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Dear Colleague

We recognise the importance of this opportunity to respond as employers to this consultation on the technical provisions which value our main pension scheme. In 2013/14 the University made employer contributions to USS of £24.2m and our employees contributed £11m. This is a significant investment for both parties. It is an important component of the University's reward package supporting our world-class staff.

This is the University's first formal opportunity to respond, and our response is entirely consistent with the informal responses we have made through the covenant assessment and work by UUK and AON Hewitt on behalf of employers.

We are deeply unsettled by the increase in the deficit of the scheme over the three year period 2011 to 2014. In the 2011 valuation we received significant assurances from USS trustees and Mercers as actuaries for USS trustees around the level of deficit recovery being achieved by the new career average section of the scheme. We cannot see a level of economic or demographic volatility in the three year period which can justify or give rise to an increase in the scheme deficit of £9.4bn.

We have significant concerns about the technical provisions. Specifically

- The use of the gilts plus methodology to value the scheme. Whilst we understand the trustees believe they are being required to do this to meet the requirements of The Pensions Regulator (TPR), we note that TPR has issued a new code of practice in July 2014 which moves away significantly from this approach.

- The use of technical provisions which are inconsistent with an assumption of a long term environment of low gilt rates, for example salary increases above RPI and investment returns at gilts plus 1.1%.

- The approach to de-risking which we consider to be flawed.

- The proposed recovery period of fifteen years given the employer covenant is strong over twenty years.

- The lack of supporting evidence for a number of the assumptions.

Our detailed response is set out below.

1. The gilts plus valuation methodology

This gives rise to a £7.6bn increase in the deficit since 2011. Gilts are at an all time low, and economic forecasts would not foresee these levels continuing out for the coming 20 years. First, an increase in interest rates that would be accompanied by increases across the yield curve (this rise in interest rates would affect both nominal and index-linked gilts); and second, a potential increase in inflation produced by the knock-on effects of the quantitative easing measures implemented over the last years in the U.K. and that still need to be transmitted into the real economy in the form of increasing inflation. These increases in inflation would be fully reflected in the index-linked gilts producing an increase in their yield to accommodate rises in inflation. A partial increase would still be seen on nominal gilts.

We understand that USS trustees believe that they are required to use this methodology to meet the requirements of the regulator.

In summer 2014, TPR updated its Code of Practice, setting out how schemes should be funded, and this has moved away completely from the concept that delivered very prudent assumptions in scheme valuations, and looked at gilt yields as a direct measure for this.

The new Code says (quite sensibly in our view) that the investment strategy should reflect the risks that the sponsor can bear, and then that the discount rate should reflect the returns that the investment strategy might produce (still on a "prudent" basis).

This potentially opens up a lot more flexibility for schemes (like the USS) with a very strong sponsor covenant. We recognise that we don't yet know the detail of how TPR will regulate this, but we believe that starting from an appropriate investment strategy, with realistic (prudent) views on the returns that can be generated from that strategy in the long term, would lead to a better, and more sensible position.

2. Technical assumptions

a. Salary increase assumption

The proposal is for an assumption of RPI +1%. This is an area where there is a large amount of data-based evidence, with a long history (25 years +) of increases at an average of close to RPI. There seems to be no justification in data for anything larger, particularly as large as RPI+1% which, if based on historical fact, would put most USS members at considerably higher real salaries than they enjoy currently. It is unhelpful for the technical provisions to (at one point) exclude the last three years to take us back to pretty much the high point of salaries with respect to RPI, though even that point is RPI +0.7% for one year. We also note that this assumption is inconsistent with a valuation which sets out a proposal of long term low gilt yields which would not support a buoyant economy and above inflation pay growth in the public sector. The evidence supports a link much closer if not equal to RPI and we propose no change to the 2011 assumption of RPI plus 0.25% as a maximum.

b. Inflation risk premium

We understand the trustees are proposing this change as a result of their proposal to de-risk and hold more matching assets. Given that we have expressed significant concerns with the de-risking proposals it would be inconsistent to support this change. Further we would note that whilst the consultation gives no evidence of what the split should be, our understanding from our advice is that 0.3% is an underestimate and a much larger figure is more reasonable. As such we propose no change to this assumption.

c. Mortality assumptions

We would contend that CMI evidence between 2011 and 2014 does not support an increase in mortality assumptions, if anything it points in the other direction. As such we can't see why a change would be made at this time to the 2011 assumptions, unless the case is that the 2011 assumptions weren't correct. As such we propose no change to this assumption. If mortality assumptions were changed on the basis of USS-specific experience, it would be helpful to know more about that evidence.

3. De-risking

We have major reservations with the de-risking approach set out by the Trustees.

We start by noting that no evidence of the past and current performance of the USS investment portfolio is included in the consultation. The USS financial accounts for 2013/14 set out a strong performance against investment benchmarks and against RPI which supports a return of significantly above gilts.

We then note that the assumptions about de-risking are again inconsistent with a valuation assumption based on gilts plus at a time when gilts are at a low point. Assuming a need to move to gilts plus 1.1% at the same time as assuming low gilt rates is layering prudence in an unnecessary way, and performing at gilts plus 1.7% is not a high risk investment strategy with this gilts assumption.

We also reflect on the three principles proposed by the trustees and their impact on the de-risking proposals, particularly looking at the first one of reducing the reliance on the sector. We raise the following questions around this approach

- The reliance on the covenant today is not the gap between the technical provisions and the self-sufficiency basis. It is the gap between the assets (which are much lower) and the self-sufficiency basis. The fact that the plan is to pay off the deficit (on prudent assumptions) is going a long way to reduce the actual gap over time, so it would be surprising if the actual reliance on covenant is increasing in real terms while the deficit is being paid off. As far as we can see, this hasn't been allowed for in the Trustees' approach.

- The use of CPI as the measure for projecting forward the allowed growth in reliance on covenant needs to be examined. The theoretically correct measure should be the rate at which sponsor covenant will grow, again there is no evidence of whether CPI is a good measure, nor of the sector's growth over the past 10-20 years.

- The focus on risk in terms of self-sufficiency, and tying that to reducing investment risk seems unnecessarily formulaic. A better way to look at this, more closely in line with the Code of Practice, would be by starting from the investment strategy – what level of risk in the investment strategy is appropriate now, and in 20 years' time. What would be the investment strategies that deliver the best investment returns for those given levels of risk? The technical provisions should then be set based on a prudent allowance for those investment returns.

- The Trustees have acknowledged that they will not in practice change the investment strategy in a straight line over the next 20 years, as implied by the proposed technical provisions calculations. Instead, they will look to take opportunities to move the strategy at the right time. Presumably this is a reflection of the point made above – that it would seem unhelpful to lock into protection assets on current prices, and current very low yields, again an example of layering prudence. We would like to see some analysis of the likely benefit that being able to time the de-risking might bring, so that an informed judgement can be made about whether or not it is appropriate to base the whole 20 year plan on current gilt prices.

4. The recovery period

The University would regard the covenant assessment carried out by the Trustees as giving confidence about the recovery period extending out to twenty years. As our view on the other technical provisions is that they layer prudence on prudence, it is hoped that if the Trustees support our other recommendations then they would be consistent with a fifteen year recovery period. If little movement is made on the other provisions then the level of prudence in the assumptions should give assurance about the room to accommodate any future adverse experience and a twenty year recovery period should be adopted.

In making these points in our response we acknowledge the challenges and limitations faced by the Trustees. We recognise that reforms to the benefits structure are necessary and we are keen to ensure that we continue to deliver an attractive, affordable and sustainable scheme for employers and current and future employees.

Yours sincerely

Nutbeam

Professor Don Nutbeam
Vice-Chancellor