1 April 2021

Universities Superannuation Scheme (USS)
2020 actuarial valuation Q&A

In our letter to the trustee (dated 26 February 2021) we set out our views in relation to the Rule 76.1 report on the financial condition of the scheme. The Rule 76.1 report includes the scheme actuary's advice and recommendations on the total required contributions for the scheme's current benefit structure in three different scenarios.

You can read a copy of our letter on the 2020 valuation section of the USS website. In it, we explained that we would be discussing our views with both Universities UK (UUK) and the University and College Union (UCU) and indicated our intention to produce this Q&A document in the context of our role in the 2020 valuation process and the recent discussions we have had with those stakeholders.

Contents

1. What is TPR's role in the valuation process?

The current statutory framework for the regulation of defined benefit (DB) pension scheme funding (set out under Part 3 of the Pensions Act 2004), came into force on 30 December 2005. This Act set out a new set of funding obligations and created TPR as the body responsible for enforcing compliance with them.

The Act gives us a number of statutory objectives, including:

- to protect members' benefits
- to reduce the risk of calls on the Pension Protection Fund (PPF) and
- to minimise any adverse impact on the sustainable growth of an employer when we exercise our functions under Part 3 of the Act.

To support us in meeting these objectives, we engage proactively with trustees of some schemes as they work through the development of their scheme valuations with their advisers and scheme actuary. This enables us to make our views clear before valuations are finalised and so helps to enable compliance with the statutory funding framework. From the trustees' perspective, this approach is generally considered helpful, as it provides them with a valuable input into their decision-making process.

How this relates to the USS

As the USS is one of the largest regulated DB schemes it was one of the first we engaged with proactively – as far back as the 2011 valuation.

Completion of the scheme actuary's Rule 76.1 report represents an important milestone on the journey to complete the 2020 valuation. We hope the report will now enable all stakeholders to work together constructively on the next phase of the valuation process. We expect that we will continue to be engaged in the process, so we can identify any regulatory issues or concerns before the 2020 valuation is completed and submitted to us.

Our primary role as a regulator is to ensure that the outcome for the 2020 valuation is compliant with the law, and, as part of that, that the level of risk is appropriate in relation to the strength of employer support for the scheme.

2. How does TPR engage with its stakeholders?

We are committed to being open and transparent in our regulatory activities and we engage with a range of stakeholders including:

- trustees
- employers
- pension providers and advisers
- legal professionals
- consumer and member organisations

We aim to have an effective dialogue with these stakeholders and value their views and feedback, which shapes the way we work. How we engage will depend on the nature of our relationship with them. There are also legal restrictions which sometimes prevent us from disclosing information that we have obtained from other parties.

How this relates to the USS

We are aware that there is significant stakeholder interest in the scheme and we are keen to support and continue an open and constructive engagement with the trustee, with UUK, representing the employers, and with UCU, as the trade union representing members in the scheme, throughout the 2020 valuation process.

Our letter in response to the Rule 76.1 report will help stakeholders understand our position and how we have reached our views. We hope that this Q&A document will help stakeholders understand our role in the valuation process more generally.

3. What is the role of trustees in the valuation process?

Part 3 of the Act provides the statutory framework for how trustees must assess a scheme's liabilities and determines the pace and period over which these liabilities must be funded. A scheme's liabilities (also known as technical provisions) must be calculated prudently based on actuarial assumptions that have been chosen by the trustees.

Where a scheme does not have sufficient assets to cover its technical provisions, the trustees must put in place a recovery plan to return their scheme to full funding on that measure. A recovery plan should be tailored to the specific circumstances of the scheme and the employer.

4. How does TPR assess actuarial valuations?

We assess valuations from schemes using a suite of risk indicators.

Our main risk indicators relate to the three pillars of integrated risk management (IRM): covenant, investment and funding. These key indicators include:

- a bespoke covenant assessment on the ability of the employer or employers to support the scheme now and in the future
- a funding risk indicator on the level of contributions
- an investment risk indicator on the scheme's current investment strategy
- an overall risk indicator which brings these three elements together

When assessing an actuarial valuation, the key elements that determine the level of risk with which we are comfortable are the employer's covenant and affordability and the maturity of the scheme. We consider that an immature scheme backed by a strong employer with high levels of affordability compared to the size of the scheme would be able to support higher levels of risk-taking.

Our risk indicators are reviewed and updated annually and are applied consistently over each group of valuations (known as a 'tranche'). Each year we publish a DB annual funding statement, which explains which risks we are focused on in that tranche of valuations. This is supplemented by our analysis of schemes in that tranche. We don't publish the parameters and assumptions we have used to set our risk indicators for that year.

There are several additional risk indicators we look at, including:

- the level of back-end loading and allowance for outperformance in the recovery plan
- any potential avoidance issues or actions that may have weakened the covenant
- any reduction in contributions to check if they are justified based on the change in the scheme's funding position
- PPF funding risk
- mortality assumptions used for the technical provisions
- any issues raised at previous valuations or arising from other interactions with us

You can read more about our risk indicators and how we use them in our DB funding regulatory and enforcement policy.

How this relates to the USS

The current USS valuation is a Tranche 15 valuation, which includes those valuations with dates between 22 September 2019 and 21 September 2020. Our 2020 annual funding statement is most relevant for Tranche 15 valuations such as the one being carried out by the USS.

5. How has TPR determined that the proposals for Scenarios 2 and 3 in the Rule 76.1 report are at the limit of what it considers to be compliant with the requirements of Part 3?

We have assessed the proposals for Scenarios 2 and 3 against our risk indicators for Tranche 15 valuations as explained in question 4. We have also considered the specific circumstances of the USS, the approach the trustee has taken to assessing the scheme's risks, including the advice it has received from the scheme actuary and covenant specialists, and the USS's integrated risk management framework and associated metrics.

Our view of the employer covenant is primarily what drives our assessment of the funding strategies (ie the combination of technical provisions and recovery plan) that we consider to be appropriate. Our view is that the strength of the employer covenant is what we would refer to as 'Tending to Strong' in all scenarios. We explain how we assess covenant in question 6.

While we consider the covenant to be Tending to Strong, we do attribute incremental value to the covenant support measures under Scenarios 2 and 3. This is why we recognise that the proposal for Scenario 3 can include a higher pre-retirement discount rate along with a longer recovery plan than Scenario 2.

The reasons why we consider the covenant to be Tending to Strong, along with further details of how we assessed the proposals for each scenario, can be found in our 26 February letter. In summary, our letter explained that:

In relation to Scenario 2, we are aligned with the trustee's assessment of covenant, which is also Tending to Strong. We are comfortable with the discount rate and technical provisions, along with the length of the recovery plan, in the proposed funding strategy. However, we consider that a long recovery plan combined with a significant element of additional investment outperformance can serve to remove much of the prudence in the technical provisions' discount rate assumptions. As a result, we would only be comfortable with a modest additional investment outperformance assumption over the recovery plan of around

0.5% per year. 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 additional outperformance assumption of 0.75% per year, in combination with the discount rate, 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.

In relation to Scenario 3, we are not aligned with the trustee's assessment of covenant, which they consider to be Strong. However, we do 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.

We are comfortable with a 15-year recovery plan, which is longer than we expect for a scheme with an employer covenant rated as 'Tending to Strong' or 'Strong', because of the link to the effective minimum length of the moratorium.

As for Scenario 2, we consider a modest allowance for outperformance would be appropriate, but it would need to be somewhat lower than under Scenario 2 because the recovery plan is longer. Consequently, we would be comfortable with a modest level of additional investment outperformance of around 0.25% p.a. over the recovery plan and 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.

6. How does TPR approach the assessment of employer covenant?

The employer covenant is the level of financial support available to a DB pension scheme from its employers and, if applicable, any guarantors or other contingent support.

We form our view of covenant by taking into account the employer's financial strength and the scheme's funding needs. Read more about assessing employer covenant strength.

After considering all the relevant factors, we assess covenant strength using a four-point rating scale:

- Strong
- Tending to Strong
- Tending to Weak
- Weak

In practice, when we engage with schemes directly during their actuarial valuation process, our assessment of the covenant is more detailed and specific to the employer's and scheme's circumstances. At this more detailed level, covenant strength is a continuum, allowing for a range within each of the four covenant bands.

7. How has TPR assessed employer covenant for the USS?

Our overall assessment of the covenant strength is that it is Tending to Strong. This conclusion is heavily influenced by the significant size of the scheme in the context of the sector and this conclusion was also shared by the trustee covenant adviser's recent assessment. The factors we consider most relevant to the assessment of the USS's covenant are:

- areas that could be affected by the proposed introduction of covenant support measures, such as:
  - legal access to the employer covenant, including consideration of the 'last man standing' nature of the scheme and a moratorium on employers paying their s75 debt and severing responsibilities to the scheme
  - the financial position (including the level of secured creditors) and the risk of subordination of the scheme in the event of an insolvency
  - the overall level of debt relative to an employer's balance sheet
- historical trading acknowledging the high growth the sector has experienced since the introduction of student fees
- future outlook for the sector
- cash generation and covenant-enhancing investment
- the position of the scheme in a hypothetical insolvency
- affordability, both now and in the future

Affordability

Affordability is the most important factor as it determines the most an employer can pay to a pension scheme after considering current and future operational needs and risks. Considerations in relation to affordability often include the position of competing creditors, what choices and discretion the employer has in terms of its disbursements in the ordinary course of business, whether there is any value extraction from the covenant, and the risks that can affect the future prospects of an employer.

Where payments into a scheme are constrained because an employer is not prepared to pay more despite being able to afford it, this will have implications for the covenant assessment.

We recognise that the Higher Education sector is financially successful and generates significant levels of income. We therefore believe that the sector has the capacity to ensure that the scheme's funding requirements are sufficiently met if it needs to. However, the employers in the sector, as with many not-for-profit institutions, seek to use most (if not all) of their income and capital resources to meet educational objectives and to help 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 to pay additional 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 ensure the subsequent increases could be met, without disruption to their short term cashflow plans and educational objectives. The initial lower level of contributions included deficit repair contributions (DRCs) of only 2% of salaries.

Contribution increases vs increased investment risk

We understand there is a concern that future agreed step-ups in contributions (due from 1 October 2021) 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 period, and the scheme should only take a level of investment risk which the sector has the capacity and willingness to underwrite with increased payments if necessary.

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 educational market, we also recognise that the scheme has strong access to value in the employer group (by way of the last man standing provisions).

We acknowledge 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, we consider the measures to be protective of the current covenant position. As such, adopting those 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 enable 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.

8. How can covenant be improved?

At its simplest, covenant can be improved by either a scheme’s funding position improving (meaning the scheme is less reliant on the covenant for future support) or an employer’s financial performance and affordability improving, or a combination of both.

Various additional measures may be considered to either support and protect the current view of covenant or to improve it. The advantages to all parties in considering these measures is that they may, for example, provide scope for a scheme to take more investment risk and/or pay lower DRCs over the agreed recovery plan or, in the case of an improved covenant rating, also adopt a higher discount rate.

How this relates to the USS

For the scheme, the most obvious ways to improve covenant strength are:

1. **Additional cash contributions:** These would be in the form of contributions over and above the current DRCs (as set out within the scheme’s Schedule of Contributions) to improve its funding position and could involve significantly higher contributions in the early years of a recovery plan. Alternatively, employers may choose to make higher contributions at a more consistent rate over a shorter recovery plan than the maximums envisaged for the scenarios in the Rule 76.1 report.

   The USS has a very substantial self-sufficiency deficit at the 2020 valuation date. Under all three scenarios, this deficit is materially higher than the trustee’s assessment of the reliance it can place on the covenant (which is captured in Metric B of its IRM framework). This indicates that higher contributions in the short term would be appropriate to improve the scheme’s funding position. This correlates with our conclusion that the covenant is Tending to Strong due to the insufficient cash contributions being made and the size of the scheme relative to the sector.

2. **Contingent contributions:** As an alternative to or in combination with additional cash contributions, these would be payable when certain triggers are met, such as the scheme funding deteriorating to a specified level. Contingent contributions would have the benefit of providing certainty against future risk while allowing for the scheme’s funding to potentially improve before further cash contributions are committed.

3. **Contingent assets:** These would become available in circumstances similar to contingent contributions or in the event of the financial failure of an employer. Examples of contingent assets include security over real estate or other unencumbered assets the employer can offer.

9. What is IRM and how can it be beneficial for managing a scheme?

IRM is a risk management approach that can help trustees to identify, manage and monitor the factors that affect the prospect of meeting their DB scheme's funding objectives. It should inform discussions between trustees and the employer and the decisions the trustees make relating to their strategy for meeting their objectives.

IRM involves examining how employer covenant, investment and funding risks relate to and are affected by each other. It also involves considering what to do if risks materialise. IRM forms an important part of good scheme governance. Its benefits include:

- improved decision-making due to better understanding of risks
- open discussion between trustees and employers on the risks to each other's objectives and strategies
- increased focus on the most important risks
- better preparation if problems occur
- improved use of time and resources

Read more about IRM

How this relates to the USS

The USS trustee has developed an approach that follows IRM principles with both covenant strength and notional investment strategy contributing to an appropriate funding strategy. This framework demonstrates that the scheme is highly reliant on the sector to support it over the long-term, and therefore the covenant strength and covenant horizon over which the employers can reliably provide support is key.

As set out in question 7 there is limited additional affordability of contributions that employers are prepared to pay. Without a commitment from employers to pay higher contributions and/or a reduction in benefit accrual to increase the affordability of DRCs, this restricts the amount of funding and investment risk that the scheme can take. All other things being equal, this should lead to a lower level of investment risk and a higher value being placed on technical provisions than otherwise.

There are also various ways that the covenant could be enhanced, allowing the scheme to take more risk and potentially pay lower contributions in the medium-term, as explained in the answer to question 8.

10. Should DB schemes have long-term funding targets?

You can read our view on long-term funding targets (LTFTs) in our 2020 Annual Funding Statement.

Paying promised benefits is the primary objective for all schemes. This requires trustees to look ahead and set clear plans for how that objective will be delivered within an IRM framework. Schemes that do this well often have trustees and employers agreeing a clear strategy for achieving their long-term goal, which recognises how the balance between investment risk, contributions and covenant support may change as the scheme gets better funded and becomes more mature.

Typically, this leads to a LTFT being agreed between trustees and employers. We encourage schemes to follow this practice and set a LTFT consistent with how the trustees and employers expect to deliver the scheme's benefits, and then be prepared to evidence that their shorter-term investment and funding strategies are aligned with it.

Given the varying characteristics of different schemes there is no single LTFT that will be suitable in all circumstances. For some schemes, an appropriate target might be to purchase annuities from a buy-out provider. For others, a position that places a 'low dependency' on future support from the scheme's employer might be more suitable. Trustees of schemes that continue to accrue benefits may be justified in reflecting this when planning how their LTFT will be reached.

How this relates to the USS

In relation to the USS, we are supportive of the example LTFT outlined by the Joint Expert Panel (JEP) on page 58 of its report dated December 2019:

"[The] USS aims to be fully funded on a technical provisions basis where technical provisions are valued on a low risk self-sufficiency basis for post-retirement years and on a prudent on-going basis for the pre-retirement years. The Scheme will also ensure that, at all times, the proximity to full self-sufficiency assessed on a low risk basis can be supported by employers over an appropriate time frame if the Scheme were to be closed to future accruals."

We consider this example LTFT to be aligned with the actual approach proposed by the trustee for the 2020 valuation.

Furthermore, we see other benefits in adopting a dual discount rate, where one discount rate applies pre-retirement and another post-retirement. This type of approach reflects the current profile of the membership and can evolve automatically towards a lower risk position if the profile changes in the future and the scheme becomes more mature.

We have considered the overall package in the round when assessing the proposals for the different scenarios set out in the Rule 76.1 report, as described in question 5 and in our 26 February letter. This doesn't mean we are necessarily comfortable with each individual assumption in isolation (such as the pre- and post-retirement discount rates), but our assessment is based on the package as a whole and how the assumptions work together and contribute to the overall proposal.

11. Is TPR ignoring the Joint Expert Panel's conclusions?

The Joint Expert Panel (JEP) was established in response to the dispute between UCU and the employers over the benefit changes that the employers were proposing in 2018. We welcomed the establishment of the JEP as a panel of experts tasked with considering the valuation and the longer-term sustainability of the scheme and participated in its evidence-gathering. Our statutory objectives are best addressed by the scheme having a robust and sustainable plan for funding benefits, which is agreed between the USS and the employers, and to which all parties have had an opportunity to give input.

The USS has considered the JEP proposals at different stages and explained to what extent it has taken them on board in the 2020 valuation so far. Now that the 2020 valuation is under way, our role is to assess the proposals against the framework which is set for us by Parliament, and which we apply equally to all schemes.

12. Can schemes take account of developments after the valuation date?

Trustees should decide if they want to allow for developments after the valuation date when agreeing the recovery plan with their sponsoring employer(s). It may be appropriate to allow for post-valuation experience (PVE) when there has been a significant change in the funding position of the scheme. However, there is no legal requirement to allow for this.
If trustees do choose to allow for PVE, we expect them to:

- consider both the change in the value of the assets and the change in the discount rates (and other financial assumptions) used to calculate the technical provisions
- look to adopt a consistent approach to allowing for PVE from valuation to valuation
- allow for any changes in the circumstances of the employer(s) since the valuation date that might have changed the trustees' view of covenant strength
- be mindful not to effectively double count any improvements in the scheme's funding position. Trustees should consider how the updated funding position compares to that expected under the valuation assumptions and whether the assumption for investment returns over the recovery plan needs adjusting as a result.

How this relates to the USS

In the case of the USS, we understand that both asset values and technical provisions have increased since 31 March 2020. If the trustee chooses to allow for PVE, it would need to determine an appropriate allowance for assumed additional investment performance during the recovery plan, which may differ from those applicable as at 31 March 2020.

13. TPR's role and the future sustainability of the USS

We have to work within objectives set for us by Parliament. The framework we regulate against focuses on the benefits that members have already earned under the scheme, with the aim that those benefits should be paid in full when members reach retirement. This is our primary objective in our engagement with the USS.

We expect employers to understand the risk in the scheme and, with the other stakeholders, to find a way to address that risk. The 2020 valuation results presented in the Rule 76.1 report show a substantially increased deficit. This means that, without action, there is an increased risk that the benefits members have already earned may not be paid in full, and that sharp increases in contributions might be needed to provide an equivalent level of benefits.

The continuation and continued affordability of the scheme is a decision for employers, together with employees and unions as appropriate. It is not for us to suggest ways in which the risk in the scheme might be addressed, whether by increasing contributions, finding alternative ways to support the scheme, or by changing benefits. It is for the employers (together with employees and unions as appropriate) to find the right balance between these approaches, and also the balance between employer contributions and member contributions.

14. How does TPR take account of the impact of a 2020 valuation on the sustainable growth of the USS employers?

We encourage trustees to recognise the potential impact of DRCs on employer(s) investment and financing plans, and hence on the covenant on which a scheme relies. The statutory funding regime contains flexibilities which allow trustees to address a scheme's funding needs while minimising the impact on the sustainable growth of the employer (see paragraphs 76-81, 126, 143 and 149 in our DB funding code of practice for more details). Where relevant, we similarly recognise the importance of minimising any adverse impact on the sustainable growth of the employer(s), in our assessment of technical provisions and recovery plans.

How this relates to the USS

At the 2018 valuation, DRCs were allowed to be phased in from an initial rate of 2% to an ongoing rate of 6% with effect from 1 October 2021 to provide employers with time to adjust to that higher level of payments.

The Scenario 3 proposal shows that DRCs would increase from 6% to 8.5% of salaries. This is despite the deficit increasing around fourfold from the 2018 level. The flexibility in the statutory funding regime enabled the trustees to develop a funding proposal for the 2020 valuation that limits the increase in DRCs relative to the increase in the deficit, for example by proposing a long recovery plan and including in it a significant element of investment outperformance.

While the scenarios in the Rule 76.1 report do show significantly increased contributions, these are predominantly due to the cost of providing future benefit accrual rather than the cost of funding benefits already accrued. The contributions needed for future accrual depend on the level of benefit being provided (factoring in the level of contributions that are affordable). This needs to be decided by the employers, together with employees and unions as appropriate.

We do not consider that our statutory objective to minimise any adverse impact on the sustainable growth of an employer would allow us to prioritise the provision of a particular level of future service benefits over the prudent funding of benefits already accrued.

15. Does the Pension Schemes Act 2021 and proposed new DB code have an impact on this actuarial valuation?

No, this actuarial valuation is under the current legislation and the existing code of practice on DB funding. It does not come under the code which is due to be developed under the Pension Schemes Act 2021.

The Pension Schemes Act received Royal Assent on 11 February 2021. In relation to DB funding, it builds on the existing approach and sets new requirements to help trustees focus on long-term planning and clarifies what is expected of schemes based on their own circumstances.

The next stage is for the DWP to develop regulations, which they will be consulting on later in 2021, to sit alongside the new Act. We will then run a second consultation on the new DB funding code during the second half of 2021. Ultimately, the new code is expected to come into force during 2022, and all actuarial valuations with effective dates after it enters into force will be expected to follow the new code.

You can read more about the Pension Schemes Act in our Executive Director, David Fairs' blog. Details of our first consultation on the new DB funding code, including our interim response, can be found on our website.

16. What action is TPR likely to take if the 2020 valuation is not completed within the statutory timeframe?

The statutory deadline for completing the 2020 valuation process is 30 June 2021 - 15 months from the valuation effective date of 31 March 2020. We have enforcement powers which we can use if a valuation is delayed beyond the statutory deadline.

We understand that the deadline is now unlikely to be met and the reasons for this. 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.

If it is the case that the statutory deadline is going to be missed, then we would want to understand the position at that point in time (including the extent to which the trustee is exercising its powers under the scheme's trust deed and rules). In particular, we would expect the trustee to provide a plan which would set out a credible programme to complete the 2020 valuation in a reasonable timeframe (including any employer consultation steps). If part of this timeline is taken up by further JNC consideration, we would expect both the trustee to set out an acceptable period of time for the JNC process to be completed, and the JNC to cooperate with and work within that timeframe. Provided the trustee has a clear programme to conclude the 2020 valuation within a reasonable timeframe and then matters progress in accordance with this timetable, we would not anticipate using our powers in respect of the breach of the statutory deadline.

17. What are TPR's scheme funding powers?

Our scheme funding powers allow us to direct the way in which the technical provisions are calculated, to set a recovery plan, to change future service benefits and to impose a schedule of contributions to be paid by employers and scheme members.

We do not exercise these powers lightly and follow general principles of public law, including assessing whether the use of any power is reasonable and whether it addresses our statutory objectives. Our preferred approach is built on helping trustees and stakeholders to identify how best they can assess risks to their scheme and act to manage them.