The Pensions Regulator
Making workplace pensions work

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Private and Confidential
Professor Sir David Eastwood
Chair, Universities
Superannuation Scheme Ltd

Sent via email only:
d.eastwood@bham.ac.uk

Our ref: C134794663

6 August 2019

Dear Sir David

Universities Superannuation Scheme
Actuarial Valuation as at 31 March 2018 (the 2018 Valuation)

This letter from TPR is a copy of one recently sent to the Trustee, with some non-core material removed, i.e. the deletion of some restricted information in paragraphs 14 and 15, in order that it can be properly shared with other stakeholders. The omitted material will have no bearing on the current JNC or UUK considerations. This letter is being shared to ensure the JNC and UUK (as the formal consultee) are clear on our position.

1. I am writing further to our ongoing engagement with the Trustee and stakeholders concerning the 2018 Valuation.

2. I understand that at its board meeting on 31 July 2019, the Trustee agreed in principle for the scheme actuary's Rule 76.1 Actuarial Report, which allows for total contributions being paid in line with Option 3, to be issued to the JNC for it to consider how contributions are to be split amongst the employers and members.

3. Our comments are based on the papers shared with us in relation to the 17 and 31 July 2019 board meetings, and on the board's decisions that (a) the level of long-term reliance on the sector will remain at £10bn, and (b) there will be no investment outperformance assumed within the recovery plan above that assumed in the technical provisions.

Additional analysis undertaken

4. Thank you for arranging for the outstanding analysis (as highlighted in my 26 June 2019 letter) to be completed and for engaging openly with us as the work progressed. This additional analysis is informative and has helped us finalise our views on the valuation proposal. We would expect this analysis to also assist the Trustee in its current decision-making and consider that it should be used in the Trustee's other engagements with stakeholders (see Bill Birdi's letter of 29 July 2019 to Jeremy Hill and Louise Howard and further below).

Covenant

5. We view the future introduction of debt monitoring and *pari passu* security for the scheme for new secured debt as positive actions and we look forward to seeing the output of the working group. As this work relates to the 2018 Valuation, we expect it to be concluded within a relatively short timeframe.

6. We also note the recent approval of a time-limited rule change relating to "withdrawing institutions" designed to mitigate the risk of disaggregation in the short term. We understand that this has been approved pending further work on a more substantive review of participation arrangements which may lead to a different rule change. Please keep us informed as this work progresses.

7. The additional analysis on the prospects for the sector and the additional detail on the affordability of contributions have been useful in that they illustrate the sector's resilience and scope to afford additional contributions. We also note the acknowledgment from a cross section of employers of the breadth and scale of actions that would need to be taken in a range of downside scenarios. The employers' ability and willingness to fund additional contributions is a critical element of the 2018 Valuation. Notwithstanding the ongoing review by the Joint Expert Panel (JEP), employers should recognise and prepare for the 2021 step up in the contributions which will take effect if not superseded by the 2020 Valuation and which will provide an important backdrop for that valuation.

8. Our view of covenant remains "tending to strong" (CG2). This is on the basis of the size of the scheme and the volatility in the funding level, the repeated delays in stepping up contributions to address deficits, and the recovery plan being for a period of 10 years which is longer than we would expect to see for a scheme with a "strong" or "tending to strong" covenant. Furthermore, although positive steps have been taken, the risks of disaggregation, and of increasing debt levels in institutions, have not gone away.

Proposed 2018 Valuation approach on the basis of Option 3

9. The approach for the 2018 Valuation's technical provisions (under both Option 1 and Option 3) is broadly consistent with that used for the 2017 Valuation, and as such it remains at the limit of what we consider to be compliant with legislative requirements for prudence. Considerable risks remain over both the long and short term, as highlighted by the recent risk analysis and it is not currently clear that agreement on the actions (and scale of actions) that might need to be taken would be forthcoming.

10. We note that significantly more cash would be received into the scheme in the short term under Option 1 than under Option 3. We also note that the contributions due under Option 1 would be significantly lower than the contributions due under the current schedule of contributions - which we understand have already been budgeted for by the employers. The ability and willingness to pay cash into the pension scheme are key characteristics we would expect an employer with a strong covenant to demonstrate. We believe that the Option 1 outcome would be more consistent with the “strong” covenant rating that the Trustee assumes is appropriate and are disappointed that the opportunity to obtain a meaningful level of additional cash payments into the scheme, in the short term, has not been taken.

11. We recognise, however, that at present Option 1 is not being considered by the Trustee and employers and we do take comfort from PwC’s analysis that confirms that the majority of the employers are both able and willing to meet the contributions for the duration of the Option 3 recovery plan. The remainder of our comments on the valuation relate to Option 3.

12. We recognise that the proposed recovery plan is shorter than that put in place following the 2017 Valuation and that there is now no allowance for additional investment outperformance relative to the technical provision assumptions. However, at 10 years, the recovery plan length remains longer than we generally deem appropriate for, or consistent with, a “strong” or indeed a “tending to strong” covenant.

13. The analysis provided illustrates the scale of the risks associated with the funding approach. For instance, the analysis shows that there is a 5% chance that three years after the valuation date the total contribution rate could increase to 55% of salaries, and a 22% chance of an increase to above 40% of salaries. Of course, many assumptions underlie such projections but the overall message is clear – the risk of some very serious downside scenarios arising over relatively short periods of time is not insignificant. The Trustee and other stakeholders must actively monitor and manage this risk and, for example, should develop and document what their likely response (e.g. assets sales, capex delays, benefit changes, implement strategic change(s), etc) would be to such downside scenarios arising.

14. [Deleted]

15. [Deleted]

2020 Valuation and beyond

16. We understand that the JEP is expecting to publish its second report in September 2019 and the output from this review (which will involve a review of the valuation process and governance and the long-term sustainability of the scheme) will be used to inform the next actuarial valuation at 31 March 2020. We also understand that the employers have been cognisant of the JEP review and the proposed 2020 Valuation in agreeing that total contributions will be paid to the scheme in line with Option 3 for the 2018 Valuation. However, our feedback in this letter on Option 3 is predicated on the assumption that the step-up in contributions in October 2021 will take place and the employers have budgeted to meet them.

17. We look forward to continuing our engagement with the JEP and the key stakeholders as the review and recommendations develop. However, we will expect any changes in approach proposed for the 2020 Valuation to be consistent with legislative requirements

and take account of the significant risks the scheme and employers face (as highlighted in the recent analysis).

18. In relation to these required features, we think it is important that there is clarity on the scheme's long-term funding target (LTFT), a concept that is expected to form the cornerstone of our revised DB funding code, which we expect to consult on later in the Autumn. The rationale for having a LTFT, together with a plan to reach it, is ultimately to ensure that there is a clear focus on protecting member benefits. The need for a LTFT does not fall away for schemes that are open to accrual since we consider that members in open schemes should have the same level of security on their accrued benefits as members in closed schemes. Ultimately the provision of future accruals should not compromise the security of accrued benefits.

19. We recognise that the current USS valuation methodology is constructed such that there is a long-term target level of funding based around the concept of a 20-year covenant reliance target. Implicit with this approach is a long-term investment target, a plan to reach this investment target and the need to ensure that the ongoing technical provisions are consistent with this direction of travel.

20. Although following the next JEP report there might be justifiable consideration of possible changes to the current methodology, we would not want to see removal of the focus on the long-term target. As such, we expect any changes to the 2020 Valuation approach to take account of the principles outlined above, and to consider the content of our DB funding code consultation once issued, with an overriding aim of being clear about how accrued member benefits will be protected.

Risk analysis and communication with the employers and other stakeholders

21. The recent risk analysis work shows there is the possibility in several feasible downside scenarios for the contribution requirements to increase beyond levels that are likely to be sustainable for (many) employers and members.

22. The USS Executive has noted that "management actions" could and would be taken should these situations arise (or beforehand as appropriate). However, it is unclear how effective or timely some of these management actions might be, for instance whether individual employers would be able to follow through to the extent required following downside scenarios of varying levels of severity. We suggest that:

    a. to improve the credibility of the "management actions" being an effective response, the Trustee encourages UUK to develop a framework agreement with employers that outlines a range of appropriate mitigations that employers would individually apply in a range of downside scenarios; and,
    b. the Trustee gives consideration to developing its risk management framework to include the circumstances under which it would look to review or reduce the level of investment risk to limit the possibility or consequences of some of the downside risks.

23. Ultimately, the key levers available to the Trustee in severe downside scenarios appear to be increasing contribution rates and/or changing future benefit levels, the latter of which is not under the control of the Trustee. Given the effective reliance the Trustee places on these potential actions to address the impact of risks crystallising, we expect the Trustee to

give specific consideration to how it would likely react, and how it would expect other stakeholders to react, in a range of downside scenarios.

24. As other stakeholders have the key role in determining future benefit levels, it is important that those stakeholders (i.e. UUK and UCU through the JNC) can make informed decisions. We therefore expect the Trustee to proactively provide or facilitate provision of information to other stakeholders, particularly but not exclusively where it would be either inefficient, or indeed impossible, for the other stakeholders to have the information otherwise.

25. The fact that the Trustee's valuation approach is complex means there is even more of an onus on the Trustee to communicate openly and clearly. We feel the risk analysis work now produced is an example of work where output could usefully be shared with the stakeholders to inform their discussions. We are pleased that Bill Galvin's email of 31 July 2019 indicated that the Trustee had agreed to take steps to facilitate provision of information to the JNC. Developing some information sharing protocols could be helpful and we would like to be kept informed on how sharing of information progresses.

26. The risk analysis information also seems relevant to the work being carried out by the JEP. Given the importance that is being attached to the JEP's findings by stakeholders we suggest that the Trustee considers providing details of the analysis carried out to the JEP.

27. We believe that increased sharing of information around the scheme's and employers' risk exposures and the options available to either manage those risks or address them in downside scenarios should help to inform key stakeholders and lead to improved funding outcomes.

Our view of the 2018 Valuation and our position

28. As we explained above, we have concerns that Option 3 misses the opportunity to secure a material amount of cash funding for the scheme in the short term compared to Option 1. Notwithstanding these concerns, we confirm that we do not anticipate carrying out any further investigations or have further material queries in relation to the 2018 Valuation following its submission. This is subject to:
    - the final documentation in relation to the 2018 Valuation reflecting our current understanding of the proposed funding agreement; and,
    - a suitable agreement for the recovery plan.

29. Please note that this letter confirms only that, having had regard to TPR's objectives and priorities, we do not anticipate carrying out further investigations in relation to the 2018 Valuation once submitted. If there is a material change in circumstances and / or we receive information which is materially different from that which has been provided, then we may undertake a further assessment of the 2018 Valuation which could result in the use our powers under section 231(2) of the Pensions Act 2004 in relation to them.

30. This letter does not provide any confirmation as to whether the funding proposal for the 2018 Valuation complies with any or all of the requirements of Part 3 of the Act (which is the responsibility of the Trustee). Nor does the letter relate to (or provide any comment on) the exercise (or potential exercise) of any of TPR's other powers.

Next steps

31. The 2018 Valuation has not been submitted within the time requirements for a statutory valuation, and both the recovery plan and schedule of contributions need to be agreed. Please continue to keep us informed on a regular basis of the progress on the 2018 Valuation.

32. We consider that it would be appropriate for this letter to be shared with the JNC and with UUK as the formal consultee. Please confirm if you are happy to do that.

Yours sincerely

Mike Birch
Director of Supervision
The Pensions Regulator