UCU/UUK Valuation Discussion Forum – Craig Berry, University of Sheffield

I am a member of USS and UCU. I worked previously as the TUC's Pensions Policy Officer, which involved engaging with UCU officers. I currently research UK pensions policy, which has involved engaging with USS executives.

1. What are the key principles which you believe should be used in the valuation of pension schemes?

The valuation of pension funds must be based primarily on **maximising the long-term security of member benefits (1).** In economic and legal terms, pension funds consist entirely of members' capital, since nominal 'employer contributions' are also part of employees' remuneration. As such, all aspects of the regulation and management (including valuation) of pension funds must be geared towards ensuring that member benefits can be paid in full, and moreover, that members' reasonable expectation that the scheme they are contributing to in good faith will exist when they retire.

The **sustainability of scheme structure and fund practice for sponsoring employers (2)** must also be an important consideration in how pension funds are regulated and managed, since their ability to sponsor schemes is undermined if valuation processes lead to employee remuneration levels (in the form of 'employer contributions' to the fund) that jeopardise the organisation's financial health.

At the same time, however, valuation processes must be **consistent with the business model of sponsoring employers (3)**, including their ability to manage and develop their workforce. Many employers rightly recognise the value of defined benefit pensions provision to their human resources strategy, and as such fully intend to protect this form of provision. Unduly conservative valuation processes do not properly reflect this relationship, nor the longstanding commitment of the UK state to higher education as a whole.

Given the importance of pension funds' financial health to the security of member benefits and the continuation of sponsoring employers' chosen business model, it is vital that fund capital is invested in the most efficient way possible. Valuation processes must therefore **enable efficient investment strategies (4)**, and indeed reflect the investment efficiency that large-scale defined benefit pension funds are typically able to attain.

Two further principles flow from that related to investment efficiency. Firstly, valuation processes must **seek to minimise volatility (5)**. The markets within which pension fund capital is invested are inherently volatile when viewed from a short-term perspective, but not over the long-term, that is, the timescale at which funds actually operate in economic terms. Moreover, the large scale of most open defined benefit funds enables investment diversification to mitigate market uncertainties.

Secondly, valuation processes must be **based on analysis of the actual fund in question (6)**. Pension funds are actual economic entities operating in actual markets: information about their portfolio allocation and the recent performance of their investments (and their sponsors) is abundantly available to scheme trustees, and this information should form the basis of their valuation.

2. **The gilts+ valuation methodology is the method currently adopted by the USS trustee. Do you consider that any developments to this approach are appropriate to the USS context and if so what do you believe those should be which are consistent with the principles outlined in question 1?**

The USS trustees have created a significant degree of confusion regarding whether 'gilts+' is the fund's valuation methodology, or rather a way of *expressing* the methodology. Trustees claim that the fund's discount rate is calculated with reference to actual scheme assets, practice which would be in line with USS's statement of investment principles. Given that gilts comprise only a small proportion of USS's portfolio allocation, we must assume that gilts+ is merely a shorthand expression, albeit one that rightly allows for some automatic stabilisation in the valuation process.

However, trustee practice contradicts this stated principle. Although fund investments 2011-2014 outperformed the USS forecast, the discount rate has been reduced from 6.1 to 5.2 per cent. This is entirely due to movement in the relevant gilt rate, therefore demonstrating that gilts+ represents the methodology rather than its expression. Despite the downward movement in gilt rates having only a limited impact on fund asset values, the trustees have elected not to adjust the 'plus' figure of 1.7 per cent, clearly demonstrating that 1.7 per cent is added to the relevant gilt rate purely to act as a prudence buffer, rather than to allow for adjustment to reflect actual asset values within the fund.

As such, only the 'gilts' side of the gilts plus 1.7 per cent equation is used to assess actual investment performance, which contradicts the USS's own principles and my principle 6 (outlined above). The relationship between gilt rates and expected performance of the fund has not been explicated by the trustees, which means the USS valuation process is highly opaque. It is also provides for sub-optimal outcomes in economic terms. While, as argued above, gilts+ might be justifiable, if loosely applied, in order to enable a degree of automatic stabilisation in valuations, the way it has been applied to the USS fund produces the opposite result. It imports short-term volatility into the valuation of a long-term fund, contradicting my principle 5.

Furthermore, it is clear that gilts+ not only reflects the way that the fund's capital is invested, but rather that it is driving the USS investment strategy, contradicting my principle 4. There is a significant degree of circular, and therefore flawed, logic at the heart of the 'derisking' investment strategy. The trustees claim that the fund should in future be invested more heavily in gilts, yet they justify this on the basis of the higher cost of meeting future liabilities – but this higher cost is due largely to the imposition of a lower discount rate, unduly based on gilts. Wilfully adopting such an inefficient investment strategy is directly against the interests of both scheme members and sponsoring employers.

In accordance with my principle 3, the USS, including its valuation processes, must be structured in a way that reflects its importance to the business model of its sponsoring employers within the UK higher education sector. The decision of the trustees to develop a 'self-sufficiency' valuation (a *post hoc* rationalisation for the gilts+ methodology) both contradicts and undermines this business model. Self-sufficiency is only a relevant consideration were the scheme likely to be wound up, but USS's own covenant review clearly indicates the improbability of this scenario. There is absolutely no reason to assume that a significant number of UK universities will close in the foreseeable future, or that they will cease to support USS as a vital part of their remuneration package for current and prospective employees. Scheme fundamentals therefore pose no threat of disinvestment, yet the fund is being valued as if the opposite were true, with little explanation.

In failing to base valuations on actual scheme assets, providing for an inefficient investment strategy, undermining the business model of sponsoring employers and unnecessarily exposing the fund to volatility, gilts+ is clearly not the most appropriate means by which to achieve my principles 1 and 2.

3. **Do you consider there to be a better alternative approach to setting the discount rate which could be credibly accepted by the trustee and be acceptable in the regulatory framework?**

In the first instance, the USS must adopt valuation processes that are consistent with its own principles, more transparent, and based on published analysis of scheme fundamentals. In general, the USS needs to recognise that, as the UK's largest private pension scheme, it need not slavishly follow market practice, especially insofar as many schemes in the private sector are either closed (to new entrants or new accruals), preparing to close, and/or adopting liability-driven investment strategies. In any case, many schemes already employ valuation processes based on actual scheme assets, rather than a rigid gilts-based methodology. There is no reason – at least none that the trustees have shared – that prohibits USS from seeking to lead, rather than be led by, market practice.

It is clearly permissible, and indeed highly desirable, that the USS would seek to develop an 'ongoing' rather than self-sufficiency valuation. It is also permissible within the regulatory framework that, even if a gilts-based approach were used, for the USS to introduce flexibilities. For instance, the 'plus' figure of 1.7 per cent is to some extent arbitrary: the trustees could use the 'gilts' side of the equation to provide for prudence, while adjusting the 'plus' figure to reflect scheme fundamentals. Moreover, the trustees could adopt a 'smoothed' approach to establishing the relevant gilts rate. The 2014 valuation demonstrates well the fallacy and inefficiency of a snapshot approach to valuation, and so the trustees could consult on methods by which the rate chosen could reflect gilts rate over a longer period of time. Again, this approach would be entirely in line with the regulatory framework, and would remain broadly in line with the principle of 'mark-to-market', which has become conventional but is not explicitly required by legislation.