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Chief Executive
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Your Ref
Our Ref BG/JMR
Date 23 August 2019

By email only

Dear Alistair

Consultation on Schedule of Contributions and Recovery Plan for the 2018 actuarial valuation

Following the decision of the JNC at its meeting on 22 August, please find attached to provide a basis for this Consultation a draft of the Schedule of Contributions and Recovery Plan, which outline the proposed rate of member and employer contributions payable to USS from 1 October 2019. They include details of the share of the employer contribution that is attributable to the planned deficit recovery plan.

The actuary's report on the actuarial investigation under rule 76.1 which was issued to the JNC on 7 August indicates an aggregate contribution rate of 30.7% from 1 October 2019 and 34.7% from 1 October 2021 (in line with "Option 3") resulting in a decrease to the aggregate contribution rates compared to those set out in the current (2017) schedule of contributions. The decision of the JNC under Rule 64.10 addresses the saving from the decrease in the aggregate contribution rates by splitting the saving between employers and members. The resulting proposed total contribution rate is 30.7% from 1 October 2019 (9.6% for members and 21.1% for employers) and 34.7% from 1 October 2021 (11% for members and 23.7% for employers), these splits reflecting the 35:65 (member/employer) default cost-share basis set out in the rules.

The consultation on the Schedule of Contributions and Recovery Plan is the only remaining statutory consultation arising from the actuarial valuation as at 31 March 2018 and, as for previous consultations, it is a consultation between the Trustee and Universities UK which is the person nominated by the rules to act as the representative of employers for these purposes. This consultation satisfies the requirement to consult under section 229 of the Pensions Act 2004 (as amended in paragraph 9 of Schedule 2 to the Occupational Pension Schemes (Scheme Funding) Regulations 2005).

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The statutory deadline for completing the 2018 Valuation of 30 June 2019 was passed around six weeks ago. The timescales that have previously been communicated to UUK and employers, and confirmed by UUK as acceptable given the desire to implement a new Schedule of Contributions ahead of 1 October 2019, remain very challenging.

To formally confirm what is required, UUK has agreed that it will provide the Trustee with its response to the Consultation no later than close of business on **11 September 2019** to allow the Trustee to complete the 2018 Valuation, submit the final report to TPR, and work with UUK and employers to implement a revised Schedule of Contributions in advance of 1 October 2019.

The trustee is aware that UUK may wish to allow space for any further negotiation with UCU on the distribution of future contributions between members and employers under Option 3. On that basis, the trustee would be open to considering UUK's views on whether a different split in the aggregate contributions should apply under Option 3, though any change in the split would require a further decision of the JNC.

As we progress towards the completion of the 2018 Valuation there have been two substantive issues on which the USS trustee board, executive and its advisors have been extensively engaged in recent weeks.

We are sharing additional information with UUK and employers on these issues to support collective understanding of covenant, affordability, and investment outlook risks facing the scheme in relation to funding.

1) **Engagement with TPR on Option 3 and additional analysis included with the Schedule of Contributions and Recovery Plan consultation**

The final correspondence from TPR confirming they have concluded their queries on Option 3 has already been shared with UUK via the JNC. In determining to implement Option 3 the trustee undertook some additional analysis on employers' ability to support the required contributions rates as well as the risk associated with the proposed contribution structure and benefits. A summary of this work, "Further analysis of contribution affordability and risk for the 2018 valuation", is provided in the attached annex to inform UUK and the employers understanding of the matters considered by the Board.

2) **Conditions in Financial Markets**

Over the past 12 months, global economic momentum and inflation have decelerated, and monetary policy bias has been reversed in most developed economies. Recent weeks have seen a deepening of these trends. Global equity market returns have been mixed for the period and there have been falls in real interest rates. The Trustee must consider post valuation date experience,and conclude that the long term assumptions underpinning the funding proposals remain safe, in concluding the 2018 valuation.

When the Trustee set the contribution rates for the 2017 valuation and those for the 2018 valuation technical provisions consultation, an important consideration was the short-term reliance position. This is a measure of the additional funding that the trustee deems would be required in the absence of the willingness and capability of our employers to support the

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investment risk in the scheme, and can be seen as a proxy for the reliance on the covenant of the scheme's employers. It was in no small part the high level of reliance that caused the trustee to decide to make only limited allowance for out-performance in the recovery plan for the 2017 valuation. The improvement in the short-term reliance between 31 March 2017 and 31 March 2018 which largely persisted up to the completion of the 2017 valuation allowed the trustee to agree a slightly lower deficit recovery contribution than that consulted upon (5% as opposed to 6%).

However, since September 2018 we have seen a downwards drift in real interest rates, that has become pronounced in recent weeks. At the end of July the real yield on 20 year UK index linked gilts was -2.20%, and in August they have fallen even lower. At the time of the last trustee meeting 21 August they stood at -2.44%. These conditions now result in a self-sufficiency deficit of almost £31bn.

The factors driving a deterioration of the self-sufficiency position are also seen in the technical provision deficit, under the trustee's monitoring arrangements. The last available position based on the 'Fundamental Building Block' approach to establishing the discount rate at the end of July indicates a deficit of £6.6bn. This is significantly higher than at the valuation date 31 March 2018 when the deficit using this measure amounted to £3.6bn. Further, on the same monitoring basis, the required contribution rate to cover future service benefits has also increased, up by slightly more than 2%.

Whilst it is difficult at the current point in time to determine if this is a temporary phenomenon or a more permanent regime shift, the trustee will need to make a judgement on this matter, in the coming weeks.

At the board meeting on 21 August the Trustee came to the view that it will proceed with the 2018 valuation on the basis of Option 3 for the purpose of the consultation on the Schedule of Contributions and Recovery Plan, but would continue to monitor the financial position of the Scheme. The board instructed the executive and the Scheme Actuary to undertake additional analysis during the consultation period to support their decision making on the Schedule of Contributions following the consultation.

Given recent volatility in financial markets and the regulatory requirement that the Trustee conclude the long term assumptions underpinning the funding proposals remain safe, there is a real risk that the Trustee will, at the end of the consultation and before concluding the valuation, need to reconsider the contribution rates and/or evaluate other mitigating actions that may be required.

The Trustee acknowledges that the second phase of the work of the stakeholders' Joint Expert Panel (JEP) is ongoing and that it is expected to report in the Autumn. The Trustee's current assumption is that a further valuation as at 31 March 2020 will be carried out to allow early opportunity for consideration of the JEP's conclusions, subject to the stakeholders also having considered the findings of the report and developed their own positions.

Finally, the Trustee will write to UUK separately regarding next steps around the implementation of debt monitoring and pari passu arrangements and broader discussions around employer participation issues including a potential permanent rule change around withdrawing institutions. The Trustee

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would like to thank UUK and employers for their positive engagement so far and welcomes the proposal from UUK and employers to establish a joint USS/UUK working group to progress these issues further.

Yours sincerely

Bill Galvin
Group Chief Executive Officer

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