USS – Finalising the 2020 valuation

The USS Trustee is consulting on the Schedule of Contributions, Recovery Plan, and Statement of Funding Principles for the 31 March 2020 valuation. Once these documents are finalised and signed, the 2020 valuation will be completed.

At a glance…

- We welcome the USS Trustee's pragmatism in allowing the scheduled 1 October 2021 contribution increase to be avoided following the JNC resolution and covenant support commitments. The total contributions would increase from 30.7% to 31.2% rather than to 34.7%. We believe this will be welcomed by most employers and employees.
- For reasons we explain – including the material improvement in funding position after the valuation – we believe it is unnecessary for the USS Trustee to increase contributions by 0.5% overall (split 0.3% employers, 0.2% employees). A preferable approach would be to retain contributions of 30.7% in our view, at least until April 2022.
- There is clearly a very limited time window for this consultation – albeit stemming from the JNC resolution being passed at the end of August and the proximity of the 1 October increase. This is not ideal, and we would recommend that employers seek to engage over the requested period.
- We note UUK's comments about the wording in the Schedule of Contributions on accelerated contributions for individual employers in certain scenarios, and support their view that it should be clearer that this applies only exceptional circumstances (and the provisions only apply if the Benefit Change Deed is put in place by 28 February 2022).
- We are concerned with the USS Trustee's positioning that 18 years is an unusual recovery length and that they would typically expect shorter recovery periods at future valuations. We do not regard 18 years as unusual for the scheme specific circumstances of the USS (including the proposed 20-year moratorium).

Why bring you this paper?

This note sets out our views on the three consultation documents provided by the USS Trustee. Please read our advice alongside UUK's email to Heads of Institutions also issued today.

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Two contribution outcomes

To finalise the 2020 valuation now, the Trustee provide two separate contribution outcomes dependant on whether a Benefit Change Deed is agreed by 28 February 2022. We have summarised the various information on contributions in the table below:

	With Benefit Change Deed agreed by 28 February 2022				Without Benefit Change Deed			
With effect from:	Member	Employer	Total	Including DRCs	Member	Employer	Total	Including DRCs
Oct-21	9.8%	21.4%	**31.2%**	0% (*)	9.8%	21.4%	**31.2%**	0% (*)
Apr-22	9.8%	21.4%	**31.2%**	6.3%	11.0%	23.7%	**34.7%**	0% (*)
Oct-22	9.8%	21.4%	**31.2%**	6.3%	12.9%	27.1%	**40%**	3%
Apr-23	9.8%	21.4%	**31.2%**	6.3%	13.9%	29.1%	**43%**	6%
Oct-23	9.8%	21.4%	**31.2%**	6.3%	15.0%	31.0%	**46%**	9%
Apr-24	9.8%	21.4%	**31.2%**	6.3%	16.0%	33.0%	**49%**	12%
Oct-24	9.8%	21.4%	**31.2%**	6.3%	17.1%	34.9%	**52%**	15%
Apr-25	9.8%	21.4%	**31.2%**	6.3%	18.1%	36.9%	**55%**	18%
Oct-25	9.8%	21.4%	**31.2%**	6.3%	18.8%	38.2%	**57%**	20%
Apr-26 to Jul-32	9.8%	21.4%	**31.2%**	6.3%	18.8%	38.2%	**57%**	20%
Aug-32 to Mar-38	9.8%	21.4%	**31.2%**	6.3%	11.8%	25.2%	**37%**	0% (**)

(*) The current benefit structure means cost of accrual is not being met during this period so there is no contribution towards the deficit

(**) shorter recovery plan length for this scenario. These contributions would be subject to JNC review in relation to cost-sharing

If different benefit changes are agreed (to the JNC resolution) then the contributions (and valuation documents) may be revisited.

Position if Benefit Deed implemented by 28/2/2022

Here, the USS Trustee will adopt a pre-retirement discount rate of Gilts+2.75% p.a. and a Recovery Plan 18 years in length with investment outperformance of 0.5% p.a. in excess of the discount rate.

Under the JNC benefit reform proposal, this results in a contribution increase of 0.5% compared with the current aggregate contribution rate of 30.7%, applying from 1 October 2021. Most of the increase (0.4%) arises due to new benefits being valued for deferred members that were not included in previous valuations (described here).

We acknowledge that the USS Trustee has accepted the argument put forward by Aon and UUK that a higher discount rate and longer recovery plan could be adopted in light of benefit changes being implemented (as they are proposed to be, subject to consultation). We are pleased to see that this principle is also now included within the draft Statement of Funding Principles.

Some employers may be reluctantly content with the outcome, and will note that most of the increase arises due to benefits not valued previously.

However, we believe there are stronger arguments for continuing with a 30.7% contribution rate at least until April 2022 for the following reasons:

- It would only take a modest change to the recovery plan structure (or pre-retirement discount rate) to make 30.7% work. Given the level of judgement being applied to some of the assumptions, the USS Trustee should be encouraged to look at the package of proposed covenant support and JNC benefit resolution in the round, and help the stakeholders to find a solution by retaining 30.7% given the importance of affordability for employers (and employees).
- If a 31 March 2021 valuation were carried out, then a 30.7% contribution rate would be achievable unless the USS Trustee decided to materially strengthen the Recovery Plan (for example by bringing the length down to under 10 years and halving the investment outperformance allowance, but we would argue this is incompatible with the covenant support being provided and the desire for intergenerational fairness). Even without calling a 2021 valuation – and we acknowledge that the sector has had to go through three valuations already in the last four years (2017, 2018, 2020) – the USS Trustee could therefore take comfort from this post valuation experience to maintain contributions at 30.7%.
- It is also conceivable that the final benefit reform may be refined to achieve a total aggregate cost of 30.7%, if for example employees would prefer for their contributions not to increase which would lead to potentially slightly greater benefit reform. This would then mean that contributions are increased from 30.7% to 31.2% for six months only i.e. until benefit reforms apply on 1 April 2022. The additional contributions would only amount to around £20M or 0.03% (in funding level terms). We believe it would be inconvenient (and operationally time consuming for the employers) to increase the contributions for six months only to then reduce them. While the USS Trustee has determined that 31.2% is its preferred outcome, we believe it would be more pragmatic if 30.7% were maintained until at least April 2022 to give the stakeholders time to arrive at a final position following consultation with employees and representatives.

Position if Benefit Deed is not implemented

If the Benefit Deed is not implemented and the full covenant support package is not provided, then the contribution outcome will be very difficult.

The USS Trustee will adopt a Gilts+2% p.a. pre-retirement discount rate, a 12 year and 4-month recovery plan, and asset performance of 0.5% p.a. (but only for the first 10 years). The USS Trustee allows for contributions to step up as set out in the earlier table over a four-year period to allow to some extent for affordability concerns. This results in a slightly longer recovery compared with previous illustrations (which used a 10-year period, although asset outperformance is still only counted over the original 10 years).

If employer agreement were needed to the Schedule of Contributions, then it would be difficult for employers to agree to these contributions unless they were demonstrably affordable. However, employer agreement is not needed to these contributions under the Rules, and the USS Trustee need only consult with UUK. Although the USS Trustee has we understand considered affordability, we have not seen the analysis on this, and as part of this consultation it would be useful for employers to confirm whether these contributions are indeed affordable. For the increased employee contributions to come into force under the second leg, these would require consultation with employees and their representatives. We understand that these backstop contributions will be consulted on as part of the formal 60+ day consultation coming in November.

Conclusions

The USS Trustee has provided a path to finalise the 2020 valuation (albeit further changes may be needed depending on any changes made to the JNC benefit resolution following consultation with members and their representatives), and to mitigate the 1 October 2021 increase. At a high level, we believe this will largely be welcomed by many employers and employees.

Although the USS Trustee has already set out why it believes 31.2% is appropriate (rather than 30.7%), we believe there is a strong case for retaining 30.7%, and this rate should remain in place until at least April 2022 in the valuation documents agreed now.

We agree with UUK's comments in their HOI email about the accelerated contribution wording – in particular that it should be made clearer that it applies in exceptional scenarios only. As set out in our documentation comments in the Appendix, we would also draw out our concern with the USS Trustee's statement that they would typically expect a shorter recovery plan under less stressed market conditions. Employers (and employees) could infer from this that the Trustee will simply bank the covenant support provided and give it limited consideration at future valuations when it comes to determining the recovery plan. We also note that 18 years does not look atypical for the USS given past practice in recent valuations, and that it is within the 15-20 year range recommended by the Joint Expert Panel.

We would be pleased to discuss this further.

Appendix – Detailed comments on documents

Recovery Plan

There is no mention of what deficit contributions are payable before 1 April 2022 (if the Benefit Change Deed is agreed by 28 February 2022) or before October 2022(if it is not). We understand that this is because there are effectively no deficit contributions – as the future service rate already exceeds the contributions requested in this scenario.

There is also a small clerical point that 31 March 2024 in the contributions for the Benefit Change Deed scenario should read 31 March 2025. This also applies for the other documents and we understand will be corrected.

From an accounting perspective, employers will typically need to include the value of their share of deficit contributions on the balance sheet. The ambiguity of future contributions could be unhelpful particularly for any employers with accounting dates between 1 October 2021 and 28 February 2022 (or when the Benefit Change Deed is agreed, if earlier). We understand that the USS will publish further guidance to help employers here.

Schedule of Contributions

The positioning for when the “with Benefit Change Deed” scenario applies is slightly different to the Recovery Plan, since it covers both the JNC resolution or a variation that the Scheme Actuary certifies requires no greater overall contributions – whereas the Recovery Plan simply refers to whether a Benefit Change deed is implemented. The wording of the documents should be aligned.

For the increased contributions under the no Benefit Change Deed scenario, as a practical point, the increased employee contributions would likely drive increased member opt-outs, and this would lead to the deficit contributions rising even further as a percentage of remaining payroll. Presumably the USS Trustee is content to consider this at future valuations rather than now (if the backstop were to apply), but it adds a further dimension to why these rates may be difficult to implement.

In the section “Employer contributions towards DB benefits” it is implied that deficit contributions form part of the employer contributions alone (e.g. *“the deficit contributions included within the Employer contributions would be…”*). This should be corrected, as any increase in contributions is shared 65%:35% (employers:members) under the default cost-sharing provisions.

In section 5 (“Acceleration of employer contributions in certain circumstances”), we support UUK’s comment that it should be clearer that this mechanism would be used in exceptional circumstances only. We also understand that this section does not apply if the Benefit Reform Deed is not agreed by 28 February 2022 (as only debt monitoring, and not the pari passu requirements, would then apply). From an actuarial perspective, one practical concern we have is that the USS Trustee may be incentivised inadvertently to always show a valuation deficit at future valuations (and require deficit contributions), otherwise section 5 will not obviously work as a deterrent.

Statement of Funding Principles

Our general view is that draft SFP is as expected, and the changes are consistent with the USS Trustee's previous consultation materials particularly in regard to how the assumptions have been determined by the USS Trustee.

As what is largely a drafting comment, there is a further variation in what is required for the with Benefit Change Deed scenario (compared with the wording in the Recovery Plan and Schedule of Contributions) – through the comment *"If benefit changes are implemented which are materially different in form to those set out in such resolution, a revision to this Statement of Funding Principles could be required."* Expanding our first comment in the previous section, we would recommend the USS Trustee aligns the three documents in terms of when the "with Benefit Change Deed" contribution outcome applies.

For the "Rectifying a failure to meet the statutory funding objective" section, there is reference to the Trustee determining contributions based on a variety of factors including the Trustee's objective assessment of the affordability of contributions for employers. We are not convinced that the resulting contributions (with 3% step-ups every 6 months, of which employers pick up 65% of the increase) would be considered affordable by employers based on previous feedback.

We disagree with the characterisation in this section that 18 years is *"an unusually long recovery plan reflecting the unusual market conditions around 31 March 2020."* We believe the consideration of what is "usual" does not consider adequately the unique covenant support the USS, or the covenant support measures, or address satisfactorily the issue of intergenerational fairness given the sharing of cost increases. In addition, for the 2014 and 2017 valuations the recovery periods were 17 and 17.25 years and so we would argue that 15-20 years (as recommended by the JEP) should not be considered "unusual" for the USS.

We are also concerned with the statement *"The Trustee would typically expect to adopt a shorter recovery plan under less stressed financial market conditions."* This risks confirming the worst suspicions of employers that the Trustee will simply "bank" the covenant support (including the 20-year moratorium) and ascribe it limited value at future valuations. In responding to this concern as part of its comments on a potential 2021 valuation, the USS Trustee points to the fact that the covenant package enables a strong covenant, which in turn would reduce the deficit and cost of future benefits. We accept the merit in this point, but the "value" of moving from 15 to 20 years for the moratorium that enabled an 18-year recovery plan for the 2020 valuation would have been lost. We believe that the USS Trustee will need to do more to allay the fears of employers on this issue of enduring value for the covenant support measures, to preserve their backing and employer goodwill.

In the Notes to Statement of Funding Principles section, the pension increase assumption where increases are capped at 2.5% is taken to be CPI minus 35bps. This is a new assumption and we confirm that we are comfortable with this from an actuarial perspective for the Technical Provisions.

On the discount rate (both pre- and post-retirement), our primary comment on the documentation is that while the document opines at length around choosing assumptions having regard to the self-sufficiency position and IRM plan, it still remains unclear what assumptions would apply at a different date – there appears to be a lot of judgement reserved for the USS Trustee. We prefer a simpler approach to setting assumptions so stakeholders can more easily track and predict where future valuations will land. This would likely be crucial were the stakeholders to pursue a Conditional Indexation approach in future, where parties would need to be confident that good asset outperformance would be shared with employees rather than converted into additional prudence. This transparency point should be discussed further with the USS Trustee in our view.

TAS compliance

This document has been prepared in accordance with the framework below.

This document, 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').

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