London School of Economics and Political Science ("the School")
Universities Superannuation Scheme ("USS")
Initial consultation on the Methodology and Inputs for the 2017 Valuation ("the initial consultation")

Introduction
This paper provides the School's responses to the initial consultation on the methodology and inputs to be used for the actuarial valuation of USS as at 31 March 2017. In providing this response, the School notes that further consultation will take place on the detail of the valuation assumptions later on in the valuation process.

In preparing its response the School has considered the following:-

- Methodology and Inputs for the 2017 Valuation: Initial assessment – Technical discussion document for sponsoring employers dated 17 February 2017
- Methodology and Inputs for the 2017 Valuation – powerpoint presentation dated February 2017
- Aon's initial views discussion document prepared for UUK
- Input from the School's Pensions Advisory Group

Key issues
The technical discussion document provided sets out the USS trustee's initial assessment of the methodology and key inputs for the 2017 valuation. The key areas relate to:-

- How the maximum level of reliance that can be placed on the employers is determined;
- The range of values used for the key valuation assumptions.

The trustee has requested comments on all aspects of the methodology and inputs with a particular focus on the following three areas as set out on Page 4 of the discussion document and repeated below for ease of reference:-

(i) The approach to determining the maximum reliance which can be placed on the employer covenant in future when funding the scheme, and in particular the inputs that are used to determine the reliance. The trustee has assessed that contingent contributions paid over a time horizon of 20-40 years from now, of 7% of pensionable pay, consistent with the 2014 view is still reasonable.

(ii) The view on future investment returns, and in particular whether employers prefer to rely on the current market view for long term interest rates, or whether they prefer the view that long term interest rates will revert to higher levels than markets currently predict;

(iii) The degree of confidence required that the assumed pension costs will prove a reliable forecast, and how much risk the employers prefer to take out of the maximum risk possible. Specifically, is the risk appetite different for funding benefits earned to date versus the benefits the sector wishes to promise in the future

Responses
The School's responses are set out below under the headings of 'covenant', 'investment returns and discount rate' and 'future benefit provision'. We have concentrated on what we see as the main issues, noting that we will have the opportunity to comment on the more detailed aspects of the valuation later in the process.

1. Covenant

We note that the covenant assessment carried out by PWC and EY shows a strong covenant with an increased time horizon of 30 years compared to 20 years at the 2014 valuation.

1.1 Time horizon - the increased time horizon could be allowed for in the valuation in the following ways;

- Extending or delaying the 20 year (investment) de-risking period, which would support a higher discount rate or increased allowance for investment outperformance in the Recovery Plan
- Extending the period over which the deficit is removed from the 17 year period used at the 2014 valuation

1.2 Self sufficiency – the School would support the use of a less prudent self sufficiency target based on a discount rate of gilts plus 0.75%. The School also supports the view that USS could implement a low risk portfolio that would provide a very high probability of the trustee being able to pay all members' accrued benefits in full.

1.3 Quantification of reliance – we note that the proposed reliance on covenant is quantified as the value of 7% 'contingent contributions' payable over a period of 15 to 25 years with a base case of 20 years. The same approach was adopted in 2014 (i.e. 7% over 20 years). We do not support an increase in the period over which contingent contributions are paid. We would also note that the majority of employers have stated that 18% is at the limit of affordability.

1.4 Growth in reliance – the School does not support inclusion of any allowance for growth in the reliance, in real terms, in the future.

2. Investment returns and discount rate

2.1 Gilt yields - We note the adverse impact of the significant fall in gilt yields since 31 March 2014. We also note that, if gilt yields do not revert at least some way towards 2014 levels, the scheme is unaffordable in its current form and significant benefit changes will be required to reduce or stop defined benefit accrual.

2.2 Discount rate - we would support a higher discount rate to the extent that the lower self sufficiency target can be reflected in a lower technical provisions target. We would also support a higher discount rate to the extent that de-risking can be delayed or extended by taking into account the increased 'strong covenant' time horizon.

2.3 Recovery Plan – we would support an extended Recovery Plan term which extends up to 30 years to reduce the annual deficit cost.

We would also note that the Recovery Plan adopted at the 2014 valuation included an allowance for future investment returns above the discount rate (but below the expected best estimate return). This had the effect of reducing the level of prudence in the funding assumptions as only part of the funding deficit is met by cash contributions from the employers. Whilst we would support a similar approach being adopted at the 2017 valuation, we would like to understand the value that is attached to assumed future investment outperformance relative to the discount rate and the corresponding proportion of the deficit that is assumed to be removed by future returns which are not guaranteed.

2.4 Reversion - we do not have a view on whether gilt yields will revert some or all of the way back to 2014 levels. However, we are prepared to support a contingent stepped approach where reversion is assumed to take place within a clearly defined framework which includes triggers for contribution increases and benefit changes if reversion does not materialise and funding does not improve as expected.

For example, triggers could be put in place so that contributions are increased and/or benefits changed in a pre-defined way from 1 April 2020 if the funding level and deficit are below an agreed trigger level as at 31 March 2019.

This approach provides scope to allow yield reversion with a pre-agreed action plan to provide some protection for the scheme and employers if yields remain at current levels. In our opinion, it would provide an appropriate level of prudence whilst allowing time for the market reaction Brexit and Trump.

3. Future benefit provision

We note that the latest benefit changes were implemented less than 12 months ago. The School's view is that it is too soon for further changes to be made. As noted above, we also wish to allow a reasonable period of time for markets to react to the recent Brexit and Trump votes, the impact of which will take years rather than months to unfold. However, we want to ensure that there is a pre-agreed framework with defined changes taking place in 2020 if conditions are unchanged or have worsened following the 2017 valuation.

In terms of the risk appetite for funding past and future benefits, the School would not adopt a different approach. Here, we would note that future benefits will become past benefits and so should not be funded differently.