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Sir Martin Harris
Chairman of the Trustee Board of the Universities Superannuation Scheme
USS
Royal Liver Building
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Dear Martin

Universities Superannuation Scheme ("the Scheme")

Thank you for your letter of 25 July 2014. We are grateful that the trustee board have taken time to consider our concerns and provide a response.

Your response included information prepared for the Board which aimed to reconcile the two approaches under discussion. As we do not believe that account was accurate, we have followed your example in tackling this in a separate attached note.

You have listed the points considered by the Board in coming to the conclusion to reject alternative approaches to the valuation. As our members are likely to take a keen interest in these discussions, we think it is important that we respond to each of these points separately and our responses are therefore set out below.

1) *"Different models exist, but did not identify any fundamental differences that would give rise to materially different outcomes, once its funding objectives are taken into account"*

   This suggests that one should differentiate between different models on the basis of their outcomes on any one specific date. We do not believe this is right and are not supporting an alternative methodology simply because it has a better outcome. Rather we are suggesting that the 'gilts plus' methodology has produced and will continue to produce volatile outcomes. Volatility in results was identified by the USS engagement paper "Scheme funding within USS" as a major problem for the scheme and the sponsoring employers. Changing the valuation methodology would, in our view, be a far more rational response to the problem of volatility than to change the investment strategy to fit the valuation methodology and by doing so increase the expected costs of the scheme to all the stakeholders.

2) *"There are advantages of using a consistent method of establishing the discount rate from one valuation to the next and indeed compelling reasons would be required for a change in the approach"*

We agree with this point but would suggest that there are compelling reasons to change, namely:

- The points set out in the de-risking paper about the desire for less volatility in the results, and

- The fact the valuation methodology is being allowed to influence the investment strategy making the scheme more expensive than it needs to be

3) *"The annual survey published by The Pensions Regulator indicates the current widespread use of the method put forward by the scheme actuary and adopted by the Board"*

We find this comment puzzling. Whilst the Regulator publishes an analysis of the additional returns schemes assume over a gilt based discount rate and publishes data on schemes using dual or single discount rates, it does not indicate the methodology used by trustees in setting their discount rate. In other words, the Regulator recasts trustee assumptions on a 'gilts plus' basis for analysis but does not record the approach used by schemes in setting this rate. Indeed, the Regulator has taken pains over the last couple of years to remind the industry that there is flexibility over the setting of the discount rate and that it does not expect the discount rate to be a fixed margin above gilt yields in varying market conditions. If the Trustee Board has been given this incorrect indication of the Regulator's survey, we would suggest it is important that it be corrected.

4) "*Whether the gilts plus basis, the model suggested by UCU, or indeed any other model of future investment returns for return seeking assets is used, a number of key assumptions are required to be made, upon which the trustee board must exercise a degree of judgement based on professional advice. Depending on the view taken, these methods can lead to similar results and using 30 September 2013 market conditions does in fact do so"*

Comments questioning the reconciliation put forward in the information provided to the trustees are set out in the attachment. But we would repeat the point that our concerns are not simply about whether methodologies produce better, worse or similar answers. Instead we are concerned that the current methodology causes unnecessary problems by introducing unnecessary volatility and more importantly that the valuation methodology is being allowed to drive the investment strategy. It is important to note that in theoretical terms, the valuation assumptions do not affect the actual cost of the benefits which are determined by actual investment returns, actual longevity and so on. But if the methodology drives the investment strategy as it is being allowed to do, this has a real effect on the long term cost of the benefits.

5) "*Given the board's desire that there should be no increase in the scheme's reliance on the covenant provided by the sponsoring institutions, tests have been developed that will determine the appropriate discount rate in the future such that the difference between the technical provisions and a "self-sufficiency" value of liabilities is maintained within a given range. The expected return on assets will then be used to determine the appropriate investment approach. This limits the outperformance above gilt yield which can be assumed in the discount rate irrespective of any different views on what the best estimate investment return may be based on different models".*

This last point is important and our response to both this and the arguments raised in the second set of bullet points in your letter about why the "*trustee does not believe there is a sufficiently strong case to increase the level of optimism in the long term best estimate of outperformance above the gilt yield*" are covered in the attached note.

As always we would be pleased to discuss these issues further. We thank you again for engaging in correspondence with us on this subject. We only ask that you keep an open mind on the final choice of discount rate until after the valuation results have been considered by the Trustee and employers.

Yours sincerely

Sally Hunt

General Secretary

Copy: Bill Galvin, USS

Michael MacNeil, UCU

Appendix

a) Optimism and Reliance on the Employer Covenant

Different regulatory views

We note The Pensions Regulator's view that reliance on the employer's covenant is indicated by the difference between the technical provisions and the liabilities valued on a "self-sufficiency" basis. We also note that a self-sufficiency basis is driven by bond yields.

We also note the view of the Financial Reporting Council which sets the Technical Actuarial Standards ("TASs") which apply to actuarial work and advice. The Pensions TAS requires actuaries to provide a neutral (i.e. best) estimate of the value of the liabilities, alongside their calculation of technical provisions. The purpose of this requirement is to enable Trustees to "understand how prudent they are being when choosing assumptions and setting contribution rates"[1]. The FRC also state that they "do not consider that the solvency position indicates the level of prudence in the technical provisions"[2].

As the solvency and self-sufficiency measures are generally taken to be near equivalents (especially for very large schemes whose opportunities to buy out will be limited), this means there are two differing views from the regulatory bodies overseeing pensions and actuarial advice.

We do not make this point to claim precedence for one view over another but to point out the different approaches and to discuss the implications of these for the question of how much reliance there is on the employers and how pessimistic the basis is. This discussion is developed in the next section.

It is worth pausing to note that the view taken by the Regulator is one interpretation and should not be presented to trustees as the only possible approach. Indeed it is the trustees and not the Regulator who have the fiduciary responsibility to the scheme members. To say trustees must follow the approach taken by the Regulator undermines the control, decision making and responsibility that legally lies with the trustees. By contrast, the Regulator has a duty to protect the PPF so it is entirely likely that the preferences of the trustees and the Regulator would diverge. If all trustees were to do in a valuation were to follow the Regulator, there would be no need for trustees to be involved in funding decisions – and no responsibility for poor funding decisions would lie with them, in contradiction to the duties given legally to the trustees.

The legislation does make it quite clear that trustees are responsible for making decisions on scheme funding. They should therefore feel entirely justified in making decisions that do not simply mean only ever doing what the Regulator would do.

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[1] FRC TAS P Significant Considerations 7.7
[2] FRC TAS P Significant Considerations 7.11

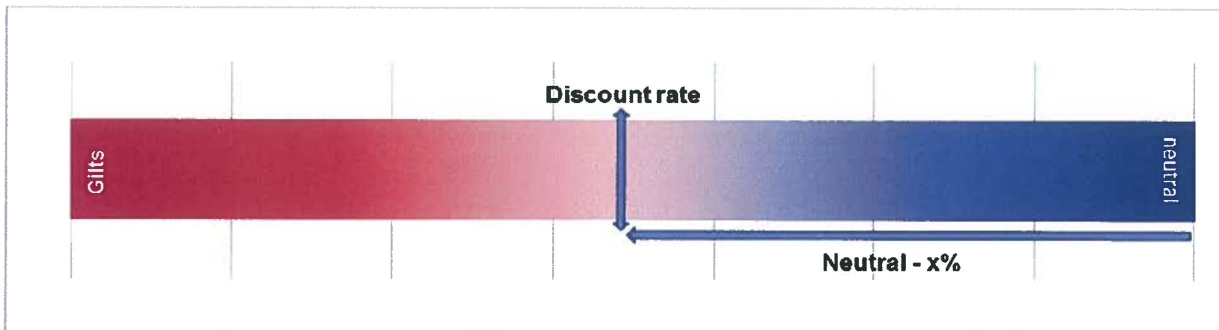
Ongoing view and self-sufficiency view

There is a wide range of values which can be placed on the benefit cash flows of a pension scheme, from a neutral estimate to a solvency or self-sufficiency estimate. As the value increases from the neutral estimate, the margin of prudence increases and the reliance placed on the employers' covenant decreases.

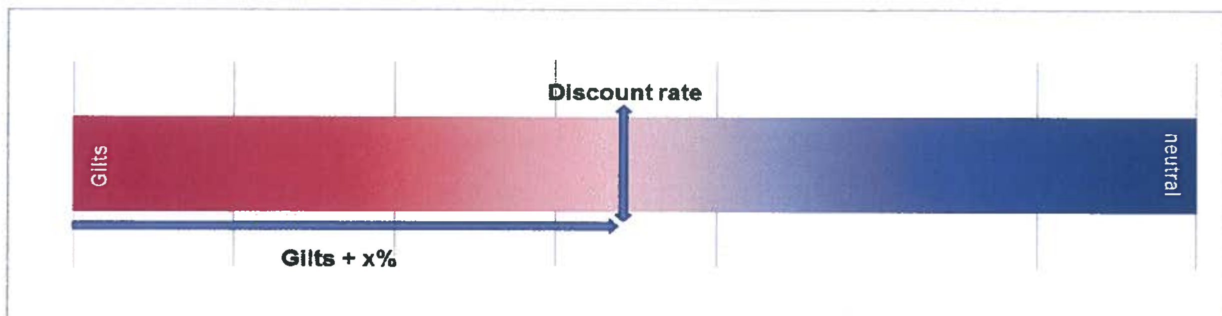
The statutory valuation of a pension scheme is an "ongoing" view, in which the scheme is assumed to continue in its current state. The scheme is required to fund prudently for the payment of benefits in the future.

The neutral estimate required by the FRC involves taking a realistic view of the likely future investment strategy of the scheme and the expected return from these investments. A realistic ongoing plan would factor in the expected income from the assets and compare it to the expected outgo on the benefits. A neutral discount rate would value the expected income from the assets at their market value.

An ongoing prudent funding approach would take a neutral best estimate return on the asset portfolio and deduct an amount to allow for prudence. We might term this is "neutral minus" approach to discount rates. Here the distance moved ***from right to left*** indicates the reliance on the employer covenant.



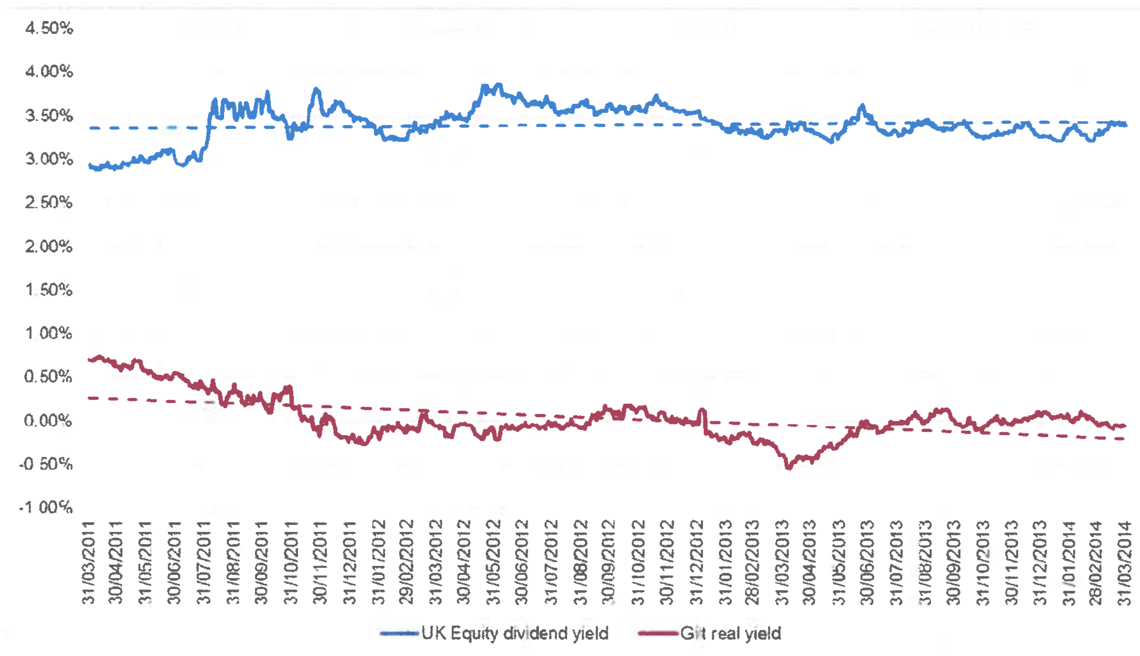
By contrast the approach favoured by the Pensions Regulator for its internal use is to set the starting point as one assessed using a gilt discount rate and to add a prudent level of outperformance to a gilt yield – a "gilts plus" approach. Here the distance moved ***from left to right*** indicates the reliance on the employer covenant.



The discount rate and the investment strategy

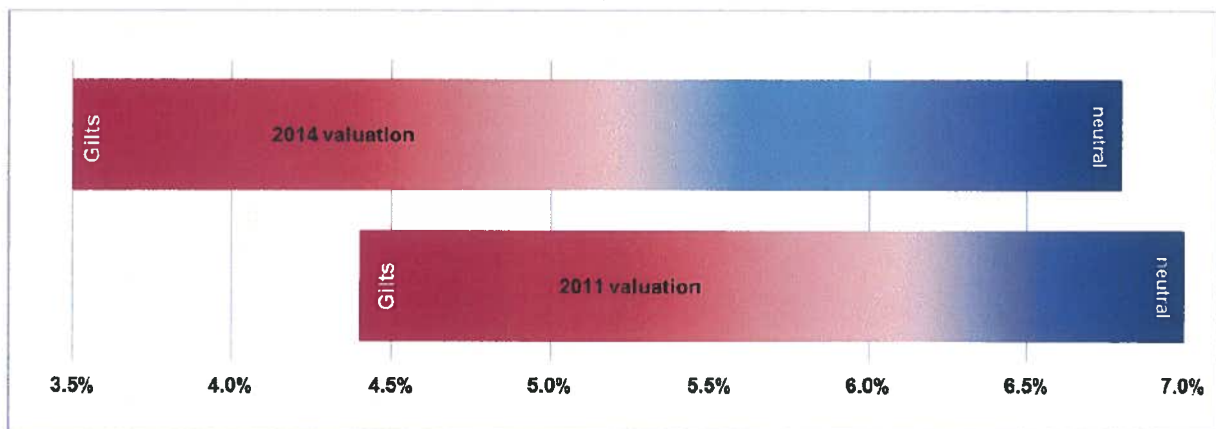
The effect of using one or the other of these approaches will change over time and consideration of the approach used needs to be given before any assessment can be made of how a change in the basis affects the level of optimism or reliance on the employer covenant.

The gap between yields has widened over the inter-valuation period, as shown in the graph below:



For USS, over the course of the inter-valuation period, gilt yields have fallen but equity dividend yields have risen slightly so the gap between a self-sufficiency and neutral basis has widened.

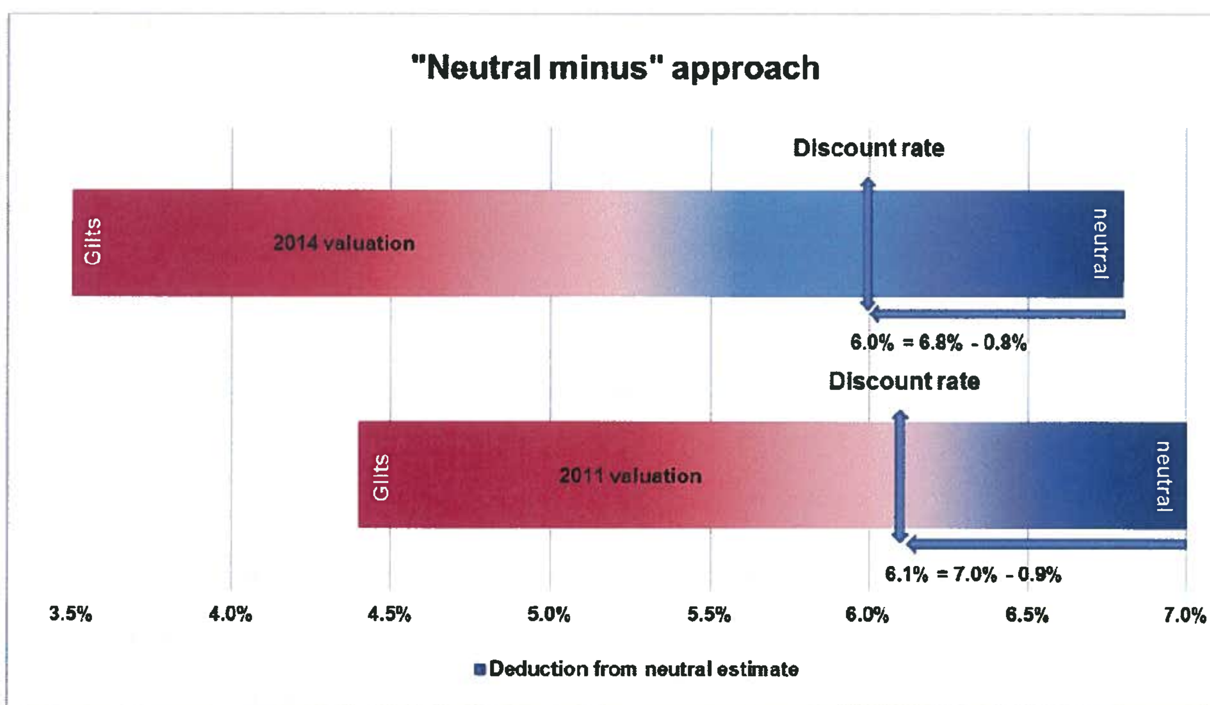
In the graphs below, we show this with the neutral return being built up as shown in our previous note. (Please note that for the 2014 valuation we are working with market conditions as at 31 March 2014, not 30 September 2013).



If the valuation methodology follows an FRC type “neutral minus” approach, the change in basis from 2011 to 2014 would reflect the change in yield on the actual assets held by the scheme (such as the change in UK equity dividend yield, and other data considered relevant by the internal investment team) since the previous valuation, and this would represent:

- A weakening of the position of technical provisions relative to the self-sufficiency target, and therefore increased reliance on the employers’ covenant in a termination context, but also

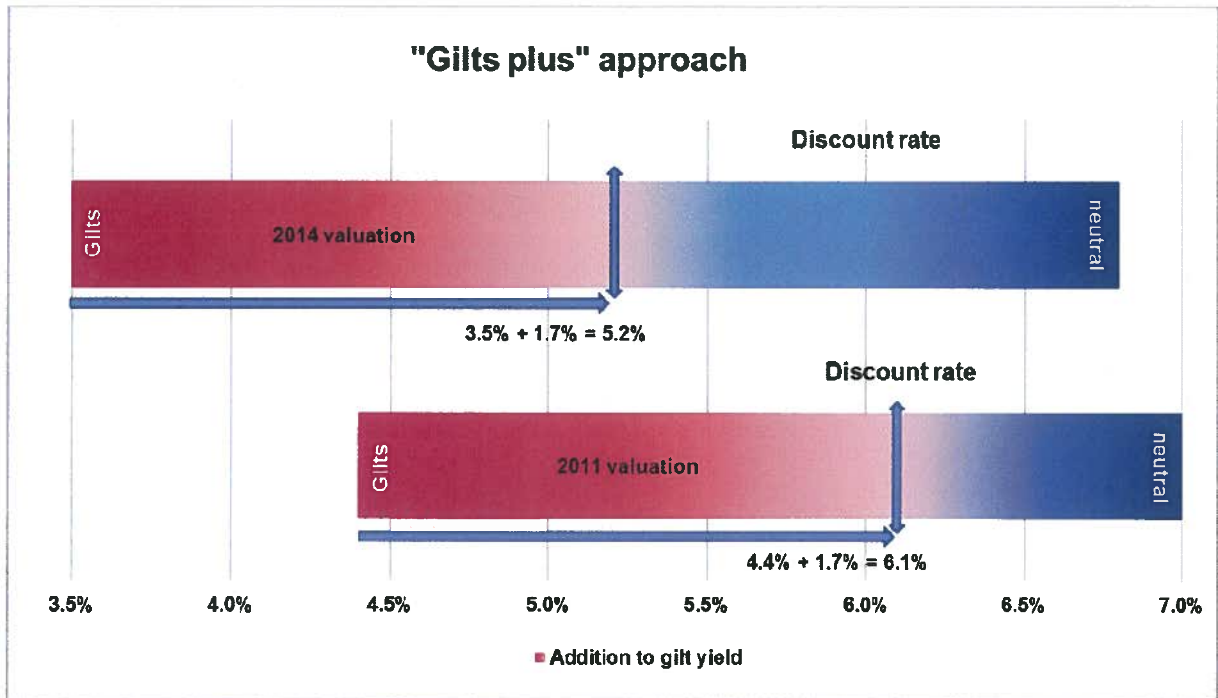
- An unchanged margin of prudence relative to an ongoing neutral value of the liabilities calculated using an IRR approach, and therefore no change in reliance on the employers’ covenant in an ongoing scheme context. In fact, the reliance has fallen a little due to the lower proportion of growth assets in the portfolio.



If the choice of discount rate in 2014 is set with reference to gilt yields, then this represents:

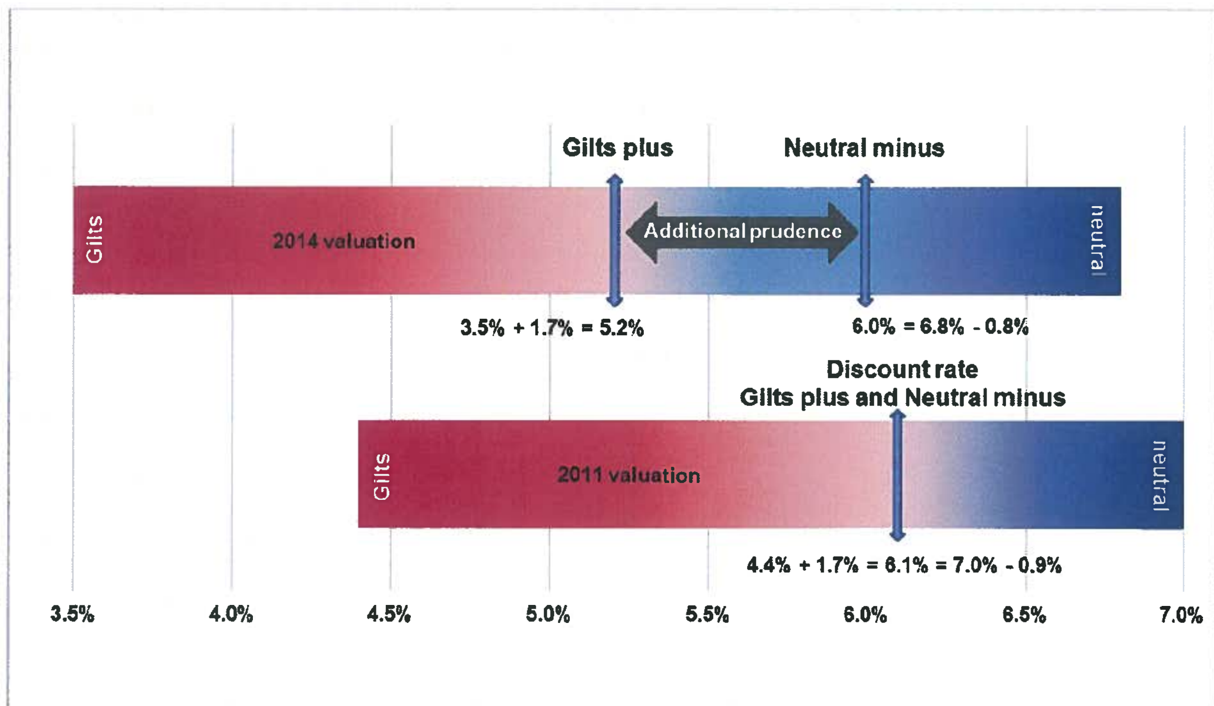
- a maintenance of the position of technical provisions relative to the self-sufficiency target, and therefore no change in the level of reliance placed on the employers’ covenant in a termination context, but also

- an increase in the margin of prudence relative to an ongoing neutral value of the liabilities calculated using an IRR approach, and therefore less reliance on the employers’ covenant in an ongoing scheme context.



It is important to note that with a multi-employer last man standing scheme like USS, the chances of involuntary termination are very remote and it would seem sensible to follow an ongoing FRS type approach. This means that an increase in the discount rate used (relative to gilts) does NOT represent a more optimistic basis – rather adopting the same addition to gilt returns would imply building in a significant additional margin of prudence to the basis, relative to a neutral ongoing view.

The chart below shows a comparison of the two approaches to constructing the discount rate as at the 2011 and 2014 valuations, showing the widening of the gap between the self-sufficiency basis and neutral basis.



This diagram illustrates two important points. First at 2011, there is no difference between the two methods because we calculated the "neutral minus" construction to reproduce the 2011 discount rate. Second the grey arrow shows the significant additional prudence compared to a neutral basis being introduced by using a gilts plus approach in 2014 without acknowledging the change in market conditions since 2011.

b) Reconciling the Discount Rates

This section addresses the paper on Determining an Appropriate Discount Rate attached to your letter of 25 July.

We realise that the construction we gave of a discount rate using the Internal Rate of Return (IRR) method was very simple. This was to ensure that all the stakeholders could participate fully in the debate without issues being clouded by unnecessary complication. We entirely accept that the approach is capable of development by factoring in further information about equity markets and we identify with the commentary on this subject provided by the internal investment team.

There are two technical points in the reconciliation of the discount rates provided which we would like to discuss.

Inflation risk premium

Paragraph 2.10 proposes a change to our construction of the expected return on equities to allow for an inflation risk premium. However, we used an assumption of 3.2% pa for RPI as at 30 September 2013 in our construction of the expected return on equities, which included an inflation risk premium adjustment of 0.3%. This is shown in the table below.

Date	Bank of England spot rate for inflation (20 years, annualised)	Adjustment for inflation risk premium	RPI Assumption
31 March 2011	3.76%	- 0.3%	3.4%
30 September 2013	3.54%	- 0.3%	3.2%
31 March 2014	3.62%	- 0.2%	3.4%

The adjustment for the inflation risk premium has therefore already been made and should be removed from the table reconciling our discount rate with that of the scheme actuary's to avoid double counting.

Future real dividend growth and the investment team's opinion

The second item in the table on page 6 (reproduced below) is an alteration to the best estimate return on equities. The relevant matter for discussion, though, is not the best estimate return on equities but a prudent estimate of the expected return on equities. The premise of our construction of the 5.8% pa IRR based discount rate was, first, to identify the prudent real dividend growth assumption which reproduced the 6.1% pa discount rate used in the 2011 valuation (0% pa), and then to use this assumption for real dividend growth to construct a ***consistent*** IRR-based discount rate as at 30 September 2013.

Thus the second adjustment in the table (which reflects a decrease in the best estimate dividend growth assumption) is not relevant to the construction of a prudent IRR discount rate as the same prudent dividend growth assumption implied by the 2011 discount rate has been used. This adjustment should also be removed.

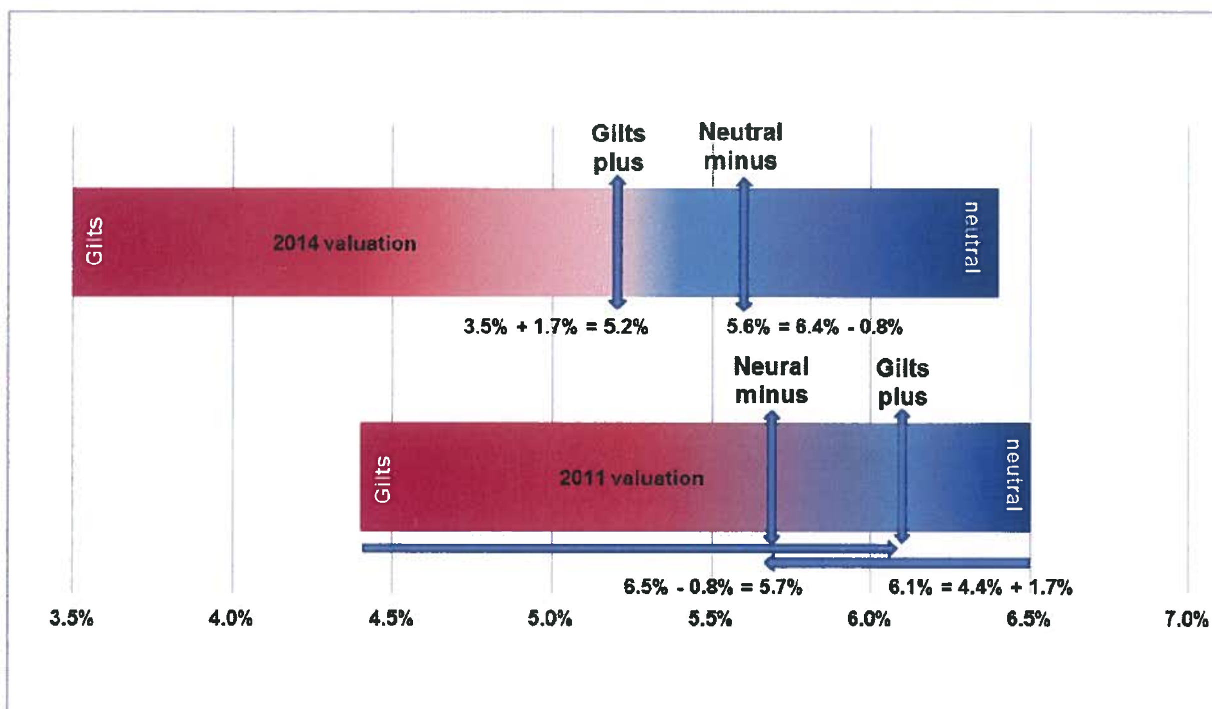
UCU discount rate	**5.8%**
Allowance for inflation risk premium	(0.22%)
Allowance for real growth on future dividend increases	(0.37%)
Allowance for investment mix and other differences	0.20%
Difference in level of prudence	(0.25%)
Unexplained	0.04%
Scheme actuary's proposed discount rate	**5.2%**

Conclusion

The IRR based discount rate of 5.8% pa uses a different methodology to that of the scheme actuary and for this reason cannot be reconciled to the proposed gilt yield-based discount rate of 5.2% pa.

Lower future dividend growth

In our construction of a best estimate return on equities, we used an assumption of 1% pa real dividend growth relative to RPI, as noted in 2.11. We did not advance a justification for this assumption, we simply noted lower prospects for growth in the future than in the past. We note in 2.12 the opinion of your internal investment team that, having considered a range of relevant additional factors, they expect future real dividend growth of not more than 0.5% pa. There is clearly no knowing which the "better" answer is but even with a 0.5% future dividend growth rate, an internal rate of return approach would be preferable to the "gilts plus" model currently being used. Below we illustrate a comparison of the "neutral minus" and "gilts plus" bases, but using an assumption of 0.5% pa future real dividend growth to construct the neutral estimate, and -0.5% pa prudent real dividend growth for the discount rate.



On this basis at the last valuation, adopting the "neutral minus" approach could have resulted in a more prudent discount rate than the 6.1% adopted by the Trustee. As mentioned above, we are not supporting an alternative methodology because it has a better outcome at all times, it does not, but because the gilts plus methodology has and will produce volatile outcomes.

For the investment team looking to manage the scheme's assets, a target in IRR terms may also be far easier to manage than a target in gilts plus terms.