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Your ref
Our ref DKB/JMR
Date 28 June 2021

By email only

Dear Alistair

Thank you for your continued engagement on the valuation and for the significant work you are doing with employers to support them through this process.

I am writing in response to your request of 16 June for further information and clarification from the USS Trustee on the pricing of UUK's proposed package. Our Board meeting on 16 June recognised that UUK is carrying out a further two week consultation with employers.

I understand employers' frustration at what they may perceive as spurious "decimal point accuracy". Please be assured that we do understand the bigger picture: the valuation is a hugely complex process and there are many uncertainties. And while we would, all other things being equal, wish to be as accommodative as possible to stakeholder wishes, we have a responsibility to ensure pensions are adequately funded, and even small discrepancies, and small percentages, can be costly and significant when projected out over the decades. The Board considered the position and the arguments UUK had put forward very carefully before concluding on its view.

I have set out the Trustee's responses to the six questions you posed. We are of course happy to discuss these matters further with you, and we appreciate the opportunity we had for the USS executive to provide an update to UUK's Employers Pension Forum last week. We note the request from employers for clear communications on these matters.

On your specific questions:

1. **"Why is the 0.5% difference considered so material to long-term USS funding, and what is the objective reason why the USS Trustee, and/or the Pensions Regulator, considers that it is so essential (especially given the other favourable movements at this valuation, notably on covenant and on future DB risk)?"**

   We have considered very carefully 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, and have taken 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.

This has included adopting one of the specific combinations of pre-retirement discount rate and recovery plan parameters that UUK/Aon proposed in their consultation with employers. The result is a contribution rate of 31.2% of salaries. This is a significant movement from our previously stated position.

We noted in our letter of 9 June that there were a number of adjustments required that meant that a contribution rate of 30.7% was not considered acceptable. Taken together these adjustments, which are allowed for in the 31.2%, amount to a c0.7% of salaries increase in the total contribution rate required: +0.3% of which relates to the movement in the assumed implementation date for benefit reform from 1 October 2021 to 1 April 2022 and +0.4% to the adjustments to liabilities in relation to deferred members with short service benefits and late retirement entitlements. As noted in the 9 June letter, the need for a potential adjustment in relation to short service benefits was initially signposted to in the Rule 76.1 Report. Having investigated these matters and received further advice from the Scheme Actuary, we now need to allow for them in the valuation.

Had we priced UUK's alternative benefit package simply based on the 'Scenario 3' assumptions from the Rule 76.1 Report, the result would have been a 34.7% contribution rate, prior to adding the above adjustments.

Compared with this, the combination of the Trustee's counter proposal on the covenant support package, the reduction in DB risk, and post-valuation experience has led to an overall reduction in the pricing of more than 3.5% of salaries.

We understand that UUK has engaged directly with TPR in recent weeks. TPR set out its views in its letter to us of 11 June that was copied to UUK. We have now also published this letter in the Engagement section on our website.

2. **"In your letter you explain that the price "*with UUK's benefit proposals with the covenant support details in your* [UUK's] *consultation would still be materially higher than your target contribution rate of 30.7%*". What would the price be on this basis, which effectively reflects the difference between pari-passu arrangements with a trigger at 10% or 15% of assets? If there is a value being placed on there being no gap between the short and long-term moratoria, what is the value being attributed to this?"**

The longer rolling moratorium is a very welcome development and we have placed a significant value on it, both through a longer recovery plan and our consideration of the overall risk position and assumptions.

However, as noted in our letter of 9 June, UUK's proposal also contains elements which act to weaken the covenant package, including the 15% test for Metric E, limiting the debt monitoring framework to 'material' employers and the risk of a gap between the moratoria.

Overall, our assessment is that these factors are a net weakening of the covenant compared to 'Scenario 3' (for which we had previously indicated a contribution rate of 34.7% for the UUK alternative benefit proposals, if we simply use the 'Scenario 3' assumptions from the Rule 76.1 Report) and hence our conclusion that the contribution rate would be materially higher than 30.7%. Precisely how much higher would depend on the detail of each of these different factors.

In arriving at the Trustee's contribution proposal, we believe we have specified assumptions which are likely to be achievable by the employers through the covenant support we have proposed and which, in aggregate, represent a marginal strengthening of the covenant as compared to 'Scenario 3'.

On the specific changes to the package:

- We regard the 10% in the tests for Metric E as significant because it represents the amount of security each employer can grant to other creditors before the Trustee can require pari passu. Above the 10% threshold (and excluding debt existing at 1 August 2021 and other exemptions), the Trustee can seek pari passu on 50% of the remaining value (i.e. matching other secured creditors). Whilst many assets in the sector are of high quality, in the event of insolvency, the distressed, 'alternative use' value of some assets could be significantly reduced and a high value already prioritised to other creditors could materially impact the amount available to the Trustee. Note the 10% is consistent with our proposal when we began engaging with UUK and employers on this issue in Spring 2020.

- We have confirmed that this package of support would allow us to exclude the 61 Limited Participation Institutions from action under the debt framework (including pari passu) in addition to the de minimis rules set out in 'Scenario 3' while maintaining the view that the covenant can be assessed as Strong. We believe this is a significant movement on the Trustee's part.

We would not be able to place a value (or receive covenant advice) on the gap between the short and long-term moratoria without further details on the length and other terms of the gap and, in particular, an assessment of the likelihood of any significant employers leaving during that period. This is one of the reasons we have stated it is difficult to price the UUK covenant support package as proposed in the consultation.

3. **"Can you explain how you believe the difference in contribution requirements of 0.5% might be bridged?"**

The options include consideration by the JNC of changes to the proposed benefit structure under Rule 64.10; either in relation to contribution splitting or through further adjustments to the proposed hybrid benefit structure parameters. We are happy to support UUK in further considering these options.

4. **"In your letter dated 9 June 2021 you state that you will continue to monitor and consider the effect of post-valuation experience until the 2020 valuation is signed; how would any changes be reflected?"**

We have had regard to post-valuation experience in pricing the UUK alternative benefit structure as at 31 March 2020, and have explained in the 9 June letter how that reinforces our confidence in the adjustments made to the technical provision assumptions as at March 2020, and supports the pricing outcome and the overall level of risk being taken in this valuation. While we would always need to be alert to any material changes (either positive or negative) and to consider the advice of the Scheme Actuary in our response, we think it unlikely there will be much scope for further movement from post-valuation experience. TPR has shared their views in their 11 June letter.

5. **"Would the USS Trustee be willing to take a second opinion on the value which it proposes to attribute to the covenant support measures, and the importance (and precision) of this difference in the levels of threshold within the proposed pari-passu arrangements?"**

We have carried out a comprehensive assessment of the covenant position and have relied upon significant amounts of detailed, independent, specialist covenant advice in relation to both the overall assessment and the value of the covenant support measures. We believe we have given the covenant support measures full credit through the pricing of the overall package and have concluded that under either 'Scenario 3' or the Trustee's counter proposal to UUK we can assess the covenant as Strong. We have also allowed for an 18-year recovery period from March 2021, as proposed in UUK's consultation, which we consider exceptional.

We have spoken to UUK and many individual institutions as part of the covenant assessment process, and in detail on the covenant support measures through the formal working groups, and through informal groups, 1:1s and webinars. We have also discussed covenant matters (including the covenant support proposals) at length with TPR and we understand UUK has also represented its views on covenant separately to TPR on a number of occasions. TPR has stated in its latest letter that it continues to view the covenant as at (the upper end) of 'Tending to Strong' under the Trustee's counterproposal for covenant support measures.

We are happy to consider if there is additional or new information, or specific analysis, from alternative sources that UUK believes could alter our assessment of the value attributed to the covenant support measures. However, we would need convincing that the information or any opinion being offered was from an equivalent source given the complexity of the overall covenant assessment and the interlinkages with the available risk capacity calculations and integrated risk management framework (IRMF).

6. "You reference in your letter the delay in implementing any benefit modifications as one factor in deciding on the proposed pricing. You will be aware that there was a delay of approximately three months after Christmas 2020 during which the USS Trustee was in close engagement with tPR; can you say how this has been taken into account in your assessment of the effect, on your pricing, of the commencement date of any benefit modifications?"

We recognise there have been a number of delays throughout the valuation process and that this valuation has been more complex and challenging than any party would have anticipated or wished for.

We fully acknowledge that one of those delays was in relation to issuing the Rule 76.1 Report. However, the additional time spent engaging with TPR between late December and late February was, in our view, necessary and directed at ensuring that the best possible pricing outcome could be delivered to the JNC in the Rule 76.1 Report. We have tried to be flexible with the timeline and process for the 2020 valuation where we can while ensuring that sufficient time is allowed for UUK's own consultation processes with employers, and that a robust process is in place that will ultimately avoid the risk of enforcement action by TPR. We will continue to be flexible where we believe this will be beneficial to the overall valuation process and outcome – for example, by granting the three-month extension to the JNC.

Since the Rule 76.1 Report was issued, we have updated the assumption on the implementation date for benefit change from 1 October 2021 to 1 April 2022. A 1 October 2021 implementation date, even just for contribution changes, would have been extremely challenging under any scenario, given the need for an end of March JNC decision to complete the 2020 valuation by September. However it clearly would have resulted in a contribution rate for UUK's alternative benefit structure closer to the 30.7% proposed in UUK's consultation, were all the other assumptions reached through the engagement around the Rule 76.1 Report process, and thereafter, to still apply. A 1 April 2022 implementation date for both contribution changes *and* benefit change remains challenging given the three-month extension to the JNC timeline, the very significant decisions that are required from the JNC, and the need for statutory consultation processes to be completed.

This change in assumption results in an increase to the contributions (all else equal) as Scheme members are assumed to earn the current (higher) benefits for an additional six-month period. The calculation of the 31.2% contribution rate assumes implementation of those contributions from 1 October 2021. This rate could in practice reduce to 31.1% of salaries from 1 April 2022 if introduced alongside benefit reform from that date, on the basis that the October 2021 contribution increases in the current Schedule of Contributions apply for the period from October 2021 to March 2022.

Finally, we are aware that there is interest from employers in receiving further information from the Trustee on the 31 March 2021 position. We are discussing these issues with the JNC on 6 July and will respond to UCU and UUK more formally summarising our views, and publishing information, following that meeting.

Our view is that the 31 March 2021 position does not deliver a materially different outcome in overall contribution terms than the 2020 valuation given the largely offsetting movements in future service costs and DRCs. A 2021 valuation could also carry some additional downside risks, which fall into two categories. The first category of risks relates to the process and the timeline for finalising the 2020 valuation and implementing the associated changes. The second category of risks relates to the potential outcome of a 2021 valuation, noting that, even under a stream-lined valuation process, we would need to assess any developments that would significantly impact the overall risk position, for example by updating the outlook for HE funding, or taking account of further changes in financial conditions.

I hope this further information is helpful in explaining the position to employers and look forward to hearing the results of your short consultation with employers.

Yours sincerely

Kate Barker

Dame Kate Barker
Chair