USS 2020 valuation – methodology and assumptions for technical provisions
Consultation response from the University of Oxford

Status of response

The following response was prepared by the working group set up by the University's Council to consider USS matters, and the response has been approved by Council. A draft of this response was also shared with the University's USS members for comments prior to it being finalised.

Overview

Before responding to this consultation, we would like to highlight a more fundamental issue in terms of the funding regime to which USS is subject. USS is supported by the covenant of higher education sector institutions with several decades and in some cases several centuries of "credit history" and the scheme's cash inflows are expected to exceed outflows for many years into the future. We believe that these two features mean that USS bears a greater resemblance to schemes such as the Teachers' Pension Scheme than to the private sector schemes for whom the current funding and regulatory regimes are designed.

As one of the largest employers participating in USS, we remain committed to the scheme and believe it is the right pension arrangement for the higher education sector in the UK. In our opinion, the greatest threat to the scheme is that members will lose confidence in its stability, affordability and intergenerational fairness, leading to a sharp increase in drop-out rates. We believe there is a way forward within the current framework and in line with the recommendations of the Joint Expert Panel (JEP) that would be affordable for both employers and members. A pre-retirement discount rate of gilts+3.5% or higher and a recovery period of 15-20 years with allowance for outperformance are two JEP recommendations that would produce much more affordable outcomes.

Response to consultation

The University is disappointed that USS has chosen to consult on the technical provisions in isolation from other aspects of the valuation.

Although we understand that this consultation does not formally include details of the recovery plan, we are also disappointed by the range of potential contributions USS has chosen to set out, all of which are above the affordability levels previously communicated by USS employers and members. The consultation document states that USS, "*aim to make the cost of funding new pensions as sustainable as possible,*" but this stated objective is not borne out in the document that follows it. We believe that this disconnect between objective and text risks undermining employers' and members' confidence in USS and risks undermining their engagement in the valuation process. For example:

- we have already had feedback from some of our members that USS represents poor value or is failing – this reaction may well lead to further members opting out of the scheme in circumstances where the current rate of opt out is already a concern;

- employers may now see little incentive to engage with further consultations on debt monitoring, pari passu or the proposed rule change, since even with these in place the scheme appears unaffordable.

Consistent with our responses to previous consultations, the University remains supportive of the recommendations set out by the JEP and of the work of the Valuation Methodology Discussion

Forum (VMDF). We are pleased to see that some JEP recommendations have been reflected in the technical provisions consultation. In particular, the adoption of dual discount rates is a positive step; we understand this methodology change would have avoided contribution increases if it had been adopted for the 2018 valuation. However, we believe that the affordability of the scheme relies on the adoption of two further JEP recommendations regarding pre-retirement discount rates and deficit recovery period.

Pre-retirement discount rate

With a "strong" covenant, the consultation document suggests that the highest pre-retirement discount rate that would be acceptable to the USS trustee would be gilts+3.5%. Even allowing for a reduced allocation to return-seeking assets of 55%, gilts+3.5% represents a 78% confidence level. This seems unnecessarily high in the context of the strongest possible covenant.

Gilts+3.5% was the highest of the three pre-retirement discount rates set out by the JEP. However, that was in the context of financial conditions at the time, and without any additional covenant measures in place.

The JEP recommended that the pre-retirement discount rate be expressed as a fixed margin above CPI inflation, rather than above gilt yields. Since the JEP report was published in December 2019, gilt yields have fallen by around 0.5% pa relative to CPI inflation. **As such, gilts+3.5% would now represent the middle of the range set out by the JEP with scope for a higher rate to be adopted. The range should then increase further if additional covenant measures are agreed.** USS therefore needs to justify why, against the views of the JEP, it considers that a pre-retirement discount rate higher than gilts+3.5% would not be acceptable.

Please also note that we do not agree with USS' view that the adoption of a dual discount rate approach should lead to a reduction in the allocation to return-seeking assets.

Recovery plan length

Whilst we acknowledge that this consultation does not include the recovery plan, we consider it unhelpful to have shown recovery periods of eight and ten years. The lowest level of deficit contributions illustrated using this recovery period is 11.9% – even at this level, the amount the sector could reasonably afford in addition would not provide an acceptable level of future benefit accrual (whether that was DB or DC in nature).

The JEP recommended a recovery period of 15-20 years with some allowance for investment outperformance. We also note that both the 2017 and 2014 valuations were concluded on the basis of a 17 year recovery period. We believe that a recovery period of this duration would go a long way towards securing affordability of contributions without unduly compromising the prudence of the scheme.

Valuation timing

We strongly disagree that decisions on the long-term future of USS can be made in the context of what are extraordinary circumstances in the global economy. The UK Treasury has cancelled this autumn's budget noting that "now is not the right time to outline long-term plans", yet there is a danger that that is exactly what we are heading towards with USS. In particular, current interest rates reflect a significant level of government intervention, and it is therefore improbable that the long-term rates implied will continue over the time horizons considered in this consultation

document. Decision making in the midst of such market dislocation risks proving to be thoroughly reckless.

We appreciate that a decision was reached earlier in the year to proceed with the 2020 valuation, but in light of a further six months' experience it is essential that USS reconsiders this and sets out the implications of delaying the valuation until 2021.

29 October 2020