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The Times Business Comment

March 12th 2018

"It is reckless for USS to keep betting on equities"

https://www.thetimes.co.uk/edition/business/it-s-reckless-for-the-lecturers-pension-scheme-to-keep-betting-on-equities-z3nxw7cr2

This week there will be further strikes by university teachers protesting at being moved from a guaranteed, defined-benefit pension to a less generous defined-contribution pension, with no guarantees. How will this dispute end?

The Universities Superannuation Scheme is Britain's largest private sector pension scheme, covering about 70 "old" universities and almost 300 smaller institutions. Its accounts for March 2017 show a deficit of £17.5 billion (£60 billion of assets and £77.5 billion of liabilities) on an FRS 102 basis, the accounting standard for all private sector pension schemes.

Defined-benefit pension costs have spiralled in recent years — people are living longer and real interest rates are lower — and most companies have moved already to cheaper defined contributions. Universities are not immune and many have closed their individual pension schemes for non-teaching staff.

The total annual cost of the present USS defined-benefit pension is about 40 per cent of salary, versus a 23.9 per cent cash contribution from members and universities. Even if members increased their contributions from 8 per cent to, say, 14 per cent, how could universities afford to pay the balance, an increase from 15.9 per cent to 26 per cent of salary? The extra £700 million a year would squeeze core teaching and research.

Under the defined-contribution pension, universities will pay 13.25 per cent of salary a year and members 8 per cent. For the same total cost, the USS could continue a defined-benefit pension at only half the present level.

John Ralfe Consulting Limited
Tel: 0115 982 1911 07779 574193 JohnRalfe@JohnRalfe.com
www.JohnRalfe.com

As well as paying for new pension promises, universities also must increase their deficit contributions. The proposed deficit contribution of only 4.75 per cent of salary (about £350 million in year one) would take over 40 years to shift the £17.5 billion deep-dark deficit, way beyond the Pensions Regulator's guidelines.

Annual pension costs and total liabilities reported in company accounts reflect the underlying economics of pensions; a pension is like a bond. A legal obligation to make a future pension payment, secured on pension assets — say £100 million in 20 years — has the same present value as a legal obligation to make a future bond payment of the same amount and the same date, also secured on assets.

In practice, this means calculating annual pension costs, and total liabilities, by discounting future pension payments to a present value using the objective AA corporate bond rate. The teachers' union claims these annual costings, and total liabilities, are overstated and that universities can still afford to provide a defined pension, albeit slightly less generous. The union and its advisers say that holding equities, with a higher expected return than bonds, magically shrinks the annual cost and total pension liabilities.

By holding equities, not matching bonds, the USS is taking a bet, which may or may not pay off. If it does, the value of assets versus liabilities will increase. But it is dishonest to take credit for this today and to claim it shrinks pension costs and liabilities.

Meanwhile, the USS is also denying the size of its deficit, creating a smokescreen to hide its slide in funding. From 2007 to 2017, it went from a £2.5 billion surplus to a £17.5 billion deficit. The root cause of the £20 billion loss over ten years is the USS's aggressive long-term bet that equities would outperform boring bonds, which has not paid off.

And the USS has not learnt any lessons. In March 2017, it held only 10 per cent of assets in "liability hedging gilts" to match pension liabilities. Despite its abysmal track record, the scheme wants to keep betting on equities, taking investment risks underwritten by universities that they would not dream of taking directly.

To continue this bet — much larger than any bet taken by any UK hedge fund or investment bank — is reckless and threatens the long-term future of higher education.