Universities Superannuation Scheme (USS)
Date: 23 August 2019
Prepared for: Universities UK
Prepared by: John Coulthard FIA
Andrew Claringbold FIA
Joanna Davies FIA

31 March 2018 Valuation – Final consultation

Introduction

The Trustee is consulting on the Schedule of Contributions and Recovery Plan for the 31 March 2018 actuarial valuation, which represent the final stages for this valuation.

The Trustee has adopted "Option 3" as explained in our 14 May note, which results in total contributions of 30.7% of pay from 1 October 2019 to 30 September 2021, and 34.7% thereafter. Before the higher contributions are applied, there will be an additional valuation carried out at 31 March 2020 which will take place after the second phase of the Joint Expert Panel (JEP) work is completed.

As a reminder, the JEP had recommended a quick fix for the 2017 valuation ahead of the 2020 valuation, and we are in the current position because the Trustee preferred to finalise the 2017 valuation and then call an additional valuation at 31 March 2018 to consider the JEP recommendations. This leads to considerable time pressure because higher contributions are due to come into force from 1 October 2019.

Proposed changes to contributions

The proposed employer contributions following the completion of the 31 March 2018 valuation are summarised below, alongside the default contributions that would apply from the 31 March 2017 valuation.

Table 1: Employer contributions

	2017 valuation	Proposed replacement rates under 2018 valuation
Now	*19.5%*	
From 1 October 2019	22.5%	**21.1%**
From 1 April 2020	24.2%	**21.1%**
From 1 October 2021	24.2% (to 31 March 2034)	**23.7%** (to 31 March 2028)

Table 1: Employee contributions

	2017 valuation	Proposed replacement rates under 2018 valuation
Now	*8.8%*	
From 1 October 2019	10.4%	**9.6%**
From 1 April 2020	11.4%	**9.6%**
From 1 October 2021	11.4% (to 31 March 2034)	**11.0%** (to 31 March 2028)

It should be noted that if the split between employer and employee contributions was slightly different from those set out above from 1 October 2019, this would not materially affect our comments in the rest of this note.

Comments

The calculation of the level of contributions is dependent on:

- The actuarial assumptions used to calculate the liabilities,
- The length of the Recovery Plan, and
- The allowance (if any) for expected investment performance over the Recovery Plan

Previously, the Trustee had not explained what parameters it had adopted in these areas to calculate the level of contributions under option 3. Indeed it had suggested that it was consistent with Option 2. Under Option 2 the actuarial valuation assumptions were consistent with an assumed covenant reliance in 20 years' time of £13Bn. This would have led to a deficit at the valuation date of £2.2Bn and a future service rate of 27.6% in which case the proposed contributions would have been consistent with a short Recovery Plan. Option 2 was only proposed in combination with funding level triggers, which would have led to a high probability of significant increases to contributions within the next few years.

However, the Trustee has now confirmed that it is proposing to finalise the valuation based on the Option 1 assumptions (the difference being that the assumed covenant reliance in 20 years’ time is £10Bn in real terms rather than £13Bn, meaning that this JEP recommendation is rejected). This results in a £3.6Bn deficit at the valuation date, and a higher future service rate of 28.7%. Furthermore, the Trustee has also proposed to make no allowance for investment outperformance – in contrast to the 2017 valuation where some allowance was made. The consequence of this is that the Recovery Plan runs until 31 March 2028.

If we view the valuation as part of a short-term fix ahead of the JEP 2 recommendations, then the approach proposed by the Trustee may be viewed as not unreasonable. These changes may also have been required to satisfy the Pensions Regulator to take no further action on the 2018 actuarial valuation, although we have no visibility of the discussions here. We note that UUK has now been given authority to share the letter from TPR to USS on 6 August with USS employers.

On balance, rather than risk a higher 1 October increase by prolonging the discussion and also exposing the valuation to additional TPR scrutiny, we believe it would be reasonable for the employers to accept the final Technical Provisions proposal that is embedded in this consultation about the Recovery Plan and Schedule and Contributions.

However, with an eye on the upcoming actuarial valuation at 31 March 2020, we believe it would be reasonable for the employers to register concern at the structure of the proposed Recovery Plan.

- In particular the length of 10 years from March 2018 falls far short of both the JEP recommended length of 15-20 years and the Recovery Plan agreed at the 2014 valuation. We acknowledge that this viewpoint clashes with the latest TPR thinking of requiring strong employers to correct deficits over short periods, however we operate in a "scheme-specific" funding regime, and that the nature of the sector's covenant where institutions are set up as registered charities means it is may be more appropriate for employers to support deficit contributions over longer periods, and this should not cause the Trustee concern given the strong visibility of covenant.

- In addition, by not allowing for some expected asset outperformance, this has the effect of increasing the contribution rate due from 1 October 2021 and/or lengthening the recovery plan, all else being equal. This again is out of kilter with the JEP recommendations and the 2014 valuation.

Set against this, there is considerable time-pressure due to the scheduled increase on 1 October 2019. Arguably this time pressure is entirely of the Trustee's making since it could submit an interim Schedule of Contributions to delay the increase (as we argued for the 2017 valuation here). However, we would not advise the employers to rely on being able to secure an interim schedule since the Trustee rejected this option for the 2017 valuation.

Comments on separate note of work carried out for TPR

Before moving to our conclusions, we note that the Trustee has carried out work for TPR on three workstreams and has set out its conclusions in a separate note ("Further analysis of contribution affordability and risk for the 2018 valuation"). This additional work seems to have been carried out at the request of TPR to help TPR become comfortable with the 2018 valuation.

The paper largely explains itself, but as one observation, we are not convinced with the modelling of potential contributions TPR has requested. The modelling has we understand been carried out using a fixed margin relative to gilt yields (so a simplified approach) and has also assumed a 10 year recovery plan with no allowance for asset outperformance. If a longer recovery period were adopted, along with sharing of asset outperformance, then the conclusions (e.g. a 5% chance that the contribution rate will exceed 55% in 3 years' time) may be that the 5th percentile is significantly less than 55%.

However, it is concerning that market conditions appear to have worsened recently. There is no guarantee that the April 2020 actuarial valuation will result in contributions that are lower than 34.7% from 1 October 2021. The Trustee has confirmed that the deficit at the latest available date of 31 July 2019 has increased from £3.6Bn to £6.6Bn.

Conclusions

The 2018 valuation offers a chance to disapply the scheduled contributions increases that are due to apply shortly (from 1 October 2019) and that would lead to employer contribution of 22.5%, and employee contributions of 10.4%.

We believe that employers will want to support the finalisation of the 2018 valuation under the Option 3 approach.

Having now seen further details, we are not convinced of some aspects of the proposed Recovery Plan (particularly the short length, and lack of sharing of expected asset outperformance) which may serve to exaggerate the contributions required from 1 October 2021. We suggest raising these points with the Trustees, and in practical terms focusing on preparations for the 31 March 2020 actuarial valuation.

Compliance

The advice in this report 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’).
