Universities Superannuation Scheme (USS)
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USS Proposal for 2018 Valuation Monitoring and Action Framework

Introduction

The Trustee has completed the 31 March 2018 actuarial valuation, and the next valuation is due in five months' time (at 31 March 2020).

In the meantime, as part of reviewing the 2018 valuation, the Pensions Regulator has asked the Trustee to develop and engage with the stakeholders regarding a monitoring and action framework for post valuation experience.

The Trustee has already used a monitoring framework following the 2014 valuation that was rooted in Tests 1, 2 and 3. TPR prefers a framework following the 2018 valuation that leads to potential actions being taken between valuations.

There is no legal requirement for the Trustee to put in place a monitoring and action framework between actuarial valuations. Having said that, in its latest guidance the Pensions Regulator's does say it "expects" trustees and employers to have realistic contingency plans for key downside risks.

The Trustee has proposed a temporary framework that will apply until the 2020 valuation, and has asked UUK to comment by 13 November.

Proposed Monitoring

The Trustee proposes to monitor four metrics. These are described in detail in the Trustee's paper "2018 Monitoring and Action Framework" and are summarised below.

Table 1: Summary of Trustee's proposals

	Metric	When triggered
1. Self-sufficiency deficit affordability ratio	**Self-sufficiency deficit / Value of 10% of pay for 30 years**	**> 85%**
2. Future service cost coverage ratio	**Actual future service contributions / Best estimate future service cost**	**< 115%**
3. Deficit recovery contribution adequacy	**What % of expected asset outperformance (the gap between best estimate return and the discount rate) is needed for Recovery Plan to correct the technical provisions deficit**	**> 50%**
4. Covenant rating	**Assessed by the Trustee, based on PwC assessment**	**If downgraded to Tending to Strong**

The first three metrics relate to the financial position of the Scheme. The fourth metric is the strength of the employers.

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Proposed Actions

If any of the metrics are breached, then the Trustee will convene a meeting to discuss what action to take. The Trustee lists four potential actions:

- **Revise the 2018 Schedule of Contributions (SoC),** i.e. put in place a new interim SoC ahead of the 31 March 2020 actuarial valuation being completed, with new contributions. This would require consultation with UUK on behalf of the employers (and potentially with employees), and we understand that the JNC would have the opportunity to put forward alternative proposals. In our view it would be more difficult for the Trustee to justify this option to stakeholders since the next valuation is just around the corner, and will follow the Joint Expert Panel (JEP)'s second report.
- **Accelerate the 2020 valuation,** which we understand means completing the valuation by around 31 March 2021 (rather than taking up all – or more than – the 15-month statutory deadline).
- **Undertake a valuation at 31 December 2019,** i.e. bring forward the valuation date by 3 months, which is another way to bring forward the next valuation discussions. We would question the merit of bringing forward the valuation date, as the scheduled valuation will be imminent, and choosing a non-31 March date will incur the additional cost of obtaining audited assets at a different date.
- **Changing in investment strategy,** which means reducing the amount of investment risk being taken (which could result in a higher contribution rate at the next valuation). This would require consultation with employers.

In summary, because the next valuation is only five months away, the options available to the Trustee to engage with stakeholders and take actions ahead of the upcoming valuation discussion are limited practically. This arises because there is only a two-year gap between actuarial valuations (2018 and 2020), and the 2018 valuation took 18 months to complete. In future, there should be a longer period between valuations for any framework (beyond these temporary arrangements) to apply.

Comments on the metrics

Metric 1: Self-sufficiency affordability ratio

In the discussion on "contingent contributions" from earlier this year, our preference was for any trigger contributions to be based on a technical provisions deficit rather than self-sufficiency.

The Trustee uses self-sufficiency as a measure of the reliance on sponsors at any point in time, and wishes to ensure that the reliance does not exceed the ability and willingness of the sector to support the Scheme.

With metric 1, we observe that the ratio is less sensitive to movements in interest rates or inflation expectations than simply considering the self-sufficiency deficit (because such movements affect both the numerator and denominator of the ratio). Indeed, while the metric is described as a short-term metric, it does not appear overly sensitive to short-term movements in gilt yields.

The metric envisions that in certain scenarios the Trustee may wish to extract contributions of 10% of pay, over the 30-year visibility of covenant, to bridge the gap to self-sufficiency. The figure of 30 years stems from PwC's assessment of the visibility of covenant in the sector. The "10% of pay" is the Trustee's assessment of what the sector might pay towards the self-sufficiency deficit in a bad scenario (with an assumption that employers would still pay a reasonable (in the Trustee's view) sum towards future service benefits). UUK is not being asked by the Trustee for a view on the employers' risk appetite (which would form part of a formal valuation discussion).

The metric is designed to offer a signal ahead of the situation becoming irrevocable (based on the Trustee's assumed parameters for what the sector will pay and over what period in a bad scenario). This is why the Trustee is proposing to consider scenarios where 85% is breached rather than waiting for 100%.

For this to trigger, interest rates would need to fall by 0.4% p.a. (with no change in asset value) or the assets would need to fall by £6Bn (with no change in interest rates) from the position at the valuation date. In practice, lower interest rates often lead to higher asset values (particularly where schemes are "hedged") and so more material changes in either variable are likely to be needed. This is illustrated further in USS's note.

We do not have strong views as to whether 15% is the correct figure for the Trustee to adopt for the metric it has devised. However, we draw some comfort from the fact that the trigger has not been breached over the difficult market conditions that followed the 31 March 2018 actuarial valuation.

We would also observe that this appears a less testing trigger than the Trustee's preferred position for trigger contributions (when this was discussed earlier this year). This should however be expected since the Trustee effectively assumed that the first trigger applied when choosing Option 3.

Metric 2: Future service cost coverage ratio

The Trustee is testing here whether the contributions collected for new benefits are at least equal to the evolving best estimate view of the cost of providing benefits.

As with metric 1, a 15% margin is applied, so that the Trustee considers taking action before the point at which cash contributions do not even cover the best-estimate cost of benefits.

For this to trigger, the Trustee estimates that the discount rate would need to fall by about 0.7% p.a. (from the position at the valuation date), which would require the 67th percentile investment return using the Trustee's assumptions to fall by this amount.

We do not have strong views on whether 15% is the correct margin, but again note that the metric has not tripped in difficult conditions which provides some comfort that what the Trustee is proposing to monitor is not overly sensitive to market conditions.

Metric 3: Deficit recovery contribution adequacy

The Trustee is testing here whether the Recovery Plan (the document setting out what combination of contributions and expected asset outperformance) remains feasible, and does not put too much reliance on potential investment outperformance over the period of the recovery plan.

With this test, the Trustee is content to allow up to 50% asset outperformance for the Recovery Plan, compared with the 0% allowed for in the 2018 valuation, the 10% allowed for in the 2017 valuation, and the 50% allowed for in the 2014 valuation. Allowing for asset outperformances pushes down the cash contributions required.

For this to trigger, the Trustee estimates that the deficit would need to increase by £3Bn without an increase in the expected return on assets, or expected returns would need to fall by 0.2% (but with no prior increase in the value of assets) from the position at 31 August 2019.

This metric has also not tripped over the difficult conditions that have followed the valuation date. The metric potentially becomes more challenging over time as the recovery plan period shortens, and assuming that this is not increased at future actuarial valuations. In practice if there is another very short recovery plan in future, something we would oppose generally, then we would question the continued inclusion of this metric.

Metric 4: Covenant rating

The approach to funding taken by the Trustee is underpinned by the PwC assessment of covenant as being Strong. The fourth metric considers the covenant rating on a monthly basis, and leaves open the possibility of taking actions between actuarial valuations based on the assessed covenant deteriorating to “Tending to Strong”.

We are more concerned with this metric than with the other three. In practice covenant strength is a continuum (rather than falling into four discrete categories), but there appears to be much focus on whether the covenant is say at the bottom of “Strong” or at the very top of “Tending to Strong” on PwC’s 4-point scale. Giving this kind of metric a more ongoing role in any long-term framework could inadvertently put a lot of power in the hands of PwC, with employers under pressure to fall into line on certain topics (e.g. the pari passu rule change) or else fail this metric. This could lead to disappointment among employers particularly if an unpopular action is taken by the Trustee, only for the covenant to be downgraded for some other reason at a later point anyway.

While it is better for UUK and employers to know the consequences of their actions before they are taken, we recommend keeping the application of this metric under review, and challenging where appropriate any stated impact on covenant of particular actions.

Wider thoughts

As we are five months away from the next actuarial valuation, it is not clear to us that the Pensions Regulator's suggested approach is meritorious. We can see merit in designing a post valuation framework after the post-JEP valuation has been completed, when there should be greater trust and consensus around the approach being adopted.

However, if we take the view that the Trustee needs to put in place such a framework now because its regulator has instructed it to, then we are broadly supportive of the Trustee's proposed approach since:

- The triggers are not overly-sensitive to short-term market movements, and have not been breached during the poor market conditions over the summer. This provides some comfort that we are not being forced into unnecessary discussions between actuarial valuations.
- The actions the Trustee is contemplating are not pre-defined, and would require consultation with UUK at the time.
- This framework is temporary, and a new framework will be developed as part of the 31 March 2020 actuarial valuation.

In the covering letter from Bill Galvin, UUK is asked whether there are any other measures the Trustee should consider, and how much information employers would like to receive. These are broad questions. In our view, it would be helpful for the Trustee to provide clearer information to the stakeholders about how much risk is being run on their behalf (and on behalf of future generations). This would be most useful if the risks were interpreted in the context of what matters for employers/members. For instance, how might contributions evolve in different economic scenarios, and what would be the consequences if the contribution rate could not exceed particular levels. These questions should be explored as part of the 2020 valuation, and should be informed by the second JEP report.

Looking ahead to 31 March 2020 valuation

While the monitoring metrics have not been breached, market conditions have worsened since the 31 March 2018 valuation date. Employers (and employees) should be mindful that the Trustee will currently expect to collect the increased contributions due from 1 October 2021, and note that the cost of future benefits may also increase under the current approach. These factors could lead to a testing 2020 valuation discussion, notwithstanding the publication of the second JEP report.

Next steps

In the time available, we suggest that employers are asked to share any concerns they have with UUK. On balance, we recommend acknowledging the proposed temporary framework, subject to this being reviewed and discussed in more detail as part of the 31 March 2020 actuarial valuation, and consulted on with employers and other stakeholders.

Compliance

This note 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').
