Comment and analysis on interim monitoring of the 2020 valuation (as at 28 February 2022)

The latest interim monitoring report provides some positive indicators of the current funding status and contribution requirements of the scheme, as a result of the changes to benefit structure agreed by the Joint Negotiating Committee (JNC), and recent market developments.

The value of the scheme's assets as at 28 February 2022 stood at £88.8bn, with an implied Technical Provisions deficit of around £2bn. The indicative required contribution rate has fallen – due primarily to the lower future service cost arising from the 2.5% cap on annual inflation protection from 1 April 2026 onwards under the JNC's changes.

This is to be welcomed.

Markets, of course, are volatile. The value of the scheme's assets stood at £93bn at the end of November, for example. Recent months with positive funding indicators need to be viewed alongside more negative indicators from the pre-Christmas monitoring period.

This volatility emphasises that these monitoring metrics are not a predictor of the likely outcome of a valuation, where the task of the Trustee and advisers is to look through market volatility and make long-term judgements. As we made clear in our recent blog, a full valuation requires substantial first principles analysis and overlaying judgement by the Trustee.

The report also indicates the cost of retaining the scheme's prior benefit structure, *without* the additional covenant support that has been provided by employers through the outcome of the 2020 valuation. At the end of February, the indicative contribution rate required on this basis would be **between 44.7% and 46.9%** (a future service cost of 40.6% and a deficit of £6.3bn).

Even allowing for the same level of covenant support as is supporting the revised benefit structure from 1 April 2022, the indicative contribution rate required for the pre-1 April 2022 benefits would be between **38.9% and 41.5%** (with a future service cost of 38% and a deficit of £3.6bn).

This is set out in the following note published by USS on 1 April 2022 following a request by Universities UK.

These contribution rates are still well above the current contribution rate being paid (31.4%) and illustrate the extent to which the scheme's revised benefit structure is limiting the impact of higher-than-expected inflation and a reduced outlook for future investment returns.

This information has been shared with, and explained to, our stakeholders. The Trustee is concerned that the information contained in the monitoring statements is being used to draw conclusions that are not warranted by the nature and context of the information. Definitive statements are being made without the full context and caveats to the metrics illustrated, which could well be misleading to members.

Contribution requirement for pre-April 2022 benefits

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Given the monitoring position of the Scheme shown in the interim monitoring of the 2020 valuation at the end of February 2022 there has been speculation about the contribution requirements that would be required to maintain the pre-1 April 2022 benefits (current benefits). This note provides details of the contribution requirements for the current benefits using the monitoring methodology as at the end of February 2022.

Indicative contribution rate
The indicative contribution rates for the current (pre-existing) benefits at end of February have been calculated using the same underlying assumptions as are used for the interim monitoring of the revised benefits with the following exceptions:

- The pre-retirement discount rate has been reduced by 25bps from gilts+2.45% to gilts+2.2%. (This is consistent with the approach that was adopted at the valuation at 31 March 2020 and when post-valuation experience has been considered at later dates and in particular at 31 March 2021.)
- The recovery period for the deficit under the first of the two DRC calculation approaches is limited to 15 years from the 31 March 2020 valuation date with out-performance of 0.25% a year allowed for over this period. For the revised benefits a longer recovery period is used equal to 18 years. The use of these recovery plan periods is consistent with the approach the Trustee adopted for determining the contributions under each of the benefit structures for the 2020 valuation.

Table 1, below, details the indicative contribution requirements for the "current" benefits allowing for the covenant protection that has been put in place, based on the same calculation approach as used for the interim monitoring. For ease of reference, Table 2 provides the contribution requirements for the revised benefits.

Table 1: Indicative contribution requirements for current benefits

	28 February 2022		31 March 2020
Pre-retirement discount rate	Gilts+2.2%		Gilts+2.5%
Post-retirement discount rate	Gilts+0.6%		Gilts+1.0%
Deficit Recovery Period	15 years from 31/3/20	10 years	15 years from 31/3/20
Allowance for out-performance	0.25% a year	Nil	0.5% a year
Technical Provision deficit	£3.6bn	£3.6bn	£15.4bn
Future service contribution	38%	38%	33.6%
Deficit recovery contribution	0.9%	3.5%	8.9%
Total Contribution	38.9%	41.5%	42.5%

Table 2: Indicative contribution requirements for revised benefits

	28 February 2022		31 March 2020
Pre-retirement discount rate	Gilts+2.45%		Gilts+2.75%
Post-retirement discount rate	Gilts+0.6%		Gilts+1.0%
Deficit Recovery Period	18 years 1 month from 31/3/20	10 years	18 years 1 month from 31/3/20
Allowance for out-performance	0.25% a year	Nil	0.5% a year
Technical Provision deficit	£2.0bn	£2.0bn	£14.1bn
Future service contribution	25.6%	25.6%	25.2%
Deficit recovery contribution	0% covered by out-performance	2.0%	6.2%
Total Contribution	25.6%	27.6%	31.4%

From Table 1 and 2 it can be seen that the deficit for both "current" and revised benefits at 28 February 2022 has fallen relative to that at 31 March 2020, this results in lower deficit contributions at end February than at the valuation date.

However, the future service cost for "current" benefits has risen by a greater percentage and absolute amount compared to that for the new benefits (13% v 2% and 4.4% v 0.4% respectively). The explanation of the different changes in future service contribution requirements is that since 31 March 2020 we have seen an increase in inflation expectations which on a single equivalent basis is up 0.7% a year. The full effect of this increased inflation expectation is reflected in the future service contribution requirement for "current" benefits but is mitigated in the revised benefit structure by the 2.5% cap on inflation increases that comes in after April 2025.

The future contribution to restore the current inflation protection to the revised benefits would be of the order of 5%-6%. This is prior to consideration of whether the additional benefit should result in the Trustee reducing the discount rate for technical provisions due to the build-up of additional liability (previous indicative figures provided to the stakeholders allowed for such a reduction as advised by the Scheme Actuary).

For completeness it should be noted that the higher inflation expectation on the contribution requirements for the "current" benefits is mitigated by higher gilt yields. The decrease in the discount rate spreads relative to gilts since 31 March 2020, which make allowance for the decreases in expected returns and credit spreads since then, will have increased liabilities and future contribution requirements.

The indicative contribution rates quoted in this note have been calculated on the basis of the approach that the Trustee has adopted for monitoring purposes and are not necessarily indicative of the rates that would emerge out of a full valuation. In particular it should be noted:

- The Integrated Risk Management Metric A adopted by the Trustee at the 31 March 2020, which measures if the target level of the technical provisions is adequate, is showing "Amber" at the end of February, which would question if a sufficiently high technical provisions was being set if the monitoring approach was adopted.
- The deficit recovery contributions under the monitoring are significantly below that set at the 2018 and 2020 valuation and may be challenged in the course of a full valuation by the Pensions Regulator.
- Both the technical provisions assumptions and recovery plan parameters would be reconsidered by the Trustee in light of detailed advice as part of a full valuation. These would then be subject to consultation with the employers.

Whilst the monitoring at end of February 2022 does show an improved position relative to 31 March 2020 it is within the range of fluctuation that would be expected over the course of an inter-valuation period. If a similar position to the monitoring was established at a valuation it may be possible to reduce contributions or increase benefits or a combination of both.

Limitations of monitoring calculations

The monitoring calculations are not as accurate as a full valuation because they do not take updated member data into account (the position is rolled forward from the valuation date in line with the valuation assumptions). In addition, other approximations are made within the monitoring.