The Pensions Regulator
Making workplace pensions work

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Sir David Eastwood
Chair of Trustees
Universities Superannuation Scheme Ltd

Sent via email only

Our ref: C72540470

11 December 2018

Dear Sir David

Universities Superannuation Scheme (the Scheme)
Actuarial Valuation as at 31 March 2017 (the 2017 Valuation)
Actuarial Valuation as at 31 March 2018 (the 2018 Valuation)

We are writing to set out our views on the key issues and risks that TPR feels should be taken into account when finalising your 2017 Valuation and when preparing your proposed 2018 Valuation.

The timeframes within which you will need to complete these valuations are short and we are aware that discussions with stakeholders about the 2018 Valuation have started. We are making our views clear now, to give you the best opportunity to conclude the 2018 Valuation within the statutory deadline.

Summary

1. You have confirmed that you will complete the 2017 Valuation by February 2019. You will then conduct a 2018 Valuation which will allow you to take into account some of the points set out in the Joint Expert Panel (JEP) report.

2. As we set out in previous correspondence, we are prepared to accept the 2017 Valuation proposal on technical provisions but it is at the limit of what we regard as being compliant with the requirement for prudence under the Pensions Act 2004. We have yet to see an agreed proposal for the recovery plan which is currently subject to an employer consultation due to be completed in January 2019.

3. We remain of the view that the covenant remains ‘tending to strong’ and employer affordability is constrained. Our work with you on the 2017 Valuation has highlighted limitations on affordability:

   a) We believe that the future scale of the Scheme relative to the future scale of the sector (specifically those institutions supporting the Scheme) and its ability to support the Scheme is a key consideration. If the Scheme grows relative to the sector, any increase in the size of the deficit would place a more significant burden on the employers supporting the Scheme. We acknowledge that very high level analysis by USS was included in the JEP report suggesting that the sector could grow relative to the Scheme. Given the importance of this issue, we believe detailed work should be undertaken to understand how this relationship might vary under different future scenarios. Processes should also be put in place to monitor, manage and mitigate the impact of this risk.

b) We also see potential risks to the strength of the employer base from at least two further factors which could impair the employers' strength and constrain affordability in the near future: the uncertainty of Brexit's impact; and the Review of Post-18 Education and Funding which is due to report in January 2019. We expect the Trustee, through PwC, to continue to monitor the impacts of these events and any other developments to inform their covenant assessment as part of the 2018 Valuation process.

4. The JEP report highlighted areas where the Trustee could reduce the level of contributions to the Scheme by reflecting experience since the 2017 Valuation date and by accepting a higher level of risk in respect of specific areas. UUK has indicated that, subject to some conditions, *"the vast majority of employers that responded to the consultation are supportive of the JEP's recommendations"*.

5. The JEP recommendations principally increase reliance on investment performance to fund benefits. However, these create a potential for increased volatility in the Scheme's position and for the Scheme deficit to increase if actual outcomes are worse than predicted. The JEP report did not quantify these risks in terms of the potential for further deficit increases in realistic downside investment outcomes and what level of contributions would be required to clear such deficits over a reasonable period.

6. Constraints on affordability are currently evident among employers in respect of the contributions being discussed for the 2017 Valuation. Placing increased reliance on investment performance therefore increases the risk that future contributions may be required at a level which would be damaging to employers in order to address such potential downside outcomes.

7. If the employers want the 2018 Valuation to include greater risk than the 2017 Valuation, we expect further analysis to be undertaken. In particular, we expect USS and UUK to:

a) quantify the scale and range of risks;
b) provide evidence to the employers so that they can understand the scale and range of risks and the implications; and,
c) demonstrate and agree how the employers will support these risks.

8. We expect the Trustee and UUK to design and implement appropriate contingency measures, with legally binding triggers for action to support the risk being taken, including additional cash payments that would be contingent upon the Scheme's performance. This is particularly so if the level of risk exceeds that allowed for within the 2017 Valuation.

The role of TPR

9. We aim to understand the risks (covenant, funding and investment) to which the Scheme and members' benefits are currently exposed and how those risks might vary over time so that we can properly fulfil our statutory objectives when we consider the Valuations.

10. We believe the most effective way to engage with schemes on valuations is to set out our comments and any concerns to the trustees and other key stakeholders at an early stage so that they can be addressed during the ongoing valuation and negotiation process. This is the approach we have taken with you since 2010. If we believe at any stage that it is not clear that the risks are understood or that they can be supported sufficiently by the employers' covenant and funding plans, we will inform the Trustee and other key stakeholders of our concerns.

Concluding the 2017 Valuation

11. We understand that, following the recent 60-day consultation with USS members, the Trustee is now undertaking a consultation on the schedule of contributions and recovery plan with the employers which will end on 11 January 2019. The Trustee confirmed that you remain on track to submit the completed 2017 Valuation in February 2019.

12. As we previously said in our letter of 29 August 2018, we would be unlikely to take any further action in relation to the proposed technical provisions for the 2017 Valuation, if it were to be implemented and based on the Scheme's current circumstances remaining broadly unchanged. We also support the Trustee's approach to impose phased contribution increases using the process set out in the Scheme's rules.

13. However, the proposal for the 2017 Valuation is at the very limit of what TPR finds acceptable as it would see the Scheme carry higher levels of risk than we would consider manageable for a 'tending to strong' covenant. We indicated in our August letter that risk means increased volatility in the funding position and contribution requirements. Combined with the increasing scale of the Scheme, this underscores the need for meaningful contingency planning and triggers for action. As such, any further movement away from the 2017 Valuation proposal which involves additional risk will need to be fully backed by additional, tangible and realisable contingent support from the employers. In other situations, we have seen schemes reach agreement with their employers that, in the event that the deficit is above the level anticipated, they would fund additional contributions which are set at predetermined amounts based on scheme performance.

14. We are not yet sighted on the structure of the 2017 Valuation's recovery plan but we would stress that the 2014 Valuation's recovery plan length at 17 years was a notable outlier particularly for schemes with a 'strong' or 'tending to strong' covenant.

15. In reaching our view on the 2017 Valuation proposal we are aware that there was a short term improvement in the funding level from 31 March 2017 to 31 March 2018. We acknowledge that the Trustee could choose to take this positive post-valuation experience into account when consulting on the schedule of contributions and recovery plan. However, we also note that funding levels have fluctuated since 31 March 2018 and this will need to be considered when finalising the 2017 Valuation.

16. Although trustees may take post-valuation experience into account, they should avoid 'cherry picking' of such experience as part of any valuation process. If positive post-valuation experience is allowed for in a valuation, we would ordinarily expect to see the same approach in a subsequent valuation.

Covenant assessment and affordability

17. An ongoing area of disagreement between TPR and the Trustee relates to the assessment of the Scheme's covenant.

18. We recognise that the majority of Scheme liabilities relate to Pre-1992 universities whose stronger academic reputations, asset bases and revenue streams will tend to make them more resilient to changes in the overall market.

19. However, our view is that the Scheme's covenant is 'tending to strong'. Our assessment is based on:

    a) the substantial growth of the Scheme in recent years;

b) the limitations on cashflows available to service the Scheme's contribution requirements, highlighted by the fact that the current proposal appears to be close to the maximum affordable level of contributions;
c) the volatility in the Scheme's funding level due to the level of risk in the Scheme's investment strategy and the ability of the employers to effectively support that risk, particularly if the scale of the Scheme increases relative to the sector; and,
d) the significant increase in borrowing in the sector (as acknowledged by PWC) which, without a commensurate increase in income, will weaken the covenant in the future.

20. Factors which could impair the employers' strength and constrain affordability in the near future include the uncertainty of Brexit's impact and the Review of Post-18 Education and Funding which is due to report in January 2019.

21. With regard to Brexit, we note that Moody's state in their most recent review of the sector *"Depending on the terms of the final deal, Brexit remains a major concern for universities in terms of (1) research funding; (2) attracting and retaining top EU talent; and (3) student recruitment both from the EU and internationally"*.

22. On the Post-18 Education and Funding Review, we note that in a recent letter to The Daily Telegraph, Professor Sir Anton Muscatelli and Dr Tim Bradshaw set out that they believe that a cut in annual tuition fees to £6,500 without this being replaced by direct government funding is likely to have numerous negative impacts on the sector. Dr Bradshaw stated *"That level of fee cut being talked about would affect every university and every course. The scale of cuts being talked about it is a threat to all ultimately."*[1]

23. We expect the Trustee, through PwC, to continue to monitor the impacts of these events and any other developments to inform their covenant assessment as part of the 2018 Valuation process.

Size of Scheme versus sector

24. The Scheme is already of significant scale compared to the scale of the USS employers in the sector and there is significant volatility in the Scheme's funding level. The ability of the sector to provide cash support to the Scheme to fund ongoing accrual and repair deficits is already close to the limits of what can be provided on a sustainable basis. A key concern is the future ability of the sector to effectively support the Scheme, as the scale of the Scheme increases and as the sector develops.

25. Although some high level analysis has been completed, we expect USS together with UUK to undertake detailed sensitivity and scenario analysis around the potential future development of the Scheme and sector scale. This would enable a more thorough assessment to be made of the scale of this risk and the factors which significantly impact the risk.

26. This is a key risk which needs to be fully understood and managed, and a risk which should form part of the ongoing monitoring and contingency planning framework for the Scheme.

The 2018 Valuation

27. The statutory deadline for submission of the 2018 Valuation is 30 June 2019. We expect the Trustee and all the other stakeholders to work collaboratively together to ensure that this statutory deadline is met.

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[1] The Daily Telegraph online 23 November 2018 "Tuition fee cut will send universities into crisis, leading vice-Chancellors warn" and "The Russell Group's letter to The Daily Telegraph" https://www.telegraph.co.uk/education/2018/11/23/tuition-fee-cut-will-send-universities-crisis-leading-vice-chancellors/

28. The JEP report outlined, in relation to the 2017 Valuation, a number of alternative valuation options for the stakeholders to consider.

29. While we welcome the insight the JEP review provided, we believe that any proposal which USS and UUK wish to consider further (including those suggested by the JEP or other stakeholders) should be fully quantified. For instance, the JEP report does not articulate the potential future impact on the Scheme of the proposed increase in reliance on investment returns and the resultant volatility that could result from the JEP recommendations, or the ability and willingness of the employers to manage those risks. We believe that more analysis needs to be undertaken so that all stakeholders can make fully informed decisions.

30. A number of the recommendations (made in the JEP report) are relatively straightforward and do not appear likely to cause a concern as they reflect realised experience, for example:

   a) following a 2018 Valuation being called, market conditions as at 31 March 2018 will form part of the assumption set; and,
   b) as more recent evidence is available regarding mortality progression, it is appropriate for the Trustee to take this into account in setting the 2018 Valuation assumptions.

31. We understand that the majority of employers are supportive of the JEP's recommendations, i.e. they would like more investment risk to be taken within the Scheme's investment strategy. In principle, as long as the risk is supported, we are not against the employers placing greater reliance on investment performance and adopting a potentially more volatile investment approach as a consequence. However, we expect the level of the resulting risk and the range of realistic potential downside outcomes which involve increases in the Scheme's deficit to be fully quantified, monitored and managed.

32. We expect the employers to understand fully the implications of taking on that greater level of risk within the Scheme's investment strategy and to be able to demonstrate that they can fully support that risk if it is not rewarded. This includes understanding the implications for cash funding of the Scheme and the implications of an additional pensions cash call on their universities' future funding, development and capex plans. We also expect the employers to be able to demonstrate their ability and willingness to fully support these risks through formal contingency plans including hard triggers for cash funding of any increased deficit. In our considerations of any future proposals for the 2018 Valuation (JEP or otherwise) if the resultant risk profile and contingency plan is not robust, we may not be persuaded that the risk can be managed adequately and may conclude that the proposal may therefore not be appropriate.

33. We appreciate that agreeing an appropriate contingency plan across all the employers will be challenging. However, a valuation which is agreed without the employers demonstrating that they can and will support the overall approach should the risks not be rewarded may not be compliant with the requirements under Pensions Act 2004. We expect an appropriate, legally binding contingency plan to be agreed and submitted along with the 2018 Valuation. We are open to the employers and their advisors putting forward alternative proposals for consideration. However, our preference is for contingent cash support to be provided.

The Trustee's Tests

34. As set out earlier, the future scale of the Scheme and the future ability of the sector to effectively support it is a key consideration. As part of the 2014 Valuation, the Trustee developed a monitoring system to assess the reliance of the Scheme on the sector.

35. Although some of the details of Test 1 received criticism in the JEP report, we continue to believe that the Trustee should consider the reliance of the Scheme on the sector within their overall valuation approach. Considering a scheme's overall reliance on its covenant now and in

the future is a key part of how trustees should assess the sponsoring covenant. Therefore, we continue to believe that the intent behind Test 1 is relevant and that it should form part of your approach to assessing the Scheme's funding position. It is only one of a number of factors to consider, so the Trustee should attach the appropriate weight to it.

36. We expect effective monitoring to be supported with pre-agreed actions should the level of reliance of the Scheme on the sector exceed the Trustee's tolerance levels. We support the retention of the intent of this Test within the Trustee's ongoing monitoring approach.

Next steps

37. As part of the 2018 Valuation process we expect the Trustee and UUK to work collaboratively to:

a) quantify the risks that the JEP recommendations (both individually and collectively) would introduce;
b) be able to clearly articulate these risks (and their potential impact) to the employers; and,
c) be able to explain how those levels of risk will be monitored and underwritten.

38. We expect the following further work to be undertaken:

a) Ongoing covenant work by the Trustee's advisers, especially with regard to the impact of Brexit and the Review of Post-18 Education and Funding, on the ability of the sector to afford adequate pension contributions. We also expect any future covenant review to consider the impact of increasing borrowing levels in the sector.
b) Further analysis (including scenario and sensitivity analysis) should be completed on the future scale of the Scheme relative to the future scale of those institutions which support it and their ability to effectively support the Scheme. This will help employers to better understand their exposure to risk from the Scheme.
c) We do not expect this analysis to be sufficient on its own. However, it should form an input into an assessment of the ability of the employers to effectively support the level of risk in the Scheme and also help to assess the longer term impact on employers.
d) Appropriate contingency plans with firm triggers for cash payments should be agreed as part of the 2018 Valuation submission.

I have copied this letter to the other key USS stakeholders. Please do not hesitate to contact us if you wish to discuss any aspect further.

Yours sincerely

Mike Birch
Director of Supervision
The Pensions Regulator

cc Sir Andrew Cubie
Chair, Joint Negotiating Committee

Sally Hunt (via Paul Cottrell)
General Secretary, University and College Union

Alistair Jarvis
Chief Executive, Universities UK