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Scare stories about USS liabilities are overblown

By Ros Altmann

Criticism of the Universities Superannuation Scheme pension fund raises fundamentally important issues for UK defined benefit pensions. John Ralfe suggests that one of Britain's largest pension schemes, with 390 employers and 300,000 members, is "hiding" or underreporting its pension deficit. This conclusion is not well founded.

Mr Ralfe seems to believe the FRS17/IAS19 10-year double-A corporate bond yield discount rate is an "objective" measure of pension liabilities, and therefore "correct", while USS's use of gilts +1.7 per cent – its expected return on assets – is subjective, and by implication "wrong".

In fact, both are merely estimates of the present value of possible future liabilities. FRS17/IAS19 is helpful for standardising and comparing pension funds in accounting terms, but it is not a reliable liability measure.

Pension liabilities have some similar characteristics to bonds but, importantly, bonds are not a "matching asset". Bonds cannot match the duration, inflation and longevity aspects of pension liability increases. Even in theory, 10-year corporate bonds do not match pension liabilities, while in practice schemes that switch entirely into bonds would struggle to meet their long-term liabilities – and there is not enough volume in the market for the largest to do so anyway.

It is entirely appropriate for USS to use its own scheme-specific discount rate, as is rightly enshrined in our defined benefit pension system. Schemes should be allowed to manage their own position best, rather than trying to all behave in the same way.

It is important to distinguish between closed, mature schemes with just one sponsor, which are effectively in "run-off", and an open multi-employer scheme still collecting contributions from members and accruing benefits.

Mr Ralfe also asserts that USS's discount rate takes credit for unearned equity risk premium. This is too simplistic. USS has progressively diversified its asset allocation in recent years. Its exposure to listed public equities is below 50 per cent as the scheme rightly aims to benefit from additional investment risk premia including illiquidity, with investments such as property, infrastructure, private equity and debt. This is not a "massive bet" as he puts it, but reflects diversification of investment risks and potential returns.

Pension funding has become more challenging in a post-quantitative-easing world, where investment risk and mark-to-market pension liabilities have been distorted by Bank of England gilt purchases. This requires a measured, long-term response to pension funding, which can look through shorter-term distortions and readjust over time where necessary. Indeed, switching to bonds at current rates may itself be a "massive bet" exposing schemes to credit and duration risk.

USS may need to increase contributions, adjust benefits or amend its investment approach, perhaps following the forthcoming 2014 triennial, but that is an ongoing process for any properly run pension scheme. It has been dealing with a legacy deficit for a number of years and has not been sitting on its hands. It has already made adjustments in 2008 and 2011, with increased contribution levels, reduced benefits and an adjusted investment approach to reduce risk relative to the liabilities.

Further changes may be required to ensure intergenerational fairness to cohorts of sponsors and members with such a large, open scheme, but this should be negotiated on the basis of long-term forecasts rather than knee-jerk reactions to short-term market factors.

USS management should review appropriate funding levels in the context of an integrated risk management approach that ties together the strength of the sponsors with the investment strategy and actuarial assumptions. The extreme volatility of interest rates recently has made this task much more difficult, but also enhances the case for considering such matters with a longer-term time horizon.

Pension reform will have an impact on USS too, as "contracting out" seems set to end in 2016. National Insurance contributions for employers will rise by 3.4 percentage points and for employees by 1.4 points. To offset this, schemes will no longer have to replace the earnings-related part of state pensions, which should reduce future liabilities.

Rather than encouraging schemes to invest more in corporate bonds, USS and other large funds have assets that can help the UK economy directly, as well as providing long-term pension benefits for hundreds of thousands of members. Investing in infrastructure,

for example, could be a win-win for the UK.

Pensions are a long-term business, requiring a long-term investment approach. There is no one-size-fits-all approach and each scheme needs to take account of its own specific circumstances. A fund the size of USS cannot fully de-risk, but scare stories of student fee hikes and hidden deficits are well wide of the mark.

Ros Altmann is a former UK government pensions adviser

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