15 August 2023

Universities Superannuation Scheme (USS)

Actuarial valuation as at 31 March 2023 (the 2023 Valuation)

USS (the Scheme) is one of the largest regulated Defined Benefit (DB) schemes in the UK and is strategically important to TPR. As such, TPR has been proactively engaging with USS on the 2023 Valuation as it progresses. We have been providing Universities Superannuation Scheme Limited (the Trustee) and its advisers (including the Scheme Actuary) with our initial views on various aspects of the 2023 Valuation information provided to us throughout this engagement.

In this document we have set out our initial views on some key aspects of the 2023 Valuation proposals we have seen.

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1. TPR's role in the valuation process

The current statutory framework for the regulation of DB pension scheme funding is set out under Part 3 of the Pensions Act 2004 (the Act). The Act sets out a set of funding obligations and created TPR as the body responsible for enforcing compliance with them.

The Act gives us a number of statutory objectives, including:

a) to protect members' benefits
b) to reduce the risk of calls on the Pension Protection Fund (PPF) and
c) to minimise any adverse impact on the sustainable growth of an employer when we exercise our functions under Part 3 of the Act.

The Act and its legislation will continue to apply until the Pension Schemes Act 2021, along with any new Regulations, and the revised DB Funding Code come into force.

The revised DB Funding Code will be forward looking, so only schemes' valuations with effective dates on or after the commencement date will be affected. As such, trustees currently working on a valuation should continue using the DB code currently in force.

2. USS and TPR 2023 Valuation engagement to date (July 2023)

We have been constructively engaging with the Trustee and its advisers in relation to the 2023 Valuation, including attending some Valuation Technical Forum meetings. We provided our initial views so that they can be considered and progressed, where appropriate. We will also continue to engage in the valuation process to ensure we can identify any regulatory issues or concerns.

3. Executive summary

This is a high-level snapshot of TPR's initial views which are outlined in more detail below. For the avoidance of doubt, the summary below should be read in conjunction with sections 4 – 7 and USS's TPs consultation[1] and supporting information[2] documents published on the USS website on 19 July 2023.

a) **Employer covenant** - We agree with the Trustee's assessment that the employer covenant of the Scheme is Strong, being the highest rating from TPR's range of four covenant grades. This is most notably driven by the overall financial strength of the Scheme's employers relative to the Scheme's deficit (which has materially reduced since the 2020 valuation).

b) **TPs proposal** - We have no concerns with the pre-retirement discount rate proposal of gilts + 2.5%. However, the post-retirement discount rate proposal of gilts + 0.9% appears to be relatively high.

c) **Stability and Surplus** - The wider economic climate plays a key role in the Scheme's funding position and cost of providing new benefits. With this in mind, we understand that USS and its stakeholders are considering the stability of future contributions. The analysis in the TP consultation documents show the benefits of keeping a TPs surplus in the Scheme to act as a buffer against potential future investment market volatility.

4. Employer covenant

Our primary role as a regulator is to ensure that the outcome for the 2023 Valuation is compliant with the law, and, as part of that, that the level of financial risk being taken by the Scheme is appropriate relative to the strength of employer support for the scheme (the Employer Covenant).

We agree with the Trustee's assessment that the Employer Covenant is Strong. This view takes into account a number of factors but most pertinently we note:

a) The resilience demonstrated by the UK Higher Education sector as a whole in recent years. This includes the strong market position the employers hold and the strong prospects for the sector overall, particularly from international student income growth; and

b) The Scheme's funding position has improved significantly and that the deficit on a 'self-sufficiency' basis has materially reduced since the 2020 valuation (by c.90%). The aggregate level of employer resources relative to this much reduced deficit are characteristic of a Strong covenant.

However, notwithstanding the improvement in funding levels, we also recognise that there remains a substantial level of risk and volatility within the Scheme. With a sizeable level of 'Value-at-Risk' as at the valuation date, the potential for the Scheme funding level to materially weaken remains a key risk to the Employer Covenant.

We also agree that the characteristics of the employer covenant allow the Scheme to be more confident over the longer-term covenant outlook, relative to (i) many other schemes and (ii) the 2020 valuation. This takes into account the covenant support metrics agreed which we consider to be protective to the covenant, as they give greater comfort that the covenant could not be wilfully or accidentally diminished. However, we still do not consider that the Employer Covenant characteristics support a 30 year 'covenant horizon' view[3], which is a key input into the calculation of Affordable Risk Capacity (AffRC), see section 5 below.

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[1] USS - A consultation for the 2023 valuation.

[2] USS - A consultation for the 2023 valuation – supporting information.

[3] See Section 6 - USS | A consultation for the 2023 valuation.

We consider there is an inherent risk that the very nature of this sector (or indeed any sector) could change over this period, with an unknown (and unknowable) impact on the financial support that the Scheme could rely upon in the longer-term.

Given the 2023 Valuation is being conducted under the existing DB Funding Code, we have not considered whether the Trustee's view about 'covenant horizon' is in any way comparable to 'reliability' over available cash or covenant 'longevity' under the proposed revised DB Funding Code.

5. The Integrated Risk Management (IRM) Framework metrics

Within the IRM Framework[4], there are two risk metrics used to measure risk relative to self-sufficiency:

a) **Actual Reliance:** the current level of reliance on the employers given the assets currently held by the scheme, calculated as *Self-sufficiency liabilities* + *Transition Risk – Assets*.

b) **Target Reliance:** the level of reliance the Scheme is aiming to be below, when it is fully funded on the TPs basis, calculated as *Self-sufficiency liabilities* + *Transition Risk – Technical Provisions (TPs)*

The Target Reliance is compared against the AffRC[5], the AffRC is an estimate of the amount of risk the Trustee is comfortable the employers could support if needed and is calculated as the net present value of 10% of scheme-eligible payroll over 30 years. The RAG statuses[6] are set based on the ratio of Target Reliance to the AffRC.

Based on the proposed TPs and current calculation of the AffRC, the ratio of Target Reliance to AffRC is 73%, well below the 95% threshold set by the Trustee, which indicates it is in the Green zone. However, if a 'covenant horizon' shorter than 30 years, for example 20 years, was used in the calculation the AffRC would be lower. Based on the proposed TPs and a 20-year covenant horizon used, this would make the ratio of the Target Reliance to AffRC slightly above 100% which implies reliance on the covenant might be greater than is available.

As the Scheme has a significant surplus on a TPs basis the Actual Reliance is still well below the AffRC even based on a shorter period of 20 years, and therefore still shows the Scheme is in a relatively strong position. To some extent, this allays our concerns in relation to the 2023 Valuation, although note our comments below on the level of TPs.

For the avoidance of doubt, 20 years is purely illustrative and does not represent our view of what the 'covenant horizon' may actually be. However, it would be *more* representative of what we consider to be an appropriate period as compared with the currently assumed 30 years.

6. Stability of future contributions

Looking at the stability of future contributions[7] is very helpful to stakeholders, as it aids their understanding on how contributions could change if the investment strategy does not achieve the returns assumed in the valuation. Based on the analysis in the TP consultation, there are advantages in maintaining a TPs surplus in the Scheme as a buffer against potential future adverse market conditions and/or investment performance.

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[4] See Section 1 - USS | A consultation for the 2023 valuation – supporting information.

[5] See Section 6 - USS | A consultation for the 2023 valuation.

[6] See Section 1 table 2 - USS| A consultation for the 2023 valuation – supporting information.

[7] See Section 10 of USS | A consultation for the 2023 valuation.

We would also note that seeking more aggressive valuation assumptions, and lower TPs, will make significant benefit cuts and/or contribution hikes in future more likely. However, taking a more cautious approach to using the TPs surplus in the Scheme for the 2023 Valuation mitigates some of these risks. Given the importance of this topic, we will be continuing to engage on it.

7. Technical Provisions (TPs) proposal

We have no concerns with the proposed pre-retirement discount rate[8] assumption of gilts + 2.5%. We note the Trustee's comments in the TP consultation that "There is no single right answer when setting the discount rates" and whilst we do not disagree with this, we consider a pre-retirement discount rate assumption as high as gilts + 3.0%[9] is unlikely to be appropriate.

We think the proposed post-retirement discount rate of gilts + 0.9% appears to be relatively high. This is compared to what we have seen other schemes adopt in the past and we believe are likely to adopt when doing valuations as at 31 March 2023. If market conditions change at future actuarial valuations, e.g. we see a reduction in the credit spread on corporate bonds, we would expect this assumption to be lower.

One of the lenses through which the degrees of prudence in the discount rates was viewed is the statistical confidence level of those rates. The pre-retirement and post-retirement discount rates each have approximately 70% confidence[10] under USSIM's investment modelling. Investment modelling involves subjectivity and alternative models such as the one the Scheme Actuary's firm uses would generally show different confidence levels for both pre-retirement and post-retirement discount rates[11].

As explained above, the assessments of Target Reliance would be much more marginal if allowing for a shorter covenant 'horizon'. This and the relatively high post-retirement discount rate, both point towards adopting higher TPs. Therefore, we think the proposed TPs are likely to look low compared to standard risk metrics against which we assess valuations. However, as there is a significant TPs surplus at this valuation date, this makes us more comfortable with the level of TPs for the 2023 Valuation than we might otherwise be.

As a result, we are not suggesting the TPs should be increased. If there was a small surplus or deficit at a future valuation, we would expect the Trustee to consider the level of TPs, how this compares with the self-sufficiency liabilities, and whether lower discount rate assumptions would be appropriate.

Disclaimer

As noted at the beginning of this document, these are our initial views only and as valuation work progresses, we may look to provide further views in the future. A final review will be conducted once all aspects of the 2023 Valuation have been completed and formally submitted to us.

[8] See Section 8.3 of USS | A consultation for the 2023 valuation.

[9] See Section 9.4 of USS | A consultation for the 2023 valuation.

[10] See Section 8.3 of USS | A consultation for the 2023 valuation.

[11] See Section 3.1 of USS | A consultation for the 2023 valuation.