Actuarial Valuation

The USS Trustee has decided not to carry out an additional actuarial valuation at 31 March 2021.

At a glance…

- The USS Trustee has provided indicative figures for a 31 March 2021 valuation. Consistent with other updates post 31 March 2020, the overriding message is that the outcome would not be materially different when it comes to the contribution rate.
- We view the suggested approach for 31 March 2021 as more prudent than we would have expected – particularly in relation to the post-retirement discount rate, and the length of the recovery plan. The Trustee's conclusions could therefore be questioned.
- However, ultimately it is the USS Trustee's decision on whether to call a new valuation, and it has determined that there are not compelling reasons to do so. Even if a valuation were carried out, then the USS Trustee would set both the assumptions and the resulting contributions (subject to consultation with UUK). The USS Trustee also notes that the government's autumn higher education sector funding review could add time and complexity to any valuation.
- Overall, with some reluctance, we therefore question the merits of trying to insist on an early valuation being carried out, ahead of the governance review.

Why bring you this note?

This note sets out our views on the indicative 2021 valuation figures provided by the USS Trustee along with TPR's comments.

Indicative figures – Technical Provisions

The deficit has reduced significantly from £14.1Bn at 31 March 2020 to £5.6Bn at 31 March 2021 under the indicative assumptions for the UUK benefit proposal. This is a substantial (c.60%) reduction.

The future service contribution rate for the UUK benefit proposal would increase slightly from 24.9% to 25.6%.

We are broadly satisfied with the indicative assumptions except for the post-retirement discount rate (i.e. the discount rate applied to benefits once members retire). This assumption has been indicatively strengthened from Gilts+1% p.a. to Gilts+0.55%, which brings the assumption very much back into the pack compared with other UK schemes (i.e. all schemes, irrespective of the covenant strength or whether they are closed or open to new entrants). We had expected the figure to reduce back to Gilts+0.75% that was used for the 2017 and 2018 valuations now that we are in more "normal" market conditions. We also believe the inflation assumption is

Information

Based on USS Trustee's assumptions, the deficit has fallen by c.60%, with a slight increase to the future service contribution rate.

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more prudent than adopted for the 2020 valuation (relative to USSIM best estimate views).

If Gilts+0.75% p.a. were to be adopted as the post-retirement discount rate, then we estimate that the deficit would be c.£3.3Bn (a fall of just over 75%) which is slightly less than the 2018 valuation deficit of £3.6Bn; and the future service rate would have been c.25% so broadly the same as the 31 March 2020 valuation.

In the Appendix, we set out our more detailed technical comments on the indicative assumptions.

Indicative figures – Recovery Plan

The USS Trustee suggests a fixed 6% deficit contribution would apply if a 2021 valuation were carried out, despite the deficit falling by c.60%.

The USS Trustee argues that the deficit is higher than at the 2018 valuation (of £3.6Bn) when a 6% deficit contribution rate was due to apply from 1 October 2021, and so the deficit contribution should be 6%. This applies irrespective of the benefit reform proposals, and would lead to a recovery plan of less than 10 years (with 0.25% p.a. asset outperformance) under the UUK benefit reform proposal.

TPR echoes the same message in its letter, albeit the USS Trustee may go *"marginally below"*, but not materially below 6%. It also believes a more "normal" Recovery Plan should be adopted, rather than one allowing for more extreme conditions at 31 March 2020.

The USS Trustee's approach would lead to total contributions of 25.6%+6%=31.6% for the UUK benefit proposal. This compares with 24.9%+6.3%=31.2% at 31 March 2020, so represents a small increase. The USS Trustee therefore argues that the outcome of a 2021 valuation would not be materially different.

Our views on the illustrative recovery plan are as follows:

- Keeping largely the same deficit contributions despite the deficit falling materially has a direct impact on intergenerational fairness. A more balanced view, including giving employers credit for the 20-year moratorium in a 2021 valuation, could lead to a longer recovery plan being maintained, with the funding improvement leading to a smaller impact on member benefits for the current generation.
- In its 14 July letter, TPR stated that it would expect more "normal" parameters to apply if the USS Trustee decided to commission a valuation at 31 March 2021. Similar to our comments on the 2020 valuation recovery plan, we believe TPR's position on "normal" recovery periods does not place enough weight on the unique covenant of the USS, or the additional covenant support measures, or address adequately the issue of intergenerational fairness given the sharing of cost increases. In addition, for the 2014 and 2017 valuations the recovery periods were 17 and 17.25 years, and 18 years is due to be be adopted for 2020 – and so we would argue that 15-20 years (as recommended by the JEP) is "normal" for the USS.

Information

The USS Trustee's view is that 6% deficit contributions would be appropriate even though the deficit has fallen materially. It is for this reason primarily that the USS Trustee concludes that it is not worth carrying out a 2021 valuation

- TPR described the 2020 valuation as potentially not compliant with legislation, and in its latest letter of 24 September 2021, said that they were not comfortable with Leg 1 of the Schedule of Contributions (which results in the contribution rate of 31.2%) but that the position was marginal and they would not take further action. We believe TPR may be much more comfortable with the indicative 2021 results that adopt more “normal” parameters. This would support our view that the overall approach taken by the Trustee for the indicative 2021 results is more cautious (particularly as regards the post retirement discount rate and recovery plan parameters).
- We believe there is excessive anchoring to the out-of-cycle 2018 valuation. To give a different perspective, if we were to go back to the 2017 valuation, then we would note that the deficit is materially lower than the £7.5Bn that arose at the 2017 valuation where deficit contributions of 5% were required (with a 17.25 year recovery plan). UUK was also clear in responding to the out-of-cycle 2018 valuation that the 10-year Recovery Plan would not be contested further only because the 2020 valuation would be used to revisit it, and ordinarily the reduced recovery period from 2017 to 2018 would not have been expected or justified.

Closing comments

It is the USS Trustee’s decision whether to call an additional valuation at 31 March 2021.

The USS Trustee has provided illustrative valuation results at 31 March 2021 that essentially show a slight increase to the contributions required (from 31.2% to 31.6%). The USS Trustee has adopted valuations assumptions that are stronger than we would expect based on simply rebasing the assumptions to a new date. However, ultimately the USS Trustee would set the assumptions and resulting contributions in a 2021 valuation.

Carrying out a 31 March 2021 would only be worth the distraction and cost if the outcome for contributions/member benefits would be different. It would also in our view be wrong to give members the impression that benefit reform could be moderated, if the USS Trustee (which has the primary power to set contributions under the Rules) is telling us something different.

To avoid the contribution step-up that falls due without benefit reform, there is insufficient time to carry out a new valuation, for the USS Trustee to consult on the approach with employers, and for the JNC to decide what benefit reforms to propose. We would likely be in the realm of considering further benefit reforms (perhaps in 2022), rather than directly influencing the current benefit reform discussions. On balance, this would suggest completing the 2020 valuation, carrying out the governance review and discussion of longer term options such as Conditional Indexation, and waiting for the 2023 valuation (or possibly bringing forward a 2022 valuation if good progress is made on the other areas in the early part of 2022). We would be pleased to discuss this further.

Appendix – Commentary on assumptions

CPI (inflation) assumption

For the 2020 valuation, an assumption for RPI was derived from the difference between market prices for nominal and index-linked gilts – so-called "breakeven" inflation. A reduction was then applied to breakeven inflation that represented the perceived gap between RPI and CPI. Since then, it has been announced that RPI will morph into CPIH (a similar index to CPI but with housing added) from 2030 onwards. This means that the RPI breakevens effectively now represent CPIH from 2030 onwards.

We agree with USS that there is a marked "inflation risk premium", that is, the breakeven values do not represent our best estimate view of CPI inflation.

Our best estimate view of inflation has increased by 0.2% p.a. between 31 March 2020 and 31 March 2021. The USS Trustee has increased its inflation assumption for the Technical Provisions from 2.1% p.a. to 2.5% p.a.

We do not believe that the 0.4% p.a. increase represents an increase in *best estimate* views from USS, and understand the underlying FBB modelling assumptions have been increased from 2.1% to 2.25% i.e. by a similar amount to Aon. On the face of it, there is more "prudence" in the inflation assumption (for the scheme's Technical Provisions) compared with the 2020 valuation approach. However, we understand that the Scheme Actuary has recommended 2.5% p.a. as appropriate for the purpose of the Technical Provisions based on a consideration of the changes to RPI. If a 2021 valuation were carried out, then we would expect a clearer justification for the divergence between the proposed valuation assumption and the FBB modelling assumptions.

Pre-retirement discount rate

Page 12 of the USS Trustee's 2021 valuation briefing note states that the pre-retirement investment returns have gone from gilts+5.9% to gilts+4.7% from March 2020 to March 2021. Our crude approximation model for this assumption has reduced by 0.7% rather than 1.2%, i.e. a less material change.

As noted above, the USS Trustee has increased CPI from 2.1% to 2.5%. Our best estimate increase would only be up 0.2%. So, their best-estimate return has gone from CPI+4.2% to CPI+3.1% (i.e. 4.2% + 0.5% rise in gilt yields - 1.2% relative to gilt yields - 0.4% increase in CPI). While their best-estimate pre-retirement return has reduced considerably, they have only reflected a 0.3% change relative to gilts in the Technical Provisions basis i.e. they have gone from Gilts+2.75% to Gilts+2.45% which is equivalent to going from CPI+1.05% (i.e. 2.75%-5.9%+4.2%) to CPI+0.85% (i.e. 1.05% +

0.5% - 0.3% - 0.4%). So, they have strengthened the discount rate relative to CPI.

Our preference for the pre-retirement discount rate is to follow the JEP recommendation of CPI plus a fixed margin. We believe the benefits of transparency are more important in this setting than theoretical accuracy. However, we would agree though that if one were to derive investment returns again from first principles then it would not be unreasonable to have a slightly lower return relative to CPI.

Post-retirement

The USS Trustee is proposing to strengthen the post-retirement discount rate from Gilts+1% to Gilts+0.55% p.a. This is a very material change, and has not been fully justified in our view.

Now we are back in more normal investment market conditions, we would accept that it would be more appropriate to revert to Gilts+0.75% (adopted for the 2017 and 2018 valuations).

In effect the USS Trustee is proposing to bring the assumption here back into the pack with other schemes overall: we expect Gilts+0.5% to become the industry standard when the new funding code comes into place next year.

Note that even if a Gilts+0.75% p.a. discount rate were adopted for the post-retirement discount rate, since the deficit would only just be under the 2018 valuation position, the USS Trustee may still argue for a contribution rate of 30%-31% (i.e. 25% for future service plus perhaps somewhere in the range of 5% to 6% for deficit contributions). Therefore, it is arguably not worth pushing for a 2021 valuation in the hope that the USS Trustee can be convinced to move the post-retirement discount rate (assuming the USS Trustee would stick with a minimum deficit contribution of at or near 6%).

TAS compliance

This document has been prepared in accordance with the framework below.

This document, 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’).

The compliance is on the basis that Universities UK are the addressees and the only users and that the document is only to be used for the purpose of considering the merits of asking the USS Trustee to carry out a 31 March 2021 actuarial valuation.

The document has been prepared under the terms of the Agreement between UUK and Aon Solutions UK Limited on the understanding that it is solely for the benefit of the addressees.

The deficit and contribution figures at 31 March 2021 on a post-retirement discount rate of Gilts+0.75% have been estimated by using the figures provided by USS in their presentation dated 6 July 2021 and adjusting approximately for the change in discount rate using basic assumptions relating to duration. It is possible more accurate calculations carried out by USS and their advisers would be different to those shown.

For our crude estimate of the change in best estimate between 31 March 2020 and 31 March 2021 (relevant for the pre-retirement discount rate), we have used our standard capital asset modelling assumptions at these dates and applied them to a predominantly growth portfolio with similar characteristics as the USS portfolio, which is assumed to back non-pensioner liabilities. Further information on the assumptions adopted is available on request.

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