

Question raised by UUK	Response
<p>a) Please explain how the updates of the funding positions at 30 June, 30 September and 31 December 2020 have been carried out (approach used to derive assumptions, assumptions, and results). Given the material movements over 2021 to date, please supply an updated funding position e.g. at 28 February 2021. Can the Trustee give the stakeholders assurance that if the funding position improves then it will be open-minded about this?</p>	<p>a) The updates of the funding positions from 31 March 2020 under the 2020 methodology as at 30 June, 30 September and 31 December 2020 have been carried out using an approach agreed with the Scheme Actuary which looks at the range of outcomes quoted in the Technical Provisions consultation document and is driven by:</p> <ul style="list-style-type: none"> • Changes in credit spreads for calculating the post-retirement discount rate • Changes in the FBB expected returns on the pre-retirement portfolios for the pre-retirement discount rate (although this is not a one-to-one relationship) • Changes in the forward gilt yields • Changes in expected CPI, with an allowance for an inflation risk premium at dates since 31 March 2020 • Changes in market values of the assets held by the Scheme <p>The Scheme Actuary has also considered the return forecasts of his own firm as at 30 June, 30 September and 31 December 2020.</p> <p>Up to the end of January, our monitoring and advice from the Scheme Actuary indicates an improvement in the deficit position but an increase in the cost of benefits (future service cost). As such, the overall contributions had not improved relative to the valuation date. There has been a further improvement in the deficit position on a monitoring basis in February but with offsetting increases in the future service cost, suggesting that total contribution rates are largely unchanged from the valuation date. The inflation breakeven rate observed in the market also increased in February, which might reflect higher inflation expectations for the future, or simply an increase in the risk premium as a reward for taking inflation risk. This is further complicated by the government's reform of RPI. Overall, it is too early to draw firm conclusions on future inflation.</p> <p>It is important to note that the assumptions underlying these results are subject to further consideration and that the CPI inflation assumption has not been updated for the effect of RPI reform. The allowance for assumed additional investment returns in the recovery plan, and the impact of the Trustee's integrated risk management framework, would also need careful consideration at any date since 31 March 2020. These are not captured in the monitoring results.</p>
<p>b) TPR has provided quite specific guidance on individual valuation parameters. Has TPR provided to the Trustee any evidence for why its views are on the cusp of legal compliance as is claimed? Employers would like to see the evidence to support this legal position.</p>	<p>b) TPR in its letter of 26 February articulated its views on the covenant. Should you wish to see evidence from TPR, we suggest this is raised directly with TPR as part of your ongoing direct engagement with them.</p>



<p>c) Can the USS Trustee explain why it has not completed the consultations required by law before issuing an actuarial report under sub-rule 76.1, particularly given the material nature of the recovery plan contributions for this valuation? If it believes it is justified in publishing the report before consultation has taken place, how does it intend to preserve the genuineness of the subsequent consultations?</p>	<p>c) The Trustee has completed the consultation on the methods and assumptions to be used to calculate the Technical Provisions (TP) required by the legislation. Legislation does not require the TP consultation to be conducted at the same time as SOC and RP consultations and conducting them at different stages introduces greater flexibility in the overall valuation process for all parties. It should be borne in mind that the Rule 76.1 Report is not the same as the actuarial valuation report that will ultimately be submitted to TPR after all consultations required by legislation have been completed. It is a creature of the Scheme Rules (which was inserted by the stakeholders after the 2011 valuation) and starts a process under the Scheme Rules which is separate from the legislative process.</p> <p>The valuation process required by the USS Rules and in particular the JNC power under Rule 64.10 mean a sequence of consultations and decisions is natural. The Trustee does not have prior visibility, still less control, of any JNC decision in response to the Trustee communication that an increase in contributions is required. As UUK is aware, the JNC can provide for sharing of that increase between employers and members in any proportion it wishes and/or changes to future benefits. The Trustee cannot therefore assume that such an increase will be shared in the default 35/65 proportions set out in Rule 76.8. Promulgating a formal proposal for a SOC or RP in such circumstances could lead to wasted time and expense for all, as new consultation would likely be necessary to reflect any substantive decision from the JNC. Not surprisingly, then, the last two valuations have featured a sequence of consultations with UUK ahead of Trustee decisions.</p> <p>The Trustee has provided more information on possible recovery plans and contributions than would be strictly necessary for a consultation on TPs alone. By not consulting on the SOC and RP at this stage, it has provided the stakeholders time and space for discussion and negotiation around covenant and benefit reform, both of which would likely mean significant change to any SOC and Recovery Plan between the launch of the 76.1 report and the completion of the full valuation process under the Rules and the Pensions Act 2004. The Trustee will consult on the RP and SOC in due course, at the point when both the Trustee and UUK will be able to address any JNC decisions (or lack of them) as part of that consultation.</p>
<p>d) Why has the USS Trustee seemingly paid very little regard to the detailed responses of employers to the Technical Provisions consultation? There is, understandably, great concern amongst employers that their views have been dismissed – particularly given the USS Trustee’s positioning that the valuation outcome is so largely down to the employers.</p>	<p>d) The Trustee Board has considered UUK’s response to the TP consultation in detail and received advice from the Scheme Actuary in relation to it. We have not been party to the detailed responses of individual employers as those were sent to UUK in its role as the representative body for employers and the formal consultee. Under legislation and the Scheme Rules, the Trustee is only able to consider and take account of the response of the formal consultee.</p> <p>Some of the views expressed in UUK’s consultation response related to wider issues than just the TP consultation and the Board also considered those. Where the responses have been more equivocal, for example in the case of risk appetite and affordable risk capacity, we have been as pragmatic as possible and transparent in the assumptions we have made. The Trustee has published an explanation of how it took UUK’s consultation response into account in Section 2 and Appendix C of the Trustee Update and has detailed its response on 13 specific areas in relation to assumptions and methodology aspects. A further copy of that explanation can be accessed here.</p>



	<p>Note that Appendix C was also produced to be consistent with the discussions in relation to a communications blueprint at the JEP Tripartite Talks, in particular to be clear with stakeholders what inputs have been received, what are the most material matters for the Trustee’s decision making, and what could still change.</p> <p>Covenant support is a key factor in this valuation, and we have given detailed consideration to employers’ comments in relation to the covenant made in response to our early Discussion Document, the consultation on debt monitoring, and the TP consultation. We noted from the TP consultation feedback that employers did not support additional covenant support measures such as contingent contributions or contingent assets which are associated with the lower contribution rates shown in the TP consultation.</p> <p>We also received feedback in the TP consultation and from the separate consultations on the moratorium, debt monitoring / <i>pari passu</i> framework and refined our proposals. As a result of this:</p> <ul style="list-style-type: none"> • We have developed an alternative covenant scenario (Scenario 3) with a moratorium that is significantly shorter than the 30-year moratorium envisaged in the TP consultation (and the permanent change discussed prior to that) which we have assessed as sufficient to support a strong covenant; and • We evaluated a covenant support proposal created by UUK, have attributed value to that proposal (as illustrated by the reduced contribution rates in Scenario 2 versus Scenario 1) and have used that Scenario as the basis of the Trustee’s determination under Rule 76.
<p>e) If the issue of covenant has emerged as a central point of challenge in the latest discussions between the USS Trustee and TPR, why has the USS Trustee not considered it helpful to speak with UUK on behalf of the scheme sponsors, given the deep knowledge and understanding of university finance which exists within the employer group? Employers can provide significant assistance to the USS Trustee in making the case to TPR for a strong covenant.</p>	<p>e) We are aware that UUK engaged directly with TPR through both bilateral meetings before and after Christmas and through written communications (having been briefed on the former and copied in on the latter).</p> <p>We have also had ongoing engagement with TPR throughout the 2020 valuation in relation to covenant matters, particularly given the additional covenant assessment work carried out over the summer and into the early autumn in order to more fully understand the impact of the COVID-19 pandemic.</p> <p>TPR made its position on the covenant clear in its recent letter: “The clear capacity of the sector to support the Scheme has yet to be evidenced by a demonstrable commitment by the Scheme’s sponsors when the Scheme requires increased cash contributions to meet its funding needs.”</p> <p>Note that TPR considered the covenant to be TTS at the 2018 valuation also. The importance of covenant support was expressed clearly in concluding the 2018 valuation and the covenant assessment was as ‘strong on negative watch dependent on implementing the measures described. We have continued extensive discussion with UUK in relation to the importance of the covenant and the need for covenant support over the last 20 months. The potential outcomes we have illustrated throughout this valuation (both in the Discussion Document and the TP consultation and now in the Rule 76.1 Report) have reflected the importance of the covenant.</p>



<p>f) There is a worrying concern regarding the exit of one strong employer from USS. We noted the statement from the USS Trustee in December 2020 in which the rationale for the arrangements is largely based upon this one event ... “Assumptions of employers’ mutual support and enduring commitment to the Scheme had been constants in the approach to all previous valuations. Prior to Trinity College Cambridge’s decision to exit the Scheme, they were taken as read. We now need to evidence them and make them tangible.” Does the Trustee, with its understanding of the sector, still believe this statement to be true? This unique event seems to be having a disproportionate impact on the USS Trustee’s assumptions, with a financial difference in contribution rates of 14.1% of salary, or approximately £1.1bn per annum of contributions, based upon the figures presented.</p>	<p>f) The Trustee’s covenant advisor, PwC, has advised the Trustee that without covenant support being provided at least in line with that envisaged for Scenario 3 their assessment of the covenant will be downgraded to tending to strong. PwC also assessed UUK’s covenant support proposal (Scenario 2) and assessed that it would not be sufficient to maintain the covenant as strong. Given the clear advice from our covenant advisor we do not believe that our approach is disproportionate. The existence of the current temporary moratorium makes it difficult to know whether or not the Trinity College example is a unique event. The significant number of employers with the resources to settle their current s75 debt are important to the overall strength of the covenant. It is not clear that an employer would always share their emerging plans with either us or UUK, although even in the last couple of weeks we have been approached by a number of institutions to provide estimates of their section 75 debts. Consequently, our belief in the importance of the covenant support provisions has not diminished. However, we have sought to accommodate employers to the extent we can by creating Scenario 3 (see above). Finally, it should be noted that a significant factor in the lower contributions in Scenario 3 (as compared to the Scenarios 1 and 2) is the longer Recovery Plan. We believe that a commitment to the Scheme of at least the length of the Recovery Plan is a reasonable pre-requisite to recover the deficit over a period of 15 years.</p>
<p>g) Bearing in mind that an employer that chooses to exit from USS must pay a section 75 debt (or insurance buy-out debt), can the USS Trustee (i) confirm if it believes it is the case that the insurance buy-out level of funding is insufficient for USS’s employers – and indeed does it believe that The Pensions Regulator holds this view too, as appears the case from its backing of the USS Trustee position, and (ii) in what circumstances could an employer be required to make contributions higher than the insurance buy-out amount? The high section 75 debt obligations already in place are a strong measure to prevent employer exit, and in any event provide for the full insurance cost of an employer’s liabilities to be secured.</p>	<p>g) TPR’s opinion does diverge from ours to some extent – they believe the covenant in Scenario 3 is tending to strong. However, PwC’s assessment is that the underlying Scheme covenant is strong and access to the sector, the last-man-standing structure and the employers’ joint and several liability which allow the Scheme to rely on the full support of the sector are important parts of that assessment. The Trustee and PwC have been consistently clear that protecting this feature of the Scheme in the long-term – and at least for the duration of any Recovery Plan, with a rolling period thereafter exceeding three valuation cycles – is one of the conditions which would enable an ongoing assessment of the covenant as strong. Given the last-man-standing structure, the future liabilities of each employer are not limited to their current s75 debt. The circumstances in which the Scheme might require support in excess of an employer’s current s75 debt are likely to be those in which: - The Scheme deficit – and the value of the s75 debt – has increased significantly in the future; and / or - The employer’s share of the Scheme’s liabilities has increased, for example if other employers have been unable to meet their share of the obligations</p>



	<p>If the employers are and remain financially strong, and if investment returns are sufficient, these would not become a concern. However, these risks need to be considered in the context of the potentially long-time horizon over which the Scheme will be required to rely on the covenant.</p> <p>If the Scheme were to close and move to a self-sufficiency target, the employers remaining in the Scheme would be required to repair the deficit over time, including to the extent other employers had been unable to meet their obligations. Some employers with substantial assets but a relatively small share of the deficit contribute proportionately more to the covenant than others in underwriting the risk of an extreme downside scenario. Some could afford to pay their Section 75 debt and leave the Scheme, weakening the collective financial strength of the remaining employers. Retaining these employers within the covenant, rather than allowing them to exit, helps to maintain the long-term financial support for the Scheme.</p> <p>In our risk framework, the maximum level of employer support for the Scheme, used in Metric C, is the available risk capacity of £76bn (in Scenario 3). This is our estimate of the most which could be afforded by the sector in an extreme funding downside. The available risk capacity would be significantly reduced if the maximum which could be assumed is each employers' share of the s75 debt, with appropriate haircuts for the weaker employers.</p>
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