Protecting pensions

29 September 2017

In order to put a price on providing a promised £1 of pension for each year in retirement through the USS Retirement Income Builder, we're effectively trying to predict the future.

In our mission to deliver the promised level of benefits, we need to ensure the required contribution to fund the benefits is consistent with the risk that the employer can support so that members' benefits are paid in full.

But the future is ultimately unknowable, so we must make a range of informed, sensible assumptions based on detailed analysis and modelling to arrive at our conclusions on future economic and social trends largely outside our control.

One of the key assumptions we make is the rate of inflation-beating returns we can reasonably expect to achieve by investing the assets we currently hold and intend to hold in future. Our 'best estimate' has only a 50/50 chance of success – so, in line with our legal obligations, we "weight the coin" and apply a degree of prudence to set the price at a 67% chance of success.

The prudent return rate we expect to achieve, relative to CPI, is based on detailed analysis of the investment outlook and, crucially, the level of investment risk employers are willing to support within the maximum level the trustee judges they can collectively support.

This last point is key because a low-risk investment approach results in higher security (and a lower probability that additional contribution will be needed in the future) and, in turn, fewer potential changes to the scheme - but it ultimately provides lower expected returns. As a result, the payroll contributions required for a given level of benefit are over 50% more than we expect to need from our proposed investment approach. Our proposals suggest that the defined benefit part of the promise costs 27% of pay and under a low risk approach we could need to charge in excess of 40% of pay to give the extra security.

USS invests in a diversified set of assets that target returns above inflation. (You can see how successful this approach has been by reading my colleague Roger Gray's analysis here.) In doing so, we consciously take calculated risks: our assets might not perform to the degree we expect; or we might fall short of the funding we need to pay the pensions that have been promised.

So what if, at a time of global economic uncertainty, our forecasts turn out to be wrong? How do we satisfy ourselves with a high degree of confidence that the promises being made to our members will be kept: that pensions already built up will be paid when due?

At USS, we apply what is known as 'Test One': we make sure we never take more investment risk than we believe sponsoring employers would collectively be able to support.

This is predicated on their ability to pay additional *contingent* contributions if necessary to secure the pensions promised to date.

We've taken independent expert advice on the strength of participating employers' finances, and the macro-economic factors that are likely to drive the sector's growth over the long term.

Guy Coughlan

Chief Risk Officer

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This has reinforced the confidence we can place on the strength of employers over the next 30 years (at least), and tells us that they would collectively be able to pay 7% more in contingent payroll contributions, should extreme circumstances arise.

We're not suggesting this would be easy for them to do. It would take some hard business decisions with consequences elsewhere which means it is not something we plan on happening to support pensions. But our independent analysis tells us that the long-term capacity is there as a buffer if it is absolutely needed.

This, in turn, establishes our investment risk budget: the maximum amount of investment risk we can plan to expose the scheme to in the short, medium and long term.

It is important to note here that our job as trustee is to establish the parameters – the maximum level of risk we would be *prepared* to take given how much risk we feel the employers are collectively able to bear.

We then actively ask the employers, just as we are doing now through their formal Universities UK representatives, whether they agree with this view and, importantly, how much risk they actually *want* to take.

They can, of course, choose to take less risk because pensions is just one of many important priorities employers have to manage in the current challenging environment. Once the risk budget is agreed with employers, how do we quantify and manage it?

Well, one of the measures we use for monitoring the scheme's funding position is known as 'self-sufficiency'.

This is the amount of assets that would be required to move the scheme to a low-risk investment portfolio – one that has less than a 5% chance of ever requiring a further contribution from employers. It contains a diverse mix of assets that are mainly bond-like in their characteristic, they are not just UK government loans ("gilts").The gap between the assets we actually hold and the amount of assets needed in a self-sufficiency approach is a measure of the reliance we are placing on employers.

It influences our investment approach over time because we manage our exposure to growth assets to ensure that the level of reliance we place on employers is targeted to be within the range that employers are able to support: the value, in today's money, of 7% in contingent payroll contributions over several decades.

Some people think self-sufficiency is a target portfolio, but it is not; it is a parameter beyond which we must plan not to go if we are going to be confident that the pensions already promised to members are secure.

Opinions will vary on our judgements of future events. Some will believe that our approach is too prudent; others will believe it is not prudent enough. Ultimately, it is for the trustee to be satisfied that it is acting responsibly.

In the trustee's view, ensuring the self-sufficient portfolio option is always within financial reach protects the pensions members have earned and gives confidence that pensions offered for future periods of employment are similarly secure.

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