



University and College Union

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Tom Merchant  
Chief Executive  
Universities Superannuation Scheme Limited  
2nd Floor, Royal Liver Building  
Liverpool  
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Dear Tom

**Consultation on the proposed technical provisions for the USS actuarial valuation**

I refer to your letter of 17 October 2011 and the enclosure setting out the board's proposals on the assumptions that are to be used for assessing the scheme's technical provisions for the actuarial valuation of USS.

You will be aware that UCU representatives met with the scheme actuary and USS officers on Friday 11 November. The meeting enabled a number of questions to be posed concerning the board's current approach to the scheme's technical provision and I should like to thank-you for facilitating this meeting.

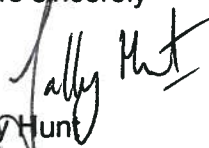
We have obtained opinions from two actuaries on the board's approach. As a result of that advice and taking into account the responses received from Mercer's (the USS actuary) last Friday, it is our view that USS is setting itself unnecessarily conservative assumptions that generated an unnecessarily gloomy picture of the fund's health.

Please find attached a summary of UCU's position.

Your letter asked for a response by 14 November and I am grateful to Brendan Mulkearn of your office for the extension until today, which allowed for the information received at the meeting with the USS actuary last Friday to influence our response.

I should be grateful if you could bring UCU's views to the attention of the board. If the Trustees require any further explanation of the UCU's comments do not hesitate to contact me.

Yours sincerely



Sally Hunt  
General Secretary

Enc

Copy: Michael MacNeil, National Head of Higher Education  
Geraldine Egan, National Pensions official

## **UCU views on the assumptions for the 2011 valuation of USS**

UCU recognises the need for the Trustee to adopt a prudent approach to the choice of actuarial method and assumptions used for the purposes of the valuation. This is not just because of the statutory requirements but also and perhaps principally because of the need to provide an adequate level of protection for our members' benefits. Nevertheless, the level of prudence that is adopted is inevitably a matter of judgement and the Union is concerned that taken as a whole the proposed basis is excessively conservative. The problem created by adopting such a conservative basis is that it places unnecessary pressure on the approach that the employing institutions adopt towards the level of Scheme benefits that they consider to be affordable. We therefore urge the Trustee to consider changing the assumptions that are discussed below. We consider that the result is a basis that while still prudent is a better reflection of the cost of members' benefits.

In summary the changes that we propose in the assumptions are as follows:

- Increase in discount rate for the purposes of Past Service valuation calculations from 6.1% to 6.4%
- Increase in margin between CPI and RPI from 0.8% to 1.0%
- The removal of the additional reserve for short-term increases in CPI
- A reduction in the assumption about ill-health retirement.

These are discussed in turn below, followed by our estimate of the overall impact they would have on the calculation of the Technical Provisions. We recognise that the figures we provide are only initial estimates and that the Trustee will need to obtain definitive figures from the Scheme Actuary.

### **Discount rate for the purposes of Past Service valuation calculations**

Annex A of your letter dated 17 October 2011 sets out the Trustee's reasons for adopting a discount rate used for the purposes of the Past Service valuation calculations (i.e. the Technical Provisions) of 6.1%. The UCU recognises the need for prudence in setting this key assumption but considers that the previous assumption of 6.4% meets this requirement. Our main concern is that the Trustee's proposal appears to pre-empt future discussions on the Scheme approach to investments, as encapsulated in the Statement of Investment Principles. An assumption of 6.1% is not justified by the Scheme's existing SIP, which does not envisage the extent of the move away from return-seeking assets upon which that figure appears to be based. The current situation is that the terms for any de-risking of the assets are not yet known. It is therefore too soon to make changes to the valuation assumptions in advance of the conclusion of such a review. In particular, any de-risking strategy would need to address the timing of any sales of equities and, given the state of current investment markets, it is not clear that the time will be right to make such a move for some time.

Additional reasons why we are not convinced by the Trustee's stated reasons for reducing the discount include:

- While there is not necessarily any compelling reason to have the same discount rate for the past and future assumptions, particularly as USS has adopted different rates for several years now, the argument that they should be brought into line could equally be used to suggest that the future service discount rate should be raised to the past service rate;
- Even if there has been a change in the Trustee's and its advisors' expectation for equity returns in the short term, what is most relevant for this purpose is the expectation in the long-term and we see no suggestion that these have changed and, in any event, this would require a change in the SIP;

- Given the Scheme's long-run expectations for equity returns, it can be argued that their prospects may well be better not worse following a fall in the market and that this suggests, if anything, that a more optimistic yield on equities is appropriate;
- the underlying principle is that the value of the liabilities should be consistent with the value of the assets, using market rates and indicators at the valuation date, which means that adjusting the assumptions because of some subsequent short term experience is potentially unnecessary and distorting;
- We are not aware of a general move to reducing prudent equity-risk premiums (ERPs) as a result of recent market turbulence;
- Although the Trustees point out that the Final Salary section is now closed, there is a new open section of USS which means that the Scheme, taken as a whole, is still open to accrual and any maturing of the Scheme's liabilities will only become material in the longer-term and does not justify a significant change to the overall investment strategy at this stage;
- Within the calculation of the discount rate it would be possible to make an allowance for the potential outperformance of corporate or overseas bonds above gilts while still remaining prudent; and
- We note that USS are taking independent covenant advice and that the outcome of that advice could alter the final outcome, but at this stage the "working assumption" is that the covenant of the participating employers remains robust and, hence, there is no suggestion of a weakening employer covenant, which is usually a driver in reducing an ERP.

The general point we wish to make is that the Trustee is bound to base its assumption about the discount rate on the approach to investment agreed between the Trustee and the employers as set out in the SIP. Unless and until there is an agreed change in the SIP we do not consider that there is sufficient justification for a reduction in the discount rate used to calculate the Technical Provisions.

Based on the figures provided by the Scheme Actuary, we estimate that if this discount rate were to be 6.4% rather than 6.1%, that the Technical Provisions would be reduced by around £1.8 billion.

### **The margin between CPI and RPI**

We note that the Trustees have proposed that increases in the CPI should be based on the expected increases in the RPI, with the following adjustments:

- Deduct 0.8% pa to allow for the anticipated long term difference between RPI and CPI (giving an assumption of 2.6% pa); and
- Include an additional reserve to allow for the fact that pension increases (which are now based on CPI) are expected to be higher, in the short term, than the assumption derived in this way – the reserve based on increases at the rate of 3.4% pa for the next 3 years.

With respect to the first adjustment, i.e. the gap between the CPI and the RPI, we want to draw the Trustee's attention to the Office for Budget Responsibility (OBR) report "Economic and Fiscal Outlook", dated March 2011, which provides an authoritative analysis of long term expectations for future RPI and CPI inflation. This report set out that the average difference between RPI and CPI inflation over the year 2010 was about 0.8% pa, with an expectation that this will rise to 1.2% pa in the long run. The 0.8% pa, difference between RPI and CPI proposed by the Trustee is therefore only

2/3rds of the long term best estimate difference, giving a significant margin for prudence of 0.4% pa. We consider that there is scope for this margin to be reduced, perhaps to 0.2% pa, which would lead to a difference between RPI and CPI inflation assumptions of 1% pa, and a CPI assumption of 2.4% pa.

In addition we consider that the proposed additional reserve is unnecessary. This is because the any short term inflation effects will not only affect price inflation but also, potentially, the return on fixed interest investments. However, the Trustee's proposal does not make any allowance for short term interest rate effects although consistency would suggest that either both or neither short term effects should be allowed for. The most straight-forward way to achieve would be for no allowance for short term inflation effects to be made.

Based on figures provided by the Scheme Actuary we estimate that the effect of reducing the CPI assumption to 2.4%pa could reduce the Technical Provisions by in the region of £0.6bn and that the effect of removing the reserve for short term increases would be to reduce the value of them by a further £0.3bn.

### Ill-health retirement assumption

Annex A to your letter reports that over the three year inter-valuation period the number of ill-health retirements was only 50% of those expected in accordance with the assumption used on the occasion of the last valuation and proposed by the Trustee for the current valuation. The UCU does not believe that this is justified, given the change in the rules governing ill-health retirements.

Based on figures provided by the Scheme Actuary, we estimate that if the assumed rate of ill-health retirements were to be reduced by 50%, that the Technical Provisions would be reduced by around £0.1 billion.

### Conclusion

The changes in assumptions proposed by the UCU are summarised out in Table 1, together with an estimate of their impact on the technical provisions. It should be noted that the figures are a broad indication of the result of the change in assumption and we recognise that definitive figures would need to be provided to the Trustee by the Scheme Actuary.

<b>Change</b>	<b>Impact on Technical Provisions</b>
Increase in discount rate for the purposes of Past Service valuation calculations from 6.1% to 6.4%	-£1.8bn
Increase in margin between CPI and RPI from 0.8% to 1.0%	-£0.6bn
Removal of additional reserve for short-term increases in CPI	-£0.3bn
Change in ill-health assumption	-£0.1bn
Total (allowing for impact of compounding the changes)	-£2.7bn

The impact this has on the Technical Provisions overall is shown in Table 2.

	<b>Position at 11/11 Meeting</b>	<b>With changes in Table 1</b>
Pensioners	£14.1bn	£13.4bn
Deferred Members	£2.8bn	£2.6bn

Actives	£18.4bn	£16.6bn
Total	£35.3bn	£32.6bn
Assets	£32.4bn	£32.4bn
Deficit/Surplus	£2.9bn	£0.5bn
Funding Level	92%	99%

As mention earlier, the UCU fully understands the need for prudence in calculating the technical provisions. However, we believe that the even with the changes suggested above that the valuation basis would retain a sufficient degree of prudence. This view is reinforced by the advice to the trustees from the Scheme Actuary, in accordance with professional guidance, that a “neutral” estimate of the liabilities, i.e. assessed after stripping out the margins for prudence, would be some £4bn to £5bn less than the technical provisions. In other words, the overall margin of prudence built into the calculation of the technical provisions amounts to some 16%. Even with the changes we propose the margin for prudence would still be £2 billion to £2.5 billion, or up to 8% of the liabilities on the neutral basis.

November 2011.<sup>1</sup>