USS

USS covering note to UUK on matters relating to the 2018 valuation

7 May 2019

Completion of the 2018 valuation

The USS Trustee Board noted UUK's response to the technical provisions consultation, and the questions and feedback from employers in relation to various aspects of the 2018 valuation, including the pricing of the Upper and Lower bookends, the rationale for the proposed level of deficit recovery contributions (DRCs), and the requirement for contingent contributions.

The board also reviewed UUK's proposal for a Contingent Contribution Arrangement ("CCA"), developed with Aon. The board concluded that changes would be needed to elements of UUK's proposed contingency arrangements in order for the Lower bookend rate of 29.7% to be applied, to provide adequate protection from short-term risks. These changes relate to some of the metrics applied for calibrating trigger events and the scale of increases required if and when triggered. The changes required provide the Trustee with the ability to address a material worsening of the scheme's short-term risk position – which, as we have previously set out, could have a detrimental impact on our ability to achieve the right outcomes in the long-term. This is the fundamental driver behind the contribution rates the Trustee requires under all of the options now available. The contingency arrangement put forward by UUK does not, in the Trustee's view, address this adequately in its current form, but modifications could be made to progress with this option.

A full response to the issues raised by employers, an explanation of how the UUK proposal for a CCA falls short against the framework and principles set out by the Trustee, and a summary of what modifications to the CCA would be required in order to deliver contributions at the Lower bookend is provided in the enclosed document, *"Trustee's reply to UUK's feedback and questions on the Consultation on the 2018 Technical Provisions"*.

In considering the advice of the Scheme Actuary, its covenant advisors EY Parthenon and PWC, and the executive, the Trustee concluded that there are now three alternative contribution structures by which the 2018 valuation could be completed and which it is now inviting the stakeholders to consider.

All three structures would be acceptable outcomes for the Trustee however, as there are considerable challenges to completing the process in a timely manner under Option 2 (an explanation of which is set out below), the Trustee would require an alternative path under Option 1 or Option 3 to be taken in advance of Option 2 being implemented.

The options as agreed by the board are as follows:

Option 1 – Upper bookend

The board agreed that the contribution rate for the current benefits should remain unchanged from the rate consulted on of 33.7%. This is set out as the Upper bookend but is essentially the amount the Trustee believes is required to pay for future service and address the deficit based upon a 31 March 2018 valuation date in the absence of any contingent support.

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The contribution rate to apply from 1 October 2019 would be unchanged from the 2017 valuation outcome, but the rate to apply from 1 April 2020 would be lower (currently scheduled to be 35.6% under the 2017 Schedule of Contributions).

To meet the statutory deadline of 30 June 2019 under this Option, the JNC would need to decide that it would not be making any alternate cost-sharing proposals or benefit changes under Rule 64.10 (and thus the default cost sharing position under Rule 76.8 applies) at, or very shortly after, its meeting on 17 May. If the JNC were to use the 3 months allowed to it under the rules, after submission of a Rule 76 Report, to decide on benefit or other changes, the statutory deadline would be missed.

Option 2 – Lower bookend and a contingent contributions arrangement

The board agreed that the Lower bookend would be set at 29.7% which would be subject to an acceptable proposal on contingent contributions to address the additional risk being taken.

The board considered the UUK/Aon proposal for contingent contributions and has set out in the enclosed document the Trustee's reply to UUK and what changes it requires in order for the proposal to be acceptable to the Trustee at the Lower bookend.

Given UUK has been clear that this Option will require any contribution increases triggered by the CCA to be shared with members, this Option would require agreement by the JNC, a statutory consultation with affected members and their representatives and the preparatory tasks associated with that, and then the rule change would be confirmed and executed. The process would be lengthy which, combined with the complexity of the changes involved, would likely lead to a completion date in around June/July 2020. Contribution rate increases as at 1 October 2019 and 1 April 2020 would therefore apply and the statutory deadline (in the absence of a Schedule of Contributions/Recovery Plan under Options 1 or 3 being completed in advance) missed by some 12 months.

Option 3 – 2020 valuation

This is a new Option and can be characterised as an alternative contingent mechanism to Option 2.

The contribution rate would initially be set at 30.7% (9.6% members and 21.1% employers) and that would apply from 1 October 2019 (subject to the valuation being completed in time for changes to be implemented so as to meet the cut off dates for an October payroll change).

A 2020 valuation would be undertaken and, subject to that and ongoing discussions between stakeholders, the contribution rate would remain unchanged until 1 October 2021 when it would increase to a minimum of 34.7% in the absence of an alternative Schedule of Contributions from a completed 2020 valuation.

As with Option 1, to meet the statutory deadline of 30 June 2019 under this Option, the JNC would need to decide that it would not be making any alternate cost-sharing proposals or benefit changes under Rule 64.10 (and thus the default cost sharing position under Rule 76.8 applies) at, or very shortly after, its meeting on 17 May. If the JNC were to use the 3 months allowed to it under the rules, after submission of a Rule 76 Report, to decide on benefit or other changes, the statutory deadline would be missed as well as the cut-off date for a change to the 1 October 2019 increase (the payroll cut-off is 31 August 2019).

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Covenant

The board concluded, having received advice from EY Parthenon and PwC, that the employers' covenant remains strong but should be placed on "negative watch". Two factors gave rise to the "negative watch": (i) the risk of strong employers exiting the scheme; and (ii) the risk to the scheme of employers increasing debt levels.

The board supported PwC's recommendations that:

- Employers' debt levels be monitored against a number of metrics with the Trustee seeking clarification of employer business plans should the metrics exceed certain levels. This monitoring would be part of an annual attestation;
- Institutions wishing to grant security in the future to lenders (on existing or new debt) should be required to grant *pari passu* security to the trustee; and
- Should these measures prove to be inadequate or fail to obtain employer support consideration would need to be given to additional measures.

The board concluded that satisfactory implementation of debt monitoring and rule changes in relation to exiting employers (see below) were important to the adoption by the Trustee of the assumptions underpinning valuation Options 2 and 3 being offered to employers.

Clarification of withdrawing employer rules

PwC's advice to the Trustee is that the risk of strong employers withdrawing from the scheme in future could see the covenant downgraded from "Strong" to "Tending to Strong.

PwC has advised that a clarification to the rules which strengthens the Trustee's discretionary powers to determine whether an employer can exit the scheme would support maintaining the current covenant rating.

The contribution Options outlined above assume that UUK will work with the Trustee to ensure both the rule change and debt management process can be put in place. The clarification to the rules is the most pressing of these issues and requires a rule change to be put forward to the JNC for consideration in the coming weeks and execution of that rule change in advance of the completion of the 2018 valuation.

17 May JNC and Rule 76 Report

There is a board meeting on 16 May, at which the Trustee will review any feedback from stakeholders on the Options for completion of the 2018 valuation described above, the support for debt monitoring, and a clarification to the scheme rules. The board has reserved making a decision on the issuing of the Rule 76 Report until that meeting.

Should the JNC be unable to make a decision supporting a rule amendment and the Options put forward to the JNC to complete the valuation at its meeting in May, it is likely that the board will elect to finalise the Rule 76 Report and issue it to the JNC shortly thereafter.