Universities UK

17 July 2020

UUK Representatives' Views on Progress of the USS Valuation Methodology Discussion Forum (VMDF)

Important note

This report represents the personal views of the UUK VMDF representatives and their adviser. It is not a formal UUK position, which would be premature to provide absent consultation with employers.

Introduction

Thank you for facilitating the VMDF, and for facilitating and providing supporting materials for the eleven meetings we have had. In this note, we set out our observations on the VMDF discussions, along with our comments on the key valuation items discussed.

Key observations

We have the following high-level comments on the VMDF discussions:

- Considerable common ground has emerged between UUK and UCU representatives about pensions risk and the long-term nature of the USS. If we can agree a tripartite understanding of risk (and the problem we are trying to solve), then this opens up the possibility of better outcomes for all parties.
- Any increase to costs in the current climate could lead to the university sector being starved of funds at a crucial time – or to unnecessary benefit changes that would damage industrial relations. Therefore, it is vital that any proposed increase to contributions is kept to the absolute minimum and that every avenue should be exhausted.
- There are some apparently straightforward questions that have not been resolved, where greater closure would help our discussion move on. From a UUK perspective, these include:
  - **Are combined contributions of 26% sufficient for current benefits? If not, why not?**
  - **Is it necessary to de-risk from 65% in growth assets and, if so, over what period? Does de-risking help in downside scenarios, when assessed over the long-term?**
  - **What actions would the Trustee take in bad scenarios? In particular, what are the practical risks that members and employers are exposed to in terms of increased contributions, and when would it be reasonable for the Trustee to move to a self-sufficiency portfolio?**
  - **How will the valuation methodology factor in the Joint Expert Panel's (JEP) recommendations about the Recovery Plan and smoothing of contributions?**
- While different stakeholders *"may place different emphasis on different areas"* as noted by USS in meeting 10, we believe it is premature to fall back on such anodyne and polite positioning, and through the consultation and other channels the Trustee should address the stakeholders' main concerns and questions.

- Turning to the individual meetings, while we are grateful for the effort and support, taken as a whole they have not achieved as much as we had hoped. From our perspective, meetings 1 and 2 were useful as broad scene-setting, and to help focus UUK and UCU on key questions. Meetings 3-6 were then not particularly useful as the main information requested on 14 February 2020 was not available until meeting 7. Meeting 7 was very useful – but there was an inherent tension between the modelling results which seemed to show that de-risking was not a good idea, and a USS view that short-term risk was a concern and short-term de-risking a potential remedy. Meeting 8 had a limited agenda. Meetings 9 to 11 were again very useful, particularly meeting 11 when we were presented with the modelling requested on 7 April 2020 – and we are grateful for the significant effort of the USS team to produce this analysis, although the VMDF then ran out of time to explore common ground and fully digest the results. Overall, we believe that the VMDF meetings were useful, but that the process will have been frustrating at times for all stakeholders.
- We can understand that the Trustee will be keen to draw a line under the VMDF and move to the consultation in August 2020. We await with interest how the Trustee will respond to our feedback. However, if the Trustee's proposed approach is largely in line with that set out in the Discussion Document consultation, then we believe there will inevitably be calls for the VMDF to keep going until it can be shown that every avenue has indeed been exhausted.

Our views on principal issues that the VMDF has considered

We set out our more summary comments below on the main issues discussed (excluding covenant which had a more limited airing).

a) Discount rate

- The modelling evidence (meeting 9) shows that returns of CPI+1.2% p.a. are sufficient for the scheme to be fully funded in 20 years with a 26% contribution rate from the comparatively low asset valuation at 31 March 2020. We asked in meeting 9: Why is this an issue since CPI+1.2% looks low compared with historical returns (and many endowment targets), and since the modelling provided for meeting 7 showed the Scheme was robust to selected bad events? This question was still being explored in meetings 9 to 11 with additional modelling of more extreme scenarios, but there lacks a clear conclusion that will be easy for employers to engage with in our view. Until this can be addressed definitively, it is difficult to see how UUK can have a meaningful consultation with employers without claims that there is no problem to fix.
- If there is evidence to move beyond the above point, then we believe that employers may largely support a dual discount rate approach on the basis it was recommended by the JEP. We are grateful to the Trustee for being open to amending its approach.
- For the post-retirement discount rate, using a discount rate consistent with the self-sufficiency provides an in-built escape path to close to self-sufficiency. It is consistent with the JEP recommendations. From a VMDF perspective though, it is fair to say that other approaches (such as a single flat discount rate) were not ruled out convincingly.
- For the pre-retirement discount rate which is especially crucial for the cost of new benefits, the JEP suggested three options to be considered. We note from meeting 7 that Gilt+3.4% p.a. (closest to Gilts+3.5%) is consistent with a 67th percentile return for a 65% starting investment strategy (at 31 December 2019), and The Pensions Regulator's (TPR) view at meeting 10 that TPR expects the average discount rate for 31 March 2020 valuations to be a little higher than for previous valuations (and indeed the JEP may have suggested a higher set of discount rates had they provided views at the valuation date).

- The JEP preference for a pre-retirement discount rate was "CPI + fixed margin" (set equivalent to Gilts+3.5%, say, at the valuation date). We are not convinced of the merits of using USSIM's Fundamental Building Block (FBB) assumptions instead which are harder to explain and monitor. A 67th percentile is very sensitive to input assumptions and could be quite volatile, though the precise figures for the deficit and future service rate should not overly matter if there is an adequate smoothing mechanism. Also, as a reminder, the Trustee indicated concern about 67th percentile FBB assumptions at the 2018 valuation (due to the increased gap to gilt yields), so the extra complexity does not necessarily give more robust results.

b) Recovery plan and smoothing of future service rate

- If the Recovery Plan falls outside of the parameters recommended by the JEP, then it will be harder to engage employers and gain acceptance that the approach is reasonable. In the first JEP report, the experts recommended a 15-20 year recovery plan based on the strength of covenant. Then JEP recommended that there was some sharing of asset outperformance in the Recovery Plan, and provided illustrations based on 25% and 50%. The JEP report also recommended smoothing of the contribution rate.
- In meeting 1, USS noted that a strong covenant means a longer recovery plan can be adopted. We agree. This is particularly important for a cost-sharing scheme, from the perspective of intergenerational fairness.
- The scheme has no short-term risk of running out of money. If additional contributions are required to help reduce risk over the long term, then in our view it would make more sense to spread them over the long term (e.g. 20 years) to avoid one particular cohort suffering the additional costs (especially as it is forecast that the investment performance for contributions collected and invested in the next 10 years will be particularly bad).
- The first consultation stated that the Trustee would consult on the Recovery Plan at the same time as the Technical Provisions. It is vital that meaningful information is provided (rather than, say, a crude recovery plan illustration such as 10 years with no asset outperformance – with no context about whether this is really what the Trustee is requesting). Otherwise employers may have incorrect expectations about the need for change.
- In meeting 2, the USS Executive also suggested that smoothing of future service contributions could be applied from one valuation to the next.
- In meeting 11, we saw the results of the 7 April 2020 modelling request. This showed that having contributions that are "unsmoothed" could lead to some potentially unfair outcomes for particular generations of members (with the worked example showing deficit contributions of 14.3% for 3 years, 9.8% for 3 years, and then zero; compared with payments between 0% and 2.8% under smoothing). With any smoothing process there is a balance between over-reacting to noise, and not reacting quickly enough to genuine emerging trends. With modelling only being presented in the last meeting, the VMDF did not have the full opportunity to hear the Trustee views and explore common ground, however from a UUK representatives' perspective we see material advantage in a funding methodology that smooths out short-term volatility – taking advantage of the unique covenant visibility, and acting consistently with the scheme's long-term investment strategy.

c) Investment strategy

- There is clear agreement between UUK and UCU representatives that the dual discount rate approach does not necessitate the Trustee holding a bond-like portfolio for pensioners – i.e. there is a difference between a *funding* basis and the *actual* investment strategy. This has been acknowledged verbally by USS representatives, and it was

therefore disappointing to see this narrative reappear on a slide in meeting 10. In our view, the investment strategy should be set based on modelling of alternatives and comparing the pros and cons. 7 April 2020 request for modelling provides a potential risk framework to test different strategies from an employer perspective.

- It is not clear to us what is a reasonable level of risk reduction over time. We have seen no compelling evidence from an investment perspective for why the Trustee is justified in moving the starting asset allocation from 65% growth down to 55%. It may be a sensible course of action, but we have not seen anything yet to support this conclusion. In fact, all modelling evidence provided so far seems to suggest that it is not useful – including the latest modelling presented at meeting 11.
- In meeting 11, we questioned the narrative that the current investment strategy targets 20% growth in 20 years whereas the proposed approach targets 50%.
- We are also unclear when the Trustee believe it would be appropriate to move to a self-sufficiency portfolio. In meeting 7, USS concluded that taking more rather than less investment risk improves the results even in the stress scenarios. At present, there is no clear explanation for when it would make sense for the Trustee to move to a self-sufficiency portfolio – other than for very hypothetical scenarios like "if there is no covenant" (or no university sector in the UK).

d) Risk management and the role of self-sufficiency

- We support adopting a long-term investment strategy at a high level commensurate with a long-term covenant. The Trustee is deliberately (and rightly in the view we believe of many employers) running an investment strategy that is very volatile and unpredictable on a self-sufficiency basis – when measured over the short-term. We therefore struggle to see how self-sufficiency can reasonably be described as the Trustee's primary risk metric – otherwise why has the Trustee not taken investment actions (such as interest rate hedging) to protect this position.
- Making self-sufficiency the centrepiece of the Trustee's risk metrics (rather than being part of a suite, as is currently the case), is fraught with difficulties. We believe other methods – that are more directly linked to cash contributions – are more effective to measure risk. From an employer perspective, the main practical risks are around the contributions paid. There also needs to be visibility of what "nuclear events" would "force" the Trustee to "de-risk" and effectively close the Scheme.
- There seems to be a desire from USS to use self-sufficiency as a paradigm, with other measures judged as falling short (meeting 10). But there is little about funding unknown future liabilities that does not require subjective judgement and interpretation – self-sufficiency has itself changed over time (e.g. from Gilts+0.5% p.a. to Gilts+0.75% p.a. and now possibly to Gilts+1% p.a.). Furthermore, the current review of RPI means that there is acute uncertainty about the relationship between RPI linked gilts and the nature of a "self-sufficiency" portfolio to match CPI-linked liabilities in a scheme without a significant CPI cap. There is no point having a perfect risk measure but no information for employers on how it will be used to drive contributions or other actions – we would prefer a less theoretical basis for measuring risk with more focus on actions.
- From a communication perspective, making self-sufficiency the primary risk measurement will likely mean that it will be impossible to move on from criticisms of Test 1. We believe employers would find it easier to engage with an approach that is grounded in Technical Provisions (noting that this itself hard-codes a path to near self-sufficiency), is much clearer on what actions the Trustees would take in different circumstances, and follows the JEP recommendations for the different parameters. We would urge the Trustee to consider whether its preferred approach can be set out in

these terms, with self-sufficiency forming one of the suite of risk metrics as it currently does.

- There seems to be a dichotomy of views between UUK representatives who were focused on what contributions could arise in bad outcomes, with the USS view that risk is mainly about the self-sufficiency deficit. This is leading to a big rift in thinking particularly given the falling yields. However, the rift appears partly theoretical because the Trustee is not obviously managing the scheme in terms of keeping the self-sufficiency deficit under control. From the modelling presented to date, de-risking from growth assets does not obviously reduce risk. In the absence of risk sharing within benefits, the main lever that seems to help manage bad scenarios is additional cash contributions (together with faith in growth assets) paid over long periods.
- If the Trustee can adopt a framework along the lines of the modelling presented in meeting 11, then this will be helpful for engaging employers on the risks they are facing and the potential mitigations that could be sought, since employers will then have much greater insights into the potential actions that might result.

Next steps

We hope that our feedback is helpful at this stage, and we would be pleased to discuss this further.