USS briefing: Accelerated Year-end Review 2022

This briefing note covers the results of the Trustee's Accelerated Year-end Review (AYR) for 2022 and a request from Universities UK (UUK) and University and College Union (UCU) to consider the viability of implementing interim changes to benefits and/or contributions ahead of the 2023 valuation.

Background

Despite a backdrop of significant volatility in financial markets and rising inflation, the Financial Management Plan (FMP) monitoring report for the end of March 2022 suggested the Technical Provisions deficit stood at £1.6bn and the future service cost required contributions of 24.7% of pay. Given the degree of volatility in financial markets at that time, and associated uncertainty, the Trustee Board commissioned an AYR to provide a more considered insight into the scheme's funding position as at 31 March 2022. The AYR, which will feed into the annual actuarial report the Trustee is required by law to produce in any year it does not hold a full valuation, incorporated:

- a light-touch review of the covenant
- a review of notable developments in published mortality expectations
- a review of the investment assumptions and strategies
- a review of the funding assumptions (allowing for the risk management framework metrics)

Whilst the AYR does not involve as much analysis as a full valuation, and therefore cannot be relied upon by the Trustee to the same extent, it does provide greater confidence in the financial position of the Scheme than the FMP monitoring report. A full valuation would require a deeper review of the covenant position and a fuller review of the investment assumptions, framework and approach, updated member data and demographic assumptions, and further consideration of discount rate assumptions in light of the risk framework and any covenant and investment developments. It would also require a series of formal consultations with UUK.

The results

USS

At a meeting on 23 June 2022, the Trustee Board considered, and welcomed, the results (see the technical appendix for more details):

- A much-improved deficit position compared with 31 March 2020 (£2.1bn v £14.1bn)
- Similar future service contribution requirements for the new benefit structure to those currently being paid (24.8% v 25.2%)

Without the benefit changes introduced on 1 April 2022 – but allowing for the improved covenant support package put in place for the 2020 valuation – the indicative position at 31 March 2022 would be a future service rate in excess of 36% of pay and a deficit of more than £3bn (which would require deficit recovery contributions *in addition to* the future service rate).

The results of the AYR and the underlying technical details were shared with UUK and UCU representatives on the Joint Negotiating Committee (JNC) on 7 July and have been reproduced in this briefing note.

Looking ahead

The Board noted that the remainder of the quarter (to end of June 2022) was likely to see a continuation of the positive trend for scheme funding that has emerged since the turn of the calendar year – despite the value of the scheme's assets falling from around £93bn at the end of November 2021 to around £78bn at the end of June 2022.

Falling asset prices – if accompanied by rising long-term expectations for investment returns and higher interest rates – can be helpful to the Trustee's assessment of both future service contributions, which account for the vast majority of the overall contribution rate, and the deficit. This is in contrast to conditions during the 2020 valuation (filed in September 2021), where rebounding asset prices coincided with record-low bond yields.

The Board also noted that it was particularly challenging to make judgements based on only a few months of positive monitoring data and against a backdrop of considerable market volatility. But if the recent improvement in the funding position is sustained, it would potentially be good news for the 2023 valuation and the JNC may be able to consider the prospect of lower contribution requirements and/or enhancing future benefits.

Interim changes

At the JNC's request, the Board also considered the viability of implementing interim changes to benefits and/or contributions ahead of the 2023 valuation. The Board noted that making interim changes ahead of the next valuation would be extremely unusual for USS and would require a very solid basis for decision-making, which the current level of volatility simply does not provide.

Even if the Trustee held the view that a solid basis existed:

- The scale of changes that could be supported is limited (e.g., a further deferral of the 2.5% cap on inflation-linked benefit increases – already deferred until 31 March 2025 – or limited changes to contributions)
- The time it would take to prepare and implement a specification from the JNC (including any required consultations) would run into the early planning stages for the 2023 valuation
- The degree of volatility means there is a risk that the recent improvement in the funding position might not be sustained and any changes considered now might need to be reversed
- The precedent it could set may also have less desirable consequences: The Pensions Regulator might reasonably expect mitigating actions to be in place if the funding position deteriorated

While it is important to be cautious in setting expectations, the Trustee thinks it is important that energies are instead focused on positive preparations for the 2023 valuation and working with stakeholders to consider how to approach any opportunities that could arise. That would include the JNC prioritising the improvements it would want to make (perhaps under a pre-agreed framework) and engaging with the Trustee on the approach to be taken for the valuation – and the Trustee getting a head-start on the associated data and analysis. If preparations begin early, and frameworks for any such decisions are agreed in advance of the valuation, it may be possible to conclude the valuation and implement changes more quickly than has been the case recently.

Technical appendix

What is the difference between the FMP monitoring and the AYR?

USS

In the **FMP monitoring** to 31 March 2022 we allowed for changes in:

- The value of the Scheme's assets
- Expected returns and investment conditions which affects pre- and post-retirement discount rates
- Inflation expectations

The **AYR** as at 31 March 2022 went further than the monitoring in that it:

- Confirmed our view of the covenant and that the input from the covenant to the Integrated Risk Management Framework (IRMF) remained reasonable. In particular it confirmed:
  - The covenant rating of 'strong'
  - The assumption about sector growth of CPI + 1%
  - The period of covenant reliance of 30 years
- Reviewed the self-sufficiency discount rate, rather than applying the monitoring formula, the output was also used to update the post-retirement discount rate. The review resulted in a small reduction to the self-sufficiency and post-retirement discount rates (versus the monitoring position at 31 March 2022)
- Updated the transition risk used in the IRMF
- Examined where the parameters and results of the AYR sit in respect of the IRMF
- Considered whether any adjustment should be made to mortality assumptions, particularly in respect to Covid, and concluded not

Whilst the AYR did not involve as much analysis and cannot be relied upon to the same extent as a full valuation, it does provides greater confidence on the financial position of the Scheme

Results of the AYR compared with the 2020 valuation and the 2021 deep dive

- The AYR shows a similar future service contribution requirement, but an much improved TP deficit

	31 March 2020 valuation	31 March 2021 deep dive	31 March 2022 AYR
Technical Provisions	£80.6bn	£86.2bn	£91.0bn
Assets	£66.5bn	£80.6bn	£88.9bn
TP Deficit	£14.1bn	£5.6bn	£2.1bn
Future contribution requirement	25.2%	26.0%	24.8%*
Deficit Recovery Contributions	6.2%**	5.0% - 6.0%	0.2% - 6.3%
The AYR shows an improved deficit position in part due to more optimistic, less prudent, assumptions			

Notes:
*Future service contributions at 31 March 2022 include no allowance for assumed investment outperformance. Allowing for outperformance reduces the future service contribution rate by approximately 0.3% of salaries.
** Will increase to 6.3% from April 2024.

Comparison between the AYR and the 31 March 2022 FMP monitoring

USS

	Valuation 31 March 2020	Monitoring 31 March 2022	AYR 31 March 2022
Post-retirement discount rate	Gilts + 1%	Gilts + 0.60%	Gilts + 0.55%
Pre-retirement discount rate	Gilts + 2.75%	Gilts + 2.45%	Gilts + 2.45%
Technical Provisions	£80.6bn	£90.4bn	£91.0bn
Assets	£66.5bn	£88.8bn	£88.9bn
Deficit	£14.1bn	£1.6bn	£2.1bn
Future service contributions	25.2%	24.7%*	24.8%*
Deficit recovery contributions	6.2%**	0% - 1.5%***	0.2% - 6.3%****
Self-sufficiency deficit	£35.5bn	£26.6bn	£27.8bn

The AYR shows a similar picture as the monitoring: a much improved deficit position and future service contributions slightly lower than at the valuation and also a better risk position relative to self sufficiency

Notes:
*Future service contributions at 31 March 2022 include no allowance for assumed investment outperformance. Allowing for outperformance reduces the future service contribution rate by approximately 0.3% of salaries.
**Will increase to 6.3% from April 2024
***Assumes a recovery period equal to that remaining from the 2020 valuation or 10 years
**** Potential range given current DRCs, The Pensions Regulator's position and reduced deficit (see further slide 12)

Update to 2020 covenant assessment for AYR

USS

What key characteristics have stayed the same?
✓ UK HE sector remains well positioned (global rankings materially unchanged) in a growing market
✓ "Last man standing" structure means resources of stronger HEIs are ultimately available to support weaker HEIs
✓ Contributions follow employees, providing cost flexibility to institutions in the event of a down-sizing
✓ UK HE sector is flexible, adaptable and resilient in the face of crises, as demonstrated during the Covid pandemic

What has changed?	
✓ Moratorium on employer exits strengthens pooling of resources across employer group	× Domestic tuition fee freeze makes domestic students less attractive, increases sector reliance on int'l students for growth, profitability…
✓ Debt Monitoring Framework gives enhanced insight into, and focus of attention on, employer leverage	× …at a time of increasingly volatile global geopolitics, highlighting the risk of increasing int'l exposure
✓ Improved financial position and performance in each of last 2 financial years (cash flow ⇧, net debt ⇩)	× Macro-economic outlook has deteriorated, with growth slowing, inflation accelerating and interest rates rising
✓ International demand more resilient than expected in pandemic; domestic demand supported by demographics	× Inflation in particular poses risks to affordability of contributions for some employers
✓ Fresh evidence during pandemic of government willingness to support sector in a crisis	× Financial polarisation continues: outcomes-focused regulation, reliance on int'l students favour high-tariff over lower-tariff HEIs…

- +ve / -ve developments broadly balanced; not obvious covenant weaker overall, potentially has strengthened
- Further analysis would be required for a full assessment (e.g. of affordability and inflation, downside scenario analysis) which will be performed at the next valuation

Integrated Risk Management Framework (IRMF) measures

USS

	2020 valuation	2022 AYR
Metric A		
Affordable Risk Capacity	£30 - 33bn	£33 - 36bn
Difference between Self-sufficiency and Technical Provisions	£21.4bn	£25.7bn
Headroom	£9 – 12bn	£7 – 10bn
Threshold for Green	£8bn	£8.5 – 9.5bn
RAG status	Green	Amber/Green
Metric B		
Affordable Risk Capacity	£30 – 33bn	£33 – 36bn
Self-sufficiency deficit	£35.5bn	£27.8bn
Headroom	- £2 – -5bn	£5-8bn
Threshold for Green	£6bn	£6.5 – 7.5bn
RAG Status	Red	Amber/ Green

Metric **A** indicates more risk in funding the Scheme is being taken in the 2022 AYR compared to the 2020 valuation whilst Metric B indicates the risk position at 2022 has improved relative to that at the valuation. Further work would be required to understand the level of comfort provided by these measures which will be undertaken at the next valuation.

Note: Metric C is Green at both the 2020 valuation and the 2022 AYR

Comparison of prudence in the 2020 valuation and 2022 AYR

USS

- In aggregate, the prudence lenses show lower level of prudence in the 2022 AYR compared with the 2020 valuation, reflecting the different context and different prevailing conditions

Prudence lenses and context	2020 valuation	2022 AYR
Discount rates: Gilts+ pre/post	2.75% / 1.00%	2.45% / 0.55%
Lens 1: Confidence level in the TP discount rates	Pre-retirement: 81% Post-retirement: 73%	Pre-retirement: 73% Post-retirement: 62%
Lens 2: Ratio of TP to best estimate liabilities (TP/BE)	127%	118%
Lens 3a: Ratio of TP to SS liabilities (TP/SS)	79%	78%
Lens 3b: Distance of TP from SS liabilities (SS – TP)	£21.4bn	£25.7bn
Lens 5a: Headroom in affordable risk capacity above TP distance from SS as a %	32%	25%
Lens 5b: Headroom in affordable risk capacity above TP distance from SS in £bn	£10.0bn	£8.7bn

The 2022 AYR is more optimistic and uses less prudence than the 2020 valuation

Note: Figures based on the Valuation Investment Strategy. The confidence levels have been considered for the pre- and post-retirement sub-portfolios separately. These are based on 30-year returns relative to 30-year and 15-year fixed interest gilts respectively. Although there is not necessarily a single theoretically correct approach to determining overall aggregate confidence levels, as an indication, weighted averages based on the pre/post retirement liability weights (approx. 55%/45%) could be considered. This would give 77% and 68% for the 2020 valuation and 2022 AYR respectively.

Economic & financial assumptions at 31 March 2020 & 2022

	31 March 2020 valuation	31 March 2022 AYR
Market value of assets	£66.5bn	£88.9bn*
FBB pre-retirement expected return (30 years)	Gilts + 5.28%	Gilts + 4.67%
Pre-retirement discount rate	Gilts + 2.75%	Gilts + 2.45%
Post-retirement discount rate	Gilts + 1%	Gilts + 0.55%**
Gilts (single equivalent) nominal	0.7%	1.7%
CPI (single equivalent)	2.1%	3.0%
CPI with 2.5% cap (single equivalent)	1.7%	2.1%
Single equivalent discount rate	Gilts + 1.6% CPI + 0.3%	Gilts + 1.2% CPI - 0.1%
The assumptions for the AYR are more optimistic (i.e. have less prudence in them) than those used at the valuation		

Notes: * 31 March 2022 monitoring used a market value of assets of £88.8bn
** 31 March 2022 monitoring used a post-retirement discount rate of Gilts + 0.6%

Potential range of deficit recovery contributions (DRCs)

USS

- The table below provides a ***potential*** range for DRCs, depending on the choice that would need to be made for the length of the recovery plan.
- Determining the length of a putative recovery plan and the corresponding size of the DRCs is not part of the AYR, and would only be made after consideration of all relevant factors as part of an actuarial valuation.

Approach	DRC	Recovery plan length	Comments
Maintain current DRCs	6.3%	2.5 years	Would be consistent with TPR's expectations
10-year recovery period	0.2%	10 years	Recovery period shown in monitoring - unlikely to be appropriate given TPR guidance
6-year recovery plan	1.4%	6 years	Two valuation cycles, slightly above the average recovery plan length per latest TPR publication
3-year recovery plan	4.9%	3 years	Period to implementing updated contributions from 2023 valuation

Note: DRCs allow for investment outperformance of 0.25% pa and are based on assumed payroll growth of CPI + 1.5% pa