

12 January 2015
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Your ref: BG/JMR

Dear Mr Galvin

Thank you for your letter of 18 December 2014. We have numbered the paragraphs of your letter, and use this to refer to it in our response below.

Most importantly, a conspicuous omission from your letter is an attempt to address the issue of the wild fluctuation in valuations (our letter, page 2, second last paragraph). We would appreciate a response as to why the USS Trustee does not recognise such instability as an indication that the methods of estimation are clearly not fit for purpose and therefore challenge the methods.

1. We provided comments to the University of Warwick as part of the response to the Universities UK response.
2. This fails to address the point we made. We did not refer to the USS's previous or historic approach to valuation assumptions, but rather to the USS fund's historic performance. We are puzzled as to why this historic performance is ignored.
3. We, along with many others, disagree with these claims. QE is producing a demand-driven yield decrease across the range of gilts maturities because the Bank of England's operations take place across the full range of gilts and maturities. As we are sure you know, as large proportions of the gilts issued by the government (DMO) are being bought by the Bank of England in QE operations, even the long-dated gilts do not reflect market expectations for yields, but rather short-term considerations about supply and demand. With regard to 'second guessing' the economic markets, as we are sure you are aware, the "taper tantrum" in 2013 demonstrates how gilt yields rise dramatically in response to the possibility of QE ending, while the Bank of England has indicated an intention to cease QE on a timescale which is very short in comparison to long gilt maturities.
4. We are most interested by this paragraph and are perplexed as to why this was not presented clearly (or at all) in public communications. We would welcome receiving the details, particularly the interpretation of 'realism' and the 'appropriate margin for prudence' in relation to actual performance of the various asset classes.

5, 6 & 7. (Replies to point 2 in our November letter.) We note that you describe the RPI inflation assumption as an objective measure.

We note that you have not acknowledged that public estimates of the inflation risk premium are in the range 0.5%-1% for 5 to 10 year bond maturities (page 3 of referenced paper), and must logically be higher for longer maturities (since the cumulative uncertainty about yields has to be greater). This is supported by historic data from the Bank of England.

With respect to the last sentence of para 6: the actions of USS can have no effect on the *market-implied* Inflation Risk Premium; we *do* accept that you intend to decrease the yield from USS assets.

The latest estimate of CPI from the Bank of England Monetary committee for the year 2017 is 1.91% and the present target is 2%, which implies that RPI should lie between 2.7% and 2.9%, in contrast to the 3.4% assumed by USS (3.6% - 0.2%).

8. With regard to salary growth, we note that you choose to ignore the most recent three years of salary data: is this ignored because it is inconvenient? Even with this exclusion, you cite general pay growth as RPI +0.7%, not +1.0%.

We would welcome an explanation of why the trustee is minded to assume $3.6\%+1.0\% = 4.6\%$ for future salary instead of the evidence-based $2.9\%+0\% = 2.9\%$.

9. We are puzzled, indeed concerned, by your inclusion of the first sentence of paragraph 9 as, although it is factually correct, it is entirely irrelevant to the conclusions of any given actuarial valuation. It is the conclusions of the April 2014 valuation and the corresponding estimates of liability which drive the present discussion.

If in 1990, the assumption of RPI +1% had been used in the 1990 valuation, then the estimate of liability for 2014 would have been overstated by 25%: this is why the expectation of future increases is important. In this case we do know that the liabilities would have been 'overstated', i.e. that the estimate of liabilities is seriously biased. The equivalent inference is that an assumption of RPI + 1% in April 2014 results in an overstatement of liabilities in 2034.

10. We referred not to one year of observed life expectancy, but to the most recent working papers published by CMI: wp63 and wp69, which refer to recent years. CMIwp69 also stresses the sensitivity to the assumptions on the rate of mortality improvement. Did you wish to imply that the most recent CMI reports are not valid? With regard to supporting data, we refer you to CMI wp39. Figure 6.1, for example, clearly shows the so-called 'golden cohort', born 1927-1936, who have annual mortality improvements which are higher than those born later. The observed data for those born in the 1960s includes *negative* annual mortality improvements.

11. Your comment on circularity is tangential, at best, to the points which we made. If the assumptions are determined (driven) by the target to be achieved, the assumptions include that target, as the target is an estimate *derived from assumptions*.

We refer to the desire to reduce the return on the investments in order to decrease the variability in estimates of liability, i.e. `risk' is expressed as `variance', not as potential loss to members of USS. The assumption that future returns are dominated by gilts both *reduces variability and increases the estimated deficit*.

12. You have conflated the period over which estimated excess liabilities need to be funded with the period over which the funders will tolerate any variability in contribution rate. The 40 years might refer to the technical average duration of fund. We understand that the Ernst & Young covenant assessment confirmed the enduring nature and solvency of the higher education sector to and beyond 20 years.

In the light of your statement about benefit design, we would like to have your comments on these remarks from UUK's 22 October submission to the JNC: `It will be noted that in looking at their Tests, the Trustees take no account of any Defined Contribution benefits that are introduced. These pose no obligation risk on the employers – in effect, risk is borne fully by members. As such, the Trustees exhibit a marked preference for DC benefits over DB benefits.'

The USS publicity officer who spoke at Warwick University (9-11 December 2014) also stated that the aim of the move to DC is to transfer all risk from the employers to the members of USS. Since you have agreed that the sole obligation of the Trustees is to the scheme's beneficiaries, it seems highly invidious that they were enthusiastically agitating for such a change.

Yours sincerely,

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