

USS: Consultation on Technical Provisions and Recovery Plan

1. This cover note accompanies a formal Consultation document received on 30 October 2014 from the trustee of the Universities Superannuation Scheme (USS or the Scheme). This Consultation (*2014 Actuarial Valuation: A consultation on the proposed assumptions for the scheme's technical provisions and the recovery plan*) is part of the actuarial valuation process as at 31 March 2014 and seeks the employers' views on two key areas:

(i) the actuarial assumptions that will be used to calculate the Technical Provisions of the Scheme as at the valuation date – in effect the value of the Scheme's liabilities which will be compared with the market value of the Scheme's assets at the same date to determine the quantum of deficit. (These assumptions are also used to calculate the cost of new defined benefit accruals.)

(ii) on the assumption that a deficit will be shown, the Recovery Plan (which spells out what contributions will be due from employers to address the deficit).

The legal position under the Rules of the USS is that, strictly speaking, the trustee need only “consult” with the employers in these areas, meaning that the trustee is responsible ultimately for the decisions made here (subject to review from the Pensions Regulator). However, the employers are in turn responsible for meeting any additional contributions due, and so the employers have some leverage in practice (and of course the trustee will wish to agree the outcome with the employers, rather than trying to impose a solution).

The Consultation also includes a draft replacement of the current Statement of Funding Principles (a document setting out the principles by which the Technical Provisions and Recovery Plan are constructed).

2. The Consultation sets out the initial results of the 31 March 2014 actuarial valuation based on the assumptions proposed by the trustee, and assuming the current benefit structure (i.e. final salary and CRB sections) remain in place. The initial results reveal a deficit of £12.3Bn at the valuation date (compared with the figure of £13.1Bn estimated using market conditions at 30 September 2013, and communicated to the employers in the consultation on USS's December 2013 engagement paper), and an illustrative contribution rate for employers of 25.7% of payroll (compared with the earlier estimate of 25.1% of payroll).

The Consultation outcome will however be affected by the ongoing benefit discussions, as ultimately the decisions taken on benefits will impact both the discount rate used to determine the deficit, and the contributions that are payable.

3. Employers are invited to submit their comments – via Universities UK – on the Consultation document by **Friday 28 November 2014**, so that the trustee board can consider

responses at its meeting on 4 December 2014. The consultation has also been sent to the University and College Union, as a key stakeholder.

4. The Consultation is part of the formal dialogue between the trustee and employers as part of the 2014 actuarial valuation. It builds on a number of exchanges of documents and conversations that have taken place to date, on the valuation process, notably:

(a) the December 2013 USS Engagement Paper (*Scheme funding within USS, an engagement with Universities UK*), which set out the trustee's conclusions on the covenant assessment carried out by Ernst & Young (EY), and which sought answers from employers on questions relating to the development of a Financial Management Plan;

(b) the March 2014 response from Universities UK to the questions posed in relation to the Financial Management Plan, drawing on the responses to a Web Survey (prepared by Aon Hewitt on behalf of UUK) representing almost 90% of the active membership of USS;

(c) the July 2014 USS paper (*An Integrated Approach to Scheme Funding*) which set out some guiding principles and specific tests which the trustee had developed in relation to the Scheme's future funding and benefits;

(d) the October 2014 papers from Universities UK setting out proposed changes to Scheme benefits, which have been shared with the trustee.

5. Universities UK has asked its adviser, Aon Hewitt, to review the Consultation document. Aon Hewitt has not had a long period of time since the receipt of this document, as we wished to ensure its early distribution to institutions in order to respond, as USS has requested, by the end of November 2014, but Aon Hewitt has raised a number of issues which are set out below. In a number of cases we are awaiting responses from USS to our enquiries (and responses are due shortly), but have decided to circulate this paper to employers, rather than awaiting those responses.

6. Aon Hewitt raised three principal areas of technical comment on the trustee proposals:

(i) the inflation risk premium (IRP - which is applied to market implied RPI inflation) is proposed to be reduced from the 2011 valuation assumption – not just from 0.3% pa to 0.2% pa, as indicated in the December 2013 Consultation, but to 0.1% pa after a period of 20 years. Aon Hewitt believes that the case for the reduction in the IRP is not well made;

(ii) the assumption proposed for CPI inflation (0.8% pa lower than RPI, as described on page 25) is not consistent with the current Statement of Funding Principles which states that, other than the discount rate, and longevity assumptions, all assumptions will be chosen on a "best estimate" basis. The best estimate assumption for the RPI/CPI gap is stated on page 33 to be 1.0% pa;

(iii) other "demographic" assumptions are stated as being best estimate, but at first glance there is little backing evidence that these assumptions have been validated as such. The key areas here would be the base case longevity assumptions, and percentages of beneficiaries on death,

but there are a number of other assumptions where further information has been requested from the trustee but was not available in time for this circulation.

While these might seem rather dry discussions, the cumulative potential effect could be to alter the liability by an amount measured in billions of pounds, and so these areas are worth exploring further, particular in the context of ensuring an employer contribution rate within a 16-18% envelope.

7. The Consultation paper considers (page 16) "post valuation experience" – the change in the financial position since 31 March 2014. USS talks of a "significant reduction in the funding level" after the valuation date. Aon Hewitt has set up a version of their Risk Analyser tracking software, which approximately models the change in funding levels, assuming no changes to the Technical Provisions assumptions proposed by the trustee. The results make for sobering reading – the deficit came close to £20bn at one stage. This volatility adds further weight to the view that changes are needed to reduce the exposure of employers to the USS, in particular to the liabilities associated with the defined benefit aspects of the scheme. Also, the post valuation experience may influence the trustee's views about funding the Scheme in a number of areas. That said, we would not expect any short term increase to the deficit to translate automatically into higher contributions.

8. We asked the trustee to indicate – both on their proposed assumptions, and also with modifications proposed by Aon Hewitt – the likely cost of the proposed benefit package set out by the employers in their October 2014 paper, together with an assessment as to whether that package satisfies the terms of the trustee's three tests.

We received yesterday evening a high level summary showing that, on the trustee's proposed assumptions, the cost of the proposed benefit package is 19.5% of payroll assuming a 15 year deficit repair period (and 18% of payroll assuming a 20 year deficit repair period).

9. Universities UK will provide a further update to you once further information from USS has been received, and we will also set out a proposed draft response to the USS's consultation. In the meantime, please direct any comments, questions and responses in relation to this Consultation to Tony Bruce at pensions@universitiesuk.ac.uk.

4 November 2014