Pension Crisis

Details of the 2020 valuation of USS have now been published and they are not good news. To maintain the present level of Pension Benefits would require massively increased pension contributions from both staff and employers. Even if Pension Benefits were cut for future service, USS would want increased pension contributions. The methodology and assumptions used by USS in its valuation are being hotly disputed by UCU and also UUK.

Member contributions to the USS pension fund are currently 9.6% of salary and employer contributions are 21.1% making a total of 30.7%. As part of the 2018 valuation, these are due to increase to 11% and 23.7% respectively in October this year making a total of 34.7%. All parties had hoped that, by agreeing to a valuation at March 2020, the October 2021 increases could be avoided. Alas, this is not the case and the valuation documents released by USS indicate that it requires total contributions in the range 42.1% to 56.2% to maintain current levels of DB pensions. The range corresponds to three different covenant scenarios based on different degrees of commitment that the employers are willing to make in supporting the scheme.

Up until recently, the employer covenant (*the ability of employers to financially support the scheme if something unexpected went wrong*) was regarded as strong. Universities have been around for a long time and participation in higher education is increasing. The UK HE system has a good reputation internationally and there is strong demand for its services witnessed by increases in admissions despite the Covid pandemic, and increased applications, both home and international, for admission next September. The pre-92 universities in USS have been around for many decades, while Oxford and have been around for centuries and have huge endowments. These are all good reasons to believe the covenant is strong and that the pre-92 universities that are the backbone of USS can ride out short-term economic downturns.

However, the view on the covenant changed last year when Trinity College Cambridge, one of its richest members, bought itself out of the scheme. Rumour had it that a few others were likely to follow suit. This matters because the large asset base of the rich institutions enables the Scheme as a whole to bear more risk. Since then, USS has been asking the Universities to take steps to strengthen the covenant. These involve giving USS a veto on institutions leaving the scheme and accepting measures that that would prevent institutions from giving other debts precedence over their pension obligations. The response from universities has been mixed, but the upshot has been that the proposals at present on offer are not sufficient to allow the covenant to be rated as strong.

<u>Need for a Strong Covenant</u>

A strong covenant is important because the risk bearing capacity of the scheme depends on the willingness and ability of the employers to collectively support it well into the future. The stronger the covenant, the more the scheme can invest in risky assets which are expected to have higher rates of return. That brings down both the cost of the pension promises already made and the cost of future service. If there is a deficit in the scheme, a strong covenant may make it possible to spread deficit recovery contributions over a longer time period. The relevance of this can be seen in the table below which is based on USS's valuation report. Scenario 1 involves no additional covenant support, Scenario 2 is the level of support that UUK indicated it was prepared to give, and Scenario 3 is the minimum level of support that USS believes is required to allow the covenant to be rated as strong.

Contributions proposed in March 2020 valuation	Scenario		
	1	2	3
Future service rate	37.0%	34.7%	33.6%
Deficit contribution	19.2%	14.9%	8.5%
Total Contributions	**56.2%**	**49.6%**	**42.1%**

The employers are currently willing to provide Covenant support consistent with Scenario 2. **Clearly getting them to Scenario 3 would make a real difference and we need the employers to do at least enough to get there. 42.1% is better than 49.6% but it is still far too high for both employers and members.**

How Have We Come to This?

Part of the answer is current monetary policy. As a result of quantitative easing, interest rates are very low and that inflates the present value of pension promises that have already been made. Low interest rates also tend to inflate asset prices but this has not been sufficient to offset the increase in the present value of the liabilities with the result that many Defined Benefit schemes find themselves in deficit. As well as creating potential deficits, low interest rates also impact on future service cost causing every £1 of future pension promises to cost more now.

Reckless Prudence

The other part of the problem is excessive prudence on the part of the Pensions Regulator and USS. USS is the largest private defined benefit pension scheme and because it is so large (assets currently circa £70 Billion), the Pensions Regulator watches it like a hawk. The Pensions Regulator sees its job as making sure that existing pension promises can be paid and that schemes like the USS don't fall into the Pension Protection Fund. It is also supposed to keep an eye on things like affordability but having had its fingers burnt by Philip Green and Carillon, it is increasingly cautious and is **requiring USS to build more prudence into its discount rate than even USS would like**. **It also thinks that the employers have not shown sufficient commitment to the scheme.** The letter from the Pensions Regulator to the USS trustees says: 'The clear capacity of the sector to support the scheme has yet to be evidenced by a demonstrable commitment by the scheme's sponsors when the scheme requires increased cash contributions to meet its funding needs'.

There is an additional problem that the valuation methodology used by USS doesn't take sufficient account of the fact that the scheme is an open one and somewhat immature. **It is immature because cash inflows (your contributions plus expected income from existing assets) exceed cash outflows (pensions in payment) and will do so for quite a long time into the future. This should enhance the ability of the scheme to take more risk and to ride out the ups and downs in asset markets. The valuation methodology approved by the Pensions Regulator doesn't take sufficient account of this and forces schemes like USS to 'de-risk' prematurely by investing in low-return assets such as government bonds ("Gilts") that have provided historically low returns for the past decade because of quantitative easing. This is having the effect of making pensions unaffordable.**

Where Do We Go Now?

UUK has written to USS asking them to review the proposed valuation. It has also written a letter of complaint to the Pension Regulator. However, more importantly, UUK seems to be willing to revisit the issue of covenant support, which should take us into Scenario 3 territory at the very least**. UCU is supporting UUK in asking USS to review the valuation. It is also urging UUK to do what is necessary to ensure the covenant is strong. The additional covenant support measures highlighted by USS include a moratorium on scheme exit and offering contingent contributions or assets that could be called upon in the event that a larger than expected deficit really does materialise. If implemented, such measures could enable a significant reduction in the total contribution below Scenario 3's 42.1%.**

On the worrying side, as usual, UUK is pleading poverty. It is indicating that it cannot afford to increase its contributions above their current level and is arguing that benefit reforms will be required. We have been reminding UUK that the post-92 universities, which are generally less well- resourced than the pre-92s, are already making employer contributions of 23.68% to the Teachers Scheme compared with 21.1% current employer contribution to USS. If post-92 universities can afford 23.8%, why cannot pre-92s afford the same or even higher, especially given the way student numbers have, to everyone's surprise, gone up rather than down as a result of the Covid pandemic?

USS have uploaded a huge amount of information on the valuation on their website (see here), which everyone should look at it when they have time. There is no doubt that this is a difficult time for our pension scheme. **The present valuation proposals do not offer a solution but, with goodwill and the co-operation of all parties, something better is certainly possible.**

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