USSEmployers

AN INFORMATION PAPER FOR EMPLOYERS CONSIDERING THE TRUSTEE'S CONSULTATION ON THE TECHNICAL PROVISIONS FOR THE USS 2020 ACTUARIAL VALUATION

1 INTRODUCTION AND CONTEXT

The USS Trustee is undertaking a valuation of USS as at 31 March 2020, and on 7 September 2020 the trustee published its consultation on the scheme's technical provisions – running for eight weeks until the end of October. We recognise the extraordinary challenges which universities are currently facing in the light of the Covid-19 pandemic, and we recognise that this consultation could not have come at a worse time for those in the midst of these demands. We are extremely grateful to employers for continued engagement with these USS issues.

Universities UK's (UUK) role in the consultation is to provide views on behalf of the employers to the trustee, and to respond to the trustee's consultation. The trustee has itself broken the consultation down into eight questions to try to make this process more manageable. This particular consultation involves the trustee seeking views on the assumptions which it proposes to use in assessing the funding position of the scheme in relation to the rights which have been built up. However, the consultation is somewhat wide-ranging and delves into questions about covenant support requests and 'risk appetite'. Unfortunately, the trustee does not yet provide an overall view on how the pieces fit together so employers cannot see with clarity yet what the outcome of the valuation would be under different approaches. This makes this perhaps the most difficult consultation we have faced.

In every scenario presented by the trustee in this consultation there *will* be a deficit in the scheme's funding position, and therefore deficit recovery contributions (DRCs) are going to be needed. DRCs form a part of the overall contributions payable by employers and members to USS, and it is therefore important that employers and stakeholders understand how much the trustee wants in order to pay off the deficit. The trustee has decided that it will consult separately – and later – on DRCs, although it has listed some illustrative numbers in the TPs consultation document itself – but it emphasises these are not part of this consultation exercise. To add to the uncertainty, the trustee states [p9] that the costs shown for the build-up of the current benefits going forward are illustrative, and 'are not formally part of this consultation' – and we have as yet no signal from the trustee as to when the recovery plan or other consultations will take place. Employers might see this two ways; on one hand it confirms that nothing is set in stone at this stage and employers and might be reassured that the position can change; but on the other hand the absence of consultation, now, on the contributions illustrated in the TPs consultation might mean that the real focus will be on those future contributions-related consultations and that any responses at this point may need expressly to be conditional upon more certainty about contribution outcomes.

In this paper we thought it would be helpful to provide some orientation around the issues for employers, and:

- explain the materials which UUK has produced to accompany the TPs consultation
- make clear where this consultation sits within the overall valuation timeline
- discuss some of the issues and concerns which we have identified with the content, and our plans and responses, so that employers might take these into account
- describe what the next steps are likely to be
- confirm the engagement which we plan with you, the scheme's employers, over the coming months

Over the next few months employers will face some potentially difficult decisions in relation to USS. While this TPs consultation covers just one part of the overall valuation outcome – and we might have hoped to receive more information to give a fuller, rounded picture of the likely valuation outcome, within a more specific contribution range, and within a single consultation – it is vital that employers respond with their views. This will be the only opportunity for employers to comment on some of the fundamental assumptions the trustee is proposing, and the trustee will take decisions having considered the responses provided by employers, formally through UUK, to this consultation. In the absence of a full employer response, USS are likely to reach negative and unwarranted conclusions.

2 THE MATERIALS WHICH UUK HAS PRODUCED TO ACCOMPANY THE TPS CONSULTATION

The central document for this consultation is the trustee's consultation on technical provisions[1]. The trustee has also published two supporting documents, one entitled '*Scenario Testing & Stochastic Analysis*' which was presented as supporting information for the Valuation Methodology Discussion Forum (VMDF), and one entitled '*Higher Education Institutions (HEIs) Free Cash Flow Model for risk capacity*' which is an assessment of risk capacity undertaken by the trustee to inform its overall covenant assessment[2].

To support employers in developing their responses, UUK has prepared this information paper – and has also published advice from its actuarial adviser, Aon. This Aon advice focusses on the eight questions which have been put forward by the USS trustee in its consultation document [p9 and repeated on p34].

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[1] https://www.uss.co.uk/~/media/document-libraries/uss/how-uss-is-run/2020-valuation/uss-technical-provisions-consultation-2020-valuation.pdf

[2] https://www.uss.co.uk/how-uss-is-run/2020-valuation

UUK will be hosting webinars in the last week of September to present the key details, but more importantly to give employers the opportunity to ask questions and join colleagues in discussion on the valuation. Further information is available by emailing pensions@universitiesuk.ac.uk.

3 RESPONDING TO THE EIGHT QUESTIONS PUT FORWARD BY THE TRUSTEE

The trustee has prepared questions for employers on specific areas of the consultation document, some of which are technical and actuarial (broadly, questions one to four), such is the nature of the consultation material generally. The remaining questions, from five to eight, cover broader issues of the covenant measures, risk appetite and contributions in exceptional circumstances. The trustee's questions are wide-ranging, and it might be difficult for employers to respond conclusively; we expect that some employers might take the view that the implication of a response in one area is entirely dependent upon another element – and then in an overall sense dependent upon the final outcome being a more sustainable scheme for employers and members. This is a point we have made a number of times in recent months, and the difficulty of seeking responses from employers without the fuller picture of a potential scheme outcome is, we believe, very apparent.

To be clear on what we mean by being able to illustrate the broader outcome of the valuation and for the scheme, if employers were (say) minded to respond to question seven with an expression of support for affordable risk appetite of 10% of salary for 30 years, then they may wish to know exactly what this means for the overall cash contributions.[3]. All decisions on risk involve trade-offs, but at this point those are not clear. For example, it is difficult to express a clear view on risk appetite without seeing its broader implications, and the balance between risk appetite and decisions in other parts of the overall valuation.

And perhaps most importantly, would decisions in this area of risk appetite improve the likelihood of securing a better *overall* outcome in terms of a more resilient and sustainable scheme for employers and members? We have confirmed our commitment to working with the trustee to build the more rounded illustrations which might be presented to employers – and we are working with our USS colleagues to try to achieve this. We do want employers to respond to the questions where they feel able, and to the extent they think appropriate – and the associated guidance from Aon will, we hope, help employers in understanding the implications of the various questions and their back-story, and which responses and other points they might feel able to provide.

If you feel you need any additional information from the trustee before responding to the consultation, please let us know and we will feed through these comments and any themes, to help both employers and the trustee get the most out of this consultation exercise.

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[3] It is noted that table C2, on page 62 of the trustee's consultation document, shows the value of different risk appetites in terms of their overall quantum, but what is not shown is the effect on the illustrative contribution rates of different positions in relation to risk appetite; this is needed.

4 WHERE THIS CONSULTATION SITS WITHIN THE OVERALL VALUATION TIMELINE

This TPs consultation is the first of the formal exchanges between the trustee and UUK and employers on the valuation. Nothing is decided at this stage. As we have stated, the wide range of the potential contribution outcomes in this TPs consultation makes it especially difficult for employers to express any clear views at this point. We have to build the broader picture in order for employers to feel confident to express views on issues like risk, or on tangible covenant measures, which are potentially very significant to employers and their strategic planning.

We have a clear timeline for this first TPs consultation, but we can be less certain of the remaining parts of the valuation in overall terms. We think there are five headline phases which will need to be progressed between now and next Easter, which we believe are as follows:

Indicative timeline for responding to the 2020 valuation

ASSUMPTIONS	COVENANT	SUPPORT MEASURES	STRATEGIC RESPONSES	NEGOTIATIONS ON RESPONSES
The specifics of the technical provisions, eg methodology, assumptions, risk appetite (as far as possible)	Engage with USS on the remaining covenant work, so that they understand Covid-19 implications	Develop the covenant support measures, to ensure they are defined and understood – and their value is known	Consult with employers about the type of responses that might be needed, build the discussion, provide indicative figures, engage with UCU	Decide on the proposed responses and confirm the mandate, and progress discussions with UCU through the JNC
Helps us to reduce the illustrative range of outcomes, get closer to the likely contributions and scale of responses needed	*Builds the foundation as to whether there is any real prospect of a "strong" covenant rating (which will be crucial to recovery plan length etc.)*	*On debt monitoring, pari-passu and the rule change on employer exits, so that employers can be clear if they support them or not, with a clear 'value' put on them by USS*	*Provide rounded, meaningful information on costs and risks, and build understanding in advance of the consultation which will take place with employers*	*Through formal consultation the consensus position of employers can be put forward, and hopefully a negotiated outcome secured*
Now, through to 30 October 2020	*October / November 2020*	*Through to late 2020*	*December 2020 – early 2021*	*Early 2021*

We would emphasise that the above is very broad in nature, and two significant activities which we have not included – and for which the trustee has not at this point provided any specific timeline – are (i) the formal consultations which will need to take place on the recovery plan, schedule of contributions and statement of funding principles – and potentially, later on, the statement of investment principles – and (ii) any formal consultation with affected employees and their representative bodies should there be proposed changes to contributions and/or benefits which are 'listed' under the relevant pensions regulations (in which case a minimum 60 day consultation is required).

5 SOME OF THE ISSUES AND CONCERNS WHICH WE HAVE IDENTIFIED WITHIN THE TPS CONSULTATION, AND OUR PLANS AND RESPONSES

While we recognise the trustee's duty and obligation to undertake a valuation of the scheme – and the very specific processes which are involved – there are a number of difficulties that we have identified with this particular TPs consultation which we would want employers to be aware of. We set out some of our concerns below, with our proposed responses and mitigations:

(a)	**Timing**: The valuation is taking place against a very difficult and uncertain backdrop of the Covid-19 pandemic and its impact upon the sector's employers. There has also been a considerable impact on the scheme's investments, and uncertainty regarding the prospects for economic recovery and future economic growth. *We understand that the trustee has not concluded its covenant work, and awaits further inputs and analysis from its advisers, PwC, in the autumn to help it to form a view. We would urge the trustee to consider this information carefully; it will need time to fully assess the implications of Covid-19 upon the scheme's employers in terms of student admissions, governing support for universities etc. The trustee will also need to time to properly reflect on the broader economic impacts of Covid-19 on the prospects for future investment returns, and to explain more fully how the experience since 31 March 2020 can be taken into account in any final valuation outcome.*
(b)	**The covenant default**: For now the trustee has assumed that the covenant supporting the scheme is weaker than it was in 2018 and is 'tending to strong', although this *could* be improved with covenant support measures (see below). The trustee's covenant assessment, the analysis of the collective strength of the current strength of the scheme's employers, is incomplete and will not be concluded until the autumn. *Given that the covenant work is incomplete we understand the position of the trustee in being unable to confirm at this stage the formal covenant status it wishes to assign – but we would ask that binary assessments are avoided as far as is possible, and that full account is taken of the unique and enduring characteristics of the employers that back USS. Also, we emphasise that the covenant measures, while undoubtedly desirable from the trustee's perspective, are not given greater focus or prominence over the making of sensible judgements about the fundamental strength and resilience of the scheme's employers.* *We believe the Trustee should also give credit to the institutions for continuing cash contributions during the pandemic. This should provide greater comfort that the institutions are strong enough to cope with extreme events.*

(c)	**We have only broad illustrations of the recovery plan contributions (and indeed of the costs of providing future service benefits)**: The trustee wishes to undertake a consultation on the recovery plan later in the process. With a significant deficit likely, the level of any deficit recovery contributions is crucial as it forms part of the overall contribution payable, and in determining how much employers can pay to fund the new pensions which employees will build up. *We need better clarity on the likely recovery plan contributions – even if the details need to be confirmed later – and in particular a sensible discussion on the likely duration of any recovery plan and the use of investment outperformance which properly reflect the value of the employer covenant. The USS covenant, by any measure, is uniquely secure and durable and it seems inappropriate to start with illustrations of general DB scheme norms. We have therefore asked Aon to provide illustrative DRCs in line with the JEP recommended timeframe of 15-20 years, and not inconsistent with previous recovery plan durations approved by the USS Trustee and the enduring nature of the scheme's employers.*
(d)	**Increasing the pressure for covenant measures**: The trustee seeks a range of covenant support measures from employers but it is not clear if the requests are reasonable, and even if employers find them acceptable what the benefit to them would be of agreeing to such measures. *We set out below, in section 6, details of the current status of discussions and our position on the likely acceptability or otherwise of the measures.*

(e) **The range of contributions being discussed is too wide to be meaningful**: The trustee has illustrated a very wide range of funding outcomes – from a £9.8bn deficit to a £17.9bn deficit, and potential contributions from a combined contribution of 40.8% of salary in the best-case scenario to 67.9% of salary in a worst-case scenario. The current combined contribution is 30.7% of salary, with employers paying 21.1% and members 9.6%, rates which are considered to be at, or for some beyond, the limit of affordability. It should be noted that if there is a delay in implementing new rates of contribution for this valuation, there are 'backstop' increased rates of contributions due from 1 October 2021 of 23.7% for employers and 11% for members. The following table summarises the range of rates proposed, and the extra cash which would be required:

Summary of Illustrative contribution rates and their financial implications

All rates assume contribution increases, whether future service or deficit, are shared 65:35

Amounts in square brackets are based on a scheme payroll of £8bn

	Current	Worst case scenario (tending to strong covenant)	Best-case scenario (with covenant measures +)
Employer contributions	21.1% [£1.69bn]	45.2% [+£1.9bn]	27.6% [+£520m]
Member contributions	9.6% [£768m]	22.7% [+£1.05bn]	13.2% [+£288m]
Total Contributions	30.7% [£2.46bn]	67.9% [+£2.97bn]	40.8% [+£808m]
Future Service Contribution	28.7%	37.6%	29.4%
Deficit Recovery Contribution	2%	30.3%	11.4%

We have explained that we believe we need to proceed on a step-by-step basis, meaning that we will seek responses from employers to the TPs consultation as far as they are able to provide, but that we expect that this will be an iterative process, bringing together the various strands of the overall valuation approach over the coming months (and that conclusive responses to lock-down certain aspects of the valuation at this point are unlikely to be given).

(f)	**Some reforms may well be needed, but unclear to what extent**: It seems likely that some reforms of the scheme will be needed, as even in the best-case scenario the required contributions to keep current benefits are well above existing contribution levels. There does not appear to be a status quo option. The range of potential outcomes is extremely wide – and it is not clear what kind of reforms might be needed to future benefits, and/or their extent in any specific sense, in order to lower contributions for employers and members. *We want to be sure we fully understand the likely position(s) before moving ahead with any certainty on these issues, and will only do so with the full engagement of employers, and in open dialogue with UCU through the Joint Negotiating Committee.*
(g)	**Risk appetite questions almost impossible to answer**: The USS consultation asks questions of employers in relation to risk appetite, which they may find very difficult to respond to. At one level, employers are asked about the level of contributions they would be willing to pay to USS *in extremis*, for example if investments go badly and there is a significant and prolonged shock to the scheme's assets. Would employers be willing to commit to 15% of salary in these circumstances for up to 30 years? (with one irony being that in some scenarios DRCs are actually higher than 15% of salary without, it appears, the situation being *in extremis*). The trustee is proposing that employers make bigger commitments to these forms of contribution should they be required in extremis, and payable for longer – but it is not clear what the benefit would be for employers of agreeing to a larger risk appetite. *We believe that the trustee understands the difficulty here, although in his letter of 28 August 2020 to Alistair Jarvis (top of page four) Bill Galvin, the CEO of USS, makes a point of saying that feedback in particular is sought on this point of affordable risk appetite. We believe that a coherent position of employers would be that the recommendation in the Joint Expert Panel's second report that employers might need to support a "slightly higher" risk appetite still stands and is not ruled out – however how much, for how long, has to be decided on once the likely (narrower) contribution requirements are better known and the potential outcomes from this valuation are clearer.*

(h)	**The scheme payroll may grow more slowly**: There is the question of payroll growth (question 7d of the trustee's questions), which is crucial to the trustee's assumptions, and where the reality is that the scheme payroll may not grow at CPI+2% in the future as the trustee has proposed. The scheme payroll is the aggregate value of the pensionable pay of the scheme's active members – and is affected therefore by the number of active members in the scheme, the rate of opting out or not joining, the rate of appointment to eligible posts within the scheme's employers, the number of people retiring who are not replaced, as well as to the assumed rate of future salary increases, incidence of salary increments etc. *We think this assumption needs careful analysis, as the sector's payroll may not grow at CPI +2% per annum over the coming period – and care is needed not to simply continue an historic assumption. We welcome the initial views from employers about the growth in USS payroll that they anticipate within their own institutions, and we plan also to ask the trustee to provide further, recent data on payroll growth, and perhaps supporting data in relation to the extent to which growth is different between employers, and how any differences are distributed between the scheme's employers (the key issue being that it is not clear if this assumption is strongly affected by the data from a small group of large employers).*
(i)	**How much investment de-risking is assumed, and over what period**: The issue of investment strategy for the scheme is unresolved – the existing proportion of growth assets is 64%, and the active/pensioner ratio – and the relevant risk appetite positions – would suggest it is reduced to 55% for a strong covenant, and 40% for a tending to strong covenant. A Valuation Methodology Discussion Forum (VMDF) was created, following the recommendations of the Joint Expert Panel in its second report, to consider issues relating to the valuation methodology approach, including the investment strategy. Despite the considerable modelling and analysis undertaken by the trustee and USSIM for the VMDF discussions, it seems there is little consensus on the future investment approach and in particular the benefits or otherwise of gradual de-risking of the scheme's assets. It is recognised that a full consensus would be difficult to reach on such issues, given their nature and the different perspectives of the employer and member representatives, and the trustee, but there is a feeling that the VMDF discussions have fallen short in their objective of at least building the credibility and understanding of the trustee's funding and investment approach, even if there is disagreement as to the actual direction. *The picture regarding the assumed future investment strategy under the different scenarios presented in the TPs consultation document is impossibly complex, and it would be helpful for the trustee to set out[4] – in clear terms – its future proposed path for the scheme's investment and, for example, if a reduction in growth assets is planned in all scenarios, to present evidence to support why and how it would do this.*

[4] The trustee may be planning to do this in a later consultation on the Statement of Investment Principles, but it would be helpful to understand the trustee's intentions

6 THE COVENANT SUPPORT MEASURES

The central message is that we continue to work with the USS team to understand, and more fully define, the covenant measures proposed by the trustee. We believe that the best approach is to continue to build mutual understanding of the proposals, develop the trustee's detailed specifications – and after having had a confirmed default price without covenant support measures confirmed by the trustee, then seek specific responses from the trustee on the value, in terms of lower contributions and/or risk of implementing the measures – so that they can then be credibly put to employers. We hope that the trustee is aware that employers recognise the huge commitment in terms of value and importance of such measures, and that they cannot reasonably be asked to confirm their support or otherwise for them unless it is clear what benefit they would derive.

In terms of specifics, firstly on the issue of the two connected proposals of enhanced debt monitoring and *pari-passu* arrangements on new secured debt, a consultation on the proposals was undertaken by the USS Trustee which ended on 3 August 2020; UUK has recently provided to the trustee a note of the comments received from employers (available on our USS employers website[5]). UUK has had invaluable assistance from a group of sector finance specialists, and they have provided knowledge and perspective which has helped in being clear that the proposed arrangements would not at this stage be acceptable – but we continue to engage constructively. From the responses we have seen and other exchanges, we believe that, with modification, a way can be found to implement proportionate arrangements on debt monitoring which employers could support. The *pari-passu* elements of the trustee's proposals appear more difficult; the proposals need more work, and more time for employers to consider. We have urged the trustee to take specific steps in order to progress engagement with employers, to undertake further, specific engagement on the proposals in a follow-up consultation which ideally presents a revised proposition with a more appropriate future implementation date, and which is timed so that employers can see the specific benefit which might be gained from the measures (likely from late November, after the USS Trustee Board on 24 November when we expect a default price will be set). We think these steps are essential to the trustee gaining the support and engagement of employers with the framework.

Secondly – on the issue of proposed long-term rule changes to prevent an employer from leaving USS without the trustee's consent – there is again constructive engagement and UUK is once more grateful to a group of employer representatives, and sector specialists, who have contributed to UUK's understanding and to the presentation of questions and challenges to the USS team. We have, in the last few days, received responses from the USS Trustee to a central question of the last few months, which is, what are the circumstances in which the trustee – having refused to provide its consent to an employer that wishes to fully exit from the scheme (under the proposed long-term rule), but which has paid its section 75 debt as its statutory employer debt – would seek further contributions? We are reviewing the trustee's response, but the entire proposition from the trustee turns on the response to this question, and it is crucial to any proposal put to employers. Are we describing a

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[5] At www.ussemployers.org.uk

scenario in which there is the multiple failure, without rescue, of strong employers within higher education – or does the trustee envisage using this power in lesser scenarios? If approved, such a long-term legal commitment would represent a very substantial, additional legal pledge to the scheme the like of which has not been seen in multi-employer DB schemes. Once we have built a full understanding of the trustee's proposals, we will consult with employers – but we cannot responsibly do this before the trustee is able to provide satisfactory responses to some of the central questions.

7 THE ENGAGEMENT WHICH WE PLAN WITH THE SCHEME'S EMPLOYERS OVER THE COMING MONTHS

To support employers in developing their responses, UUK has prepared this information paper – and has also published advice from its actuarial adviser, Aon. This Aon advice focusses on the eight questions which have been put forward by the USS trustee in its consultation document [p9 and repeated on p34].

As advertised in our note of 7 September 2020, UUK will be hosting a series of webinars to present the key details, but more importantly to give employers the opportunity to ask questions and join colleagues in discussion on the valuation. The hour-long events will be held via Microsoft Teams and are scheduled as follows:

- Monday 28 September at 1.30pm
- Tuesday 29 September at 10am
- Wednesday 30 September at 1.30pm

We would invite you, or a nominated appropriate individual within your organisation, to request an invitation to a webinar by emailing pensions@universitiesuk.ac.uk. Please include the email address of the person wishing to attend, including details of their role, and state which of the three dates is preferred. We will follow up with registration details and a mechanism for submitting questions in advance of each session.

As the 2020 valuation progresses we will continue to support employers with their own internal and external communications. Latest updates and supporting materials will be published on the USS Employers website,[6] and will be tweeted from @USSEmployers where appropriate. Staff involved in communications should direct any questions or enquiries to the UUK pensions team at pensions@universitiesuk.ac.uk.