University and College Union

Universities Superannuation Scheme

Valuation as at 31 March 2014

Introduction

The USS Trustee is legally required to carry out a formal valuation, also known as an actuarial valuation, every three years to analyse the financial position of the scheme. This formal valuation is carried out by the Trustee with the support of the scheme actuary, an appointed specialist who reports to the board, as required by law and under the scheme rules. The valuation processes involve placing a value on the scheme's assets at the valuation date, and calculating the amount needed to pay the pension rights already accrued under the scheme, both for pensions already in payment and those which will become payable in the future. This determines the amount of any deficit in the scheme. In addition, the valuation determines the ongoing cost of benefits building up in the future. The next valuation of the USS has an effective date of 31 March 2014 - this refers to the point in time at which all of the scheme information is collected and the date at which a snapshot is taken of the financial position of the scheme. It can be some time after the valuation date before the valuation results are finalised.

In December 2013, USS produced an engagement report entitled 'Scheme funding within USS'. This report was intended to inform a number of discussions between the Trustee and institutions relating to the USS, including the assumptions to be used in the 2014 valuation.

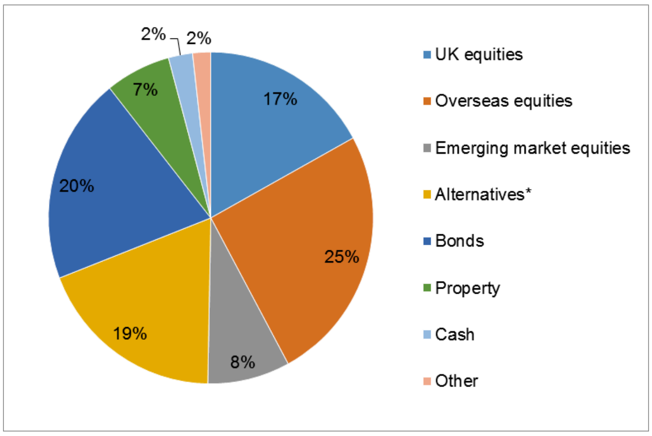
De-risking and investment strategy

According to the USS report, the key risk to the scheme is instability over time in the amount required from employers and employees to pay for the scheme. This amount is determined by the results of the valuation and also depends on how the scheme's assets are invested.

The USS report suggests that changes will be needed to ensure the scheme remains affordable in the future. It also argues that a degree of investment de-risking is appropriate to allow for potential long-term risks. Derisking means increasing USS' holding in gilts and bonds, and reducing its exposure to growth assets such as equities and property. Growth assets carry more risk than assets such as gilts and bonds and because of this generally have higher return potential. So, de-risking the investments would likely mean lower investment return for the scheme in the future.

This would increase the cost of both past and future benefits in the scheme. (If investment returns are assumed to be lower, you need more 'in the bank' to pay for the benefits that have been promised).

The current investment strategy of USS is shown in the graph below:



*Alternatives comprise private capital, infrastructure and absolute return and are expected to achieve similar rates of return to equities

Based on this strategy, the Trustee estimates that the assets will return approximately 2.75% pa above the yields on gilts.

The Trustee has proposed a long-term de-risking strategy which involves moving to an investment strategy which will produce a best estimate rate of return 1% lower than the current approach.

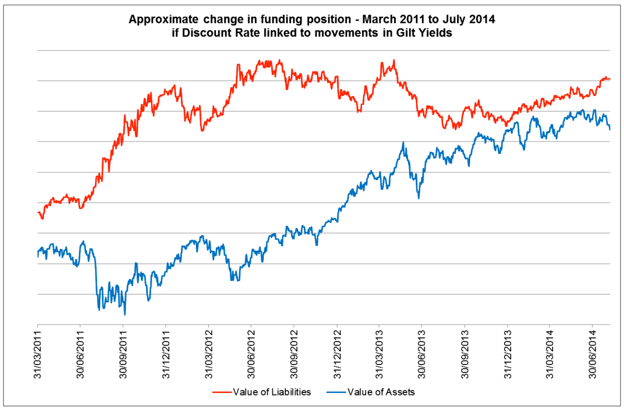
Comments on the de-risking strategy

It is true that the current investment strategy combined with the current valuation methodology do produce volatile valuation results. Whilst valuations are only snapshots, they are important as the deficit disclosed does drive the deficit contributions institutions need to pay as well as setting the cost of ongoing benefits.

The volatility arises because the current methodology (termed the 'gilts plus' approach) sets the value of the liabilities using gilt returns and compares this to the market value of assets.

Because the return on gilts (which drives the liabilities) and the value of the assets are unconnected, the valuation results are volatile. The solution proposed by the Trustee is to invest more of the assets in gilts so the assets move in line with the liabilities assessed on a gilts basis. In other words, the valuation methodology should drive the investment strategy – and drive it into lower yielding assets so increasing deficits and increasing the cost of benefits.

This is particularly problematic now as gilt yields have fallen significantly over the past 6 years due to the effects of quantitative easing and the flight to quality. The graph below shows the effect on a typical pension scheme of using the gilts methodology over the past 4 years.



So, if as is the case for the USS, most of the assets are not in gilts, but the liabilities are calculated with reference to gilt yields, there is a fundamental mismatch between the value of the assets and the value of the liabilities.

Application of alternative approaches

We have taken our own actuarial advice on the approach proposed by the Trustee. Our advice indicates that a more appropriate method would be to value the scheme liabilities by taking into account the actual investments held by the scheme and the expected returns on these investments.

This alternative approach, which is used by other schemes, would reduce the volatility in the valuation results as it would mean that the assets and liabilities move in line with one another. So the alternative valuation approach would address what the valuation approach referred to as the biggest risk facing the scheme.

We recognise that the Trustee is required to take a prudent approach to the valuation and fully support this (as a way to ensure that our members' benefits are secure). But the assumptions being adopted by the Trustees were in our view over cautious and lead to an inflation of the scheme deficit.

De-risking proposal

The proposal to de-risk the current investment target from one with an expected return of gilts plus 2.75% to one with an expected return 1% pa lower than the current approach not only bases the future investment strategy on an unhelpful methodology, but would increase the contributions required from sponsoring employers in the short-term, making the USS more expensive which is something that all parties are trying to avoid.

We would argue strongly that the assumptions to be set for current and future valuations of the USS should not be assumptions based on a gilt return plus a fixed margin. The assumptions should reflect the investment return expected from the actual assets held by the scheme.

Action we have taken

Clearly it is the scheme Trustee, along with their scheme actuary, who will control the approach and methodology used in a valuation. We (with support from our actuarial advisers) have put various arguments forward for a change in valuation methodology but the Trustee have been unwilling to accept our suggestions.

We will continue to put forward arguments for a more appropriate approach to valuation assumptions and to argue against the need for de-risking in discussions with USS.