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Your ref
Our ref DKB/JMR
Date 9 June 2021

By email only

Dear Alistair

Thank you for your letter of 3 June 2021 and your update on UUK's recent consultation with USS participating employers.

As you know the USS Trustee Board met yesterday (8 June 2021) and we are providing this response in advance of your UUK Board meeting on 10 June.

UUK request for pricing of an alternative hybrid benefit package

You requested the USS Trustee price the alternative hybrid benefit package as illustrated in your recent consultation with employers – that being a 1/85th accrual rate; a £40k salary threshold, and CPI indexation capped at 2.5% for both pension increases and revaluation of future defined benefits that are built up (DC benefits above the threshold remain unchanged).

You asked us to consider the pricing of the hybrid benefit package alongside the alternative covenant support package also set out in your consultation, and specifically for the Trustee to give due recognition to: *"an appropriate deficit recovery plan to reflect the duration of the moratorium that has been put forward"*; *"allowance for post-valuation experience";* and *"the positive value which will be gained from having lesser DB promises built-up within the system going forwards (as would be the case under UUK's illustrative proposal)".*

This correspondence follows our earlier exchanges in relation to UUK requesting the USS Trustee review the funding assumptions underpinning the Scheme Actuary's 76.1 report. You have now confirmed that you have conditional acceptance from employers to the UUK alternative hybrid package. We have had detailed discussions with the Scheme Actuary and our covenant advisor (PwC) on the potential value of the options UUK put forward for discussion and have continued to engage with TPR on these matters as appropriate.

UUK's covenant support package

In relation to the component parts of the covenant support package in the UUK consultation, and having taken further advice from the Scheme Actuary and our covenant advisor, the Trustee's view is that:

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- The 20-year rolling moratorium (23-year initial period) is a welcome and significant commitment from UUK and employers that allows the Trustee, as at 31 March 2020, to:

    i. make the case for a longer recovery plan than the 15 years assumed under Scenario 3; and
    ii. review the acceptable overall risk position in combination with the other aspects of the covenant support package; the alternative benefits package; and consideration of post-valuation experience.

- An 18-year recovery plan is now supportable, particularly given the longer moratorium proposed.
- However, there are other elements of the covenant support package in the UUK consultation that either reflect a clear weakening compared to Scenario 3 (in the case of a 15% threshold for Metric E under the proposed pari passu arrangements and the extension of the de minimis to non-"material" employers) or that are not fully defined or confirmed which makes pricing challenging (in the case of a potential transition window between moratoria etc).

With UUK's proposed 20-year rolling moratorium, and with the debt monitoring and pari passu position arrangements as defined in the Trustees Scenario 3, we would consider this a strengthening of the covenant support package.

However, the specific debt monitoring and pari passu arrangements set out in UUK's consultation, and the uncertainty of a moratorium "transition", would weaken the overall covenant package relative to Scenario 3. As such, it would not achieve an overall contribution rate of 30.7% of USS payroll at a level of risk acceptable to the Trustee.

We have previously 'priced' UUK's hybrid benefit package at 34.7% of USS payroll under Scenario 3's funding assumptions, recognising that this pricing did not factor in any further adjustments.

We have now considered the specifics of UUK's covenant support package, the reduction in DB promises arising from the adjustments being considered to the Scheme's hybrid benefit structure, and the potential effects of post-valuation experience between 31 March 2020 and 31 March 2021.

Our view is that the price of UUK's benefit proposals with the covenant support detailed in your consultation would still be materially higher than your target contribution rate of 30.7%.

TPR's perspective on the UUK consultation package

Separately, and as per our letter of 29 March, we have been engaging with TPR in respect of our assessment of the UUK consultation package. Broadly, our understanding of TPR's position is that, in its view, the combination of the proposed covenant support measures and funding strategy as set out in UUK's consultation dated 7 April 2021 would likely not be compliant with Part 3 of the Pensions Act 2004. We understand that TPR has discussed its position with you.

We expect TPR to communicate its views more generally to the Trustee, in a letter which can be shared with UUK. We understand that TPR has a call with UUK on 9 June 2021 and it will consider the appropriate timing for its letter following this call.

The Trustee's view on a suitable way forward on the covenant support package

We recognise through our discussions with UUK and employers that there are some outstanding concerns in relation to the inclusion in the pari passu arrangements of "Limited Participation Institutions" (LPIs), who have only a very small share of their workforce participating in USS relative to their other pension schemes. These are generally, but not exclusively, post-92 institutions.

We have listened to these concerns, and we want to find a way forward for the 2020 valuation. Having taken further advice from our covenant advisors, we can confirm that these Institutions could be excluded from the pari passu arrangements, and the covenant still be considered stronger than Scenario 3, if UUK can agree to an amended covenant support package.

The overall covenant support package that would allow us to support one construction of the pre-retirement discount-rate and recovery plan assumptions proposed in the UUK consultation (and supported by Aon) for the alternative hybrid benefits package is:

- A 20-year rolling moratorium rule change on employer exits (initial term of 23 years) - *as proposed by UUK in your consultation and a strengthening relative to Scenario 3*
- A de minimis for employers/institutions with total income <£50m and total assets <£50m (as Scenario 3) and a further exclusion from action under the debt monitoring/pari passu framework for 61 Limited Participation Institutions (as defined by the relevant non-exclusive employee eligibility language in their deeds of accession) – *this is a relaxation relative to Scenario 3*
- For other institutions, the threshold for Metric E to be set to secured debt above 10% of net assets or security granted above 10% of gross assets – *this is consistent with the Trustee's Scenario 3 and a strengthening relative to UUK's consultation*
- Confirmation that no transition window will apply between the moratoria on employer exits – *this is a necessary condition for the pricing to hold*
- Further clarification and engagement on how the debt monitoring and pari passu arrangements will operate in practice (see Covenant Support Measures – Next Steps section below).

This package, which has been discussed with UUK officials, is also summarised in the **Covenant Support Package Term Sheet** enclosed with this letter.

Pricing of the UUK alternative hybrid benefit package under the revised covenant support package

Under these covenant support assumptions, UUK's alternative hybrid benefits package would be priced by the Trustee, based on the advice of the Scheme Actuary, using the following assumptions and parameters as at 31 March 2020:

- a pre-retirement discount rate of gilts+2.75% and a post-retirement discount rate of gilts+1.0%;
- a recovery plan of 18 years from the valuation date;
- allowing for out-performance during the full recovery plan of 0.5% a year on both existing assets and all future contributions (including future service contributions).

These assumptions are consistent with a set of proposals made by Aon, UUK's adviser; this reflects the desire of the Trustee to respond positively to UUK's proposals for a holistic solution to scheme funding and benefit provision.

We have also made an allowance for the delay in implementing the changes arising from this valuation and the issues we were still investigating when we issued the Rule 76.1 report. In particular we have allowed for: i) that there is now no possibility that the benefit changes could be implemented from 1 October 2021, and so 1 April 2022 is now the earliest possible date meaning a further 6 month window with benefits built up at their current level and ii) the completion of the Trustee's investigation into deferred members with short service benefits with a right to transfer out (as initially reported in the 76.1 Report from the Scheme Actuary as shared with the JNC on 2 March 2021). There is also an adjustment in relation to members with certain late retirement entitlements. The combined impact of these effects is allowed for in the contribution rates stated below.

These assumptions result in a Technical Provisions (TP) liability of £80.6bn. Deducting the value of the assets at the valuation date, £66.5bn, results in a deficit of £14.1bn.

The future service cost on the above assumptions, allowing for outperformance during the full 18 years of the recovery plan, is 24.9%. The deficit recovery contribution rate payable over 18 years, allowing for the outperformance over the full period, is 6.3%.

Combining the future service cost with the deficit recovery contributions results in the USS Trustee confirming a total indicative contribution rate of the UUK hybrid benefit package of 31.2%, based on the USS Trustee's covenant support proposals.

To explain the rationale for these changes in more detail:

- The proposed benefit reform, which results in a reduction in future defined benefit pension and lump sum liabilities, substantially reduces the amount of reliance that future benefits will place on the employers compared to the current arrangements. This enables us to use less prudence in our funding for the same level of risk. As such, we are prepared to use a higher discount rate in establishing our TPs and future service costs.
- The increase in the length of the moratorium to a rolling 20 years allows us to increase the recovery period at 31 March 2020 albeit not on a one-for-one basis.
- Together, this provides comfort and support for the overall risk position in the funding assumptions and pricing outcome of 31.2%.
- Post valuation experience, which we have considered carefully, also provides confidence that allowing for both out-performance in the recovery plan and an unusually long recovery plan is supportable.

Our counter proposal aims to achieve an outcome as close to 30.7% of payroll as possible, as UUK has requested, by optimising the value of the covenant support package that we think is deliverable by the sector.

The 31.2% indicative contribution rate confirmed above is supportable through a combination of benefit reform, the de minimis provisions, the exclusion of limited participation institutions, Metric E set at 10% (both tests as above), and with the addition of the 20-year rolling moratorium with no transition window.

We hope that UUK and employers will welcome this position in the spirit it is intended – to price the UUK hybrid benefit package as close to where UUK has indicated is affordable by indicating where adjustments to the overall covenant support package can support this. This allows us to deliver an outcome at the limits of acceptable risk to the Trustee but in line with the assumptions and parameters requested in UUK's consultation.

Post Valuation Experience and 31 March 2021 Valuation

Stakeholders have already noted favourable changes to market conditions as of 31 March 2021: the increase in nominal interest rates and asset values. But there are also unfavourable changes: an increase in market break-even inflation and decreases in future expected investment returns.

The result is a lower deficit on consistent assumptions, but a higher future service cost relative to the valuation date. The net result of both these elements is likely to be a total contribution rate that is not materially different than at 31 March 2020.

This improvement in the funding position due to PVE provides confidence that the Trustee can allow for a longer recovery period and outperformance in the recovery plan at 31 March 2020 than would otherwise be the case.

Advice from the Scheme Actuary suggests that at subsequent valuation dates when financial markets are more "normal", such long recovery periods and levels of out-performance would be inappropriate and likely to be deemed unacceptable from a regulatory perspective. This would also be likely to limit the extent to which a lower total contribution rate is achievable.

As in any valuation, the Trustee will continue to monitor and consider the effect of post-valuation experience up until the point the 2020 valuation is signed and will implement a monitoring and actions framework thereafter.

Covenant Support Measures – Next Steps

We have benefited from further discussions with UUK and individual employers in recent weeks and we provided an update in our HOI Update of 21 May.

We have also been discussing with your officials:

- Production of a draft document setting out the principles which the Trustee will apply in operating the debt framework in practice – we will publish shortly the following document for employers: ***"Debt monitoring framework – how we will work with you".***
- Consideration of any further examples to demonstrate the principle of covenant-enhancing borrowing which employers may wish to submit.
- The process under which an employer may seek a review by the Trustee Board of a decision under the debt framework.
- A statement of the Trustee's intention to ensure the enduring value of the additional covenant support measures over multiple valuation periods – we will publish shortly a statement for employers: *"**Consideration of covenant support measures in future valuations".***

We are fully committed to working with UUK to reassure employers that the Trustee will operate the debt monitoring and *pari passu* arrangements in a reasonable and proportionate way and are appreciative of the further input from UUK and employers in recent weeks. We will arrange a further briefing session hosted by our covenant team and targeted at Finance Directors in the coming weeks if that would be helpful.

Conditional Indexation – Next Steps

We are happy to work with the stakeholders to support their exploration of Conditional Indexation as a possible future benefit design for the Scheme.

As indicated in our 21 May HOI update, our initial view is that such a design could not be implemented in 2022. It would be 2023 at the very earliest – and potentially significantly later.

We expect to be in a position to provide an update to the next JNC following the Trustee Board meeting on 16 June to include our initial view on the issues that would need to be addressed and the potential indicative timeline.

As Conditional Indexation is nascent, and potentially very complex, we are currently looking at the critical path assumptions that will underpin any implementation planning.

These include: defining the key principles and features of the approach; exploring the legislative/regulatory and scheme rules implications; understanding the actuarial tenets to deliver a funding and investment strategy for the benefits; governance issues; and up-front stakeholder decision support including modelling requirements.

Garnering the necessary wide array of options and opinions from stakeholders and reaching consensus on these foundation areas will be challenging and an early indicator of our shared ability to meet any proposed timeline.

Given the significant implementation timeline, the Trustee's clear view is that changes are still required through this valuation to ensure members benefits are being adequately funded. In the absence of changes being agreed by the JNC within the extension window, the Trustee would need to implement further contribution increases in addition to those already scheduled from 1 October 2021 under the last full valuation.

Flexible Options – Next Steps

We note the commitment from UUK and employers to explore options to address the concerns around affordability and suitability and the high level of opt-outs within the Scheme.

We are keen to support the discussions at the JNC, noting that a key outstanding recommendation of the JEP's second report was for the stakeholders to investigate different approaches to contributions as part of a move away from a one-size-fits-all approach.

We are, as ever, ready and willing to work with the stakeholders actively and co-operatively on issues of benefit design and implementation and potential funding implications.

We have been providing the JNC and the JEP Tripartite Group with insight and analysis for some time now. But we need active participation from all parties to constructively explore the options that would deliver the greatest benefit for members. This includes those currently in the Scheme and those potential members that may join in future or who have previously chosen to opt-out.

Please note that further work would be required on such an option to understand the detailed design and, linked to that, the potential member take-up and funding implications of the option.

Closing Remarks

We are providing this response immediately after our Board meeting on 8 June to ensure that the latest position on pricing the UUK package can be shared with its Board on 10 June and ahead of the JNC on 14 June.

We are, of course, very keen to discuss these matters with you further and to provide further detail and clarification on this position where helpful.

We are mindful of the 31 August deadline for the JNC to complete its deliberations and make the required resolution. We remain fully committed to support the JNC and both UCU and UUK in this process as your discussions develop.

Yours sincerely

Kate Barker

Dame Kate Barker
Chair

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