USSEmployers

CONSULTATION ON THE PROPOSED 2018 TECHNICAL PROVISIONS ACTUARIAL VALUATION

UNIVERSITIES UK RESPONSE

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Summary of employer responses

UUK received responses to the consultation which together represent 89% of the active member population of USS. We believe this represents a credible level of response to the consultation, in the time available. In terms of headline responses to the questions put forward to employers by UUK, these are as follows:

1. Do you have any specific comments on the proposed assumptions for the 2018 valuation, including views on the proposed Upper Bookend and Lower Bookend?

The responses from employers on specific points relating to the upper and lower bookend values are set out in the detailed UUK response, however the principal points raised by employers are:

- employers remain to be convinced that the upper bookend value of 33.7% is the 'correct' price for the current benefits as is suggested; we ask the trustee to fully consider the responses in the detailed response when deciding on this crucial upper bookend value.
- employers find it difficult to see the trustee's justification for why two of the Joint Expert Panel's (JEP's) recommendations are proposed to be excluded in finalising the lower bookend value. Employers are interested to understand more fully how the trustee has been able to decide which proposals meet a threshold of acceptability or not. In particular, employers note that finding just one of the excluded JEP recommendations to be acceptable – the smoothing of future service costs over a limited period (say three years) – would allow the lower bookend value to reduce below 29.7% of salary (to 29.2%, the figure illustrated by the JEP and which UUK used in consulting with employers, or close to it). It is not clear why this has been rejected by the trustee.
- employers believe that the proposed levels of Deficit Recovery Contributions included in the bookend values are unreasonable and have not been justified by the trustee, given that the scheme deficit is materially lower than it was as at 31 March 2017. Employers believe it unreasonable for such a significant component of the overall contribution not to be formally consulted upon at this point in time.

2. Do you support UUK putting forward a proposal for a Contingent Contributions (CCs) arrangement to the USS trustee as it requested? If not, would you prefer to pay at the upper bookend level or what would your preferred response be?

While most employers would prefer for the JEP recommendations to be implemented without CCs, a significant majority of employers support the development of a proposal by UUK to put to the trustee, recognising that UUK had expected the trustee to present a proposal rather than developing its 11 principles. At the same time, many employers still question why a CCs arrangement is necessary, given the legal and structural basis upon which the scheme operates (which was set out, in brief, by Aon in its note of 27 February 2019).

The small number of employers not supportive of the proposal remain to be convinced of the necessity of CCs to achieve the lower bookend (some of these reasons are set out in the Aon advice notes dated 14 January 2019 and 27 February 2019), and prefer the trustee to explain further why it believes CCs are needed.

3. Do you find the proposal for a CCs arrangement set out in the Aon note acceptable, taking all factors into account? If not, what aspects would you wish to change?

Reluctantly, and on the basis that it is the 'least worst' option, employers express support for the proposal for CCs put forward by UUK. The support of employers is conditional upon confirmation that the UUK proposal delivers a contribution rate in line with the lower bookend.

We would emphasise the crucial trade-offs which have needed to be considered by employers in fairly evaluating the proposal. In particular, it is clear that employers see the arrangements as temporary, any CCs must be cost-shared, and they are justified only in that they will allow stakeholders to find a solution to the current valuation. Employers also believe that CCs will allow them to look forward to the next valuation, and that the second phase of work by the JEP will be the means through which a genuinely sustainable longer-term solution can be found.

It is clear from the consultation responses that employers wish to see an outcome to the USS valuation which is in line with the recommendations put forward by the JEP. The JEP's recommendations gave the stakeholders to USS an opportunity to achieve a settlement to what has been a difficult process. They also allow the longer-term sustainability of the scheme to be more carefully considered as part of a second phase of JEP work.

Please see the detailed response in this document in which further comments on the trustee's proposed technical provisions (and related assumptions) are set out in the light of the responses from employers, and also on the proposed CCs arrangement put forward by UUK. The proposals, which employers have confirmed they support on the terms set out above, are those as defined in the Aon note dated 27 February 2019, and we believe these proposals fully meet the 11 principles put forward by the trustee. The Aon paper provides more detail, in its Appendix 2, as to how those principles are met.

UUK's proposals have been communicated to the Pensions Regulator (tPR). At a meeting with tPR on 5 March 2019, a number of explanations and clarifications were provided by the UUK team, and tPR advised that they have no plans to offer any further comment on the proposals until after the USS trustee board meeting on 28 March 2019. (For the avoidance of doubt, tPR has not expressed a view on the proposal and this interaction with tPR should not be taken as potentially tPR having no issues with the proposal.)

The proposed CCs arrangement – now broadly supported by employers – was put forward on the basis that it represents a lower bookend solution which all parties could find acceptable. It has involved very careful consideration by UUK and by employers, recognising that difficult decisions are required. Crucially, the proposed arrangements could, we believe, be decided upon quickly, meeting the objective of submitting a timely valuation and implementing new contribution rates ahead of the planned October 2019 increases. It is hoped that the trustee shares this view.

If the CCs proposal is not supported by the trustee, UUK would expect employers to receive a clear explanation as to why this is the case given that the 11 principles set out by it have, in the view of UUK, employers and Aon, been met. It will also need to be clear how this valuation can best be resolved for all parties in the time available.

UUK's detailed response

Introduction

This is a detailed response from Universities UK (UUK), on behalf of scheme employers, to the consultation by the USS trustee on proposed assumptions for the Scheme's Technical Provisions and Statement of Funding Principles.

Employers have previously made clear to UUK that their support for the Joint Expert Panel's (JEP) recommendations is conditional upon understanding the terms of what (if any) contingent support is required by the trustee, and of the finalised contribution rates. Given that the expected sequence of events has changed and UUK has now been invited to bring forward its proposals for Contingent Contributions (CCs) (rather than a proposal being presented by the trustee), the trustee's requirements in relation to contingent support are not fully certain.

While the trustee's 11 principles give UUK some additional confidence that the proposal is credible, it is unclear whether the terms for CCs developed by UUK with its advisers will be acceptable to the trustee. We must, therefore, continue to treat the support offered by employers as conditional and entirely subject to what employers trust will be the trustee's acceptance (and, as appropriate, any details of that acceptance).

It is clear to UUK that employers are very much cognisant of the issues of risk in relation to USS. The supplementary material on risk which has been provided by the trustee, and also developed by UUK through its advisers Aon (such as the appendix to Aon's first advice paper dated 14 January 2019), has been extremely useful to employers, we believe. Employers have made it very clear that, whilst they wish to support a solution, they must understand and accept any additional risk that is involved and its implications, to protect the potential future impacts upon their finances and those of USS employers generally. Employers could not support a solution regardless of its cost or of the risk associated with it (whether current, or potential future). Indeed, several employers made clear that the upper bookend would be simply unsustainable, with the lower bookend requiring difficult choices and re-prioritisations to be made by employers. It is also clear from responses that employers are concerned about the impact of recent developments on scheme members, and for example on their views about future participation in the scheme.

The proposed bookends in overview

We note that the underlying methodology adopted for this valuation is broadly the same as that used in the 2017 valuation, including the trustee's funding tests. We support this approach by the trustee given the timescales within which the valuation is being undertaken, but UUK would also put on record its willingness, and that of employers generally, to examine and consider other approaches when the trustee considers that appropriate. We note also that the second phase of the JEP's work will look at some of these issues later in its work plan.

We note the presentation of upper and lower bookend values by the USS trustee, and importantly that the major difference between the two values is largely down to the proposed level of Deficit Recovery Contributions (DRCs) in each. The trustee makes clear that this is not a formal consultation on matters relating to DRCs – and yet the DRCs are so fundamental to their value, and therefore to the views expressed by employers on them. We think it unhelpful that DRCs are not part of the formal consultation at this point.

In terms of the upper bookend, we would firstly acknowledge that the proposals for the upper bookend are materially better than the contribution rate confirmed for the 2017 valuation (33.7% of salary compared with 35.6% of salary). That is good news, and we realise this in part reflects some welcome movement on the part of the trustee at this new 2018 valuation; of course it is also partly derived from the change in valuation date itself.

In its recent webinar, the USS Executive characterised the proposed upper bookend as *more risky* than the figure confirmed for the 2017 valuation. Aon's view is that this is not the case – as set out in the Aon note of 27 February 2019. We think it crucial to recognise that the value of the funding deficit has more than halved – £3.6bn compared with £7.5bn – although the trustee has proposed to adopt the same level of DRCs of 5% of salary. We argue below for a reduction in the level of DRCs, and we make clear that the introduction of an appropriate CCs arrangement allows the trustee to take a different view on the overall level of risk within the assumptions.

We think it important that the lower bookend is at, or very close to, the 29.2% contribution level, in line with the illustration provided by the JEP and on which UUK consulted with employers. Employers support the JEP's recommendations and the estimated employer contribution rate of 20.1% – although it is clear that such a level is at the very upper limit of sustainability (and there would be material impacts for many). We hope that the trustee will recognise that with employers offering broad support for a CCs arrangement in the form proposed by UUK, it would be helpful – in terms of moving quickly to settle the 2018 valuation by the appropriate deadlines – not to have to revert to employers to seek their views on a higher employer contribution than 20.1% of salary (and indeed for University and College Union's (UCU) views to be invited on a member contribution rate of greater than the 9.1% level illustrated by the JEP).

In the various consultation documents prepared in recent months we have seen the trustee continue its focus on self-sufficiency (and in particular *the gap* between the trustee's funding approach and a self-sufficiency position) as a primary funding metric. We see this carried across to the issue of CCs, in which it is clear that the trustee has a preference for the triggers to be activated by reference to a self-sufficiency measure. In recent days – in a webinar presented by the USS executive and in blogs from the USS team – we have heard that a figure of £20bn of self-sufficiency deficit is *'more than twice the level of reliance that employers told us they were ultimately willing to support, in the long-term, in carrying out the 2017 valuation'*. We do not believe that employers have expressed a view on the *current* level of deficit on a self-sufficiency basis – although we have of course previously expressed views on the targeted figure in 20 years' time (as part of the trustee's application of Test 1 for the 2017 valuation). We think it important, given how crucial this issue is as CCs are discussed, that the views of employers are not misunderstood here. We would like to understand if the USS Executive, or the USS trustee board, is forming any view of the 'risk appetite' of employers on the current gap to a self-sufficient level of funding, or indeed – as it sometimes alluded to – whether the trustee itself has a particular 'risk-appetite' in this respect.

The proposed assumptions in detail

We note, and welcome, that the trustee has proposed that some of the JEP's recommendations be adopted into their assumptions for the 2018 valuation. The trustee has taken advantage of the latest market conditions and data as at 31 March 2018, and indeed of updated mortality data; this is welcomed, and supported, by employers. Employers also welcome the proposed adoption of a normal pension age of 66 for the future accrual of defined benefit rights.

The trustee has indicated that it would be *prepared to consider* two further measures, namely (i) movement of the target reliance at 20 years from £10bn to £13bn in real terms and (ii) reducing DRCs by allowing for outperformance in the recovery plan or increasing the length of the recovery plan. The view from employers is that these movements would be considered appropriate – and indeed entirely justified in both respects – on their own merits. Moreover, if it were needed, the case for them would be further strengthened given the support which employers have indicated they would be willing to provide through CCs.

Employers are unclear why two of the JEP's proposals have not at this stage been supported by the trustee, in particular (i) deferring when de-risking of the scheme's investments starts and (ii) the smoothing of future service contributions over an appropriate period (the JEP had suggested two valuation cycles). The trustee's rationale is, we believe, in part built upon the assessment of the average discount rate relative to CPI and Gilts, which is shown on page 15 of the consultation document. If we set aside the limitations of these measures in assessing an overall funding approach in this way (for example, the approach to deficit recovery would not feature in this kind of assessment), we believe that employers wish for full recognition to be given to the uniqueness of the covenant provided to the scheme by USS employers. This was presented in convincing terms by the JEP in its report. The 'benchmarking' which is illustrated by the trustee on page 15 of its consultation document is considered to be of limited value, and does not provide justification that some, but not all, of the JEP's proposals should be incorporated. Adopting all of the JEP's recommendations is we believe further substantiated by the proposed addition of a CCs arrangement.

On the proposed levels of DRCs to be included in the upper and lower bookend values, as we have said it is important that the views of employers can be taken into account now given their fundamental importance to the overall bookend values. Clearly, if the trustee maintains its view that a formal consultation on DRCs will take place later, the comments made below are without prejudice to the formal responses which will follow. This is the element of the trustee's proposals on which the most substantial comments have been made by employers. We should start by reiterating that employers have continued difficulty in seeing the justification for a 5% DRCs value in the recovery plan which has been confirmed for the 2017 actuarial valuation. The decision to undertake a 2018 valuation allowed the latest market conditions to be taken into account (as at 31 March 2018), which helpfully provided a more favourable calculation of the deficit (some 42% of the deficit value as at 31 March 2017), and yet the trustee has proposed DRCs of 5% of salary within the upper bookend value. Employers have some difficulty with the logic of the trustee's approach in this area, and they support the view expressed by Aon in its paper dated 27 February 2019 that a materially lower figure would be justified (and 3.5% was used in its illustration of the gap between the bookends). In addition, as USS is an open scheme with a long term investment strategy this further supports the merits of long recovery plans with asset outperformance.

With respect to the level of DRCs proposed in the lower bookend value, it seems clear from table 4 on page 19 of the trustee's consultation document that much lower DRCs can be justified. Indeed, we know that some would argue that no DRCs are required at all, given that it would not be unreasonable for a level of outperformance – similar to that used before – to be included in the recovery plan. We think that lower DRCs would be particularly justified if an acceptable CCs proposal were put in place. Once again, employers support the approach adopted by Aon in its advice paper of 27 February 2019, which is to illustratively include 2.1% DRCs[1] – which is important in the development of the CCs proposal and to quantifying the gap between the bookends – on the basis that it will enable the lower bookend value to be 29.2% of salary. This is considered important is being able to achieve an acceptable outcome for all parties.

With the publication of new mortality guidance last week, we would expect the trustee to consider the latest tables in due course, which if these trends apply to the USS membership would likely see a further reduction in liabilities.

In the interests of transparency, we think it may be helpful for the formal advice of the USS scheme actuary to the trustee on the proposed assumptions for the 2018 actuarial valuation to be shared with employers. If the trustee considers that appropriate, UUK would be pleased to receive and then circulate that material to support further understanding of these matters.

UUK's proposal for Contingent Contributions (CCs)

The responses from employers generally support the view of the trustee that the covenant provided by USS employers is strong, and they note that this is backed by considerable advice gained by the trustee on this issue. This underpins the proposal for CCs which was put forward to employers. We understand that the trustee plans to undertake further tailored work around the 2018 valuation. UUK and employers will be pleased to provide any further inputs or assistance needed.

The JEP report made clear that the issue of trigger contributions *'is an issue to be addressed for the longer term, and as part of a wider review'*, and employers have confirmed that they back the findings of the JEP. We cannot escape the fact that the development of a CCs proposal is made more difficult given this context. We do, however, recognise the trustee's position and have developed a proposal accordingly, although we would want to make clear that employers are still fully behind an outcome in line with that put forward by the JEP.

We think that focussing on contingent *contributions* – and not giving consideration at this stage to contingent assets, negative pledges etc – is right, although we are also supportive of the JEP's particular view that other forms of support should be looked at as part of a longer-term review.

The majority of responding employers confirm that they support the proposals put forward by UUK. It is clear that they do so reluctantly, as the least undesirable of the very difficult alternatives put to them at this time and in the spirit of offering a final measure through which an acceptable conclusion to recent difficulties can be found by all parties.

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[1] It should be recognised that, in the lower bookend scenario, the deficit would be an indicative £2.2bn – and DRCs of 2.1% of salary would be equivalent to a 15 years recovery plan with no outperformance. Some level of outperformance is considered entirely reasonable and proportionate.

Employers have also expressed a number of further necessary conditions to their acceptance:

1. there is strong support for the proposal that CCs are cost-shared under the scheme's cost-sharing provisions; this is confirmed as being of fundamental importance to employers.
2. for any given CCs proposal, in the context of a scheme with a long-term investment strategy and a strong covenant, what really matters for employers (and employees) is – what is the likelihood of the triggers applying, how much is then paid, and what period of notice is given. Beginning with the likelihood of the trigger applying, the probability of CCs being triggered appears high at 30% and many employers believe that this likelihood would ideally be lower reflecting that CCs should only be triggered in exceptional circumstances – and more in line with the starting point referred to by Aon in its advice note of 27 February 2019 of 10%. We believe that, on balance, employers could live with the proposed 30% probability but it would be remiss not to also reflect the clear statements of concern.
3. employers are clear that they see the CCs arrangement as temporary, designed to achieve an acceptable solution through to the next actuarial valuation (which will provide the opportunity to look at the position afresh). It will also enable the JEP to progress, and conclude, its second phase of work. Employers also recognise the power of the trustee to call a further actuarial valuation as one of its further defences should the scheme's funding position materially worsen (for example it would have the power do so as at 31 March 2020 if that were considered appropriate), and indeed some employers have expressed the view that 2020 should be the date of the next valuation.
4. the time periods set out in the Aon proposal, for example the period over which changes in the funding position are measured, and the period of lead time available to the stakeholders before any CCs are implemented, generally seem acceptable to most employers. Employers consider it essential that any arrangement provides for the Joint Negotiating Committee to have a period within which it can consider the stakeholder response to a deterioration in the funding position, and in our view six months is the shortest period that is feasible.
5. employers wholly support the view that the assessment period needs to be sufficiently long, and the probability set sufficiently, to avoid CCs being triggered by something which is part of the normal cycle of volatility within a three yearly actuarial valuation period. In the view of employers, the CCs arrangements are intended for circumstances which are clearly beyond any predicted norm. However, there is some reluctant support for a likelihood of 30% as part of a final settlement to the valuation, alongside quarterly monitoring (with three-month averaging), and with the trigger threshold being breached if the trigger is met for two successive quarter-ends. We think this is consistent with the view of the Pensions Regulator, expressed in its letter dated 11 December 2018, that it expects employers to demonstrate that they can fully support additional investment risk – in particular *'that they can fully support that risk if it is not rewarded'*. An assessment period which is too short would not allow such an assessment – as to whether additional risk has been rewarded – to be reasonably made.
6. employers believe it helpful to see any additional risk associated with the JEP's recommendations as being the difference between the upper and lower bookends in the construct presented by the trustee. This is in line with the 2 January consultation document. While there is then a theoretical 'underpayment' compared with the position had the upper bookend applied, the sums involved are not material in the context of the covenant, and the right place to address this is at the next valuation.

7. employers believe that the proposal for three steps of increased contributions are appropriate given the strength of the covenant and its enduring, long-term ability to respond to what will always (in relative terms) be a short-term funding change, and also contribution steps of 1% each are appropriate as a means of bridging the gap, over time, between the two bookend values.

Comments on the draft statement of funding principles

We note the additional wording which has been included in the draft presented for consultation which relates to the trustee monitoring the short-term self sufficiency position. Looking back, we note that this wording was not included in the *draft* Statement of Funding Principles (SFP) presented for consultation in respect of the 2017 valuation, but was included in the final version of that 2017 SFP. In its advice paper of 27 February 2019, Aon states that it has no material concerns with the trustee documenting that it is monitoring the self-sufficiency deficit, although it would prefer this monitoring to have no role in the proposal for CCs; we agree with this view.

It appears that the reference to the 'economic basis' has been dropped; it is no longer defined, unlike for the 2017 and 2014 statements. In its advice paper of 27 February 2019, Aon states that this may suggest that the trustee is disbanding Test 3 which compared the net assets of the sector with the deficit of the scheme on an economic basis together with a 1-in-100-year bad event, or the approach could be retained but on a self-sufficiency basis. We would welcome the trustee's clarifications as to why references to the economic basis have been removed.

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