3 October 2022

Q&As on the end-of-June 2022 monitoring analysis

Why isn't the monitoring used as a valuation outcome?

The Financial Management Plan (FMP) monitoring reports track the funding position in respect of the current benefit structure in a relatively, and necessarily, crude approximation using a mechanistic approach. They only provide a snapshot of the scheme's position at a given moment in time.

By contrast, an actuarial valuation requires much deeper and comprehensive analysis of long-term assumptions on a variety of factors, including inflation, interest rates, the outlook for future expected investment returns, mortality, the covenant position, and risk capacity, overlaid with judgement taken by the Trustee.

The FMP reports should therefore not be seen as an indicator of the likely outcome of an actuarial valuation. They reflect conditions between valuations on a pre-agreed methodology with limited judgement applied. They indicate – at best – the direction of travel, rather than the destination.

The aim of the FMP reports is to give an early signal to the Trustee Board to check the ongoing adequacy of the funding plan; in particular, if contributions are likely to be sufficient to continue to cover the cost of new benefits and repair the deficit.

What could change between now and the valuation date? Why don't we 'bank' some of this improvement now?

Financial markets have been exceptionally volatile since the turn of the year and projections for the future path of inflation and interest rates could change materially between now and the valuation date.

The FMP reports often show a fluctuating position from month to month, so they must be interpreted with a degree of a caution.

The sensitivities are evidenced in the published FMP report to the end of June:

> *"Market conditions have remained highly volatile, since 31 March 2022 when the assumptions were last looked at in more detail as part of the Accelerated Year-end Review (AYR). In particular, the relative movement in the nominal and index-linked yield implies a potential change in the Inflation Risk Premium. For example, the outcome at 30 June 2022 from removing the Inflation Risk Premium and adjusting the pre and post-retirement discount rates would be a deficit of £2.5bn (slightly higher than that reported in the AYR) and a future service cost of 22.5% (significantly below that in the AYR)."*

The Board's considerations in respect of the viability of implementing interim changes to benefits and/or contributions ahead of the 2023 valuation – as set out in the Accelerated Year-end Review briefing note we published earlier this year – have not changed:

- The degree of volatility means there is a risk that the recent improvement in the funding position might not be sustained and any changes considered now may have to be reversed.
- The time it would take to prepare and implement a specification from the JNC (including any required consultations) would run into the early planning stages for the 2023 valuation.
- The precedent it could set may have less desirable consequences: The Pensions Regulator might reasonably expect the opposite to happen in future if the funding position deteriorated.

We are working with stakeholders as they consider what options might be available – to the extent that the 2023 valuation finds that recent indications of an improved funding position are well-founded. That could include the JNC prioritising the improvements it would want to make (perhaps under a pre-agreed framework). We also engaging with them on the timetable and the approach to be taken for the valuation and getting a head-start on the associated data and analysis.

By collaborating closely with stakeholders, any agreed changes to contributions and/or benefits can be put into effect more quickly than in recent valuations. The Board is supportive of working with stakeholders on an accelerated timetable for the next valuation with an ambition to make any follow-on changes to contributions and/or benefits decided by the JNC by 1 April 2024. This is a challenging but achievable timetable if all parties can work constructively together with a focus on early engagement on key inputs and assumptions, and potential outcomes, ahead of the valuation date.

Was the last valuation wrong?

In the 2020 valuation we incorporated all the information we had at the time, including the rebound in asset prices post March 2020 and record low bond yields. The valuation was filed in September 2021, some 18 months after the valuation date, the Trustee having considered over that period the impact of post-valuation experience.

There have plainly been some significant, unexpected changes to the global economic landscape since the turn of the year that have helped to improve the funding position under the monitoring basis – not least the reversal of a decade's worth of decline in real interest rates in the space of just a few months.

How much of the improvement in the funding position monitored at the end of June is down to benefit reforms and how much down to market movements?

The changes to benefits and contributions introduced in April were clearly unwelcome, but they have helped to put the scheme on a more stable and affordable footing into the future.

We are encouraged that the funding deficit has fallen, but it is important to understand this in the wider context: Given the prevailing conditions at the 2020 valuation date, and the additional covenant support measures provided by employers, we were able to set a long recovery plan which allowed us to increase deficit recovery contributions by just 0.2 per cent compared to the 2018 valuation.

Recent indications of an improved funding position are overwhelmingly the result of significant, unexpected changes to the global economic landscape since the turn of the year: Asset prices have fallen steeply because of the turmoil on financial markets but interest rates have been rising at the same time as policymakers look to tackle inflation. That marks a striking contrast to conditions during the 2020 valuation.

All else being equal, the two together result in rising long-term expectations for investment returns. In other words, the assets we need to buy to fulfil promises to members have become cheaper, which can be helpful when assessing the future service costs and the deficit. The 2023 valuation will allow us to make a robust assessment of the position.

Does this mean deficit recovery contributions aren't required?

The analysis we've published today shows that the funding position at the end of June 2022 – in respect of the pre-April 2022 benefit structure – might have been somewhere in a range of potential outcomes.

The indicative bookends are a future service cost of 27.4% of pay with a surplus of £0.6bn (based on monitoring alone) and 29.6% of pay with a deficit of up to £3.8bn (depending on the assumptions for expected inflation).

In the Accelerated Year-end Review briefing note we published earlier this year, we quoted a range of deficit recovery contributions from 0.2% to 6.3%. A similar range would be applicable to any deficit in respect of the pre-April 2022 benefit structure.

However, the FMP reports should not be seen as an indicator of the likely outcome of an actuarial valuation. They reflect conditions between valuations on a pre-agreed methodology with limited judgement applied. They indicate – at best – the direction of travel, rather than the destination.

An actuarial valuation requires much deeper and comprehensive analysis of long-term assumptions on a variety of factors, including inflation, interest rates, the outlook for future expected investment returns, mortality, the covenant position, and risk capacity, overlaid with judgement taken by the Trustee. The 2023 valuation will allow us to make a robust assessment of the position.

What could happen at the 2023 valuation if the improvement in the funding position is sustained?
The scheme has 500,000 members of whom 212,000 are active members, who are accruing benefits all the time.

The contributions being paid into the scheme now will be invested to fund the benefits promised to USS members. If the Trustee finds, via the 2023 valuation, that the overall contribution requirement can indeed be reduced, the JNC may be able to consider some element of change to the contributions payable by members and employers, enhancements to benefits, or a combination of the two.

We are working with stakeholders as they consider what options might be available – to the extent that the 2023 valuation finds that recent indications of an improved funding position are well-founded.

By collaborating closely with stakeholders, any agreed changes to contributions and/or benefits can be put into effect more quickly than in recent valuations. The Board is supportive of working with stakeholders on an accelerated timetable for the next valuation with an ambition to make any follow-on changes to contributions and/or benefits decided by the JNC by 1 April 2024. This is a challenging but achievable timetable if all parties can work constructively together with a focus on early engagement on key inputs and assumptions, and potential outcomes, ahead of the valuation date.