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Your ref	
Our ref	DKB/JMR
Date	1 October 2021

By email only

Dear Alistair

Thank you for your thorough response to our consultation with UUK on the draft Schedule of Contributions (SOC), Recovery Plan (RP) and Statement of Funding Principles (SFP) for the 2020 valuation.

A considerable effort from all parties has been required to develop and understand the Dual-Rate SOC approach and, given the lateness of the JNC's decision, the timelines have been challenging for everyone.

While we recognise the strength of feeling among employers about several aspects of the valuation, the Trustee Board is disappointed that the nature of our engagement through this valuation is not well reflected in the response. The board and the executive have worked diligently to achieve the best outcome for stakeholders from the difficult circumstances surrounding this valuation. In particular, we took considerable time and care to arrive at the positive decision to support UUK's request, via a JNC recommendation, for the Dual-Rate SOC.

Our collective efforts have provided a route through to introducing a new SOC under the 2020 valuation assumptions, thereby replacing higher contributions scheduled for 1 October under the 2018 valuation.

We will now file the 2020 valuation, noting that this will be three months after the statutory deadline.

The valuation framework secures very welcome upfront commitments from employers to provide additional covenant support, placing the scheme on a much more sustainable footing. We are also pleased that it responds to concerns about the potential for further increases in member opt-outs on grounds of affordability, given the contribution rates that would otherwise have applied under the 2018 schedule.

The Trustee Board has carefully considered your response to the consultation and made amendments where possible and appropriate.

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As you are well aware, the next important step is the employer-led consultation with affected employees (and their representatives) on the Joint Negotiating Committee's (JNC) proposed changes.

We are aiming to be in a position for employers to launch their consultation around the start of November, and for it to run until mid-January. If there are any subsequent changes to the JNC's proposals, following the employer-led consultation, we would need to consider the effect of such changes on the required contributions and may have to consult UUK again on the SOC, RP and SFP.

The effect of any changes would depend on their scale and nature. Some changes could be implemented more easily and more quickly than others. Other changes would require reconsidering certain aspects of the valuation and would take more time.

1. **The duration of the consultation**

   We do not underestimate the challenges for employers and the JNC in working through the issues raised by this valuation. The challenges raised by the pandemic have required very careful investigation of covenant support and financial assumptions by the trustee, and complicated considerations from employers on issues such as covenant support measures and contribution affordability.

   Everyone involved has, as a result, had to work to an evolving and dynamic plan. We have, however, been very clear on the key issues and have been as accommodative of the timeline pressures as possible, given the context and backdrop.

   As you may recall, we first set out an indicative timetable for the 2020 valuation in December 2019. We subsequently extended the windows for comment on both the Discussion Document (issued March 2020) and the Technical Provisions consultation (issued September 2020) to eight weeks in each case. The Rule 76.4 contribution determination was issued to the JNC on 3 March 2021, after allowing for additional time to hold a series of detailed and robust discussions with The Pensions Regulator (TPR) – as detailed in our Trustee Update. In May 2021, the JNC requested (and was granted) a three-month extension – giving it six months in total to make its decisions.

   The decisions the JNC needed to make for the SOC/RP/SFP consultation to be launched were not made until 2 September. As agreed with UUK, the consultation was then held over two weeks. There was no alternative route to introducing a new SOC by 1 October 2021 that would satisfy our legal and regulatory duties as Trustee. A longer consultation would have resulted in the rates set under the 2020 valuation not coming into effect until April next year, and the total contribution rate increasing to 34.7% from 1 October under the 2018 valuation, which is something UUK wanted to avoid. We also wanted to ensure, based on the feedback we have received, that employers' payroll teams had the time required to process new contribution rates.

   The timescales and associated pressures involved with the Dual-Rate SOC approach were made clear to UUK ahead of the JNC's decisions, and we engaged with employers' payroll teams to set out the sequencing and dependencies.

   The JNC's decisions were considered by the Trustee Board within 24 hours (Friday 3 September). The consultation materials were issued to UUK the next working day (Monday 6 September).

   We strongly agree that, ideally, the valuation process would not see decisions being delayed until the latest possible dates that only just allow for implementation. This places significant pressure on

all those involved in the closing stages and our ability to engage effectively with employers and members. We would very much welcome discussions as to how the timelines generally can be streamlined as part of a review of valuation governance.

2. The contribution rates

The cost of funding the benefits proposed by the JNC and repairing the deficit in respect of past service has been set at 31.2% of payroll.

As set out in our letter to you of 28 June 2021, this reflects our very careful consideration of UUK's pricing requests, the position in relation to the covenant support package, the reduced DB risk from UUK's proposed benefit reforms, and post-valuation experience, as well as advice from the Scheme Actuary and our covenant advisor.

We have pushed the boundaries of our risk appetite as far as we believe is acceptable, given the level of covenant support which we consider achievable, to get close to the 30.7% total contribution rate that UUK have requested. This was not an easy position for the Board to reach. Indeed, Ian Maybury gave notice of his resignation from the Trustee Board on grounds that the rate of 31.2% would "leave a residual risk to accrued benefits that was, in his judgement, too great".

Our briefing document on the likely outcome of a 2021 valuation explained that, in terms of the total required contribution rate, "…we would not expect the outcome of a 2021 valuation to be materially different from the 2020 valuation: while we compensated for exceptional market conditions as at 31 March 2020, the same adjustments would not automatically carry over to a 'more normal' 2021 valuation".

Interim monitoring has shown that the future service cost has continued to rise and that, even under the benefit reforms proposed by the JNC, the deficit at recent month-ends would still likely have been higher than under the 2018 valuation.

In its letter of 24 September, TPR has reiterated its view that the "appropriate" overall contribution rate for the 2020 valuation, based on the benefits proposed by the JNC, should be "at least 1 to 2% of salaries higher". TPR also states "although we are not comfortable with total contributions of 31.2% of salaries, we view this as a marginal situation and would not expect to take further action".

Even with the full covenant support measures in place, current benefits would have a future service cost higher than 31.2%. So, by introducing this rate now, in advance of benefit reform, we are arguably underfunding members' benefits.

TPR also notes: "Because the cost of providing the current level of benefits is significantly higher at the 2020 Valuation than at the previous valuation, the Scheme has effectively been receiving no DRCs since the valuation date."

Affordability

The question of affordability, in respect of the second 'leg' of the SOC, is nuanced. We must ensure that deficit recovery contributions (DRCs) are 'affordable'. Under the second 'leg' of the SOC, the highest DRCs reach is 20% from 1 October 2025. The affordability of the future service cost is ultimately a matter for the JNC to consider and decide upon.

PwC has indicated to us that employers have flexibility to vary their costs over time to meet financial commitments. This is why, under the second 'leg', contributions are stepped up over a period of four years. As with the 2018 valuation, this gives employers time to readjust their cost base – albeit a variety of steps would need to be taken by institutions, including cost-cutting (and we understand that these would be very far from desirable or optimal for many institutions). This phasing also gives the JNC opportunity to make decisions on benefit changes or covenant support measures before contributions step up.

We have published various covenant analysis over the course of the 2020 valuation and are happy to discuss with UUK what further analysis might be helpful in this space.

3. Deficit Recovery Contributions (DRCs)

The degree to which benefits are under-funded affects the point at which DRCs would be introduced. Under the first 'leg', they are under-funded for six months. Under the second 'leg' they are under-funded for 12 months – and the deficit is larger. This leads to a different phasing of DRCs under the different legs of the SOC. This might appear "arbitrary", but it is actually a consequence of adopting the Dual-rate SOC approach.

In terms of who pays DRCs, the "default" cost sharing rules are not relevant here as there has been a decision of the JNC. In any event, the Scheme Rules do not specify how individual elements comprising the total contribution rate are allocated. Consistent with the practice in previous years the Trustee has determined that the full amount of DRCs is included as a sub-element of the employer contribution.

One of the reasons for this is the fact that members can choose to leave the Scheme at any time without any obligation to pay any further contributions and with no impact on the benefits they have accrued at that point. In contrast, employers are required to pay a Section 75 debt. There is also a link to the process for accelerating deficit contributions (where full deficit contributions are within the scope of the acceleration provisions).

3.1. Enhanced Opt-Out and Voluntary Salary Cap rates

In line with the approach set out above, DRCs are paid by employers in respect of members on Enhanced Opt-Out and Voluntary Salary Cap rates.

For the reasons set out in Q14 of the Q&As published in support of the consultation, these rates will accordingly increase to 6.3% from 1 October 2021. That is 0.3% higher than the rates employers will have prepared for based on the SOC for the 2018 valuation.

We could consider not charging DRCs in respect of these members, but the resulting shortfall would require higher DRCs in respect of other members.

We would be happy to discuss alternative approaches to DRCs in future. We are also happy to discuss how communications to employers could be made clearer or more frequent in future if this has led to specific challenges with budgeting and preparing for the 1 October 2021 changes in some cases.

3.2. Accounting requirements

We would be happy to facilitate discussions on FRS102 requirements and, as we have done in the past in liaison with BUFDG, help finance departments in their modelling of their own liabilities (acknowledging that, as you recognise, we cannot give accounting advice). For the accounting year ended 31 July 2021, we believe that the FRS102 liability should be based on the 2018 SOC. To the extent that the accounts are published after 30 September 2021, we expect there should be disclosure of the post balance sheet date conclusion of the 2020 valuation.

4. The Recovery Plan

An 18-year Recovery Plan (RP) is now unusual for UK defined benefit pension schemes in the current regulatory environment. Our conclusion – that it is appropriate for the 2020 valuation – reflects the particular market conditions at the valuation date.

A necessary condition for securing an 18-year RP as at 31 March 2020 was a moratorium of greater length – but this was not sufficient in and of itself. The value of the moratorium is, of course, primarily reflected in the covenant rating and our consequent ability to use more optimistic discount rates. We consider the length of the RP to be appropriate in the context of the circumstances of the Scheme, including the covenant support available, and the particular market conditions as at 31 March 2020.

We have adjusted the wording in the SFP accordingly.

We would also point to our correspondence with TPR on this issue over the course of the valuation, most notably its letter of 14 July 2021.

Future valuations

We have been clear that the value of the covenant support measures (if rolled over) will also be recognised in future valuations and have set out how we intend to assess those measures consistently.

At future valuations, we would similarly expect to adopt an RP appropriate for the circumstances of the Scheme, the covenant support available, the prevailing market conditions and the regulatory environment at that time.

We must reiterate that the moratorium is part of a package of support required to achieve a strong covenant for the 2020 valuation. The strength of the covenant is critical to the amount of risk we can contemplate taking *overall* in our funding plan. Its value is reflected most fundamentally in the discount rate – key to the future service cost and size of any reported deficit – and not solely in the length or optimism of the RP.

As UUK has itself pointed out, the commitments employers have made for the 2020 valuation equate to £1.3bn a year in terms of their effect on the discount rate and the required contribution rate. We have to guard against the value of the covenant being 'double counted', and that is why the RP always needs to be considered in the context of each valuation and against the overall risk position.

5. The debt monitoring framework

We note that UUK is generally supportive of the debt monitoring and *pari passu* framework. The Trustee Board has now approved the final documentation and it will be shared with employers in a letter due to be sent this week. It has been updated (as set out across Q6 and Q7 in our consultation FAQs document here) to reflect our discussions with UUK over the past six months and the supplementary explanatory material that was published in June.

The issues raised in relation to accelerated contributions are addressed in the framework document itself. It would not be appropriate to include this further level of policy detail in the SOC, which is a technical document, and further:

- The Trustee's power to accelerate contributions derives from Rule 6.1 and is not limited to implementation of a benefit change deed in that sense. You have told us, however, that the support of UUK and employers for the covenant measures under the second 'leg' of the dual rate SOC does not extend to the *pari passu* arrangements.
- Including reference to "exceptional circumstances" would have the effect of fettering the Trustee's broad power under the rules, which Trust Law prohibits.

We will, of course, keep the operation of the framework under review and seek feedback regular from employers.

The aspects relating to accelerated contributions have already been consulted on and, like the debt monitoring and *pari passu* arrangements, will be effective as of 1 October 2021.

Benefit change deed

The wording in respect of "benefit change deed" in the SOC, RP and SFP are broadly aligned. The SOC necessarily contains greater detail and is the formulation which should remain, as the Scheme Actuary needs certainty as to when and in what circumstances contributions are due, in to be able to provide his certification. We have, however, made some clarifications by aligning the wording in the RP and SFP with that in the SOC, to ensure the language is more consistent across the three documents.

6. Key dates

28 February 2022 is an operational deadline to allow sufficient time for us to work with employers' payroll teams for a change of contributions to be implemented and consult UUK on any further adjustments to the SOC/RP/SFP following the consultation with affected employees on the JNC's proposed benefit reforms. There is very limited flexibility – if any – to delay this date further given the operational dependencies, in much the same way as we needed a JNC decision by 31 August to introduce a new SOC by 1 October. Your comments in relation to the length of the SOC, RP and SFP consultation are also noted.

If a benefit change deed is not executed by 28 February 2022, we will need to begin to implement the second 'leg' of the SOC. The Q&As published in support of the consultation cover this in more detail.

Given the 28 February 2022 is still five months away, and clear notice has been given to all parties of this date, it should be possible for the stakeholders to have progressed and concluded their discussions by that date without needing to jeopardise the delivery date of 1 April 2022.

7. Looking forward

We look forward to actively supporting stakeholders as they consider progressing with the future-facing issues raised by UUK, namely:

- development of a lower cost pension saving option within the Scheme and other member options and flexibilities
- the initial exploration of conditional indexation or other similar benefit designs
- a governance review

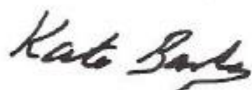
We look forward to immediate discussions with the stakeholders about how they plan to develop and mobilise these workstreams – including defining their scope and agreeing the collaborative working arrangements and resourcing commitments required of all parties. We will engage fully in these activities, but the conclusion of any of these work programmes by any future milestone date is a matter that only the stakeholders can underwrite.

In closing, I want to thank you and your colleagues again for your engagement and challenge throughout the valuation process. It has demanded a lot of all parties over a sustained period of time and in unprecedented circumstances. The changes being progressed will put the Scheme on a much more sustainable footing for the long-term. At the same time, they will maintain USS's position as one of the relatively few private schemes in the country still offering a valuable defined benefit pension to new and existing members.

The final documentation will shortly be filed with TPR and published on the USS website. We note that, absent any material change in circumstances, TPR does not plan to carry out any further investigations or raise further queries in relation to the 2020 valuation beyond those noted in its latest letter.

Our attention is now resolutely focused on supporting employers through their forthcoming consultation with affected employees on the JNC's benefit proposals, the operation of the debt monitoring and *pari passu* framework, and supporting stakeholder discussions on the future-facing issues referenced above.

Yours sincerely



Dame Kate Barker
Chair, USSL Trustee Board