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AN ACCOMPANYING PAPER FOR EMPLOYERS ON THE USS 2020 VALUATION, AND IN PARTICULAR ON THE DISCUSSION DOCUMENT ISSUED BY THE USS TRUSTEE ON 9 MARCH 2020

1 THE PURPOSE OF THIS PAPER

The USS trustee issued a technical discussion document to employers on 9 March 2020. The document, entitled "*Methodology and risk appetite for the 2020 valuation*" invites employers to express their views on five specific, and significant, questions.

This paper, and the attached annex prepared by UUK's actuarial advisers Aon, is presented to employers so that it can be read alongside their consideration of the discussion document, and might help in preparing responses to the USS trustee's questions. Also, to inform UUK's perspective, we welcome from employers feedback on the additional views and analysis expressed by UUK in this paper.

The deadline for responses to the USS discussion document is **5pm on 17 April 2020**; responses should be provided to UUK and copied to the USS trustee as appropriate.

2 IMPLICATIONS OF THE CORONAVIRUS (COVID-19) PANDEMIC

We are aware that the current priorities of employers will be on their responses to the Coronavirus pandemic, and the wellbeing of students and staff.

We recognise that this is a difficult time to be also consulting on matters relating to a valuation of USS, but we remain committed to responding to the USS trustee's timetable for progressing and concluding the valuation. That said, we are in continuing dialogue with the USS trustee and its executive, and indeed with representatives from the Pensions Regulator on these issues.

The USS trustee's latest update on matters relating to Coronavirus, and their impact upon the world's economic markets and on USS funding, are available on USS's website. We will of course advise employers if there are any developments which might impact upon the 2020 valuation process.

3 THE CONTEXT FOR THE USS TRUSTEE'S PAPER

A valuation of USS will take place as at 31 March 2020. The valuation process itself normally takes over a year to complete; the statutory rules expect completion within 15 months of the valuation date (30 June 2021). The USS trustee has been preparing for the valuation for some months, and this discussion document is important because it marks the **beginning of a phase of substantive engagement with employers**.

It is just the start, and we would note that any responses from employers may not be definitive at this stage as **more information is needed in specific areas**. Employers should feel able to respond on the basis that any views that can be expressed are indicative, and where appropriate offer very broad preference or support for a particular direction of travel; we are at the beginning of what we and employers expect will be a thorough consultative process.

The valuation has many moving parts. We believe that the USS trustee's discussion document brings together some of the important strands, but there is further work needed in some areas. Notably, additional information and evidence is needed in relation to employer covenant, and this paper spells out some of the additional details and justifications that, we believe, employers might need.

There are also other work strands – for example from the work of the **Valuation Methodology Discussion Forum (VMDF)**, created by the Tripartite Group of scheme stakeholders who have met since the publication of the Joint Expert Panel's (JEP's) second report – which need to be progressed, and for its deliberations to be taken into account. This emphasises the point that we are very early in the process – indeed we **haven't reached the valuation date** – and any views from employers and indeed from UUK, whilst valuable in terms of making progress, will be framed in preliminary and non-binding terms.

The discussion document is complex. We are conscious that many employers will wish to engage their governing bodies with the issues given their strategic importance, but much of the USS trustee's material is technical and familiar only to those closest to these issues or with specialist skills. This paper and the **attached analysis from Aon** provides some guidance and assistance as you brief colleagues and leadership groups, and prepare initial responses.

We should make clear that we recognise the significant challenge which the USS trustee has in presenting these issues for such broad **engagement**. The USS trustee has run three presentations on the discussion document (shortly after its publication), and we understand it has further communication plans. UUK will be reaching out to a number of the sector's employer groups over the coming months to offer engagement as employers consider the issues (and as always the UUK pensions team can be reached on pensions@universitiesuk.ac.uk should employers have questions on the developing materials).

Finally, we are very aware that employers might find it difficult to express views in isolation, for example their views on an increased risk appetite, or on the question of greater investment risk. The responses to those questions will, we believe, in many cases depend on what the impact might be of a particular decision on the other moving parts of the valuation and on the scheme more generally. In short, without seeing a fuller picture, how can employers **understand the trade-offs** between particular positions which might be adopted?

For these reasons, we believe it essential that an outline proposition, in overall terms, is developed which might show how the various components – which include risk appetite, investment strategy, covenant measures, contribution rates and volatility, and benefit design – might operate together under a particular strategy (or strategies). We believe that this would allow employers to be more specific in supporting any particular direction on the individual components of the valuation. We would welcome your thoughts as to whether this would help employers in expressing views, and in seeing what the collective outcome might be in overall terms.

If employers agree that an outline proposition would be helpful, we will work with the USS trustee to develop this which, we hope, will be available to employers ahead of, or alongside, the technical provisions consultation currently planned for later this year.

4 COMMENT ON THE QUESTIONS RAISED BY THE USS TRUSTEE IN ITS DISCUSSION DOCUMENT

METHODOLOGY

Question 1: *"What are your comments on the proposed new methodology"*

The following points (in addition to those made by Aon in the annex) may be helpful for employers as they consider, and make responses to, the USS trustee's first question:

- From the responses from employers to our first consultation, we believe that employers regard the dual discount rate approach as worthy of further exploration. It fundamentally deals with the development of the scheme's membership (and therefore of its liabilities) over time – and the way that it might mature in terms of the proportion of active members yet to reach retirement age, compared with those who have reached pension age and/or are already in receipt of pension.
- We believe that employers will welcome the removal of the mechanistic aspects of test one, but will also recognise the USS trustee's retention of the gap to self-sufficiency as a reference point.
- We believe that we must see the conclusion of the work of the Valuation Methodology Discussion Forum (VMDF), in this particular area of the removal of test one, before any approach on methodology is finalised. This is because the VMDF is examining how the gap to self-sufficiency, and in particular its projected value at a future point (say 20 years from now) is to feature, if at all, in the USS trustee's investment strategy for the fund over time, and the justification for any longer-term de-risking which can be derived from these calculations.
- The risk appetite on which the USS trustee is engaging is also framed by reference to the gap to self-sufficiency now, and at a future projected point. The USS trustee states that it does not wish to allow this gap to grow too wide because, should there be a "sufficiently adverse scenario", it would wish to gradually move scheme funding towards a self-sufficient position. We believe it is essential for the USS trustee to define, as far as possible, what type of event this would be, as otherwise employers will have no sense of the likelihood of this scenario, and the matter of when the scenario is reached would be left entirely to judgement (and the USS trustee's own risk tolerance in this respect).

- One of the USS trustee's principles is that both long-term and short-term perspectives are important, and that it needs to be able to "track things over the short-term to check that [we] are on course to achieve the long-term goal". We believe it important to emphasise that the defining characteristic of the scheme, and of the support from employers in particular, is the extremely long-term and enduring nature of the sector and its central objective and purpose. We hope this is reflected in the USS trustee's approach to this principle (and would welcome, if the USS trustee thought it helpful, further work – progressed through the VMDF if appropriate – to look at the appropriate balance between long and short-term perspectives).
- The USS trustee raises the issue of intergenerational fairness, and for example whether different generations of members should pay the same levels of contributions, and whether members should contribute to the scheme deficit. This is an important issue, and is one we believe should be led by the stakeholders as many of these issues are determined by the underlying scheme design (and UUK anticipates views from employers on this issue in their responses to the phase 1 consultation on the JEP2 report). In particular, in defined benefit schemes it is very difficult to eliminate intergenerational unfairness, and for example the scheme rules are clear in their application of cost-sharing to all aspects of changes to contributions whether they arise from future service, or deficit-related, costs.

COVENANT AND SUPPORT MEASURES

Question 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."*

The following points may be helpful for employers as they consider, and make responses to, the USS trustee's second question:

- The USS trustee explains that covenant is perhaps the most important of the building blocks underpinning the funding of the scheme, and we believe that employers will look forward to seeing the USS trustee's formal report on covenant – and the latest work it has undertaken specific to the 2020 valuation – so that it can be fully considered. We anticipate that this covenant work will include detailed engagement with those involved in finance within USS employers.
- We believe it will be important for the USS trustee to explain the apparent binary nature of its assessment of covenant, that it is either 'strong' or 'tending to strong', and why a clear and significant divide exists between the two (for example, a fixed difference in future service contribution requirements, or in covenant horizon). We believe that employers might take the view that, whilst respecting the Pensions Regulator's classifications, the covenant provided to USS by the scheme's employers is more complex and multi-layered, and that simple classification might be neither helpful nor appropriate. Put another way, we understand that the USS trustee's assessment for the 2018 valuation was at the "bottom end" of the strong covenant grade; but would moving to the very

top end of "tending to strong" require major changes to the funding and investment approach as suggested in the consultation document?

- It would be helpful for any updated covenant analysis to explain the USS trustee's view that one more strong employer leaving the scheme might cause the covenant rating to become 'tending to strong'. This is not intuitive, in particular when considering the likelihood and feasibility of employers leaving the scheme given the section 75 debt obligation. Even in cases where exiting the scheme and meeting the employer debt obligation is hypothetically possible, to what extent would it be reasonable to anticipate such a move, and in what circumstances would it be sufficiently damaging to overall covenant strength? This is another area where the fuller covenant analysis, and evidence, will be helpful for employers.
- With regard to the covenant support measures mentioned in the USS trustee's paper, dialogue is underway on the two issues of debt monitoring and the provision of pari-passu security to the USS trustee in specific cases where employers undertake new secured borrowing. We are grateful to the USS trustee and its executive for their engagement with UUK and its group of sector specialists in these areas. We believe that proportionate arrangements can be agreed which can work in practice, but we are not quite there yet. We continue to work constructively with the USS trustee and will consult with all employers on any proposal.
- With regard to the granting of longer-term changes to the rules – and in particular to the present moratorium arrangements which expire on the completion of the 2020 valuation – so that employers could not leave the scheme without the USS trustee's consent, we believe that much further work is required. The points that we believe must be fully addressed include the underlying justification for such changes, the extent to which such changes would guarantee the strongest covenant rating and for how long, the value of that status, and how agreement to such measures would be evaluated as part of any valuation outcome. In short, we believe that employers will require a great deal of information, and need to have a high degree of confidence in the effect of such a decision, before they would be willing to back such a long-term (rule change) measure. That said, we welcome the views of employers, and for now we intend to progress discussions with the USS trustee constructively, but with this underlying perspective.
- Each of the covenant support measures (debt monitoring, pari-passu security and longer-term rule changes) described above would individually add considerable additional backing. If taken together, we believe they would represent something quite unlike any scheme covenant found elsewhere.

PROVIDING ADDITIONAL TANGIBLE SUPPORT

Question 3: *"Do you wish to consider additional tangible covenant support measures to further strengthen the covenant and potentially support additional risk taking?"*

The following points may be helpful for employers as they consider, and make responses to, the USS trustee's third question:

- To contemplate going further on covenant measures – such as outlined by the USS trustee in its section on additional contingent support [p19, and appendix C] – would we believe be a very significant step, and whilst we welcome the continued full engagement and explanation of each possible option, we find it difficult to see the events that would give rise to employers being willing to support such a measure.
- Some of the difficulties with such an option include the fact that it might breach the underlying cost-sharing principle within the scheme (as additional contributions would likely be borne by employers only), unless such an arrangement accounted for 65% of any material change to the Scheme. It could also potentially act as a disincentive for employers and members to get behind sustainable long-term solutions for the scheme, and employers would make additional cash commitments which would be unavailable for other investment purposes.
- Even if such measures were to be contemplated, there would appear to be a significant risk of fragmentation of the scheme given that one would have to assume that not all employers would have the ability or willingness to contribute to the additional support, nor is it clear how it would be segmented amongst employers (and the Joint Expert Panel commented in definitive terms on the issue of mutuality in its report).
- In terms of a broader view on the options for covenant support, whilst some measures may be appropriate, we believe that employers would require considerable evidence to be convinced that the appropriate response lies solely in adding layer upon layer of additional commitments to the scheme, and that instead other risk-sharing measures need to be considered and analysed to see if they would provide greater long-term sustainability and resilience.

INVESTMENT STRATEGY AND MORE RISK

Question 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?"*

Question 5: *"Based on the example approach to managing risk, 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?"*

The following points (in addition to those made by Aon in the annex) may be helpful for employers as they consider, and make responses to, the USS trustee's fourth and fifth questions:

- The Joint Expert Panel made clear in its second report that the likelihood of a resolution lies in the adoption of a slightly higher risk appetite. We believe that employers might be willing to bear more risk, but that it will be important for employers to understand it, and examine the options through which there could be sharing of any additional risk with members (and/or see that other measures would be introduced which demonstrate that bearing additional risk is reasonable for employers because the scheme is becoming more sustainable).

- We believe that Aon provides a helpful framing for how employers might approach this question of bearing additional risk in the annex. Such higher risk might be supportable – alongside the need to share risk – if it can be considered to be broadly the same risk but for a longer period, consistent with the enduring nature of the covenant.
- We believe that employers will recognise the importance of the Valuation Methodology Discussion Forum (VMDF) in this area. The level of risk within USS depends to a great extent on the level of investment risk being adopted, and the discount rate used to value the pre-retirement component of the scheme's liabilities. In short, the key questions include what proportion of growth assets should be assumed, how volatile the funding of the scheme's defined benefits can reasonably be, and how we would want that to develop over a reasonable time horizon. This in turn affects any decision about the case for de-risking of the fund over time. We think it highly important that we back the VMDF as an all-stakeholder group in considering these particular issues without, for example, any presumption that investment de-risking is necessary or justified, and support that forum in being able to bring its discussions to a conclusion.

5 BRINGING IT ALL TOGETHER, AND NEXT STEPS

The USS trustee's discussion document sets up the key decisions which employers and stakeholders will need to take in the coming period. These will set the foundation for the future funding approach, and as the Joint Expert Panel has made clear, this is the opportunity to develop something which is more sustainable and resilient to future actuarial valuation outcomes, and to other scheme and economic events. We should not take rushed decisions without full detail and justification.

Scheme valuations are complex; USS's valuation particularly so. It has multiple moving parts. We believe it is almost impossible for employers to express, at this stage, a definitive view on one of the component parts without understanding the trade-offs between different positions, and in particular to see how any decision affects the other elements.

The only way to effectively demonstrate the trade-offs – and to agree on the component parts – is to illustrate an overall package, or a small number of potential packages, so that employers can see the combined effect. This is something we plan as part of the next round of consultation with employers. Through this development of an outline proposition, in overall terms, we hope that employers will see, for example, if a particular position is taken on risk appetite (and therefore on investment strategy), if contributions are set at a particular level and volatility, if specific measures are made available to support covenant, and if members themselves have a stake in the future funding approach through benefit design measures, then an overall sustainable approach can be assembled. In this way employers can reasonably consider if they feel able to offer any proposition their collective support.

We recognise this is a considerable task, but there is substantial expertise within the USS trustee and its executive which we hope we might lean on, and within the stakeholder communities, and with the supporting experts and specialists. With their support, we believe an overall approach to funding, and to long-term sustainability, can be defined.

In terms of next steps:

- We encourage employers to engage with the USS trustee's discussion document, and to respond as they feel able on or before the deadline of 17 April 2020. We recommend that employer representatives engage with their governing bodies in formulating any responses so that they can be considered to be the view of the employer. Employers may also wish to engage with local pensions forums, where that is appropriate.

  We can be less certain about the timing of the following steps, or indeed their precise sequence, as in certain cases we need to align them with the USS trustee's own valuation timeline, and with the progress of discussions with other stakeholder groups, and in some cases await developments (for example in relation to the VMDF).

- UUK's first consultation on the recommendations in the Joint Expert Panel's second report closed on Friday 28 February 2020; we will shortly publish our analysis of those responses;
- We support the Valuation Methodology Discussion Forum (VMDF) as it continues it work, and expect that it will provide an update on its conclusions to the stakeholder tripartite group (created following the JEP2 report);
- We continue to engage with the USS trustee on the potential covenant support measures, which will firstly focus on detailing a proposal on debt monitoring and *pari-passu* security provisions – and on which we confirm that full consultation with employers will take place – and then in due course, and in conjunction with the development of the indicative overall approach, on consideration of other covenant support components;
- UUK will, it is hoped along with stakeholder colleagues, develop an illustrative collective approach to the future funding and sustainability of USS. We believe this will be an effective way to demonstrate to employers the trade-offs, and to also see the benefits (and downsides) of specific positions;
- We hope to see further work from the USS trustee (notably on employer covenant) which provides additional evidence to support the indicative positions set out in the discussion document;
- In due course we expect formal engagement by the USS trustee with UUK on the statutory consultations relating to the actuarial valuation. The USS trustee has given an outline date of July 2020 for the first of these consultations.