USS

A transcript of USS's member webinar: "An update from USS"

22 March 2019

Bill Galvin: Good afternoon everybody. Welcome to the USS webinar. I'm Bill Galvin, the Chief Executive of the USS trustee company and I'm joined by Guy Coughlan who is our Chief Risk Officer.

Today we want to provide you with a brief overview of what the scheme offers for its members talk in some detail about how we fund those promises, and how the governance arrangements oversee those.

Our sincere thanks for your interest and for taking the time to join us for today's webinar. We've had almost 4,000 people register for the event, so we're very pleased that you've logged on.

We're looking to take every opportunity to inform members about address recent developments, in particular the 2017 and 2018 valuations – both of which have generated a lot of interest.

Of course, there is a huge amount of material on our website and our LinkedIn page, in relation to both the 2017 and 2018 valuations – we have looked to be completely transparent about how we have come to our conclusions, and I would encourage you to visit those pages, if you haven't already.

But pension scheme valuations are very technical and quite complex issues. We have tried to make the material as accessible as possible, and will endeavour to do so, today. It concerns me that if people don't understand the issues we are trying to manage, there may be a lack of trust in how we are going about it, and reading through detailed documents on these issues might not be the easiest task for most members. So if this webinar method of engagement works, we can use it more systematically in the future and we'd very much like your feedback in that regard.

We understand and appreciate that many members have concerns about the contribution increases arising from the 2017 valuation – as will your employers, who will have to budget for them.

I know you know, but I will say it again anyway: these are not outcomes that have been reached lightly.

We saw these challenges coming from quite a distance, as we monitored the assumptions that were used to support the 2014 valuation. The outcome of that valuation stretched our regulator thresholds to the limits, you may remember. It became clear soon into the triennial cycle that the assumptions we made then were indeed not being borne out in practice, and we let our stakeholders (UUK and UCU) know early and on a regular basis about these developments, both through the JNC and bilaterally.

And so the conclusions that underpin the 2017 valuation are the result of several years of thorough review and assessment, expert opinion, consultation with UUK and with the Pensions Regulator, all focussed on how we can securely, and as efficiently as possible, fund with a high degree of confidence what are very valuable benefits promised to our members, knowing what we know *for certain* today and making allowances for the uncertainty of the future. We have had and commissioned many views and second opinions on all issues through this process.

Of course, we fully appreciate the concerns and impassioned response these conclusions have generated, which is why we felt it was important for you to hear from us directly on these issues. Pensions are hugely important – they are the mechanism by which working generations support the generations that have preceded them. In a funded scheme, that is achieved by using the contributions to the scheme to invest in the endeavours of the next generation, and the returns from those endeavours pay in due course pay the pensions promised. Pensions are a huge component of everyone's sense of security for their futures, and a very big part of a good employment package. That importance, and the criticality of that mission, is why I and my colleagues come to work every day, on your behalves, and why we choose to work for USS rather than other providers.

I want to make clear that the primary responsibility of the trustee is the security of the pension promises made to our members. I think that is what you expect of us, as well as what the law makes clear. The trustee has an explicit fiduciary duty that we take very seriously, and of course, there is substantial regulatory oversight of how we go about our business.

Let me begin by giving you a brief reminder of the benefits in question: what you get from being a member of the scheme. I find often in addressing members these are not well understood.

Your salary contributions fund a set level of income in retirement for every year you pay in to the USS Retirement Income Builder – this is the defined benefit (or DB) part of the scheme.

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

This salary 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 and will shortly be uprated for 2019/20.)

Every year, these benefits are calculated, they're 'banked' and they're added to the benefits you have already earned. The value of your benefits increase each year, broadly in line with inflation – as they are being built up as well as when they are paid to you in retirement.

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

Above the threshold, 20% of your salary automatically goes into the USS Investment Builder, the defined contribution (or DC) part of the scheme, as do any additional contributions you might choose to make or any funds you might choose to transfer in from other schemes.

Contributions to this part of the scheme are also invested to provide retirement benefits – but, unlike the DB section, there is no fixed amount that will be paid out at retirement. The level of benefits here is ultimately dependent on contributions made, investment returns on those contributions, and how you want to take that benefit.

Being a member of the scheme also secures a number of other generous benefits that apply if you were to die in service, for death in retirement and for incapacity.

Specific factsheets covering all of these points, and the small print involved including tax benefits of investing in a pension, are available on the USS website if you want to look into them in more detail.

As trustee, we look after every single part of the process – from your first contribution, to the investments made on your behalf, to the benefits paid to you. Every step is managed in your interests.

We have a dedicated in-house investment team that actively manages the scheme's investments on a day-to-day basis in line with the strategy agreed by the Board, to deliver the right outcomes for you.

It has done this very well, consistently outperforming its "passive" benchmark, adding £1.7bn to the value of the fund over the five years to March 2018 in the process…and that is value added net of investment costs – these costs that have been independently benchmarked as more than £60m a year cheaper than global funds of a similar size, scale and complexity.

So while our USS Investment Management subsidiary continues to meet these targets, it means pension contributions are about 15% less for employers and members than they would otherwise be.

Of course, it is general economic growth that funds pensions, and as I explain later, where our challenges might be. However even through 2018, where equity markets fell over 10%, and our passive investment benchmarks (which are 60% equity) returned -4%, the scheme's investment portfolio outperformed this, and returned negative 2% in adverse markets.

So we believe USS is a very valuable offering to HE and to our members and very professionally and expertly delivered.

The hybrid nature of the scheme provides the assurance of a fixed income in retirement via the DB fund as well as the flexibility of being able to make additional, tax-efficient savings in the DC fund as your circumstances allow.

In delivering this, the trustee has a profound responsibility – and we take great care, pride and professionalism in delivering against that.

And this involves taking the contributions from you and your employer and investing them today in order to fund your benefits in the future – some of which will only be paid out several decades from now, and be in payment for several decades thereafter.

In that time, the benefits you've earned will have grown and will continue to grow with CPI inflation. So the pension we provide is more affordable (that is, lower contributions are required) where we can depend on secure, strong investment returns – relative to CPI – on those contributions.

Some investments, such as government bonds, offer guaranteed, fixed payments in future. We can buy these today and have a very high degree of confidence that we'll have the cash required in future to pay your benefits.

But these are exceptionally expensive assets to buy today – and much more so than in the past.

We can instead turn to other investments (company debt and equity) that potentially offer higher returns, and make assumptions about how much return these might generate in future.

This, in turn, can reduce the contributions otherwise required of you and your employer today to fund your future benefits. But, unlike government bonds, the payments these other assets might generate are not guaranteed. Not only can they be volatile, but the returns on them are driven by the success of the global and UK economies.

This introduces risk: because the potential for these less certain investments to achieve better returns comes hand-in-hand with the potential for them to generate less.

The global financial crisis, quantitative easing in most mature economies and the general search for secure, strong investment returns from an ageing population have created the conditions for an asset price boom in financial markets.

Record low interest rates mean the cost of "guaranteeing" cash flows we need in future to pay your benefits has increased considerably. Views of the future are very different, and many investors are sufficiently pessimistic, or sufficiently in need of secure returns, that they are prepared to pay very high amounts for these assets, relative to their prices in the past.

At the same time, the cost of other, less-certain but high quality assets we could buy to generate cash flows in future has also increased as their potential returns have become more valuable in a low-interest rate environment.

So the challenge for the USS trustee is that wherever we look in the market, the cost of the assets we'd need to buy today to generate the returns we'd need in future to pay the benefits promised to you has increased: we're having to pay more now, to get less in future returns, than we have in the past.

We cannot simply ignore this or kick the issue down the road in belief that things will improve, because the level of security we must provide for pension benefits must be high.

There are some things we know for certain today – the value of the assets we hold, how much 'risk free' investment costs – but we need to understand what the likely path and distribution of returns from other assets might be if we are to rely on them to fund your benefits.

As we've already covered, the assumptions we make here can help to lower the cost of contributions today, but they could also result in much higher contributions being required in future if our assumptions prove to be wrong.

What do those assumptions cover? More things than you might imagine:

We do need to consider how the higher education sector might grow or change over time, relative to the size of the pension scheme, and determine how much confidence we can have in its ability to pay higher contributions in future if our assumptions prove to be wrong.

This is a significant assumption in our valuation.

We need to try to understand the range of uncertainty for how future economic developments might play out, including: interest rates, inflation, global financial markets, government policies, and trying to understand the potential risks of historically high levels of debt and the changing demographic profile of an aging society.

We need to analyse our membership: how long might our members work and draw a pension for? How will the size and shape of the scheme evolve over time as more members move into retirement?

We need to look at how all of these factors could interact and influence each other and determine the cash flows we will need in future.

Then, having looked at all these elements in great detail, we need to step back and decide how much confidence we can have in the round in our ability to fund the benefits that have been promised. More important even than the central expectations is the range of uncertainty around these assumptions – because we need to be able to pay your benefits not just in good times. And that judgement about the range of future uncertainty is particularly difficult right now.

This is what we mean when we say that risk is multi-faceted, and this is where key judgements need to made in determining the cost of pensions and they we fund the scheme.

The conclusions reached by the Trustee on these issues are not made in isolation however, but thoroughly reviewed by independent third parties.

For example, during the 2017 valuation, we got clear feedback from almost every independent third party we consulted that the level of risk being proposed by the Trustee was close to the limit of what could be acceptable given the circumstances of the economy and of our sponsor covenant.

I'll now handover to Guy who will cover these points in a bit more detail.

Guy Coughlan: The fundamental characteristic of defined benefit pension plans is a promise of certainty; certainty in terms of the payments that must be made to beneficiaries in retirement.

That certainty needs to be delivered with a high degree of probability but also at a manageable cost. That can be a difficult balance to strike, and there are plenty of differing opinions as to the appropriate point of balance on this issue.

To be clear: the trustee's approach to risk is to balance its investment strategy and its contribution strategy such that enough risk is taken in the investments to generate returns that help keep the costs down – but not *so much* risk that it puts the achievement of the strategy itself as a whole at risk.

In actively relying on high growth but less certain investments and favourable improvements in interest rates to fund members' benefits, the risks involved must be measured and managed for there to be a high level of certainty that your benefits can be paid when they fall due.

When it comes to investment returns, we benchmark the risks against what is known as the self-sufficiency measure. This is based on the 'guaranteed' cash flows available from the kinds of low risk investments that Bill talked about earlier.

This is the value of assets we would need to hold in order to have a greater than 95% chance that all the benefits members have earned to date can be paid when due, without any further contributions.

In other words, this is the funding level we would need to achieve *in the absence of further support from employers*.

It's important to note we do not target this level of funding (nor do we target the asset mix it would require) precisely because we have the active support of your employers and believe we can have confidence in that support over many decades into the future.

But the self-sufficiency deficit is a measure of the reliance we ultimately place on your employers to fund your benefits if our experience of investing in high growth, but less certain investments, turns out significantly worse than expected, or indeed if we have been overly optimistic in our assumptions.

So self-sufficiency is a very important point of reference in terms of confidence in the ability to fund benefits.

By contrast, our Technical Provisions measure is not based on a 95% chance but a 67% per chance that we will have enough funds to pay your benefits.

It's the technical provisions (or funding) measure that we use to set contributions.

This reflects how optimistic we believe we can afford to be in relying on uncertain investments and economic developments to fund your benefits in future – given the degree to which we can rely on your employers if experience proves to be worse than expected.

Because, if that comes to pass we would have to go back to employers to fund any shortfall – and this is in the context of the 2017 valuation already asking employers to pay more *on a regular basis* than they have indicated is sustainable in the long-term.

There are other, interlinked risks to consider here:

The degree of uncertainty faced by the scheme and its employers, which has increased in recent years, both with the review of tuition fees and the status of Brexit just to name two factors. These are factors that are causing the Trustee concern.

Recent market conditions have not been helpful either with asset values falling, reflecting that prevailing uncertainty. Many investors have recently experienced a period of negative equity returns, for example.

It is difficult to know – with the certainty required to meet such an important promise (to pay your benefits) – just how these factors will develop over time.

The Trustee's investment strategy aims to reduce the scheme's dependency on high growth uncertain investment returns over time. This is so that the amount we are relying on for your employers to fund any shortfall is consistent with the amount they want us to target in the long-term.

Fundamentally, as the largest private pension fund in the UK by way of assets, the sheer size of the scheme means it would take years for us to "de-risk" to such a degree that employers want us to over the next 20 years.

By doing this gradually over the next 20 years means the cost is "time-averaged", reducing the impact of sudden market changes and making certain that we don't happen to pick, by chance, the most expensive time to de-risk.

It has been suggested that we do not need to do this; that changing the mix of the assets we currently use to fund the pensions would be expensive and detrimental to the scheme.

Well, at the moment, the scheme is invested over 60% in equities, which are high growth but less certain investments, and 7% in property – also high growth but less certain.

Of our 400,000 plus members, less than 90,000 are currently pensioners.

As the scheme matures, more members will move into retirement and start to draw their benefits. We will have more active members as the scheme will grow. It's not guaranteed that the high education sector, and the sector's payroll which needs to support the scheme, will grow at the same rate as the scheme.

With the uncertainty in returns that we are likely to get from the assets we're already invested in, and with the uncertainty in the growth of the sector, it's the view of the Trustee that we should gradually over time reduce the risk:

- That the scheme is unable to produce the cashflows required to fund your benefits, and
- That future deficits that might be reported in the scheme are beyond the appetite of our sponsoring employers.

If we were not to do that, we would be anticipating a positon in 20 years' time where the scheme would be very large, potentially very volatile, with uncertainty about the ability of the sector's overall payroll to manage the inherent risk and inherent volatility in the pension scheme.

We are not predicting that this is going to be the case, we're simply saying that the way in which we manage the scheme has to give us confidence that the ability of your employers to come up with money in the future should our assumptions prove to be wrong has to be adequate.

To do otherwise would see promises being made in terms of certainty in the payment of your pensions that we are not sufficiently confident could be fulfilled.

Let me now turn to the Joint Expert Panel.

The Joint Expert Panel convened by our stakeholders last year (to review the 2017 valuation) suggested several adjustments to our funding assumptions – but they also recognised that there were a number of different paths that the Trustee could adopt in attempting to lower the contribution rate form the 2017 level.

While each adjustment is worthy of consideration, the panel did not explicitly quantify the additional risks involved in implementing these suggestions (individually or in aggregate).

As I've set out, the potential consequences of taking greater risk must be quantified, and credible options for managing material downsides coming from that risk must be available. The Trustee has certain legal, regulatory and fiduciary duties to ensure that the pensions promised to members are secure and can be paid when due, and that the scheme is sustainable into the future.

That is precisely how we have approached the 2018 valuation.

It is important to make clear that the trustee has no preference as to the nature or package of benefits agreed by our stakeholders – only that the benefits promised to you can be paid.

We set the price: that is, the contribution rate required for a given level of benefits. If that increases, it is up to the Joint Negotiating Committee – which is made up of an equal number of employer and member representatives with an independent chair – to agree how to respond to that price change.

If it cannot agree – as was the case with the 2017 valuation – the scheme rules dictate that the increase in contribution is split on a 65:35 basis between employers and members respectively.

For you as a member, the outcome of the 2017 valuation is that your salary contributions will increase from 8% today to 8.8% in April, 10.4% in October and finally to 11.4% in April 2020.

Your employer's contributions will also increase significantly.

The later increases <u>may</u> possibly yet be superseded by the outcome of the 2018 valuation, but this is subject to ongoing discussions with our stakeholders.

We do not underestimate the implications of these changes for employers and for you, our members – by no means.

But they are necessary for us to have sufficient confidence that the benefits promised to you can be paid in the face of the current uncertainty.

The strength of the financial support provided by your employers is considerable – but it is not limitless, and it is certainly not the same for all 350 employers who take part in the scheme.

Some are very much stronger than others.

If our assumptions regarding future investment returns – that is, our reliance on high growth less certain assets and uncertain economic developments – turn out as expected (or better than expected), we can expect the risks and costs to reduce at future valuations.

But they are not risk-free, and we cannot simply take them for granted.

We must also consider potential scenarios which could emerge in the short term – such as significant falls in interest rates or in asset values – that could make achieving the longer term outcome much more difficult.

The former is what happened after the 2014 valuation – when the returns available from long-term UK government bonds (also known as gilts) fell unexpectedly to unprecedented lows. So we've seen in the recent past just how experience can be poorer than expectations.

Our funding plan must be as resilient as possible in these circumstances, as well.

In summary, the current funding position, current financial market conditions, and the risks currently faced by the scheme are all reflected in our proposed contribution rate (under the 2018 valuation) of 33.7% for the current package of benefits.

For its part, the Pensions Regulator made its position on these matters quite clear in a letter to the Trustee and its stakeholders in December 2018, and a copy of that letter is readily available for you to read on both the USS and UCU websites.

BREAK FOR QUESTIONS

Bill Galvin: Guy explained that the Joint Negotiating Committee is responsible for responding to the price of funding a given level of benefits; that price having been set by the Trustee.

The Trustee Board is made up of 12 people – appointed by UUK, UCU and five independent members the Board itself – who have a wide range of skills. Their backgrounds include the higher education sector, financial services, investments, pension administration, financial technology and other areas.

The Board oversees the executive and holds it to account, both at Board level and via its sub committees – which look at scheme policy, investments, audit, remuneration, and nominations and governance.

The Trustee has the sole responsibility for setting the aggregate contribution rate – both under the rules and under legislation. If it decides that the aggregate contribution rate needs to increase, as has happened, the JNC decides how that increase should be addressed, either through contribution increases or changes to benefits such that the contribution increases are mitigated.

The trustee respects these differences of roles in the constitutional arrangements, and we seek to only support but not to influence the outcome of stakeholder negotiations at the JNC.

The JNC has been part of the scheme since its inception and is quite unique in the UK: unlike the Trustee, only the chair of the JNC has a fiduciary role; the other members of the JNC are there to represent the interests of UUK and UCU.

The JNC has a large responsibility for deciding on any rule changes that it wants to propose to potentially change the shape of the benefits that the scheme offers in future or how the contribution arrangements work.

The JNC does not have any direct impact on the decision as to how much these cost; that is a matter for the Trustee.

This clear division of duties is critical: the pricing of benefits must be set independently and members can be reassured by the independent judgement of the Trustee because it has no other agenda than to seek to ensure that the defined pension benefits USS members earn are secure and can be paid as they fall due.

We are now going through the 2018 valuation; a decision needs to be reached at the trustee board about how the benefits currently provided might be costed and how it responds to proposals from stakeholders about how contingent contributions might play into that.

Once the Trustee has made a decision, it will then be passed on to the JNC to decide how to respond.