Universities Superannuation Scheme (USS)

Date: 14 May 2019

Prepared for: Universities UK

Prepared by: John Coulthard FIA
Kevin Wesbroom FIA
Andrew Claringbold FIA

Completion of 31 March 2018 Actuarial Valuation

Introduction

The USS Trustee has set out three options to complete the 31 March 2018 actuarial valuation in its documents of 7 May 2019.

Options 1 and 2 are based on the "Upper Bookend" and "Lower Bookend" from the January 2019 consultation. Option 3 is a new option that can be interpreted as being largely in line with the JEP recommendations. We welcome this development, although it has come with two additional requests (in outline, without full details). The USS Trustee seeks indicative feedback from UUK by 16 May and formal feedback by 31 May. It seems to propose finalising that valuation at the Upper Bookend shortly after then, if another option is not supported.

We have been asked by Universities UK (UUK) to set out our thoughts on the three options, and on the additional requests the USS Trustee is making for debt management and the rules for departing employers. We begin with comments on Option 3.

Option 3 – New option

Option 3 requires the following contributions from the valuation date:

	Employer (†)	Member (†)	Total
1 April 2018 to 31 March 2019	*18%*	*8%*	*26%*
1 April 2019 to 30 September 2019	*19.5%*	*8.8%*	*28.3%*
1 October 2019 (‡) to 30 September 2021	21.1%	9.6%	**30.7%**
1 October 2021 onwards	23.7%	11%	**34.7%**

Notes:

(†) Employer and member figures assume 65:35 cost-sharing adopted to increases from 1 April 2019.

(‡) This assumes the 2018 valuation is completed by the payroll cut-off date of 31 August 2018 (the date advised by the USS Trustee).

The headline rate of 34.7% from 1 October 2021 is *provisional* as the USS Trustee would carry out another valuation at 31 March 2020 under this option (rather than waiting to 2021), and put new contributions in place. These new contributions could be higher or lower than 34.7% based on the facts at the time.

We believe Option 3 is a material movement compared with previous positions, and we welcome it.

In our view, the proposed contribution rate of 30.7% is reasonably close to the JEP recommendation. In saying this, the JEP provided an example approach with a contribution rate of c.29.2%, and said that: *"The Panel believes that there are a number of different paths that the Trustee could adopt to reduce the contribution rate to below 30%; the charts above simply demonstrate one approach."*

Moreover, employers (and members) have benefited in the short-term from the USS Trustee carrying out a 2018 actuarial valuation rather than considering the JEP recommendations as part of a 2017 valuation – which could have led to higher contributions coming into place much earlier, say from 1 January 2019 for illustrative purposes. If we "average" the USS Trustee's proposal over the period 1 January 2019 to 1 October 2021 (when the contribution changes following the 2020 valuation may be expected to be implemented), then this works out as 29.8% (i.e. three months of 26%, six months of 28.3%, and two years of 30.7%). So, at least at an "average" level, the JEP recommendations appear to be met.

That said, we are not clear whether 21.1% from October 2019 will be a feasible two-year contribution rate for all (or the majority of) employers. UUK will need of course to consider employer views in the limited time available.

Additional notes:

- 30.7% is described as the average contribution over the two years from 1 October 2019 under Option 2, assuming the USS Trustee's trigger step up applies at the *earliest* date possible. This is not obviously consistent with the USS Trustee's view that Option 2 cannot be implemented until around June 2020 at the earliest. The earliest a trigger contribution could then apply would be around 8 months later i.e. February 2021. This would lead to an average contribution rate over two years from 1 October 2019 of 30.4% rather than 30.7%.
- We have asked how the 30.7% is split between future service and deficit contributions, and have been advised that this will be confirmed after the Trustee Board has considered it. As Option 3 is based on Option 2, this may suggest a future service rate of 27.6%, along with a deficit contribution for the first two years of 3.1%. (The deficit contribution would then step up to an illustrative 7.1% from 1 October 2021, leading to a relatively short recovery plan.) Further commentary can be provided when more information is available.

Option 1 – "Upper Bookend"

Option 1 is the Upper Bookend mentioned in the USS Trustee's consultation, and requires the following contributions:

	Employer (†)	Member (†)	Total
1 April 2018 to 31 March 2019	*18%*	*8%*	*26%*
1 April 2019 to 30 September 2019	*19.5%*	*8.8%*	*28.3%*
1 October 2019 to 30 September 2021	22.5%	10.4%	32.9%
1 October 2021 onwards	23%	10.7%	**33.7%**

(†) Note: Employer and member figures assume 65:35 cost-sharing adopted for increases from 1 April 2019.

The USS Trustee has not moved from its initial proposal for the Upper Bookend, and specifically on its requested 5% deficit contribution (which relates to a deficit that has more than halved from £7.5Bn at 31 March 2017 to £3.6Bn at 31 March 2018 on the Upper Bookend assumptions). The USS Trustee's explanation is one of *principle* (to reduce short-term risk). There is no quantitative explanation of what the "trustee risk appetite" is in the short term, or justification for why 5% is required rather than any other figure.

The USS Trustee moved to a new discount rate approach at the 2017 actuarial valuation. Rather than expressing the discount rate as a margin relative to gilt yields, the USS Trustee defined prudence based on a 67th percentile investment return. When the USS Trustee updated its analysis for the 2018 valuation, the 67th percentile investment return gave a higher margin relative to gilt yields, which reduced the deficit. The USS Trustee views this as potentially creating additional risk, and has sought to counterbalance the impact of its own assumption update by now considering deficit contributions relative to a "gilts+" (self-sufficiency) value of liabilities. The whole approach is in our view unusual.

It would be possible to continue to debate the Upper Bookend, and the formal consultation on the Recovery Plan provides an opportunity for this. However – in the spirit of trying to conclude the valuation – for employers considering the merits of the three options, our guidance is that there is a limited prospect of the USS Trustee reducing the Upper Bookend of 33.7% by a material amount. The USS Trustee has already considered initial views from UUK, and it sets contributions under the Rules.

Nevertheless, and in anticipation of potentially similar discussions for the 2020 valuation (or more immediately if employers favour Option 1), we recommend asking the USS Trustee to justify its choice of deficit contributions in numerical rather than generic terms. It is difficult for stakeholders to see if the USS Trustee is being reasonable in relation to the 5% deficit contributions without this analysis.

Option 2 – Contingent Contributions

As Option 2, the USS Trustee has suggested a revised version of the Aon/UUK proposal.

The USS Trustee believes that Option 2 could not be implemented until June/July 2020, and that the contributions increases due on October 2019 and April 2020 would therefore apply. The USS Trustee suggests that Option 1 or Option 3 would be required to avoid these increases.

We set out below the key elements of Option 2 vs the Aon/UUK proposal.

Parameter	Aon/UUK proposal	USS Trustee's Option 2
Initial contribution rate	29.2%	29.7%
Chance of trigger applying	c.30%	c.60% *(†)*
Contribution step-ups	Three steps of 1%	Three steps of 2%
Trigger metric	Gilts+ proxy to Technical Provisions, recalibrated every year	Gilts+ proxy to Technical Provisions, with no recalibration
Trigger threshold	Trigger metric calculated quarterly based on average of three month-ends. Needs to be breached for 2 successive quarters	Trigger metric calculated daily averaged over rolling 40 business days (broadly 2 months). Needs to be breached for 40 successive business days

(†) Note: Figure supplied on 10 May be USS Executive, based on 3-year period from valuation date. It corresponds to the Technical Provisions deficit exceeding £4Bn on the Lower Bookend assumptions (so an increase of £1.8Bn to the £2.2Bn deficit at the valuation date on this basis).

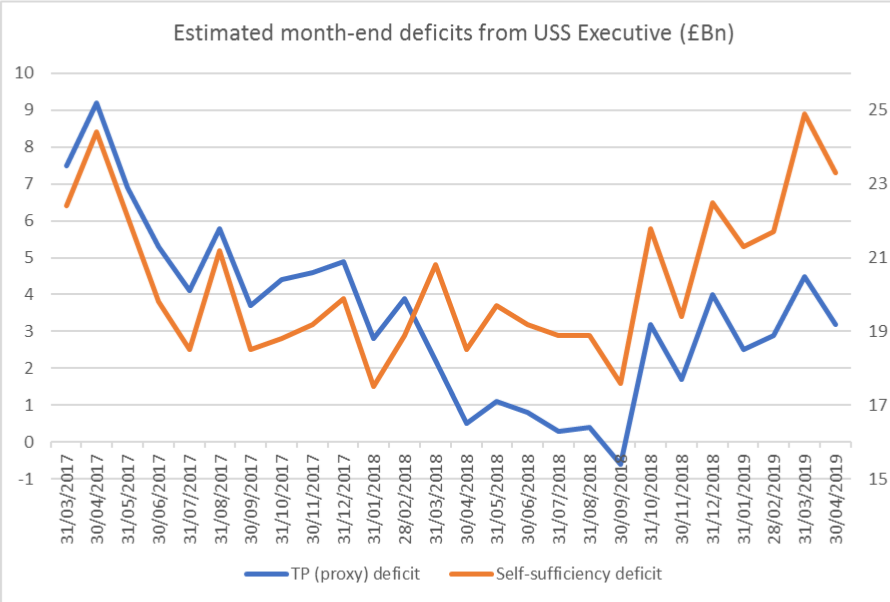
The USS Trustee sets out why it believes the Aon / UUK proposal does not meet its 11 principles. We explained why our proposals met the 11 principles in our 27 February advice. However, the principles are qualitative, and the USS Trustee's interpretation is that material changes would be needed for the proposal to be acceptable.

On a philosophical level, the USS Trustee has said that it did not like the proposal being based on a defined *likelihood* of contributions applying. We were surprised at this comment. Probabilities and trigger threshold are two sides of same coin (one defines the other, all else being equal). We believe it is easier to engage employers on the likelihood of a trigger applying, rather than trying to objectively define a threshold. We also note that the USS Trustee has not explained why £4Bn (rather than another figure) is an appropriate level for trigger threshold.

Although there is a possibility of paying lower contributions under this option compared with Option 3 (as 29.7% would apply for at least 8 months following implementation, and the trigger may never be hit), we believe that the proposal is unlikely to be acceptable for employers:

- The USS Trustee's proposal has *double* the chance of requiring additional contributions, with a c.60% likelihood. Rather than being "contingent contributions", the proposal could be characterised as requiring a higher level of headline contributions, with a low chance (c.40%) that 29.7% would be sufficient between valuations.
- For accounting purposes, employers may need to recognise the contingent contributions in full on their balance sheets (since they are paid on a best estimate basis).

- On the Lower Bookend basis, the scheme deficit was £2.2Bn at 31 March 2018. For the trigger threshold to apply, this needs to exceed £4Bn over the stated period. The chart below shows the month-end estimates of the deficit, which peaked at £4.5Bn at 31 March 2019. It would be unusual in our experience to agree contingent contributions between actuarial valuations that are expected to apply in normal conditions. The likelihood of the trigger applying may also now be higher than c.60% since the position is currently worse than at the valuation date, as illustrated below.



Note: Figure supplied on 10 May be USS Executive. They are approximate and should not be relied on.

- The contribution step-ups have also *doubled* (along with their probability of applying), to 2%. These are likely to be more difficult for employers (and members) to manage and plan for. This is attributed to the proposal in the USS Trustee's view failing principle 7 (Quantum) which arises (we would suggest) largely because the USS Trustee did not offer any movement on the Upper Bookend.

Given the effort that went into developing the contingent contribution proposal (and for employers in considering it) after the USS Trustee had decided not to set out its own proposal, it is particularly disappointing that it has been effectively rejected in this manner.

However, it is helpful that the USS Trustee has developed a new option (i.e. Option 3) which we see as effectively replacing Option 2 as a credible option. Some employers may also prefer the simplicity of Option 3 and the additional clarity provided on contributions ahead of the next valuation.

Additional requests – Debt monitoring process and Rule clarification

The USS Trustee has introduced two additional elements to the valuation. These have been introduced only a few weeks before the legal deadline of the valuation, and arise from the USS Trustee adviser's review of covenant. The USS Trustee regards these as important for Option 2 and Option 3 to be acceptable. It is not immediately clear why the requests are not relevant for Option 1 (as e.g. the longer document states that each of the options is predicated on the covenant remaining strong).

The USS Trustee requests an indicative view by 16 May. There is a stark contrast in the six working days UUK has been given to provide an initial response, with the two months or so that the USS Trustee has had to consider the Aon/UUK proposal. We set out initial comments on the additional requests below.

Debt monitoring process

The first element is a debt monitoring process:

> *"Employers' debt levels be monitored against a number of metrics with the Trustee seeking clarification of employer business plans should the metrics exceed certain levels. This monitoring would be part of an annual attestation;*
>
> *Institutions wishing to grant security in the future to lenders (on existing or new debt) should be required to grant pari passu security to the trustee; and*
>
> *Should these measures prove to be inadequate or fail to obtain employer support consideration would need to be given to additional measures."*

For the monitoring, many employers may be comfortable providing information to the USS Trustee provided that the requests are proportionate and do not lead to unnecessary discussions. Absent details of what the metrics are or where the trigger levels are set, it is difficult to comment further.

Institutions are asked to grant *pari passu* security to the USS Trustee where they provide security in future to lenders. The covenant adviser's concern is that if debt is secured against an employer's assets, then this becomes a priority call over the pension scheme, and may erode the covenant.

Some employers may share this concern, and the proposal would reduce their exposure to the effects of an individual employer becoming insolvent. Also, in our experience, unsecured debt is currently the "norm" in the universities sector.

UUK has asked for employer views on how palatable the request may be. It will be virtually impossible to achieve a considered view by the USS Trustee's Board meeting on 16 May, and until the USS Trustee sets out its requirements – which presumably will follow this Board meeting if there is sufficient employer interest in Options 2 or 3.

Rule clarification

The second new element is described as a clarification to the rules:

> *"PwC has advised that a clarification to the rules which strengthens the Trustee's discretionary powers to determine whether an employer can exit the scheme would support maintaining the current covenant rating."*

At present employers can choose to leave the scheme, but would need to meet their share of the statutory buy-out deficit (Section 75 deficit). The resulting cost will be prohibitive for most employers. Potentially the USS Trustee could already charge a higher exit cost under its contribution rule.

The USS Trustee's advisers have become concerned that, were another "strong" employer to leave, then they would downgrade the covenant to "tending to strong". We would welcome further details on why this conclusion has been reached, for it suggests that the covenant may in any event be at risk of a downgrade which could have wider implications for future valuations.

There is no detail yet available on what the request would mean, for example would employers be charged a defined premium relative to their statutory section 75 debt, or would the approach be bespoke to each employer.

Some employers may be comfortable with the proposal – for example as they are unlikely to wish to pay the buyout deficit (or higher) to leave the scheme, and to try to preserve the strong covenant rating afforded by the current mutual structure. Other employers may be concerned about the proposal. We understand that UUK will take legal advice on the proposal once details become available.

Closing thoughts

Previously employers had supported the JEP recommendations, which suggested a short-term fix, followed by JEP Phase 2, followed by a 2020 valuation. Option 3 is in our view reasonably close to this (albeit with a high headline rate applying from October 2021), and it is for employers to determine whether it is acceptable and preferable to the other options, and also whether the resulting contributions are achievable over a two-year period.

The USS Trustee has introduced two additional requests, and has given UUK only a few days to test indicative support. The severe time pressure stems from:

- The statutory deadline for the 31 March 2018 valuation of 30 June 2019. Here, we note that the Pensions Regulator's preference is for the best outcome to be reached, rather than one agreed under pressure simply to meet the deadline. *(Source: TPR's 2019 annual funding statement.)*
- The proximity of the 1 October 2019 contribution increase. Here, we note that this could be pushed back a few months through an interim schedule of contributions. This would require another USS Trustee submission to the Pensions Regulator, but it is within the USS Trustee's gift to do this.

If employers support Option 3 indicatively, then the USS Trustee could finalise the valuation based on Option 3, and also agree a separate timetable to discuss the additional requests. In suggesting this, we observe that the next valuation under Option 3 is only ten months away, and the USS Trustee has made the additional requests very late in the formal process. This timetable could be relatively short to give employers (as well as the USS Trustee) the assurance that the position is resolved well ahead of the 2020 valuation. We would be pleased to discuss this further.

Compliance

The advice in this report and the work relating to it complies with 'Technical Actuarial Standard 100: Principles for Technical Actuarial Work' ('TAS 100') and 'Technical Actuarial Standard 300: Pensions' ('TAS 300').
