USS employer consultation 2018: script to accompany presentation slides

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USS is one of the UK's largest private occupational pension schemes.

The retirement benefits it offers are funded by payroll contributions from active members and more than 350 employers – and the returns generated by investing contributions in financial markets and assets.

This presentation addresses:

- the scheme's current contribution rates and benefits
- the purpose and results of the latest valuation of the scheme
- the contribution increases proposed as a result of the valuation's findings

It also touches on how the proposed changes and timings interact with the Joint Expert Panel convened by the scheme's stakeholders.

Since April 1 2016, contributions to the scheme have been set at 8% for members and 18% for employers – 26% of payroll.

Currently, for that contribution rate, members build up a **<u>set level</u>** of income in retirement for every year they pay in to the USS **Retirement Income** Builder – the defined benefit (or DB) part of the scheme – on salary up to a threshold.

This *defined benefit* is based on 1/75th of annual salary up to the prescribed threshold.

This threshold increases annually, broadly in line with the Consumer Price Index measure of inflation. (For example, in 2018/19 it has been set at £57,216.50; it was £55,550 in 2017/18.)

Every year, your retirement benefits are calculated and 'banked'. They are then increased each year broadly in line with inflation. Each subsequent year, you earn more benefits and these are added to the benefits you have already earned, which are paid to you when you retire.

When you retire, you will also get a tax-free lump sum worth three times your annual USS Retirement Income Builder pension.

A portion of any salary above the threshold automatically goes into the USS **Investment** Builder, the defined contribution (or DC) part of the scheme.

A total of 20% of any salary above the threshold (8% from members and 12% from your employer) goes into this section, as do any matched or additional contributions or any funds recently transferred in.

The reference to 'matched' contributions is 'the match': the additional 1% given to you when you contribute an additional 1% or more to the USS **Investment** Builder and select 'the match' at My USS. You can opt to contribute more than 1%, but 'the match' only apples to the first 1%.

Contributions in this DC part of the scheme (the USS **Investment** Builder) are also invested to provide retirement benefits – but there is no guarantee as to the amount.

The USS **Investment** Builder allows you to invest in one or more of the fund options offered by the trustee, including Default Lifestyle and Ethical Lifestyle options and 10 'Let Me Do It' self-select options.

The level of benefit received is ultimately dependent on contributions made, investment returns on those contributions, and how you wish to receive that benefit.

There are various ways in which you can use your savings from the USS Investment Builder, including as one or more lump sums, transferring out to another provider to access a drawdown product to provide an income or buying an annuity which will provide a guaranteed income for life.

Contributions to the scheme also secure a number of further benefits, including:

If you were to **die in service**, your beneficiaries would receive three times your salary (regardless of the threshold) as a lump sum, and your spouse or civil partner would also receive a pension for life based on full salary, not limited by the threshold (usually equivalent to half the total amount you would have built up had you remained in the scheme until age 65 – but there are specific factsheets available on the USS website).

For **death in retirement**, the scheme currently pays a pension to your spouse or civil partner of half the pension you were entitled to when you retired, plus increases to reflect inflation to the date of your death.

If you retired through partial or total **incapacity** as a result of long-term illness or injury, you would receive a pension and a tax-free cash lump sum. The benefits would be calculated using your full pensionable salary, rather than being limited by the salary threshold and could be significantly enhanced over what you've built up.

There is some small print involved with each of these life events, but specific factsheets are available on the USS website if you want to look into them in more detail.

The current employer contribution of 18% includes:

- 13.3% in defined benefits (including death in service and incapacity benefits)
- 2.1% in deficit recovery contributions
- 2.1% to the defined contribution section
- 0.1% to subsidise the investment management costs of the DC section (the USS **Investment** Builder)
- 0.4% towards scheme running costs

The current member contribution includes:

- 8% of salary **up to** the salary threshold to the USS **Retirement Income** Builder
- 8% of salary **above** the salary threshold saved in the USS **Investment** Builder

That's a snapshot of the current position – that's the hybrid benefit structure that was agreed as a result of the last valuation in 2014 and introduced in 2016.

Like all private, funded occupational pension schemes with a defined benefit offer, the trustee has a legal obligation to carry out a valuation at least every three years.

Its purpose is to establish, at a particular point in time – in this case, 31 March 2017 – whether the assets the trustee holds can reasonably be expected to pay the defined benefits that members have already built up in the scheme, and how much is needed to continue to provide the current level of defined benefits in future for members still actively contributing.

It involves looking at the scheme's assets and liabilities at that particular point in time to assess if they are in balance – and, if required, to agree steps aimed at bringing them back into balance over time.

The assets are the snapshot market value of the investments the scheme holds at that time. (Contributions are invested to fund benefits.)

The scheme's liabilities are an actuarial estimate of the funds required, at that point, to pay the pensions that have already been earned by members.

Here, the trustee is required to make an explicit allowance for the prudent rate of return it can reasonably expect to make in future on the scheme's existing assets, and by investing future contributions in new assets.

This allowance, known as 'the discount rate', reduces the value of the liabilities – and it's the most significant assumption the trustee makes in determining the scheme's funding position and the required contribution rate.

USS's long term discount rate is driven by the ability of sponsoring employers to, collectively, bear investment risk and their collective appetite to do so – something known as the covenant.

For the 2017 valuation, the trustee undertook a very detailed study of the covenant informed by independent expert analysis. A summary of its key findings is available on the USS website.

The covenant review helps the trustee to establish the maximum level of investment risk it believes employers could support, over a defined period, in funding the scheme.

It concluded that, despite uncertainty about the short-term impact of Brexit and other challenges, the employers' ultimate capacity to provide financial support for the scheme remains strong – and can be expected to continue to be so for at least 30 years.

However, pensions are just one of many important priorities employers have to manage in the current challenging environment so the trustee formally consulted UUK – acting on behalf of all individual participating employers – on the question of investment risk in September 2017.

The feedback from this consultation was entirely consistent with feedback the trustee received in tandem from its independent scheme actuary and its independent covenant adviser, as well as the Pensions Regulator: that the level of investment risk being proposed was at, or close to, the limit of a tolerable range. The regulator actually questioned whether the scheme had a covenant strong enough to support the level of risk proposed.

Collectively, this feedback from stakeholders led the trustee to take marginally less risk in its investment strategy than had been originally envisaged, which has the effect of lowering its discount rate.

Together with the outlook for lower expected investment returns in future (more on this later), the outcome is that the cost of funding benefits in their current form would require a combined contribution rate of 37.4%.

That's more than 11% above the current rate – equivalent to around £900 million more in payroll contributions each year. The longer this is left unaddressed, the greater the potential funding challenge could be for employers and members in the future.

It's important to note that even this contribution rate is still a lot lower than the cost of securing the same benefits with an insurance company – which would probably exceed 60% of pay.

That's because the strength of the scheme's covenant – the collective ability of, and reliance upon, employers to fund a shortfall over multiple decades – enables the trustee to take a greater degree of investment risk than an insurer.

What has changed since 2014?

The most fundamental change since the last valuation in 2014 has been in the investment market.

USS constantly needs to be generating secure, strong investment returns in order to be able to pay the defined benefit pensions earned by active, deferred and pensioner members.

Why? Employer and member contributions are invested today in order to fund their future benefits, some of which will only start to be paid out several decades from now. In that time, the pensions will have grown (and will continue to grow thereafter) broadly with CPI inflation (subject to a cap).

In the same way low interest rates affect savers, if the investment outlook drops, the cost of providing the same level of pension benefits rises.

What this slide shows is that, since 2014, interest rates have fallen, relative to inflation, and asset prices have soared. These are linked: in a world of lower future returns, investors that rely on future cashflows are prepared to pay significantly more today for the assets that will generate them.

What the current market environment means for USS is that the value of its existing assets have grown by around £25 billion in five years.

But, at the same time, the prices of the kinds of assets it needs to buy today, with new contributions coming into the scheme, have increased too.

So USS is now having to pay more, to get less in return, than it expected in 2014 – and its forecasts suggest that will be the case for the next decade at least.

There is, however, significant uncertainty about how markets will evolve in future. While the trustee expects "real" interest rates to revert to levels last seen in 2014 *sooner* than is currently priced into financial markets, some observers (including the Pensions Regulator) have questioned whether the trustee is being too optimistic.

Uncertainty and risk are linked, and the cost of insuring against investment risk has increased since the financial crisis in 2008.

These are conditions that have proved to be very challenging for private defined benefit (or DB) pension schemes generally: USS is now one of around 700 DB pension schemes in the private sector that are still open to new members. In 2006 (before the global financial crisis), there were circa 3,500.

So 80% – or four out of five – schemes have closed in the past decade.

For USS, these conditions have increased the estimated cost of accruing defined benefits, in their current form, by a third since 2014.

They also present a funding deficit in respect of pensions already earned.

More than a third of the 11% increase identified by the trustee is linked to this deficit, estimated by the trustee to be about £7.5 billion (which means the scheme is 89% funded).

That doesn't mean USS has lost money (its investments have actually performed very well compared to its investment benchmarks), rather it is the impact of a

prudent reduction in investment returns expected in future – used for the 'discount rate' – that leads to a corresponding increase in the value of its liabilities.

The application of **prudence** in establishing a DB pension scheme's funding position is a requirement laid down in law *[The Occupational Pension Schemes (Scheme Funding) Regulations 2005, specifically regulation five]*.

There is substantial uncertainty around how this deficit could develop in future. Since 2014, it has tracked significantly above what was anticipated by the trustee at the time.

If it is even one standard deviation away from predictions, the deficit will be a lot higher. Anything above this and the scale of the challenge to the Higher Education sector would be substantial.

A deficit must, by law, be reduced, and part of the employers' overall contributions to the scheme will continue to be dedicated (over a number of years) to closing the funding gap.

In order to mitigate the risks surrounding the deficit and investment outlook, the trustee is increasing the deficit recovery contributions required of employers from 2.1% currently to 6% in future – forming 3.9% of the 11.4% increase in the aggregate contribution rate now required.

These are issues that the trustee is legally bound to address through the current valuation, as it is required by law to demonstrate every three years that the scheme is sustainable: that its contributions, investments and benefits are in balance with the financial support sponsoring employers can provide.

What has to happen now?

In accordance with legal and regulatory requirements governing private pension schemes, a deficit and lower future expected returns both need to be addressed, either by higher future contributions, changes to future benefits – or a balance of the two. The law will not permit the issues to be ignored.

In the USS structure, the Joint Negotiating Committee (JNC) – made up of five representatives from UUK, five representatives from UCU and an independent, committee-appointed Chair – has the task of deciding the benefit structure and cost sharing arrangements based on the trustee's assessment of the funding position.

There have been more than 30 formal meetings over the past two years with a focus on the 2017 valuation.

The JNC has received detailed reports on covenant, methodology, valuation assumptions, interest rate reversion, expected investment returns on assets, discount rates, short-term risk and mortality.

The trustee repeatedly extended the timescales to support JNC discussions, to such an extent that, on 30 June 2018, it missed the statutory deadline for completing the valuation.

However, the JNC has been unable, to date, to decide on any benefit or contribution changes that address the 11% increase required.

UUK and UCU have convened a separate Joint Expert Panel (JEP) to review the 2017 valuation – including the methodology and assumptions applied by the trustee.

The trustee has engaged constructively with the JEP since it was established earlier this year, and the panel is expected to report back to UCU and UUK in September 2018.

UCU and UUK will, thereafter, be able to reflect on their respective positions on benefit proposals and cost sharing arrangements via the JNC (and any representations they choose to make to the Trustee Board).

However, the committee is unlikely to be able to consider tabling any proposals until the end of this year.

Having missed the statutory deadline, the trustee is in breach of the law, and the Pensions Regulator has made clear that the trustee must present a credible plan for completing the process **as soon as reasonably possible** or face regulatory sanction.

The requirements of a JNC decision that might arise later this year, or early next year, would be implemented by the trustee as soon as practically possible but, depending on the complexity, could take up to 12 months to implement from the point of a decision (due to the various legal consultation requirements and technical processes involved).

Conversely, as this timeline shows, the cost sharing process sees USS formally completing the valuation in February 2019, with the contribution increases it involves coming into effect from 1 April 2019.

The cost sharing process (Rules 76.4-8) was introduced via the JNC following the 2011 valuation as a pre-determined process for dealing with the exact circumstances now faced: the inability of the JNC to agree how to respond to a change in the cost of providing benefits. This provision was further enhanced in 2014 via the JNC to deal with the launch of the new defined contribution section (the USS **Investment** Builder).

As it has been put into the rules of the scheme, as with all other things prescribed by the rules, the trustee is legally bound to follow it.

The trustee is also mindful that the security of members' pensions could be affected in the long-term if the increased costs – circa £900m a year – aren't addressed.

Taking all of these issues into account, the trustee has concluded that the cost sharing process will run in parallel with, **but entirely separately to**, the work of the JEP and the implementation of any subsequent JNC decision.

In doing so, it has been clear to state that the requirements of a subsequent JNC decision that might arise would be implemented as soon as practically possible thereafter.

What does all of this mean?

Ultimately, the cost sharing rule involves the increase to contributions required to be paid to the scheme (as determined by the trustee's valuation) being split 35:65 between members and employers respectively.

In the absence of an alternative way forward being agreed by the JNC in line with scheme rules, the trustee is of the view that contributions need to move, **progressively**, to align with the cost of accruing the current level of benefits.

Under Rules 76.4-8, the offer of the 1% employer DC match will end from 1 April 2019, which reduces the maximum combined contribution required from 37.4% to 36.6%.

This still amounts to an increase of 10.6%, circa £800m a year.

Subject to this consultation, this will be shared between members and employers on a 35:65 basis.

It's important to note that if you took 'the match', your own 1% contribution will continue to be invested in the USS Investment Builder after 1 April 2019, after your employer's matching 1% ends, **unless you actively choose to stop paying it** (which can be done on My USS).

If you take no action, your 1% will continue to be deducted from your pay.

The match aside, the fundamental structure of the scheme itself will remain the same:

- The scheme's defined benefits will not change.
- 20% of combined (member and employer) contributions on salary above the salary threshold will continue to be saved in the USS **Investment** Builder.

However, increases to member contributions will also be applied to salary above the threshold – so anything above the established 8% already being paid to the USS **Investment** Builder will be paid into the USS **Retirement Income** Builder.

The trustee has proposed to phase in the increase required, to help members and employers prepare and to afford the JNC time to consider changes that could be introduced before the higher increases come into effect.

	From 1 April 2019	From 1 October 2019	From 1 April 2020
Member rate*	8.8%	10.4%	11.7%
Employer rate*	19.5%	22.5%	24.9%

*of salary

These rates would be applied no sooner than 1 April 2019, and would, subject to this consultation, be applied unless – and until – any subsequent JNC decision on alternative arrangements can be introduced (and there would then need to possibly be further consultations).

Consultation

If you are still actively paying into the scheme or are eligible to join, you now have a chance to give your feedback on these changes (either directly or through workplace representatives).

These changes would only apply to contributions made – and benefits earned – after 1 April 2019.

To find out more, and to respond to the consultation, visit the website.

The website will be available throughout the consultation (which closes on 2 November) and will be regularly updated with responses to any frequently asked questions that arise.

Any USS pension benefits you have already built up are protected by law.

If you are a retired or a deferred member of the scheme, your pension benefits will not be affected by the proposed changes, unless you have taken flexible retirement and are still contributing to the scheme, or you are working in a role which means you are eligible to re-join USS.

If you are unsure whether the proposals affect you, check with our workplace USS pensions contact or the person that wrote to you to give notice of the consultation.