

Colleagues,

You may have been alerted to a blog published over the weekend claiming that analysis we provided to Dr Sam Marsh (UCU elected JNC representative) last week has uncovered a large and demonstrable error in the most recent valuation.

I can advise that there is no such error in USS's valuation. Dr Marsh's analysis is not wrong **in isolation** – but it is simply not an adequate premise on which to set the funding arrangements for the scheme.

The commentary that this analysis has generated is based on an incomplete understanding of the scheme's current funding proposals and of regulatory requirements. The fundamental issues at stake have been addressed at various stages over the course of the valuation. We have engaged extensively with both employer representatives and member representatives (via the JNC) appointed to consider these issues in depth and in context.

Firstly, it has always been clear from USS valuation discussion papers (and latterly from the Joint Expert Panel's analysis) that it is expected that the cost of pension provision in future will fall, as interest rates rise. We have been clear on that since the earliest discussions on the valuation.

In effect, Dr Marsh's approach takes the JEP's proposals to 'smooth' contributions over two valuation cycles, and extends that to 20 years. It is not surprising that when this is done, current contribution levels are (in aggregate) ultimately adequate.

However, it is important to understand what lies beneath the projections: most notably, an assumption – formed by USS and fundamental to the valuation - that interest rates **will** rise in the future and **sooner** than if the current forward interest rates available in the market were taken as our base case.

If that does not happen, then the scheme is less resilient to funding shocks that might emerge in the near term. [Our Chief Risk Officer goes into this in a more detail in a technical note accompanying this briefing.](#)

We only need to look at what happened in the three years between the 2014 and 2017 valuations to see how quickly underlying funding assumptions can prove to be wrong: in this short period, severe declines in gilt yields increased the potential cost of moving to a low risk portfolio (to protect the scheme from downside risk) by £13bn (from £14bn to £27bn, updated to £22bn using our 2017 assumptions).

The trustee must ensure the scheme is robust under its core assumptions, and it must also be manageable **even if interest rates do not rise.**

There are many conditions that must be met in order to present a coherent funding plan for a scheme as large and complex as USS. One is that the scheme can be in balance, and within the risk budget set by scheme sponsors, at our 'funding horizon' of 20 years. This is the focus of Dr Marsh's analysis. However the trustee must also ensure it has a credible path to this position. This path must ensure the scheme's funding position is not unduly subject to the risks of short term shocks raising the hurdle rate beyond what is credible or sustainable.

As noted above, [we have provided a more technical note on these points.](#)

There must also be a path that manages the scheme's position in the event that interest rates do not rise as anticipated – for managing 'downside' risk.

Independent expert advice on covenant confirmed that while the sector is expected to be strong in the long term, the scheme is towards the upper end of the range of the amount of risk that can be supported in the short term.

This view is shared by the scheme actuary, the schemes sponsors, and very importantly by the Pensions Regulator. Continuing to pay the same contribution rate and not moving to moderate the investment strategy would exacerbate the risk in the scheme in a manner that would not be compatible with the advice received by the trustee and could well be challenged by the regulator.

As a result, contributions must rise in the short term to manage these risks, acknowledging that the most likely – but by no means certain – path for contributions is that they fall in the future. Should this happen, there will be more options available to adjust contributions, benefits or investment strategy.

The trustee's fundamental belief is that risk is multifaceted, and requires a wide perspective, and broad tools to manage it appropriately. This approach to the valuation has been carefully constructed, and robustly built based on independent advice from our scheme actuary and covenant adviser. It has been subject to independent review by a third party actuarial firm, and by TPR. None of these reviews has suggested there is scope to take the level of risk in the funding arrangements that is proposed by recent commentary.

Subsequent claims that nothing has to change in the scheme because asset projections **in isolation** suggest current contributions are adequate understates the risk of underpaying the economic cost of pensions today: as we set out above, the recovery from any downside event could be very difficult.

As USS does not have government backing, it must be funded within the risk appetite and collective capacity of our sponsoring employers. An approach based **solely** on asset projections ignores the need for the scheme to attain a position within the risk appetite of sponsoring employers, and the time required – as a result of our size and scale and market constraints – to make adjustments to the types of assets we would need to hold to achieve this.

Legislation requires the trustee to choose prudently economic and actuarial assumptions taking account of an appropriate margin for adverse deviation, with the objective of ensuring that benefits can be paid as they fall due. It is not possible or sensible to smooth these assumptions over a twenty year period.

Finally, I can confirm that we provided all of the information and analysis that was requested by the Joint Expert Panel. Given that it ignores downside risk, the approach Dr Marsh looks to support by using asset projections alone is not an adequate approach to risk

management in the context of USS. As such, it was not requested by – or provided to – the JEP or employers.

In providing the analysis requested at the JNC by Dr Marsh, which subsequently informed Professor Otsuka's blog, we clearly stated in our document the limitations of the analysis. It is not a sufficient approach to setting funding assumptions, and would not meet the requirements of the USS valuation.

Bill Galvin

USS Group CEO