USS

Webinar: A briefing for sponsoring employers on the 2018 valuation

Date: Thursday 21 February 2019

Overview: In support of the Trustee's consultation with UUK on the Technical Provisions assumptions for the 2018 valuation, members of USS's Executive team will be providing sponsoring employers with a briefing on the scheme's funding position, key issues under consideration, and the potential role of contingency contribution arrangements.

Presenters:

- Bill Galvin, Group CEO
- Guy Coughlan, Chief Risk Officer

Transcript

- ***From 1:40***

The **2017 valuation** was submitted a few weeks ago.

It was the culmination of almost three years of engagement that began with a discussion forum on the methodology and an in-depth independent analysis of the employers' covenant and the expected growth of the sector. It involved consultations on key assumptions such as inflation and salary growth, risk appetite, mortality, and the investment strategy.

The conclusions we came to were very challenging, but they were the result of exhaustive and extensive analysis and scrutiny. It is important to note that the trustee engaged with the regulator in detail on the methodology, assumptions, and the funding path – and challenged robustly the regulator's assessment of the strength of the employers' covenant.

The outcome:

- As at 31 March 2017, we had a funding deficit of £7.5bn in respect of pensions members have already earned
- The cost of funding the benefits members are earning today has increased – the assets we need to buy with contributions coming into the scheme today, in order to generate the cash flows we need to pay benefits in the future, are more expensive; so we're having to pay more to get less in return than in the past
- The 'self-sufficiency' deficit was £22.4bn; a rise of almost £8bn from the 2014 valuation
- The outcomes were influenced in large part by market conditions at that time (asset prices; the position of gilt yields; the reduced outlook for future investment returns) and crucially, the level of risk employers told us they were willing to support.

The absence of a decision from the **Joint Negotiating Committee** on how to respond to these issues resulted in the default cost-sharing rules being applied, and the contributions required of members and employers will – as a result – increase in April 2019, October 2019 and April 2020.

Five per cent of the total contribution will, from April 2020 and for more than 14 years thereafter, be dedicated specifically to repairing the deficit.

That is marginally lower than the 6% originally proposed by Trustee, as it agreed to incorporate a level of investment outperformance in the recovery plan.

It did so in recognition of the feedback from employers to UUK's autumn consultation on the **JEP report** – commissioned by our stakeholders to help them to find a way forward in their discussions – and, in particular, their tentative willingness to take more risk in the investment strategy.

This was the extent that we could, materially, respond to such feedback in the final stages of the 2017 valuation.

By their very nature, the JEP report's recommendations would require employers to take on more risk in funding the scheme than they had expressed a willingness to in our consultation for the 2017 valuation.

The JEP report did not quantify the risks inherent in its proposals, or how any additional risk might be supported.

To reassess the willingness of employers to support such recommendations and to determine the contingency measures that would support the scheme in the event of risks materialising, the trustee needed to engage again with employers on these issues.

As the statutory deadline for completing the 2017 valuation had already passed, at the end of June, the most appropriate way to do that was to embark on a new valuation process – as at 31 March 2018 – so that these issues could be addressed properly.

A new valuation would allow a sufficiently robust, coherent, informed and internally consistent position to be developed, and the latest data and market experience to be properly incorporated.

This brings us on to the 2018 valuation.

- ***From 7:20***

In **the consultation document**, we've set out the changes in market conditions and demographic assumptions experienced between 31 March 2017 and 31 March 2018, the different risk measures that could be used to assess the impact of different funding assumptions, and the credible risks facing the scheme should experience be worse than our prudent expectations.

In summary: gilt yields continue to be volatile and we have seen less reversion than expected, but our investment performance to the end of March 2018 had been better than expected – relative to our best estimate.

Our updated mortality assumptions – reflecting another year's experience of our member-specific analysis – have had a marginally positive influence on the liabilities, and our outlook on investment returns – based on our fundamental building blocks approach – are more optimistic, which also reduces our liabilities.

In weighing up these key assumptions, and the amount of risk that can be taken, we've arrived at the contribution rate required to fund the current package of benefits:

This is on the basis of the same assumptions that were applied for the 2017 valuation being updated to reflect the latest analysis – as we would for any valuation.

We've also made an early allowance for the forthcoming change in the national retirement age from 65 to 66 (which comes into effect in October 2020, and which has a positive effect on our liabilities).

That results in a deficit on a technical provisions basis of £3.6bn, the self-sufficiency deficit stands at £20.8bn, and the combined contribution rate for future accrual alone – that is, not including the deficit recovery contributions – would be 28.7%, compared to 30.6% under the 2017 valuation.

I know many of you would welcome further clarity on the rate of deficit recovery contributions incorporated into the Recovery Plan for the 2018 valuation.

A critical factor in a Recovery Plan is understanding how much risk the trustee is prepared to take in restoring the scheme to full funding.

This risk comes in several pieces.

Critical ones include: how long is the recovery plan? The longer it is, the riskier it is – as it depends on institutions coming up with money far into the future.

Also – the level of investment returns that are assumed in returning the scheme to full funding. If we assume higher investment returns as part of the recovery plan, there would be less cash coming in from the sponsors, which adds to the uncertainty.

However, the level of risk in the recovery plan is not something you can consider on its own: it is related to the level of risk in the underlying technical provisions of the scheme – in the underlying assumptions.

The higher the risk you are putting into the underlying assumptions, the less opportunity you have to allow for more risk in the recovery plan.

These account for some of the moving parts between the 2017 and 2018 valuations.

To the extent that 2018 anticipates taking slightly more risk in the underlying assumptions, it is very difficult then to go the recovery plan and look to lengthen it or add in greater degrees of outperformance – because these things are all related.

There are also other considerations:

While the deficit on a technical provisions basis has improved considerably, due in large part to more optimistic assumptions on future investment returns, <u>the self-sufficiency deficit is still above £20bn</u>.

That is more than twice the level of reliance that employers told us they were ultimately willing to support, in the long-term, in carrying out the 2017 valuation.

A defined benefit pension like the USS Retirement Income Builder is highly valued promise, of a set level of income in retirement, protected against inflation.

So the level of certainty we need to have in the security of members' benefits must be high – but the future is inherently uncertain.

The self-sufficiency deficit is a measure of the additional assets we would need to be available to fund the scheme with a very high probability – a greater than 95% chance – such that all the benefits members have earned to date can be paid when due without the need for any further contributions.

Although we do not target this level of funding – or the asset mix it would require – the difference between the assets required under self-sufficiency and the assets held today is one measure of the risks we are running in funding the scheme – one measure of the reliance we ultimately place on employers to fund benefits if experience is significantly worse than expectation.

So the trustee needs to be satisfied that it is, credibly, within the reach of the employers and the sector.

If our funding assumptions are borne out then we can expect the risks and costs to decrease over time. However, today the scheme is close to the limit of the level of risk the Trustee can accept.

In relying on assumptions as to how investments and interest rates *could* perform over time to fund benefits, the Trustee must also have credible options for dealing with experience being materially *worse* than expectations.

This reflects the primary fiduciary duty of the Trustee: to protect the promises made to members in the past as well as those being made today.

The funding requirements for both the 2017 and 2018 valuations reflect the current funding position, expectations, and our view of the risks. They also sit against a backdrop of experience proving to be detrimentally worse than the expectations laid out under the 2014 valuation.

So we cannot simply take our assumptions for granted, and at more than £20bn, the scheme is towards the upper limit of the amount of risk it believes it can take on a self-sufficiency measure.

We therefore need to respond to the challenges of the short term risk position to ensure that we can maintain a credible path to the desired position in 20 years' time – which is full funding on a technical provisions basis and reliance being at £10bn. The Trustee believes it has a credible path to reaching this position – but it is by no means risk-free.

The degree of uncertainty faced by the scheme and its employers has increased since 2014, with the review of tuition fees and the status of Brexit just two factors alongside the current size of the self-sufficiency deficit.

Recent market conditions have not helped the situation with asset values falling, reflecting the prevailing uncertainty. Indeed, many investors have recently experienced a period of negative equity returns.

To repeat: a defined benefit pension is based on a promise, but it is difficult to know – with certainty – just how these factors will develop. This uncertainty is reflected in our proposed contribution rate for the current package of benefits under the 2018 valuation: 33.7%, which (absent of any contingent support) involves deficit recovery contributions of 5%.

This rate involves, on some measures, an increase in risk compared to the 2017 valuation – as Guy will go on to demonstrate – and allows for a number of the JEP proposals.

Adopting all of the changes proposed would fall outside the Trustee's risk appetite but we believe, subject to an appropriate level of contingent support being put in place, that a contribution rate below 30% could be acceptable.

However, these contingent support arrangements must be robust and credible and must demonstrate that they are capable of dealing with experience being materially worse than expectations and must provide greater confidence in the resilience of the long-term funding path.

If these conditions are not met, then the contribution that is required for the scheme under the 2018 valuation is 33.7%.

Guy will now talk you through the different measures of risk we can apply in assessing the overall positon – and the potential role of contingency contributions.

- ***From 19:25***

The contribution rate the trustee requires in this valuation – or indeed, in *any* valuation – depends on the amount of risk that is being taken.

The Trustee's risk appetite is coloured by its observations of the funding level in technical provisions terms, but also by its measures of risk; one of which – a very important one – is the self-sufficiency deficit, which has increased from something in the order of £14bn in the 2014 valuation to more than £20bn in the 2018 valuation.

This reflects a substantial increase in the short-term risk associated with the funding plan for the scheme.

The risks that may blow us off course in terms of our long-term strategy include:

- Risks to future asset returns – we may not make the returns on our investments that we are anticipating;
- Risks to liabilities – we may find that inflation takes off in an unexpected way and therefore liabilities grow to a larger degree than we forecast;
- We may find that gilt yields go beyond where they currently are - at negative real levels - and fall substantially further.

Any of these outcomes, or indeed a combination of adverse outcomes of these kinds, would lead to a funding level that was significantly below what we had been projecting in 17 years' time.

Of the proposals put forward by the JEP, three are fairly standard considerations in any valuation and – arguably – do not increase the risk in funding the scheme.

(I have reordered the adjustments for reasons that will become apparent later in the presentation)

These are:

- Incorporating realised investment returns
- Incorporating the latest mortality experience data
- Using updated future expected investment returns **from the FBB approach**

(I say "arguably" because our outlook for future expected returns has improved marginally and, as we cannot simply take our assumptions for granted, this could be seen by some as additional risk.)

The remaining proposals each involve a greater reliance on return-seeking investments, and therefore a greater risk that the funds we expect to generate over the recovery period may not materialise. These are:

- Increasing target reliance at 20 years from £10bn to £13bn in real terms
- Deferring de-risking for 10 years
- Smoothing contribution rates over two valuation cycles
- Allowing for investment outperformance relative to the technical provisions discount rate in the deficit recovery contributions

Individually, each of these potential changes is worthy of consideration and could well be acceptable in the context of the 2018 valuation.

However, all changes must be considered collectively in terms of their overall impact on the aggregate risk in the valuation – and set against a balanced judgment on an acceptable risk position.

Note that, although it did not quantify the risks associated with its proposals, the JEP report did recognise that there were a number of different paths the Trustee could adopt which would to lead to a required contribution rate of below 30% of salary.

Adopting *all* of the changes proposed would fall outside the Trustee's risk appetite but we believe that a contribution rate slightly below 30% could be acceptable provided it was subject to an appropriate level of contingent support being put in place to help offset the additional risk involved.

To date, no decision has been made on which of the changes that increase risk would be adopted.

As we've already covered, the current risk position on a self-sufficiency basis is far beyond where employers have said they want us to be in the long-term, and is towards the upper limit of what we believe we can expose the scheme to in the short-term if we are to maintain a credible path to the desired position in 20 years' time.

To rehearse some of the key uncertainties here: tuition fees, the status of Brexit, and recent investment market conditions. All these issues, and others, require careful consideration when set alongside the current scale of the self-sufficiency deficit.

It is difficult to know – with certainty – just how these factors will develop.

As a point of reference, let's look at how the 2017 valuation stacks up against different combinations of the JEP proposals.

We can look at different risk metrics – and it's important to note that no one risk measure is perfect in isolation. It's important, in reaching a balanced judgement, to triangulate an assessment by reference to a number of different measures.

This chart is showing one measure of the aggregate risk in the average discount rate. The higher the discount rate, in general, the higher the risk in the valuation.

This chart shows the real discount rate (spread over CPI inflation) for different valuation bases

The September 2017 TP Consultation (indicated by the dotted red line) is the benchmark for this risk, because that was the level at which the employers and many external third parties suggested was at the limit of maximum acceptability back in 2017.

The final 2017 valuation basis was lower risk (second red bar).

The last two red bars reflect the 2018 valuation incorporating different JEP proposals.

The third bar incorporates JEP proposals 5 & 6 (updating mortality and asset growth, and future expected returns).

If we look at the spread over gilts instead of over CPI we get a similar picture: that the 2018 valuation is higher risk than the final 2017 valuation. This is true on both measures.

The extent of support available from employers will be key to just how much additional risk the Trustee could accept in setting a regular, fixed contribution rate for the 2018 valuation.

Remember: we cannot simply take our assumptions for granted, so what we're looking at here is the risk of *experience* being detrimentally worse than *expectation*; the risk that we've been *overly optimistic* in our assumptions as to how the future might unfold.

This is precisely what happened after the 2014 valuation: market events – particularly gilt yields – evolved in a way that was completely unexpected and we saw a significant increase in the deficit.

So let me expand on some of my opening points and look at some credible examples of what that could look like for the 2018 valuation.

We have analysed different possible future scenarios for reliance over the next three years.

- If our "best estimate" assumptions are borne out as expected we get the green bar. Reliance of £14bn – on a best estimate basis.
- But there are scenarios for gilt yields and investment returns that could see reliance much higher, more than double that amount – some £33bn if you take the last chart.
- So there are credible risk events in which reliance rises significantly.

As the slides I showed before demonstrate, by some measures the 2018 valuation will result in more risk being taken than the 2017 valuation.

So the trustee is willing to take some more risk than in the 2017 valuation.

But for it to take *more risk* than is already built into the 33.7% "upper bookend" would require a suitably robust contingent contribution arrangement being agreed, given the current risk position and uncertainties we face.

What we'd be doing with contingent contributions is putting in place an arrangement such that contributions increase *only when they're needed*.

This is, arguably, much better than just having a fixed contribution that must be paid when there are good outcomes as well as bad outcomes.

By introducing the contingent mechanism, it means we only get the contributions when the outcome warrants it.

So what does this kind of arrangement look like?

Well, we've been engaging with UUK and their actuarial advisor Aon since the start of the consultation to inform what a proposal will need to deliver.

We have produced, and tested, a set of principles together with a high level framework that would need to be satisfied for an arrangement to be acceptable to the Trustee, and we are actively engaging with UUK as they develop their proposition.

Given the importance of this, we've extended the deadline for the consultation to allow more time for these issues to be discussed – with us and, more importantly, with you as the employers.

If the right conditions cannot be met for a contingent contribution arrangement, the trustee would have to look to its "upper book end" rate of 33.7%.

However, if the right conditions can be provided, the trustee could accept a regular contribution rate that's below 30%.

- ***From 37:34***

We’ve tried to lay out how there is the potential, with a mixture of fixed and contingent contributions, to reduce the contribution level that is required under the 2018 valuation.

It must be said, though, that the timescales are challenging: the deadline for completion of the 2018 valuation is 30 June 2019.

As we’ve set out today, the conditions are also challenging.

In order to meet this deadline, we must focus our attention on addressing the key issues currently under consideration and the Joint Negotiating Committee’s discussions thereafter.

As such, it is our view that the key consideration for the 2018 valuation is a discussion on contingent contributions – and this is a genuine consultation, so we welcome your feedback and thoughts on how such measures could be supported.

In bringing the formal presentations to a close, I want to leave you with a clear understanding of the trustee’s position:

- The primary duty of the trustee is the security of the pensions that have been promised.
- A USS pension promise is a secure and valued promise – and the trustee *cannot* let that deteriorate.
- In meeting this promise, we have a duty to protect the scheme – and employers – against the potential impact of experience being detrimentally worse than expectation.
- The degree of uncertainty faced by the scheme has increased: with tuition fees, Brexit, investment market conditions, and the self-sufficiency deficit among the key concerns.
- The cost of funding the benefits members are earning today has increased – we’re having to pay more now, to get less in return, than we have in the past.
- The scheme is currently close to the limit of the level of risk the Trustee can accept in meeting the promise that has been made to members.
- It is our legal responsibility as trustee to manage the scheme responsibly into the future.
- We cannot take our assumptions for granted.
- If our funding assumptions are borne out, we can expect the risks and costs of the scheme to decrease over time – but this is by no means risk-free, and careful management and a clear strategy for managing the risks is required.

Thank you.