University and College Union

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Dear Guy and Robert,

USS valuation ---- employer consultation

Further to our meeting last week, we are writing to share some thoughts on the 17th February "***USS Consultation Document on Methodology and Inputs for the 2017 Valuation***", for the employer consultation that will close next week, on 17th March. In line with their commitment to an open and transparent discussion of the valuation, USS has granted some UCU members access to the consultation document. The following paragraphs arise from their analysis of the document. Although we have not seen the consultation document ourselves, we certainly agree with the approach of taking reasonable prudence while avoiding over-reliance on the current, unusually low, rate of return on gilts. We would also like to point out the risk that further talk of large deficits and pension changes will undermine employees' faith in their pension. We would like to believe that as our employer the University of Bristol shares our concern with maintaining the substantial and reliable income in retirement of an extensive defined benefits scheme, with no increases in contributions or reductions in benefits.

This is an important consultation. If employers respond positively to the three proposals outlined below, it should be possible to maintain the current level of contributions and pensions benefits through the coming valuation. A negative response, however, will lead to yet another demoralizing and unnecessary drive to cut our pensions, to the detriment of the recruitment and retention of university staff.

In the consultation document, **USS appears to be offering employers a way to retain the current 18% level of regular contributions without cutting the current level of benefits**. This involves a combination of

(i) **relaxing the 'Test 1' constraints** on growth in reliance on the employer covenant over time, in the manner outlined in 4.4.3 of the consultation document;

(ii) **changing the assumed return on a 'self-sufficient' low-risk investment portfolio** from gilts plus 0.50% **to gilts plus 0.75%**, in the manner outlined in 4.4.4; and

(iii) **endorsing USS's internal Investment Management team's best estimate of expected returns on investment**, combined with a modest 'low prudence' downward adjustment of the best estimate, as outlined in 5.1.2.2.

USS maintains that, on this approach, the "required contributions can be lower, but the employers are accepting greater levels of risk: if the assumptions adopted turn out to be too optimistic then future contributions will need to rise" (p. 9).
USS cautions that employers "may prefer a lower level of risk to be taken because although affordable in extremis, they wish to reduce the chances of being required to pay higher contributions in future which could impact adversely on business plans" (p. 17). In USS's framing of things, you are therefore faced with the following dilemma: "Employers will need to decide how much risk they wish the trustee to take on their behalf. Taking the most risk keeps the current price of pension low but if the forecasts prove too optimistic then employers risk having to pay more than they are comfortable with in future." (p. 6)

Here, a false dichotomy is being presented. A cautiously optimistic approach to investment, in combination with preserving (or improving) current levels of benefits and contributions, will maintain confidence in the scheme. On the other hand, so-called low risk investment and (unduly) prudent valuation could lead to a negative spiral of increased funding shortfalls, resulting in a reduction in benefits or increase in contributions, making it in real terms higher risk than a more optimistic investment strategy combined with a less pessimistic valuation.

The following case can be made that USS is overstating the long-term risks to employers of adopting an approach, based on (i)-(iii) above, that avoids a rise in contributions or a cut in pensions until at least the 2020 valuation:

Regarding item (i) above, USS is simply endorsing the sort of flexibility regarding the interpretation of its self-imposed Test 1 that is broadly along the lines that Aon Hewitt urged in UUK's submission for the 2014 valuation, as a means of **avoiding "needlessly layer[ing] prudence upon prudence".** Such flexibility still involves a commitment to a substantial level of prudence which is inherent in Test 1.

Regarding item (ii) above, given how expensive it now is to generate income from gilts, it can be argued that a significantly greater weighting of a self-sufficiency portfolio towards equity than implied by gilts plus 0.5% would be a **more efficient means of delivering self-sufficiency.** That's one of the main points of this paper that First Actuarial released in December, about which please consult this blog post, this postscript, and this follow up to that post.

Regarding item (iii) above, in 5.1.1 of the consultation document, USS endorses a **triangulation among different approaches** to estimating returns on equity, including First Actuarial's preferred approach, which USS describes as follows: "An alternative approach, which generally gives a similar result, involves constructing a forecast directly based on expected cash flows accruing to shareholders (i.e. dividend yield and its expected evolution over time), real dividend growth and inflation" (p29). By this measure, USS Investment Management's best estimate of returns on equity must be assuming very modest real dividend growth, given how much lower it is than First Actuarial's best estimate, which assumes 1% real growth over RPI.

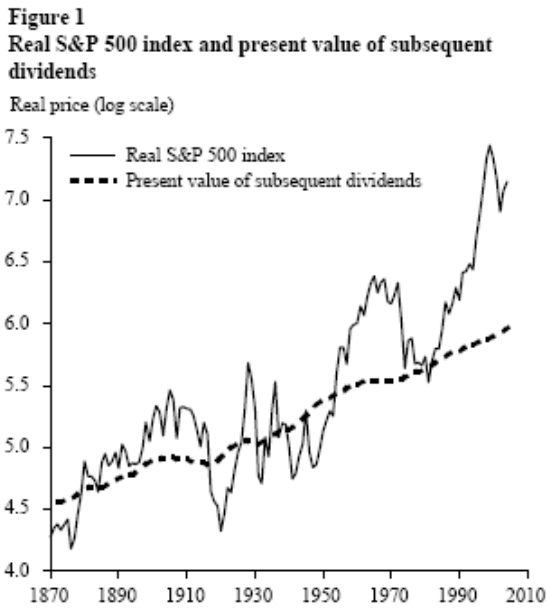
Finally, we would like to draw your attention to this linked updated cash flow projection chart from First Actuarial, which suggests that, as a result of the recent cuts to our defined benefits pensions, the scheme will remain in **positive cash flow for the next 60 years**. For reasons which are mentioned 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:

6.7 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.

6.8 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.

6.10 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:



(Source: Federal Reserve Bank of San Francisco Economic Letter 2007-32)

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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 linked document prepared by First Actuarial for some modelling of this approach, as applied to USS, and see also this blog post for further discussion of the rationale for IRR.

In closing, we urge you not to foreclose what USS is describing as a greater level of risk in preserving the current level of contributions and benefits. Even if you are not yet willing to embrace this approach, we urge you to seek further documentation and clarification from USS regarding the genuine level of risk involved. Please act in the light of the case presented above that such an approach provides a sensible and prudent means of sustaining our current defined benefit pension scheme, rather than something that employers must reject as too risky.

We should be grateful if you would reply in advance of the close of the consultation.

Yours sincerely,

Steve Condliffe, Tracey Hooper, Jamie Melrose, James Thompson and Ricky Tutin
Pensions Working Group
University of Bristol Local Association of the University and College Union

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Table of hyperlinks

Text within letter	web address
UUK's submission for the 2014 valuation,	https://drive.google.com/file/d/0B7G5ZYL-S4zDUW5ldGdVWE9KSVk/view
this paper that First Actuarial released	https://www.ucu.org.uk/media/8410/First-Actuarial-report-to-UCU-input-to-the-valuation-as-at-31-March-2017-of-USS-Dec-16/pdf/uss_firstactuarial_2017valuationinput_reportforucu.pdf
this blog post	https://medium.com/@mikeotsuka/first-actuarials-response-to-uss-s-self-sufficiency-in-gilts-approach-b4b9d46633a6
postscript	https://medium.com/@mikeotsuka/a-postscript-to-my-first-actuarials-response-post-a75542a71a29
this follow up	https://medium.com/@mikeotsuka/stocks-match-pensions-liabilities-as-well-as-bonds-4d7dc9179917
linked updated cash flow projection chart from First Actuarial	https://drive.google.com/file/d/0B7G5ZYL-S4zDR2thMTNfc0hVTzg/view
First Actuarial's submission to the 2014 valuation	http://www.ucu.org.uk/media/6937/UCU-response-to-the-USS-consultation-on-factors-affecting-the-reported-level-of-scheme-funding-Nov-14/pdf/ucu_usstrusteeconsultationresponse_nov14.pdf
Federal Reserve Bank of San Francisco Economic Letter 2007-32	http://www.frbsf.org/economic-research/publications/economic-letter/2007/october/asset-price-bubbles/
linked document prepared by First Actuarial	http://www.ucu.org.uk/circ/pdf/UCUHE257.pdf
this blog post for further discussion of the rationale for IRR	https://medium.com/@mikeotsuka/an-explanation-via-buy-to-let-analogy-of-first-actuarials-approach-to-the-valuation-of-the-uss-3eea79d41044