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‘Actuaries’ magic pencil’ hides UK university pension deficit

By John Ralfe


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The Universities Superannuation Scheme is one of the UK’s largest pension funds, with 300,000 members

The Universities Superannuation Scheme, the pension fund for 300,000 current and former academics, has now overtaken BT as the UK’s largest pension scheme, with official liabilities of £50bn at March 2013 and an £11.5bn deficit.

USS’s March 2014 actuarial valuation will fix the regular annual contribution for new pension promises and deficit contributions. With the fall in real interest rates since the 2011 valuation, it will require a large increase in university contributions – now £1bn a year – as well as an increase from members.

But how big should this increase be? Rather than the objective FRS17/IAS19 corporate bond rate used by all private sector companies to calculate pension liabilities, the 2011 valuation, and annual updates, uses a subjective discount rate – gilts plus 1.7 per cent – based on the “expected return on assets” USS holds.

The “actuaries’ magic pencil” understates liabilities and costs, taking credit for the expected, but unearned equity risk premium.

So although USS’s latest annual report contains the good news that the official deficit had fallen from £11.5bn in March 2013 to £7.9bn in June 2013, the FRS17 deficit, using the objective corporate bond rate, is still a whopping £10.5bn.

To make good a £10.5bn FRS17 deficit through cash contributions, universities would have to pay £600m a year, increased in line with inflation, for 20 years.

USS also understates the annual cost to universities of new pension promises, estimated in the 2011 valuation at 12.6 per cent of salary, after member contributions. The annual cost for universities, using the objective FRS17 corporate bond rate at June 2013, is 21 per cent of salary, after an increase in member contributions from 7.5 per cent to 10 per cent, under a cost-sharing arrangement agreed in 2011.

Universities are now paying £1bn a year to USS – 16 per cent of salary, 12.6 per cent annual cost and 3.4 per cent deficit contribution. Using the June 2013 FRS17 rate, the total contribution would almost double from £1bn to £1.9bn.

Paying for this extra £900m from higher student fees (where else would it come from?) would mean a material hike in fees.

USS has ignored the scale of its liabilities and annual costs for many years. Although the official deficit in March 2011, for example, was just £2.9bn, disclosures buried deep in its accounts show a £7bn FRS 17 deficit. The official deficit in March 2013 was £11.5bn, versus an £18.2bn FRS17 deficit.

The regular annual contribution of 12.6 per cent of salary, calculated at the 2011 valuation, was also understated. Using the objective FRS17 corporate bond rate, the cost was around 18.3 per cent. The 16 per cent total university contribution since 2011 has, in truth, not even paid for the regular annual FRS17 cost, let alone made any deficit contribution.

If USS had recognised its real deficit and annual costs over the past few years, with universities making higher contributions, today’s deficit would be much lower and more manageable.

The increase in university contributions could be reduced if new benefits were reduced, with an annual pension of say 1/100, not 1/80 of salary, abolishing the three-times cash lump sum or a further increase in the retirement age from 65, but this would do nothing to reduce the accumulated deficit.

For many years, USS held 80 per cent of its assets in equities and alternatives (it is now down to 70 per cent), with only 16 per cent of assets in bonds in March 2011 – a much more aggressive asset allocation than any private sector pension scheme.

USS argues it can take this massive bet because it has "positive net cash flow for years ahead" – annual contributions and investment income are more than annual benefits paid. But viewing any funded defined benefit pension scheme as simply "cash in, cash out" is deeply flawed.

Regular annual contributions pay for the cost of future pension promises made this year, so it is dangerous double-counting to use them to pay current pensions. USS should not be relying on contributions for new pension promises to pay current pensions.

Individual universities do not have to show their share of USS's FRS17 costs and deficit in their accounts, making the USS problem easier to ignore, and more difficult to manage. There must be more transparency in reporting, allowing universities to properly understand USS's real financial position and then they, and government, must deal with the risk it poses to the long-term future of the higher education system.

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