The Pensions Regulator
Making workplace pensions work

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Dear VMDF

Thank you for inviting us to join the meeting on 30 June 2020. I have provided a summary of our presentation together with responses to some of the questions which were raised.

Our presentation focused on three main areas:

1) Risk appetite
2) Discount rates
3) How TPR assesses valuation proposals

<u>Risk appetite:</u>

Assessing risk appetite is integral to an Integrated Risk Management approach. We expect the Trustee to consider the employer and employee appetite along with their own appetite when setting the technical provisions. The assessment of employer and employee appetite should reflect both how able and how willing they are to support the scheme. Considering risk appetite involves looking at both the short and long-term risk position of the scheme.

The current risk position for the scheme is already challenging. This is illustrated by the significant self-sufficiency deficit (or “distance to self-sufficiency”) at the valuation date compared to USS’s assessment of risk appetite for monitoring purposes. This is demonstrated by some of the analysis USS prepared and presented at the meeting including the scenario analysis.

<u>Discount rates:</u>

Setting discount rates for schemes with a 31 March 2020 valuation date is a challenge because of the impact of Covid-19. We might expect higher expected returns versus the yield on gilts compared to the recent past, however, there is a lot of uncertainty around the future economic situation and the long-term expected investment returns. This would suggest that the Trustee should take a more prudent approach than they might otherwise do if they followed a similar approach as for the 2018 valuation in terms of confidence intervals.

Assessing valuation proposals;

When we assess an actuarial valuation, we do not focus on the individual components but rather consider the overall proposal. Factors that we need to consider are the covenant strength and affordability, discount rates and level of technical provisions, recovery plan (RP) length and investment outperformance, and, to some degree, the approach to the calculation of the future service contribution rate We view covenant as tending to strong and greater covenant support is needed in order to improve that rating to strong. Covenant is about affordability, the ability to pay higher contributions and demonstrable commitment to do so, as well as long-term visibility.

For a scheme with a strong or tending to strong covenant, the trustees' starting point for the length of RP is usually the current length of RP, keeping the same end date. However, the trustees should also take into account affordability and the change in the scheme's deficit which could result in them agreeing to extend the RP. We would not usually expect a long RP for a strong or tending to strong covenant. In order, to become comfortable with a long RP for the scheme, we'd require a strong rationale and some contingent support that underpins the extended reliance on employers' affordability.

If there was a long RP combined with a significant element of investment outperformance, we consider it would remove much of the prudence in the technical provisions discount rate assumptions.

We see there is a risk of double counting credit for the covenant already taken in another part of the valuation proposal. For example, if the technical provisions were set at low TPs to reflect a strong covenant and then a long RP with significant element of investment outperformance was agreed to reflect that strong covenant again.

Questions

Q: If the employers' risk appetite is much higher than the Trustee's risk appetite, then why should the Trustee constrain it?

A: Under UK pensions legislation, the Trustee has the primary responsibility for protecting members' accrued benefits and ensuring they are paid. If it is for the Trustee to satisfy itself that the scheme's investment and funding strategy does not result in too much risk to members. If the assumptions used for this valuation are too optimistic, this creates a risk that there could be dramatic increase in required contributions at the next valuation in 3 years' time.

Q: TPR's approach is not doing anything to protect members. The interests of members are getting entirely lost in the approach.

A: We have a statutory objective to ensure that members' accrued benefits are protected and can be paid in full. This is the foundation on which we exercise our function of ensuring that schemes adopt a prudent and appropriate approach to funding. If USS is underfunded now there is an increased risk of members' accrued benefits not being paid and of unaffordable increases in contribution requirements at some point in the future.

Yours sincerely

TPR