OCR
Oxford Cambridge and RSA

Cambridge Office
1 Hills Road
Cambridge
CB1 2EU

Telephone 01223 553998
Facsimile 01223 552 627
www.ocr.org.uk

Universities UK
Woburn House
20 Tavistock Square
London
WC1H 9HQ

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Dear Sirs,

Further to the initial consultation on the USS valuation, please find attached OCR's response to the proposed changes.

Yours faithfully

Liz Allan
Group HR Director

OCR
Oxford Cambridge and RSA

Universities Superannuation Scheme ("USS")
Initial consultation on the Methodology and Inputs for the 2017 Valuation ("the initial consultation")

Introduction
This paper provides OCR'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, OCR notes that further consultation will take place on the detail of the valuation assumptions later on in the valuation process.

In preparing its response OCR 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

The opinions included in this response are those of the Officers of OCR as there has not been sufficient time for the response to be considered by the governing bodies.

Due to the quick turnaround required for this initial consultation, OCR regrets that it has not been possible to consult internally particularly with its Pensions Advisory Group. However, OCR will take into account the views of internal groups during the next stage of the consultation process, which is expected to take place in May 2017 and would ask that consideration is given by USS to allowing adequate time for this wider consultation to take place.

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:-

- The maximum level of reliance that can be placed on the employers;
- 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 (being the difference between 25% maximum contribution and the regular contribution of 18%), 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

OCR's responses are set out below. 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 Reliance (time) horizon - the increased time horizon (30 years) 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 – OCR would support the use of a less prudent self sufficiency target based on a discount rate of gilts plus 0.75% (compared to gilts plus 0.5% as used at the 2014 valuation). OCR 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 – to start, we would note that the majority of employers have stated that 18% is at the limit of affordability. As such, if an 'in extremis' situation arises, payment of the contingent contributions may require a reduction in the level of future service benefits to ensure overall affordability (i.e. an overall rate of less than 25%).

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 at 7%. However, we note that it would be possible to allow for different contingent contributions over different periods, for example to reflect reducing covenant certainty over longer periods:-

- 7% over 20 years
- 6% over 25 years
- 5% over 30 years

We would also note that the Recovery Plan term and de-risking period should be consistent with the reliance horizon and the period over which contingent contributions are assumed.

1.4 Growth in reliance – OCR does not support inclusion of any allowance for growth in the level of reliance on the employer covenant, in real terms, in the future. OCR's strong view is that the level of reliance on the employer covenant should not increase in real terms. We would also note that, under the approach used, the level of reliance has increased significantly since 2014 due to the increase in total pensionable salary roll between 2014 and 2017. As such, this already allows a less prudent approach to be adopted in 2017 compared to 2014.

2. Financial inputs

2.1 Gilt yields - We note the adverse impact on the discount rate and liabilities 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 defined benefit accrual.

2.2 Reversion – we do not support any approach that allows for reversion of gilt yields some or all of the way back to 2014 levels.

2.3 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. However, the overall reduction in prudence compared to 2014 should be limited to the decrease in the self sufficiency target (from gilts plus 0.5% to gilts plus 0.75%). We do not support any further reduction in prudence that would arise from allowing for real growth in the reliance on the covenant.

We would also support the use of a dual discount rate approach (or similar) under which a higher pre-retirement discount rate is used for active and deferred liabilities alongside a lower post-retirement discount rate to value pensions once in payment. An advantage of the dual discount rate approach is that if the scheme matures more quickly than expected, the basis naturally becomes more prudent with the discount rate tending towards the lower post retirement rate. As such, it may provide a more robust approach if and when scheme circumstances change. We would also note that the approach can be linked to the self sufficiency assumptions by setting the post retirement discount rate to be equal to the self sufficiency discount rate. However, we do not suggest that a dual discount rate is used to increase the overall level of prudence, but rather to provide a more robust methodology.

2.4 Recovery Plan assumptions – we would support an extended Recovery Plan term of up to 30 years to reduce the annual deficit cost. We would also support some allowance for outperformance in the Recovery Plan but would like to understand how much of the deficit is expected to be removed by deficit contributions and how much by assumed (but not guaranteed) future investment outperformance.

3. Risk

3.1 Covenant assessment - Whilst OCR has reservations on the covenant assessment, we acknowledge the professional advice from PWC and EY received by USS. Given this advice we would be willing to accept an approach that uses the increased time horizon on a strong employer covenant to support an extended or delayed period of investment risk reduction to the extent that the increased expected return would support an increase in the discount rate.

3.2 Level of risk taken relative to level offered - OCR does not wish to take out the maximum risk possible and would limit the reliance on covenant as noted under paragraphs 1.3 and 1.4 above.

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

3.4 Assumed pension costs – OCR's view is that assumed pension costs will remain volatile while future benefits are provided on a predominantly DB basis. If changes are required, OCR would support a staged move to full DC provision.

4. Other issues

4.1 Future benefit provision - we note that the latest benefit changes were implemented less than 12 months ago. OCR's view is that it is too soon for further changes to be made. However, as noted under paragraph 2.1 above, the scheme is unsustainable in its current form unless market conditions (and funding) improve.

4.2 Framework for change - we suggest that a framework is put in place so that pre-agreed changes are made to benefits over a period of time if the deficit and funding level have not reached agreed levels at agreed dates in the future. This could involve lowering the DC salary threshold in stages from £55,000 to increase the balance of benefits provided on a DC basis. Here, we would note that, under the current benefit structure, future pension provision is split (broadly) 85% CRB, 15% DC under the 2014 assumptions.

4.3 Sectionalisation – OCR would support, very strongly, sectionalisation of the scheme for both past and future benefit provision. Combined with pragmatic choices on future pension provision (i.e. level of CRB accrual, level of salary threshold, level of DC contributions) this would provide a flexible and sustainable model that would allow employers to tailor benefits to suit their needs as well as supporting the long term existence of USS as an open scheme.