date 24 May 2020), the Scheme Actuary advised the Trustee to limit the discount rates derived 'mechanically' by applying confidence levels on the FBB returns. This advice accounted for a wider perspective on prudence reflecting the uncertainty at the valuation date around future economic prospects and, as a result, the uncertainty over future investment returns. We support this advice and the approach of limiting discount rates in this way.

We appreciate that assumptions for expected returns can be developed in different ways and that the profile of the expected returns may vary between assumption sets. However, we note that as at the valuation date, the expected returns derived from the FBB model for the notional pre-retirement portfolio, when expressed versus gilt yields, were high compared to those produced by LCP (the Scheme Actuary's firm). We also observe that some of the FBB expected returns appear high compared to those used by some other actuarial and investment consultancies.

4. Funding proposals

Our view of the employer covenant is primarily what drives our assessment of the funding strategies (i.e. the combination of technical provisions and recovery plan) that we consider to be appropriate. As explained above, our view is that the strength of the employer covenant is 'Tending to Strong' in all scenarios. However, we do also attribute incremental value to the covenant support measures when carrying out our assessment of the individual funding strategies. We note that our view of covenant strength is the same as the Trustee's covenant adviser's view for Scenarios 1 and 2 but different for Scenario 3, where they consider it to be 'Strong'.

The proposals set out in the Rule 76.1 report are split by three different covenant scenarios and we have structured our comments along the same lines. For each scenario we have assessed the suitability of the funding strategy as an overall package, rather than being overly focused on the individual components. We have separately considered both the DRCs, which fund the deficit on the past service benefits, and the future service rates. Together these make up the total contribution rate. If the individual funding strategies for any of the covenant scenarios were changed but resulted in similar levels of DRCs and total contributions to the current proposal, we would be likely to assess the overall package similarly. Ultimately, the key outcome for any individual funding scenario is the level of total contributions that the Scheme will receive. However, where applicable, we have commented on those aspects which we consider make the overall strategy weaker and introduce more risk than we are comfortable with.

Scenario 1 – No additional covenant support
Covenant strength: TPR view: 'Tending to Strong'; USS view: 'Tending to Strong'
Key assumptions:
Pre-retirement discount rate: Gilts+2.0% p.a.
Post-retirement discount rate: Gilts+1.0% p.a.
Recovery plan length: 10 years
Additional investment return over the recovery plan: 0.5% p.a.
Total contributions: 56.2% of salaries (Future service rate 37.0%, DRCs 19.2%)

This proposal is unchanged from the version we saw and discussed with you in December 2020. We continue to view this scenario as compliant and have no comments to make on it.

Scenario 2 – UUK illustrative covenant support package
Covenant strength: TPR view: 'Tending to Strong'; USS view: 'Tending to Strong'
Key assumptions:
Pre-retirement discount rate: Gilts+2.3% p.a.
Post-retirement discount rate: Gilts+1.0% p.a.
Recovery plan length: 10 years
Additional investment return over the recovery plan: 0.75% p.a.
Total contributions: 49.6% of salaries (Future service rate 34.7%, DRCs 14.9%)

This proposal is also unchanged from the version you presented for discussion in December 2020. We continue to be comfortable with the discount rate and resulting prudence of the technical provisions along with the length of the recovery plan. We do though have some concerns around the level of the additional investment return over the recovery plan assumption. As such, we would consider the prudence of the proposal taken as a whole to be more marginal.

As we have discussed with you, we consider that a long recovery plan combined with a significant element of additional investment return can serve to remove much of the prudence in the technical provisions discount rate assumptions. Put another way, the same overall outcome in terms of the level of DRCs can be achieved by weakening (increasing) the technical provisions discount rates and assuming no additional investment return for the recovery plan. It is important that the Trustee and stakeholders appreciate this point and we are pleased that its impact has been explicitly set out within the final draft Rule 76.1 report.

Allowing for the package of covenant support measures envisaged and viewed within the context of the funding strategy as a whole, we would be comfortable with an additional investment return assumption over the recovery plan of around 0.5% p.a. Beyond that it becomes harder for us to reconcile the effective level of prudence in the approach with our view of the support being provided by the employers. As a result, we consider the assumption of 0.75% p.a. to be too high. Taken with the other elements of the proposal, this leads us to view Scenario 2 as being at the limit of compliance with the legislation.

Scenario 3 – Enhanced level of covenant support
Covenant strength: TPR view: 'Tending to Strong'; USS view: 'Strong'
Key assumptions:
Pre-retirement discount rate: Gilts+2.5% p.a.
Post-retirement discount rate: Gilts+1.0% p.a.
Recovery plan length: 15 years
Additional investment return over the recovery plan: 0.5% p.a.
Total contributions: 42.1% of salaries (Future service rate 33.6%, DRCs 8.5%)

We believe that the additional covenant support provided under this scenario can support a pre-retirement discount rate for Scenario 3 that is marginally higher than for Scenario 2. We view the proposed pre-retirement discount rate of gilts + 2.5% p.a., and associated level of technical provisions, as being reasonable.

A 15-year recovery plan is longer than we expect for a scheme with an employer covenant rated as 'Tending to Strong'. (For the avoidance of doubt, it is also longer than we would expect for an employer covenant rated as 'Strong'.) However, we accept that the length of the recovery plan can be linked to the effective minimum length of the moratorium, which would prevent a sudden deterioration in covenant arising from the departure of one or more of the stronger employers during that period. Consequently, we can see the rationale for a 15-year recovery plan under this scenario.

The comments made above under Scenario 2 in relation to allowing for additional investment return over the recovery plan also apply under this scenario. However, in this case, the impact of the additional investment return assumption is magnified given that the term of the recovery plan is longer - this is demonstrated by the figures in the Rule 76.1 report. Consequently, we would be comfortable with a modest level of additional investment return of around 0.25% p.a. over the recovery plan. As a result, we consider the assumption of 0.5% p.a. to be too high. Taken with the other elements of the proposal, this leads us to view Scenario 3 as being at the limit of compliance with the legislation.

Potential implications of a longer moratorium

Although not part of any current scenario within the Rule 76.1 report, we understand it is possible a moratorium of greater than 15 years could ultimately be agreed with employers. We have considered our likely position in this situation, particularly on an appropriate recovery plan length.

If an alternative covenant support package was agreed that included a longer moratorium, we would not necessarily be comfortable with the length of the recovery plan being extended in line with the extension in the minimum length of the moratorium. For example, if the effective minimum length of the moratorium was extended to 20 years, it does not follow that we would be comfortable with a 20-year recovery plan. We would consider the suitability of any proposed funding strategy as an overall package based on what support measures were put forward at that time.

Having a recovery plan longer than 15 years would create additional risks to members' benefits, which would need to be considered carefully by the Trustee Board and us. One way these risks could be managed is by putting additional covenant commitments in place. For example, contingent contributions could automatically become payable if the Scheme's funding position deteriorates and/or contingent assets could be provided by employers to support a longer recovery plan.

5. Next steps

The views that we have provided above assume that the respective covenant support and funding proposals are finalised, based on our current understanding of them. Please let us know if there are any material changes to the proposed covenant support packages or funding strategy proposals.

We understand that the actual investment strategy the Trustee Board wishes to implement will be considered later in the 2020 Valuation process and the Trustee Board will formally consult on the Statement of Investment Principles. We would like to receive details of these proposals once available.

We are aware that there is significant stakeholder interest in our views regarding the Rule 76.1 report. We recently met with both Universities UK (UUK) and the University and College Union (UCU) and will be doing so again following provision of the Rule 76.1 report to the Joint Negotiating Committee (JNC). At these meetings we expect to have more detailed discussions. We received a clear message that they would like us to explain the rationale of our position so that their stakeholders can understand it. We hope this letter will be of use in that regard and can confirm that we agree to your sharing it with both UUK and UCU. We also intend to produce a further communication setting out our responses to "frequently asked questions" in the context of TPR's role in the valuation process. We expect the content of that document to be informed by our discussions with stakeholders following provision of the Rule 76.1 report to the JNC.

Issuing the Rule 76.1 report represents an important milestone in the 2020 Valuation process and we do not underestimate the importance of all stakeholders working together constructively in the next phase of the valuation. Our role as regulator is to ensure that the outcome for the 2020 Valuation is appropriate and that the level of risk taken by the Scheme and any risk to members' benefits is commensurate with the level of risk which can be supported.

The statutory timescale for completing the 2020 Valuation process is by 30 June 2021, 15 months from the valuation effective date of 31 March 2020. We understand that this deadline is now unlikely to be met. We understand the reasons for this, and provided that there are no undue delays, we believe the interests of Scheme members will be best served by a valuation which has been fully considered and is compliant with Part 3 of the Pensions Act 2004. Whilst we have the ability to take action if the 2020 Valuation is delayed beyond the statutory deadline, our decision on whether to do so would be informed by whether we considered the delay to be reasonable and within the control of the Trustee.

Yours sincerely

Mike Birch
Director of Supervision