USS valuation at 31 March 2023

Comments on USS consultation materials

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Date: 26 July 2023

Private & confidential

Introduction

Why bring you this report?

This paper sets out our comments for Universities UK (UUK) on USS's consultation on the 31 March 2023 valuation, launched on 19 July 2023.

We have given permission for this paper to be shared by UUK with the participating employers on a non-reliance basis.

Next steps

We are running three webinars on 9, 15 and 24 August where we will summarise the report and take questions.

If you are reading this as a representative of a participating employer and have any questions in the meantime, please raise them with UUK in the first instance.

The consultation deadline is 29 September, with **employers asked to provide feedback to UUK by 22 September at the latest.**

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At a glance…

The valuation position has materially improved since the 2020 valuation. A deficit of £14.1Bn is now a surplus of £7.4Bn and the cost of new benefits has tumbled.

Our high-level views are as follows:

- We believe the proposed actuarial assumptions for the technical provisions are reasonable for a strong covenant with the unique characteristics of the sector. We may have minor issues on individual assumptions but, taken together, we believe the approach is appropriate to accept.
- The actions following the valuation are a matter for the stakeholders, acknowledging the importance of a contribution reduction and improvements to benefits.
- We agree that pre-1 April 2022 benefits look affordable (costing 14.5% for employers and 6.1% for employees), and that there is merit in seeking a streamlined valuation process to prioritise implementing these benefits from 1 April 2024.
- Given the disparity in current contributions versus the cost of pre-1 April 2022 benefits, we question whether the contribution rate could be amended prior to 1 April 2024. The quantum of “over-payment” is around £125M per month relative to the cost of pre-April 2022 benefits, and bringing forward the implementation date to 1 January 2024 (say) for reducing contributions may be feasible.
- We believe it would be reasonable to use the technical provisions surplus as a buffer against future uncertainty given the significant change since the 2020 valuation, subject to review as part of the wider work being carried out on stability ahead of the next valuation. An alternative approach is to seek to reduce the contributions further, and accept a greater likelihood of higher contributions (or benefit reform) being needed in future.
- There are some material work strands that will likely extend beyond the valuation. The consideration of approaches to ensure greater stability. The potential role of conditional indexation. The investment strategy and possible “de-risking”. We touch on these issues in this document but focus primarily on commenting on the consultation materials.

We look forward to discussing this further on the upcoming webinars.

Technical provisions

In this section we set out our views on USS's consultation for the 2023 valuation ("Consultation with Universities UK on the proposed methodology and assumptions for the scheme's Technical Provisions and the Statement of Funding Principles" dated 19 July 2023).

Demographic assumptions

The demographic assumptions determine when benefits are assumed to start, and how long they last for.

The assumptions used are:

- Mortality – i.e. how long members and their beneficiaries live for
- Proportion of beneficiary pensions, and age difference – i.e. the characteristics of beneficiaries such as surviving spouses
- Early retirement – i.e. the proportion of members retiring at each age (aside from those retiring due to ill-health – which is covered separately)
- Ill-health retirement – i.e. the proportion of members retiring with ill-health by age
- Withdrawals – i.e. the proportion of active members at each age who leave the scheme but without immediately retiring
- Commutation – i.e. the proportion of pension members swap for additional tax-free cash (in top of their lump sum entitlement)
- Cash equivalent transfer values – i.e. the extent to which it's assumed that members swap their USS entitlement for a transfer value, and exit the scheme.

With the exception of mortality, the Trustees have stated that they aim to adopt "best estimate" assumptions for all of the demographic assumptions. The mortality assumption is said to incorporate a small margin of prudence, stated as being worth around 0.5% of the liabilities.

We believe these principles are reasonable and in keeping with market practice for large UK pension schemes.

USS Trustee's approach for reviewing these assumptions for this valuation has been to largely keep the same assumptions as the 2020 valuation. In our view, this is a reasonable approach to take.

For the longevity assumption, the proposed changes result in a reduction of 1% in liabilities. We typically see a range of around 1% - 4% reduction, as a result of COVID, being considered in practice. Therefore, the proposed assumption is within the range of outcomes we consider reasonable albeit on the low side (i.e. a slightly larger reduction in liabilities could be justified) in our experience.

At this stage we have not seen the detailed advice from the Scheme Actuary, and we have requested to see this ahead of the webinars. However, even if an adjustment of say 2.5% were used (the mid-point of our broad range), then this would only reduce the liabilities by about a further 1.5% (and the future service rate by about 0.3% of pay).

Financial assumptions

The financial assumptions determine the level of assumed benefits (through inflation, pension increase, or salary increase assumptions), and the value placed on the liabilities (through the discount rate).

Dual discount rate approach

In keeping with the recommendations of the Joint Expert Panel, the Trustees adopt a dual discount rate approach.

A lower discount rate (the post-retirement discount rate) is applied to benefits once in payment. This aims to be a prudent level of return on a self-sufficiency or low risk investment portfolio.

A higher discount rate (the pre-retirement discount rate) is applied for non-pensioners for the period between the valuation date and when they are assumed to retire. This aims to be a prudent level of return on a predominantly growth-oriented investment strategy.

Post-retirement discount rate

The proposed assumption is Gilts+0.9% p.a. This is slightly lower than the rate used for the previous valuation of Gilts+1% p.a.

The assumption corresponds to a broadly 69th percentile, meaning that the assumed underlying investment strategy would return the discount rate or higher in 69% of scenarios. This can be considered slightly less prudent than the approach for the previous valuation (where the 73rd percentile was used).

Pre-retirement discount rate

The proposed assumption is Gilts+2.5% p.a. This is slightly lower than the rate used for the previous valuation of Gilts+2.75% p.a.

The assumption corresponds to a broadly 70th percentile, meaning that the assumed underlying investment strategy would return the discount rate or higher in 70% of scenarios. This can also be considered slightly less prudent than the approach for the previous valuation (where the 81st percentile was used).

Overall prudence

In summary, we view the proposed discount rate approach as being appropriate. There has been a slight reduction in the level of prudence (to similar levels to the 2017/18 valuations in terms of percentiles used), which means that the surplus is larger and the cost of benefits lower than had precisely the same percentiles been adopted as for the 2020 valuation. Using a less prudent approach does increase the likelihood that investment returns will be lower than the valuation assumption, however, given the level of surplus and the strong covenant this is not a material concern, and we view the level of prudence as appropriate in the circumstances.

With the benefit of hindsight, it might have been better to have adopted less prudent assumptions for the 2020 valuation (as the assumptions at this valuation were relatively more prudent than in 2017/18 and which are proposed for the 2023 valuation) in terms of giving stable contributions. However, at a practical level, the previous valuation was described by the Pensions Regulator as being at the limit of regulatory compliance.

Inflation assumptions

The approach to setting the inflation assumptions has changed from the 2020 valuation.

At the previous valuation, the Trustees used a yield curve for RPI based on the cost of hedging RPI, and then made a deduction for the difference between RPI and CPI. Using this approach and latest views on the RPI and CPI difference would result in an assumption equivalent to around 3.1% p.a. at this valuation.

The proposed CPI inflation assumption is 3% p.a., which is described as being based on a long-term expected level of CPI.

If considered in isolation, the inflation assumption is less prudent relative to the cost of hedging RPI than in 2020 although it still looks high relative to the Bank of England’s target (even after allowing for short-term high inflation). However, this is a not a material point because the investment modelling assumptions are expressed in real terms, and the prudence described in the discount rate assumptions allows for the change to the inflation assumption.

We note that using a long-term inflation assumption may result in losses in the near term (i.e. over the next valuation cycle) if short term inflation exceeds the long-term assumption of 3% p.a.. This consideration is relevant for considerations regarding the use of surplus.

Our overall view is that the inflation assumption is reasonable since changing it would just lead to the discount rate being adjusted to retain the same level of prudence. We are also comfortable with the proposed assumptions for pension increases, which include small adjustments for the impacts of any caps and floors on inflation increases.

Expense allowance

The approach to allowing for administration expenses is the same as at the 2020 valuation, although it has been proposed to increase the allowance from 0.4% of pensionable payroll to 0.5%. This will raise an additional c.£10M p.a. The rationale for the increase is not described in detail, although it is noted the future PPF levy amount if highly uncertain.

Self-sufficiency

The Trustees have proposed a self-sufficiency discount rate of Gilts+0.5% p.a. This compares to a self-sufficiency discount rate of Gilts + 1.0% p.a. at the 2020 valuation and a proposed discount rate of Gilts + 0.9% p.a. for the technical provisions post-retirement discount rate.

Although the proposed self-sufficiency discount rate has reduced, the impact is offset by the proposed removal of the 50bps addition to the CPI assumption that was used for the self-sufficiency measure in 2020. The

overall effect is to maintain a similar level of prudence in the self-sufficiency approach relative to the technical provisions post-retirement liabilities.

The self-sufficiency target is less relevant for the 2023 valuation, given the materially reduced deficit on this measure. However, the self-sufficiency target is a metric that merits consideration and will be considered further through the stability workstream in terms of its impact on future valuation outcomes.

What the results mean

Our views on what the results mean

In this section we set out comments on the consequences of the valuation results.

Stability of benefits

The consultation document sets out some modelling of the stability of benefits in Appendix 2, with further information in the supporting information also published by USS on 19 July.

The probability of the contribution rate exceeding various thresholds in 6 years is summarised below.

	6 years' time	
	Retains surplus	Does not retain surplus
Exceeds 20.6%	53%	60%
Exceeds 25.2%	30-33%	42%
Exceeds 26% (having paid 26%)	26%	35%

The probability of exceeding a combined contribution rate of 20.6% in six years' time has been calculated as around 53%, assuming the surplus is retained. This is slightly counterintuitive – one would expect the probability to not be more than 50%, since prudence should unwind and improve the position in the central scenario. The result is largely a feature of the initial simplified modelling from USS. Broadly, what's happening is that in scenarios where there is a surplus but a higher contribution rate, then this is counted as a higher contribution rate (with no offsetting of surplus), which means a higher assumed contribution. And in some scenarios where the future service rate reduces but there is a deficit, then the total contribution may be more than 20.6%. This introduces a slight skew to the results, leading to the central case being a slight increase, and this will be explored in further modelling with the stability workstream.

However, the initial modelling does give some interesting information on the stability of returning to pre-1 April 2022 benefits.

The probability of exceeding an illustrative combined contribution rate of 25.2% (i.e. the cost of current benefits at the 2020 valuation) has been

calculated as between 30-33% assuming the surplus is retained. (We understand the corresponding figure over 3-years is between 24-27%).

If the surplus is not retained, then the probability of exceeding 25.2% is around 42%. (We understand the corresponding figure over 3-years is between 38-40%.)

We draw two main conclusions from this:

- There is a good chance of contributions not exceeding 25.2% at the next two valuations if 20.6% is paid for new benefits – i.e. there is demonstrable stability.
- The stability is improved if the surplus is retained (e.g. about a 1-in-4 chance of exceeding 25.2% at the next valuation if retained, vs a 4-in-10 chance if surplus is used).

Our high-level thoughts on stability are as follows:

- Historically, contributions to the USS have been relatively stable. Between 1975 and 2011, total contributions were between 18.25% and 24.9%.
- The amount of stability is limited for a DB scheme, as the Trustee needs to carry out a legally compliant actuarial valuation at least once every three years. This has been a factor over the last decade with e.g. the Pensions Regulator opining that the Trustees were at the limit of legal compliance for the 2020 valuation.
- While interest rates have increased, this is partly a reaction to current high levels of inflation. While the gilt market pricing suggests that there is a plausible case for high rates to continue, this is not guaranteed, and increases to contributions may be required at future valuations (or potentially changes to benefits, if the contribution increase is stark).
- There are wider levers such as conditional indexation and potentially a "lower risk" investment strategy. These are out of scope for this paper, and the process for completing a streamlined actuarial valuation, but are important factors to consider by the stakeholders in due course.
- For completeness, stability from a technical actuarial perspective would be improved to the extent contributions are increased or DB benefits reduced. But this may be regarded as pyrrhic victory by the stakeholders (who may not want a very stable scheme – if the price is very high contributions or very low DB benefits).
- Since contribution changes are split between employers and members under the default cost-sharing arrangements, we can see why having a stable approach is particularly beneficial for the USS in terms of intergenerational fairness among members. In particular, it may feel unfair if one cohort of members (and leadership teams at institutions) bear the consequences of a substantial share of deficit contributions, and another benefits from a surplus.
- One approach to increase stability is to use a corridor approach (or take a more flexible approach to the level of prudence). At a non-technical level, if the stakeholders agreed to pay a higher level of contributions than the future service rate of 20.6% (e.g. 22%), then it

should be reasonable to argue that the contribution rate should stay at 22% if the valuation contribution rate is within a set distance e.g. 2-3% of this amount at future valuations. However, this assumes that stability is an end to itself, and many stakeholders may also wish to benefit from reduced contributions. This is being explored further by the stability workstream.

Contributions

The cost of pre 1 April 2022 benefits has been determined as 20.6% of pay. There is also a c.£7.4Bn surplus. It is reasonable to consider whether the total contribution rate should be reduced (from 20.6%) to a lower figure to spend or release the surplus.

Impact if surplus used to reduce contributions

It is worth considering what contributions would apply if the surplus is used to reduce the contribution rate. The Trustee give one example of spreading the surplus over 15 years. Such a partial contribution holiday would mean total contributions of 15.4%. So, the total cost (including the partial holiday) of pre April 2022 benefits would be 11.1% for employers and 4.3% for employees, under the default cost-sharing.

The principal issue with this approach is that it leads to a less stable contribution rate. More volatile contributions also exacerbate issues of intergenerational fairness and planning issues for institutions.

Ultimately, the use of surplus is a matter for the stakeholders to consider, it is not an actuarial issue. Nevertheless, given the extent of the change from the 2020 valuation to the 2023 valuation, the desire for an expedited valuation to prioritise returning to pre April 2022 benefits, and the existence of other joint working parties (covering stability in particular), we believe it would be reasonable for employers to accept a 20.6% contribution rate for the 2023 valuation.

Impact if higher contributions paid

The initial modelling from the Trustee suggests that contributions are more stable if a higher contribution rate (then 20.6%) is paid. In our view, it may be difficult to persuade stakeholders (i.e. employers and members) to pay more than 20.6% given the existence of the valuation date surplus, particularly if an accelerated timeline is sought.

When new contributions apply from

It is implicit in the Trustee consultation materials that new contributions would apply from 1 April 2024.

This means that there is a one-year period from the valuation date to 1 April 2024 whereby total contributions of 31.4% would be paid, relative to current benefits that only cost 16.2%. The sector is "over-paying" around 15.2% on a combined payroll of £10Bn, meaning around £1.5Bn would be overpaid.

It is not unusual for contributions following a valuation to be implemented some time after the valuation date, and of course employers and members

have benefited from this in the past when contribution increases have been delayed.

Nevertheless, the quantum of overpayment (about £125M per month) suggests that employers should investigate whether there could be an early implementation. Also, while this is a matter for the stakeholders, if it is decided to uplift benefits in recognition of the lower benefits accrued between 1 April 2022 to 31 March 2024, then it would appear that the cost of this could be met from these overpayments, rather than necessarily using up surplus at the valuation date.

Conclusions

Moving back to 1 April 2022 benefits appears possible with a reasonable and demonstrable degree of stability, with stability increase if the surplus is retained as a buffer.

In our view, given the sums involved, it is worth trying to implement the contribution reduction from an earlier date than 1 April 2024 as part of an accelerated valuation – for example, from 1 January 2024.

Consultation questions

Consultation questions

In this section we set out comments on the USS's eight consultation questions. In practice employers will wish to form their own views.

Overall thoughts

We support the approach of carrying out a 2023 valuation using largely the same approach as the 2020 updated for much improved market conditions.

The common objective of prioritising a move to pre 1 April 2022 benefits is achievable with a reasonable degree of stability, but there will always be an element of risk of future corrective action when running a large DB scheme.

1. Proposed discount rates, both for the purposes of valuation Technical Provisions and determining future service contributions

As covered in the previous section, in our view the proposed discount rates are appropriate for the purposes of the 2023 valuation.

2. Remaining proposed assumptions set out in the Statement of Funding Principles (covering inflation, mortality, and the other demographic assumptions)

As covered in the previous section, in our view the remaining assumptions are appropriate.

3. Any other aspect of the assumptions and methodology underlying the Technical Provisions

We have no additional comments.

4. Any other matter included in the Statement of Funding Principles

We have reviewed the draft Statement of Funding Principles. This is the legal document that sets out the principles applying to the actuarial valuation, and documents the assumptions used for the latest valuation. The document is the responsibility of the Trustees, who must consult with UUK on its contents, as part of the formal valuation consultation process.

We are comfortable with the proposed changes, which effectively bring the 2020 statement of funding principles into line with the proposed assumptions for the 2023 valuation.

5. The Trustee's overall assessment of employer covenant, including assumptions made about the level of financial support employers are collectively able and willing to give the Scheme and their Affordable Risk Capacity

The Trustee provides (in section 9) an illustration of the potential contribution rate if the employer support measures are not renewed in full.

In practice, this would mean that the moratorium on exits would still have than balance of the original 20-year period that remains, and the pari passu requirements for taking on secured debt would cease. The estimated impact of this would be to increase the contributions from 20.6% to around 23.8%.

This means that, in effect, the employers are collectively benefitting by their share of the 3.2% contribution difference (2.1%) and members are benefitting by their share (1%) assuming default 65:35 cost-sharing applies.

Our view is that this remains a substantial benefit (broadly £200M p.a. for employers across the sector, and £100M p.a. across all members). Also, it is not obvious that the employer support measures could be reinstated at successive valuations were they removed, e.g. if employers take the opportunity to borrow without the pari passu restrictions where measures are not in place, then this could leave the covenant weakened if a future valuation revealed a poor position leading employers to want to renew the covenant support in full.

However, ultimately it is for employers to decide whether the consequences of renewing the employer support arrangements are worth the cost.

6. The assumed Valuation Investment Strategy (VIS) and strategic mix of return-seeking assets and matching assets. (Note that more extensive engagement with employers on the investment strategy will take place in the later stages of the valuation process.)

We found it interesting that the assumed VIS had limited impact on the stability figures, and the discount rate. The more meaningful impact seems to be on which percentile return the Trustees choose. This could be a consequence of the Trustees illustrating a relatively narrow range of alternative investment strategies.

We believe the proposed timeline of considering the investment strategy further after the TP consultation is sensible, and in particular that a deep dive on investment strategy now would not facilitate an expedited actuarial valuation.

7. The balance and trade-offs between investment risk, the degree of prudence and stability (of benefits, contributions, and funding levels), both at this valuation and looking ahead.

This is a wide-ranging question to answer.

Ultimately, we believe that employers would welcome a position where the contribution rate is stable from valuation to valuation, and where changes are not needed to the benefit structure. This was historically the case between 1975 and 2011, but has not been the case in recent years.

Unfortunately, it is not always possible to fix all of the variables, and something needs to give in poor market conditions. The experience of the last decade has demonstrated that employers/employees can bear some of the cost of a poor valuation outcome, but that ultimately benefits become the balancing item for the scheme to remain viable.

We believe it is right that these issues – investment strategy, conditional indexation, stability (with ideas such as a “contribution corridor” to limit the variation of contributions at successive valuations being considered) – are being looked at by UUK and UCU in parallel with and following this expedited valuation.

8. Any other aspect of this consultation

We have no further comments. A consultation where the news is “very good” is clearly a lot easier to work through than previous consultations.

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