Andrew Mason
UCU Pensions Representative
Surrey University

Professor G Q Max Lu
President and Vice-Chancellor

Dear Professor Lu,

I am writing to you as the Pensions Representative for UCU at Surrey University. I know that you were not in the U.K. at the time of the 2104 USS pensions' revaluation and subsequent downgrading of employee benefits when the scheme moved from a long-established Final Salary Defined Benefit Scheme to the current hybrid scheme which comprises the old final salary scheme, a CRB defined benefit scheme and a defined contribution scheme. In addition to the complexities of having three pension schemes where there once was one there was universal agreement amongst employees who are members of the USS scheme that our benefits and our conditions of employment had been downgraded.

Part of the problem with the last valuation was the methodology, the so-called 'gilts-plus' methodology which suggested that the scheme was in a substantial deficit and required extra contributions from the universities and members. This methodology was criticised in many quarters and may not be the most appropriate method of valuing the scheme, particularly at a time of unprecedentedly low interest rates in the wake of massive quantitative easing. It also may not be the most appropriate scheme for a fund which has strong cash flow and a substantial exposure to other asset classes, including the very large exposure to equities. As a former senior investment manager who worked for USS I was astonished at the outcome of the valuation and still find it difficult to believe.

I would however like to reflect the views of the Surrey Branch of UCU, fellow pension representatives at other UK universities and those of UCU and their actuary First Actuarial as an input to the upcoming employer consultation "USS Consultation Document on Methodology and Inputs for the 2017 Valuation" that closes on the 17th of March.

As employees of the university and members of the scheme we are deeply concerned that this flawed methodology is being employed again by the USS Actuaries and also that there may be an underlying shift towards defined contributions even though the current defined contributions component of the scheme has not bedded in. Nor does it provide sufficient information on the underlying investments for scheme members to make an informed choice. The USS pension scheme has been seen as an attractive part of a University remuneration package where salaries have been stagnant and administrative burdens have increased. We all fear another demoralising and unnecessary drive to reduce pension benefits which in the longer term may prove to be detrimental to the recruitment and retention of university staff.

To the best of my understanding there is a wish by the employers association (UUK) to ensure that over the time horizon of the Employers Covenant the contingent reliance on the employers does not increase in inflation adjusted terms.

This reliance on the employers covenant is a residual figure based on an estimate of future liabilities and future assets (and other factors such as demographics of the workforce which are not relevant to this discussion). The size of this shortfall or residual is totally driven by the underlying assumptions primarily the discount rate which is used to discount assets and liabilities and the assumed rate of return. When interest rates (discount rates) are so low, a very small change in the assumed discount rate or rate of return will have a large effect on the final outcome. There also may be a move to derisking – a shift from equities (risk & return bearing assets) into bonds (assumed to be a lower risk lower return asset). The timing of such derisking could have a significant impact on the fund as we have experienced an unprecedented period of very low interest rates (very high bond prices) and it would be disingenuous to assume that a major correction in this asset class may not occur over the timescale of the employers’ covenant. Thus a prudent strategy, which is not necessary for a cash flow positive fund, may hold significant implementation risk.

I apologise for the technical nature of the rest of the letter which is based on discussions of the proposals which have taken place at other forums but which outline some key issues in the current debate.

I have attached First Actuarial’s (UCU’s actuary) document released in Dec 2016 given which argues that given how expensive it now is to generate income from gilts that a significantly greater weighting of a self-sufficiency portfolio toward equity than gilts plus 0.5% would be a more efficient means of delivering self-sufficiency. We also believe that USS's best estimate of returns on equity must be assuming very modest real dividend growth, much lower it is than First Actuarial's best estimate, which assumes 1% real growth over RPI.

I would also like to draw your attention to the updated cash flow projection chart from First Actuarial, (PDF attached) which suggests that, as a result of the recent cuts to employees DB pensions, the scheme will remain in positive cash flow for the next 60 years. For reasons which are mentioned below in numbered excerpts from First Actuarial's submission to the 2014 valuation, such positive cash flow greatly diminishes the risk of remaining invested in return-seeking assets such as equity.

I have also attached Aon Hewitt’s UUK's submission for the 2014 valuation, as a means of avoiding needlessly layering prudence upon prudence. Such flexibility still involves a commitment to a substantial level of prudence which is inherent in USS’s Test 1 which relates to the technical provisions the reliance on the employers’ covenant.

The following points have been made by UCU, their actuaries and Pension representatives from various universities:

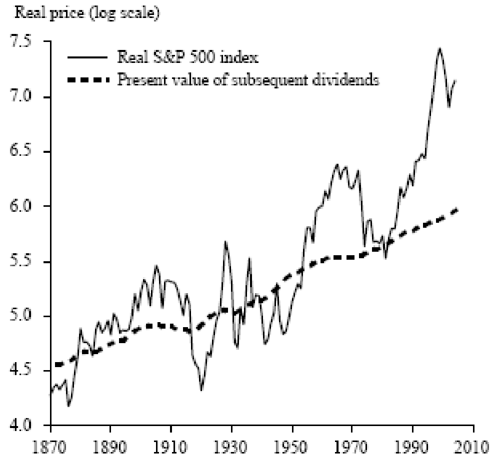
i. While the net cash flow is positive, there is no need to sell any assets and therefore no disinvestment risk to the USS. Low market prices are beneficial during this {…} period of positive net cash flow [because assets are being purchased more cheaply], so a measure of risk which suggests a market fall is a problem would be giving a wrong message.

ii. While there is no requirement to sell assets, volatility from market value fluctuations is not a concern for the USS: the main concern is the volatility in asset income. Measures of risk and funding level which are market value sensitive, as opposed to asset income sensitive, are likely to be inappropriate in this context and should be given little attention.

    i. In the >99% likely scenario of USS continuing as an open scheme sponsored by employers with a robust covenant, the issue of very high relevance is the rate of growth of asset income. Income uncertainty, not market value volatility, is the key issue for the scheme.

As we can see, moreover, from graphs such as the following, dividend income from equity is much more predictable and less volatile than the asset price:

Figure 1
Real S&P 500 index and present value of subsequent dividends



So long, therefore, as the scheme is valued in a manner that is sensitive to these more modest fluctuations in investment income rather than the greater volatility of asset prices, it seems unlikely that an in extremis scenario would emerge in which a funding shortfall becomes so great that employer contributions would need to rise to the level of 25%. First Actuarial has proposed an Internal Rate of Return (IRR) method of valuing the scheme that tracks changes in income rather than prices. See p. 7 of the attached document prepared by First Actuarial for some modelling of this approach, as applied to USS.

During communications with other Pensions Representatives it seems that not all employers/Universities accept the USS view of the world and the potential impact for employers and employees contributions. We urge you to get further clarification and supporting evidence from USS with regard to the level of risk and some explanation for their adherence to a possibly flawed valuation methodology. We feel that the case outlined above, maintaining contributions and benefits at least until 2020, provides a sensible and prudent means of sustaining our current defined benefit scheme and should not be rejected on the grounds that it may, under extreme circumstances, expose employers to further risk.

I look forward to hearing from you

Yours Faithfully

Andrew Mason

Ps This is an open letter which will be distributed to all members of the UCU Surrey Branch and I trust you will not object to your response being distributed to members

Attachments:
Aon Hewitt UUK 2 Dec 2014 response to AV consultation
uss_firstactuarial_2017valuationinput_reportforucu
First Actuarial's USS 2017.03.01 cash flows