USS

AN UPDATE FROM USS ON PROGRESS WITH THE 2020 VALUATION

In the discussion document we published in March, we asked employers to answer some specific questions relating to the proposed methodology and their risk appetite for the 2020 valuation.

This report summarises their responses and sets out how they will be reflected in our formal consultation with Universities UK (UUK) this summer.

We appreciate the commitment employers and stakeholders have shown, in conditions made more difficult by Covid-19, to understanding and responding to the challenges faced by the Scheme.

Long-term trends and influences – including better life expectancies, greater regulation, volatile financial markets, and persistently low 'real' interest rates – have combined to make the promise of a fixed, inflation-protected income for life in retirement more expensive[1]. In fact, USS is one of the few remaining private defined benefit pension schemes in the UK still open to new members.

Concerns about the impact of Covid-19 on the long-term prospects for the Higher Education sector, together with the likely adverse effects on the global economy, are adding to these challenges.

Having confidence in the security of the valuable pensions being promised to our members is as important as ever. This is what matters most to us, as Trustee, in carrying out a valuation – when we 'price' the benefits provided by the Scheme.

Our discussion document was an important, early part of this process as it will inform our forthcoming consultation with UUK on the Technical Provisions and the material details of the Schedule of Contributions, the Recovery Plan and the Statement of Funding Principles.

At this stage:

- There appears to be broad support amongst employers for: our valuation principles; our proposed methodology, including using one 'discount rate' in respect of pension benefits promised to pensioner members and another for those relating to benefits for all other members; and, continuing to explore taking moderately more investment risk over the longer-term than envisaged in our last valuation.
- Progress has been made in securing the commitments from employers made as part of the 2018 valuation to underwrite the investment risks being taken to fund our members' benefits.
- Further work is needed (on a long-term rule change on employer exits in particular but also given the wider economic uncertainty at the current time) in order to define the strength of the 'covenant' used to set the funding assumptions for the 2020 valuation. The stronger the covenant, the lower the contribution rate is likely to be to fund new pension promises.
- There is collective recognition of the challenges that current conditions present and a desire from employers to engage fully and work constructively through the valuation process.

The timeline we outlined in December will be kept under review given the challenges we are all facing. In extending by two weeks the amount of time employers had to respond to our discussion document, **we now expect to be ready to launch our consultation with UUK in late July**. The contributions required to fund the current benefit structure will be confirmed after this consultation and will take into account representations made by UUK on behalf of employers (see Page 6).

We thank employers and stakeholders for the discussions we have had to date on these important issues, in the midst of such difficult circumstances, and will continue to engage fully throughout the valuation process. This is consistent with the commitments made by UCU, UUK and USS to the Shared Valuation Principles agreed to earlier this year.

[1] **Financial Times:** 'Their house is on fire': the pension crisis sweeping the world; **Reuters:** Going Dutch? Low interest rates rattle 'world's best' pension system; **PLSA:** Paul Johnson, Director, Institute for Fiscal Studies, speaking at the PLSA Investment Conference 2019

Feedback from employers

Five specific questions were asked, and UUK separately raised some further discussion points in their own engagement with employers.

We received a total of 65 responses from a wide range of employers including pre- and post-92 HEIs, Oxbridge and colleges, and non-HEIs – representing 66% of members currently paying into the Scheme. We understand UUK received a small number of additional responses we have not seen. The feedback we received, and how it will be reflected in our consultation with UUK this summer, is summarised below. Not all responses were definitive or explicitly quantifiable, as some were dependent on more information and/or conditions. For summary purposes only, conditional responses have been categorised as positive or negative *on balance* – and should be taken as indicative. No decisions will be taken by the Trustee until the consultation with UUK has been held.

Please note: the percentage of active members stated below reflects the percentage of total active membership of USS, not just the membership of organisations who responded. They should be considered in the context that employers representing 35% of the active membership are not included in the responses.

Q1. What are your comments on the proposed new methodology?

Of the employer responses received by USS, 64% of employers (representing 47% of the total active membership) strongly supported, supported, or conditionally supported the new methodology, with only 9% (rep.6%) stating they didn't support. The remainder who responded either wanted more information (9%, rep.4%), didn't respond (9%, rep.1%) or couldn't comment (8%, rep.7%).

The use of dual discount rates was supported, again in full or conditionally, by 62% (rep.43%).

While we did not ask for feedback on the investment strategy or funding assumptions, employers did want to more information on how they would align with a dual discount rate approach. This is best summarised by UUK's comment: "In short, the structure is encouraging but deciding on the assumptions to be used within this structure is crucial."

There was a clear appreciation of the importance of our key valuation principles:

- The level of risk must be 'acceptable'
- Long-term and short-term perspectives are important
- Intergenerational fairness should be considered

The proposal to remove 'Test 1' (the application of a low-risk benchmark) from the valuation calculations was welcomed, but employers want more information on risk metrics and risk management frameworks. UUK and employers acknowledged discussions were taking place in the Valuation Methodology Discussion Forum[2] (VMDF) on these issues.

<u>How we will reflect this in our consultation with UUK</u>

We plan to use a dual-discount rate approach for the 2020 valuation. While we were not consulting on illustrative assumptions through the discussion document, employers clearly appreciate that these will be key to the valuation outcomes regardless of the approach to the methodology. They want to hear more about the relationship between the investment strategy, expected returns, discount rates and prudence. This will be set out in our forthcoming consultation with UUK.

We will remove 'Test 1' from the valuation calculations. We will also continue to develop the risk metrics and risk management framework we will need to understand and communicate risk, and to satisfy our regulatory requirements. We have shared our early thinking on these issues with the VMDF and will provide more information in support of our consultation with UUK.

[2] The VMDF was established by the Trustee as a forum for UCU and UUK representatives to provide input and feedback on the Trustee's broad methodology approach for the 2020 valuation to support the overall valuation process.

Q2. 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; and iii) pari passu security on new secured debt?

A. There was a wide range of views: 59% of employers (rep.40%) supported the proposed rule change on exits, fully or conditionally; 59% (rep.47%) supported the introduction of proportionate debt monitoring arrangements and 45% (rep.32%) supported the introduction of proportionate pari passu arrangements[3] and would consider such proposals. The strongest opposition was to the latter, where 23% of employers (rep.14%) said they did not support this measure. Across all three questions, a minority of employers said they either couldn't comment, didn't respond, or said they needed more information. UUK said the responses showed that "employers continue to be committed to the scheme and are not looking to leave…They remain engaged and supportive for the long-term, but importantly this is predicated on USS being sustainable in terms of cost and risk".

How we will reflect this in our consultation with UUK

Our covenant advisors are clear that, subject to experience over the coming months, the HE sector is still financially resilient and could potentially support a 'Strong' covenant rating. This will be subject to further advice in the autumn but will only be achievable if: the full package of support measures first outlined in May 2019 is agreed; and, the employers' commitment to making risk-taking capacity available to USS is sufficiently clear following our consultation with UUK this summer.

Our current view (pending further advice in the autumn) is that the package of support measures will materially improve the covenant position and the horizon over which we can consider taking risk. As demonstrated by the indicative figures provided in our discussion document, this can potentially support reductions in future service costs. Some progress has been made. UUK are preparing to consult employers on a proposed framework for the debt monitoring and pari passu arrangements. Progress has been slower on the long-term rule change, although many employers told us they are willing to support it in principle.

Since the discussion document was published, the immediate impacts of the Covid-19 pandemic have been felt in the HE sector; in the UK and global economic indicators; and in the turbulence in financial market indices since February. The medium to long term impact remains far less clear, and this uncertainty emphasises the importance of working with employers on issues like covenant strength and progressing cautiously through this valuation, assessing developments along the way. In the face of that uncertainty, our current assessment is that the covenant is towards the lower end of the spectrum laid out in the discussion document – but other potential covenant outcomes and dependencies will be detailed in our consultation with UUK this summer.

Q3. Do you wish to consider additional tangible covenant support measures?

Around half of employers (49%, rep.40%) did not support this, compared to 24% (rep.10%) who strongly or conditionally supported considering it. UUK stated employers were generally sceptical of how such approaches could work collectively alongside the Scheme's cost-sharing rule.

How we will reflect this in our consultation with UUK

Given the lack of appetite at this stage expressed by UUK and employers, who ultimately would need to drive forward any proposal on additional contingent support, we will focus for the time being on addressing the three covenant support measures covered in Q2 above. We will explore again the appetite for making further covenant support available in our consultation with UUK this summer.

[3] As the Scheme is an unsecured creditor (without security or other collateral), there is significant risk to covenant strength if employer assets are pledged to lenders or other third parties. This can be mitigated by similar collateral being committed to cover our liabilities, such that the Scheme is put broadly in the same position as secured creditors for any new debt employers take on.

Q4. 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?

There was support from some employers for taking a moderately larger amount of risk in the long term (compared to the level envisaged under the 2018 valuation): 8% (rep.4%) supported and 34% (rep.22%) conditionally supported, with only 8% (rep.3%) not supporting.

Almost a quarter of those who responded (23%, rep.15%) said they wanted to see more information to understand the risks this would involve. UUK again acknowledged the discussions taking place in the VMDF on this issue.

The potential impact on future contributions for employers and members, both in the short-term given Covid-19 challenges and in the longer term, was a particular concern raised by several employers.

<u>How we will reflect this in our consultation with UUK</u>

We have made good progress in developing the relationship between a dual discount rate approach and the underlying investment strategy and have discussed this with our stakeholders.

We will continue to work with UUK to understand what presentation of information would help employers to provide feedback on the consultation, alongside discussions on risk appetite (see Q5).

As is required by the Scheme Rules and overriding legislation, we will consult UUK on the overall approach and this will inform the decisions we make, as Trustee, about the Scheme's funding strategy, investment strategy and risk management approach.

Q5. 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? (You may wish to express this as a contribution of X% of salary, or a monetary amount, paid over y years).

The responses to this question were more difficult to categorise. Most did not provide a quantifiable answer but asked for more information.

UUK said: "Employers noted that pensions risk can manifest itself in many ways and it is difficult to define a 'risk appetite' in such definitive and specific terms, and certainly not without seeing a fuller picture of its practical implications."

No alternative approaches to quantifying risk appetites were suggested by employers, but they did raise a wide range of issues and concerns in relation to the risk they could support.

These included concerns about the financial pressures on the sector in the short-term in the wake of Covid-19, needing to understand the impact of taking more risk on the path of future contributions and benefits, and wishing to reduce volatility in the path of future contributions.

General concerns were also raised by employers about affordability, sustainability, and the flexibility needed by the HE sector to be able to adapt to changing conditions and be resilient over the longer term.

Many employers also asked us to work with the VMDF to develop further ways of explaining risks to employers – including adverse scenarios that would have practical consequences, and risk management frameworks.

How we will reflect this in our consultation with UUK

We recognise that there is strong interest from employers for further clarification on risk analysis and risk frameworks, including the role of risk metrics in future to replace 'Test 1'. This is an area we began to explore with the VMDF in April.

We intend to hold three further meetings of the VMDF between mid-June and the launch of our consultation with UUK in late July. These meetings will focus specifically on exploring potential adverse scenarios and their impacts on short-term and long-term risk, and the development and explanation of a risk management framework. The final position, which will have to meet various legal and regulatory requirements, will be set out in the consultation with UUK.

The following question was posed by UUK in their consultation with employers:

Do you agree it would be helpful if an outline proposition is developed which shows how the various components – including risk appetite, investment strategy, covenant measures, contribution rates and volatility, and benefit design - might operate together under a particular strategy (or strategies)?

According to UUK, the almost unanimous response from employers was that this would be helpful. We recognise this but must be clear that our consultation with UUK this summer will be based on the current benefit structure.

We are happy, on this basis, to explore what supplementary information we can provide to UUK to support their engagement with employers on the consultation. This would be in addition to analysis we are already planning in relation to risk appetite and risk management frameworks (see Q5).

Matters of benefit design are for the Joint Negotiating Committee (JNC) to consider following the consultation (see Page 6). If UUK or UCU need information or analysis from us relating to any options they want to explore, they can raise this with us outside of (and separate to) the consultation.

We plan to consult on the Technical Provisions and material details of the Schedule of Contributions, the Recovery Plan (including indicative deficit recovery contributions) and the Statement of Funding Principles at the same time for the 2020 valuation. This is in keeping with the approach taken by many other schemes and will give our stakeholders as full a picture, as early as possible, of the overall contribution rate we are likely to require.

Other issues

A wide range of other issues were raised by employers in their feedback – reflecting both short-term concerns and longer standing matters. While some of these are primarily for our stakeholders to address, we acknowledge the concerns raised in relation to:

- The timing of the valuation – some employers supported the decision to proceed but others thought the valuation should be delayed until 31 March 2021 or wanted to understand more about the rationale for proceeding as planned.
- The uncertainty and additional pressures presented by Covid-19 impacting on the short-term outlook in the HE sector and the ability to make financial commitments at the moment.
- The affordability of the current benefit structure for both employers and members, and the long-term sustainability of the Scheme.

As above, matters relating to the benefit structure are for our stakeholders to raise through the JNC.

Our decision to proceed as planned with the 2020 valuation, set out in our note to heads of participating institutions in March, is covered on Page 6.

A reminder of the roles and responsibilities of different parties in a valuation

- Watch: Roles and responsibilities

As Trustee, we are responsible for setting the overall contribution rate needed to secure and fund the future benefits the JNC decides to provide to our members through the Scheme.

This means we are responsible for setting the Scheme's funding strategy, investment strategy, and risk management approach which, collectively, determine the discount rate, funding position and required contributions.

This responsibility comes with specific legal, regulatory and fiduciary duties and accountabilities.

We are legally required to consult UUK on the Technical Provisions – the methods and assumptions we use to establish the 'price' of benefits. We are also required to consult them on formal valuation documents including the Statement of Funding Principles, the Recovery Plan (where there is a funding deficit identified at the valuation date), and the Schedule of Contributions.

The JNC is made up of an equal number of UCU and UUK representatives and an independent Chair. Its role in a valuation is to determine how any change in the overall contribution rate should be shared between members and employers, and/or if any changes should be made to the benefits provided.

This important separation of duties is embedded within the Scheme Rules.

The tripartite discussions to consider the Joint Expert Panel's recommendations and the VMDF are also important forums, but they sit outside of the Scheme's formal governance structures.

Timeline and next steps

We recognise that this is a challenging time for all the parties involved, and this was clearly reflected in the feedback from employers and UUK.

However, we are also mindful of the contribution increases scheduled from 1 October 2021 under the 2018 valuation (unless and until they are superseded by completion of the 2020 valuation), the additional funding challenges presented by Covid-19, and the difficult decisions likely to be faced by our stakeholders over the course of the 2020 valuation.

For these reasons – and having reflected on the Pensions Regulator's (TPR) guidance for schemes currently going through valuations – we feel it is important to proceed with the valuation as planned.

We will keep the timetable, and any further guidance from TPR, under review and will continue to engage with stakeholders through each stage of the process.

We are now preparing for the second key milestone: the launch of the formal consultation with UUK on the Technical Provisions and the material details of the Schedule of Contributions, the Recovery Plan and the Statement of Funding Principles.

We expect this consultation to begin in late July and run for a period of at least six weeks.

The duration will be kept under review, as we are mindful of employers' individual governance and decision-making processes – and other consultation activity, for example on the rule change, could be running in tandem.

We expect to be in a position in early autumn to advise the JNC of the overall contribution rate required. It will then have three months to decide how any change in the overall contribution rate should be shared between members and employers, and/or if any changes should be made to the benefits provided. If it cannot, the cost-sharing provisions will apply (as set out in the Scheme Rules).