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Private and Confidential
Professor Sir David Eastwood
Chair, Universities Superannuation Scheme Limited

Sent by email only

Our ref: C72540470

15 September 2017

Dear Sir David,

The Universities Superannuation Scheme (the "Scheme")
31 March 2017 Actuarial Valuation (the "2017 Valuation")

1. I write in relation to the Trustee's consultation on the proposed assumptions for the Scheme's 2017 Valuation with the employers'/university sector's representative body, Universities UK (UUK)[1].

2. We would like to record our thanks to the Trustee's executive (and to UUK) for their assistance in providing answers and analysis in response to our questions in relation to the development of the consultation and their approach to the 2017 Valuation. We trust our involvement has been useful. We look forward to this co-operation continuing as the 2017 Valuation process continues.

3. In this letter we set out our preliminary views on the consultation document. It is based on the analysis we have seen and the discussions held to date. We appreciate the Trustee's advisers (for example, PwC) are carrying out additional work, which we will consider when it has been completed.

4. Our views reflect the discussions we have had with the Trustee executive and the opinions we have aired in these discussions. The purpose of setting out our preliminary views to all of the parties is to be helpful to the valuation process, especially as that process is at a relatively early stage, with several further stages scheduled before the statutory deadline (30 June 2018).

Executive summary

5. At this stage we have not been persuaded that the Trustee's assessment (based on advice they received) of the strength of the sector's covenant rating accurately captures the risks of the Scheme. It appears to us the sector covenant is weaker than the Trustee's assessment. A key reason for our weaker view is the substantial increase in the size of the Scheme's liabilities in recent years.

6. The assessment of covenant is important as the proposals contained within the consultation document are based on a level of prudence (taking into account the significant risks within the Scheme's funding and investment strategies) that reflects a stronger sector than we believe has been demonstrated. However, even if the Trustee's views of the sector covenant were accepted, then the consultation proposals would be at the limit of what would be acceptable to us.

7. The valuation methodology itself is very complex. There are many significant risks inherent in the funding approach and there are risks with the model being used. We are not convinced that the level of these risks has been fully articulated in the consultation document.

[1] 2017 Actuarial Valuation - A consultation with Universities UK on the proposed assumptions for the scheme's technical provisions and Statement of Funding Principles (the "consultation document") dated 1 September 2017

8. Using any standard and objective methodology the level of prudence in the 2017 Valuation proposals is materially less than was present for the 2014 Valuation. This change is not clearly explained in the consultation document.

Covenant assessment

9. Employer covenant is fundamental to the funding of the Scheme[2]. This is why it has been a major focus of our discussions with the Trustee executive.

10. The Trustee has engaged PwC as its covenant adviser. It has also obtained advice on trends in the higher education sector from Parthenon-EY. In their initial covenant advice, PwC rated the sector covenant as 'strong', the strongest of the firm's four covenant ratings. PwC are carrying out further work to increase their understanding of how flexible institutions' affordability could be in a variety of circumstances and we acknowledge that the results of this may have a bearing on their, the Trustee's, and our views of the sector covenant strength.

11. We do not disagree with the views of the Trustee (and its advisers) that the sector covenant provided by the Scheme's employers has certain unique characteristics. Allowing for the demonstrable stability of the higher education sector, it is reasonable to adopt a longer-term horizon when formulating the Scheme's funding strategy.

12. Similar to PwC's approach, we use four covenant grades when assessing covenant strength for the purposes of our internal analysis. In our grades, we emphasise that the strength of the employer covenant has to be assessed *in the context of the size and needs of the scheme*[3]. We describe the strongest two grades as follows[4]:

> "**Covenant grade 1 (CG1) – Strong**
>
> Very strong trading, cash generation and asset position relative to the size of the scheme and the scheme's deficit. The employer has a strong market presence…with good growth prospects for the employer and the market...Overall low risk of the employer not being able to support the scheme to the extent required in the short/medium term."
>
> **"Covenant grade 2 (CG2) – Tending to strong**
>
> Good trading, cash generation and asset position relative to the size of the scheme and deficits. Operates in a market with a reasonably positive outlook and the employer has a stable market share. Outlook is generally positive **but medium-term risk of employer not being able to support the scheme and manage its risks."** [emphasis added]

13. There is a read across between PwC's four covenant grades and ours. Their view of the sector covenant would equate with our CG1 rating.

14. However, it appears that the sector covenant, based on our analysis, falls within the CG2 rating for the following reasons:

    a. The Scheme has grown substantially in recent years:

        i. Between 2011 and 2017 the Scheme's overall membership grew by over 40%.

        ii. Between 31 March 2014 and 31 March 2017 the Scheme's liabilities, based on consistent assumptions (and after allowing for the benefit changes introduced from April 2016), has also increased significantly, by an amount that has outstripped the increase in the Scheme's assets[5].

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[2] http://www.thepensionsregulator.gov.uk/docs/code-03-funding-defined-benefits.pdf

[3] http://www.thepensionsregulator.gov.uk/docs/guidance-assessing-monitoring-employer-covenant.pdf

[4] http://www.thepensionsregulator.gov.uk/docs/db-funding-regulatory-enforcement-policy.pdf

[5] See page 104 of the Scheme's 2017 Annual Report and Accounts - https://www.uss.co.uk/~/media/document-libraries/uss/how-uss-is-run/reports-and-accounts/2017-report-and-accounts-scheme.pdf

b. The Scheme's investment strategy presents a real challenge to the ability of the covenant to support the increasing Scheme scale and investment downside risks:

   i. For instance, we understand that the estimated 3 year 95% value at risk figure[6] (a measure of the potential volatility of the Scheme's funding position) at the 2017 Valuation date is c.£17 billion. A downside event of this magnitude would require a significant increase in deficit repair contributions to produce a recovery plan with a reasonable target period.

   ii. A key feature of the Trustee's proposal is the inclusion of a significantly less cautious approach relative to the gilt curve than in the 2014 Valuation. Then the Trustee concluded that the forward gilt curve provided a good central view of the path of future interest rates. The Trustee assumption that long-term index linked gilt yields will gradually revert to 31 March 2014 levels over the next ten years is the most significant assumption within the consultation document. The consequences of this yield reversion assumption are very considerable: (a) the scheme deficit reduces by £4.2 billion; (b) Scheme de-risking is deferred for ten years (this means that scheme de-risking is now deferred 13 years beyond the initial de-risking date set as part of the 2014 Valuation); and, (c) the level of reliance on the employer covenant that is recognised by the valuation methodology is reduced. Consequently, if yields do not revert to the levels anticipated (or fall further), the deficit will have been understated and the level of investment risk that the sector is exposed to will have increased.

c. From what we have seen, there are issues over the sector's preparedness to make the significant contribution increases that may be needed in the situations, or due to the risks, outlined above:

   i. The possibility of the reliance on sector covenant being strained by risks in the Scheme's funding position is acknowledged in the consultation document. In the section headed "Short-term risk profile" (on page 10), the following comment is made in respect of the Trustee's stress-testing analysis: "There are some credible scenarios – such as gilts falling further, or asset values declining – that could see reliance exceed a sensible current 'risk budget' that the sponsoring employers should collectively be asked to support."

   ii. The covenant of the Scheme's individual participating employers varies, including their respective ability to fund higher contributions if required. We see this as an impediment to the assumption of significant flexibility in assumed affordability based on the Trustee's current approach. This approach is based upon contributions being a uniform pan-sector percentage of each institution's payroll. There are risks with this approach without factoring in the likelihood there will be a natural resistance to any significant increase in the current rate from employers with a weaker covenant.

   iii. A covenant assessment will also look at factors other than the affordability of cash contributions, notably the level of asset backing represented by employers' balance sheets. Whilst noting that the combined value of the employers' assets is material in relation to the Scheme's current deficit we do not consider it likely that individual institutions would be prepared to commit tangible assets towards funding the Scheme's deficit. As acknowledged in the consultation document, the only relevance of the employers' collective balance sheets would be to provide cover for members' benefits in the event of "extreme tail risks"[7], and we do not believe this asset cover should be given significant weight in assessing the ongoing covenant strength.

15. Our view of sector covenant is heavily determined by our assessment of the Scheme and the sector's affordability. As outlined, there is (at least) a medium-term likelihood that additional funding will be needed. However, we believe affordability is not unconstrained in this period as there is competition for cash from the institutions' other expenditure priorities. We take the view that there are issues with the sector's ability to increase payments to the Scheme, which might arise under realistic downside scenarios, to remove the deficit over an appropriate period. It appears, therefore, that the sector covenant has more of the features of our CG2 covenant grade than a CG1 grade.

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[6] In other words the figure derived from modelling a 1-in-20 downside event within a 3 year period, a commonly used measure of risk.

[7] Page 43 of the consultation document

2017 Valuation approach and wider funding strategy

16. Given that, at this stage, we view the sector covenant to be more in line with a CG2 grade, we do not currently consider that the level of prudence contained in the consultation document is sufficient to reflect both the actual strength of the sector covenant and the significant risks within the Scheme's funding and investment strategies. As a point of reference, if we did agree that the sector has a CG1 grade, we would consider the proposals to be at the limit of what would be acceptable to us.

17. The difference in sector covenant assessment has a material impact on the valuation approach. We will not be providing detailed commentary on individual aspects of the approach at this stage as we do not know how those aspects might change if views on the sector covenant were to change. However, as it would be informative for all parties, we recommend the Trustee explains how its proposals would change if a CG2 grade was adopted instead.

Scheme risk and communications

18. In terms of the 2017 Valuation methodology, it is positive that it incorporates both the Trustee's views on covenant and its investment beliefs. Producing an integrated framework for managing risk is an initiative we support. However, the methodology used by the Trustee is undoubtedly complex, with many constituent parts, and this leads to a number of challenges, not the least of which is its communication.

19. The Trustee could have been clearer in its communications in the consultation document. Important examples are:

    a. In relation to the degree of prudence contained within the funding proposals. Using any standard and objective methodology the level of prudence in the 2017 Valuation proposals is materially less than was present for the 2014 Valuation. This change is not clearly explained in the consultation document.

    b. The significant factors which contributed to the growth of the Scheme's deficit in the period 2011 – 2017, when gilt yields fell contrary to many market participants' expectations and while the Scheme had a low level of liability hedging in place. Although we acknowledge that the Trustee has undertaken analysis, and that it believes that it has derived the most reliable forecast for long-term rates from analysis of fundamental economic building blocks, an explanation of why there has been this level of growth in the deficit will assist the parties appreciate the risk that is being carried due to assumptions and the actions proposed in relation to the future path of interest rates.

    c. It is vital that parties appreciate the accompanying risks of the funding approach (including how the risks might arise and the possible impacts). These risks are very large and volatile, and need to be considered within the context of the ability of the sector covenant to support them. Analysis in the consultation document seeks to illustrate the potential increase in the risks, especially over the short-term, on the basis of the assumptions put forward. However, it is not clear to us how this analysis has linked back into understanding the corresponding implications for the Scheme and the sector should these risks arise.

    d. There is significant "model risk" within the consultation proposals. The associated risks could be more central to the discussion. For example, there is the risk that the methodology embeds views on the path of future long-term interest rates and the path of returns it expects to achieve on particular assets held; and the Trustee's stochastic model (built to estimate the probability of reliance exceeding certain tolerance level) is very sensitive to the input assumptions.

I trust that these comments are helpful as you continue your discussions on the 2017 Valuation following the consultation.

Yours sincerely

Geoff Cruickshank
Senior Case Management Adviser
Case Management

cc Sir Andrew Cubie
Chair, Joint Negotiating Committee

Alistair Jarvis
Chief Executive, Universities UK

Sally Hunt
General Secretary, University and College Union

Bill Galvin
Chief Executive Officer, Universities Superannuation Scheme Limited