27 June 2022

USS

The Trustee's response to employer feedback on the Statement of Investment Principles (SIP)

The formal consultation on the SIP with sponsoring employers ran from 31 March to 3 May 2022.

Written consultation feedback was received from 40 employers, representing 25 pre-92 employers (including 16 of the 24 Russell Group members) 11 post-92 employers, two non-higher education institutions and two Oxbridge colleges. This compares very favourably with the last SIP consultation in 2019 in which responses were received from just 15 employers.

- Ten responses, representing 15% of the active membership, were reviewed by the employer governing body
- Four responses, representing 6% of the active membership, were reviewed by the employer executive
- One response, representing <1% of the active membership, was reviewed by an employer USS working group
- 25 responses, representing 32% of the active membership, did not note the review process

Around 88% of employers did not submit a response at all (covering 48% of both active members and the TP deficit).

Respondents covered 52% of total active members and 51% of total scheme liabilities (on a Technical Provisions basis). We have expressed the results of the consultation below, weighted by both active members and liabilities.

A number of the points raised by employers echoed or referred directly to a briefing note provided by Aon, commissioned by Universities UK. Our response to Aon's briefing is provided separately to this note, but it made a very clear statement: *"We believe that the draft SIP, as updated, correctly reflects the proposed new strategy and complies with the legislation."*

Aon was supportive of:

- *"… the aim of the Trustee to reduce funding volatility while targeting an acceptable level of return."*
- *"… the direction of travel in moving from the current Reference Portfolio to the Valuation Investment Strategy."*
- *"… the modest use of leverage proposed to achieve higher interest rate and inflation hedge ratios, since it will reduce the volatility in the funding position."*

Aon also noted the following:

- *"While the amount of leverage will be large in £ terms, it will be modest relative to the size of the Scheme and less than that used by many other large UK pension schemes."*
- *"… that, even at the increased hedge ratios proposed, the Scheme will still have lower hedge ratios than most large UK pension schemes."*
- *"The increase to the hedge ratios will increase the importance of the liability hedging assets."* As a result, Aon raised *"a number of areas that the Employers may wish to consider further relating to this, including the relatively wide range of assets used for hedging*."
- *"[There are] a number of areas in the SIP where the Employers might wish to ask for greater detail."*
- *"…we recommend including a table showing the targets and ranges for the VIS [Valuation Investment Strategy]."*

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Summary of employer feedback

In this section we provide a summary of the feedback received from employers in the consultation. More detail is available in the accompanying document 'Analysis of SIP consultation feedback'.

Employers covering 24% of active members *and* liabilities were – explicitly or conditionally – supportive of **the overall approach**, typically commenting that it was "sensible" and "appropriate" that it supported the objective of reducing volatility in the scheme's funding position. Employers representing 11% of active members *and* liabilities explicitly were not in support. Employers covering 17% of active members *and* liabilities either could not comment / needed more information (5%) or did not make any comment at all on this point (12%).

The majority of responses welcomed a **greater degree of ongoing engagement** on the investment strategy and many of the comments were requests for **further information**, for example on ESG-related issues and the oversight of USSIM.

Maintaining the proportion of **growth assets** at 60% was supported (or conditionally supported) by employers representing 17% of active members *and* liabilities. Employers covering fewer than 1% of active members *and* liabilities expressed explicitly negative views on this.

University Alliance[1] provided a note of caution on behalf of its membership as regards **the level of risk** involved: *"…the target level of risk that USS is prepared to accept to meet its objectives does not adequately reflect the position of employers with smaller participation in the scheme. There is an urgent need to address the pitfalls of a one size fits all approach and consider implementing a different investment strategy for post-92 university employers such as those we represent."*

The level of **hedging** proposed was supported by employers representing 10% of active members and 12% of the liabilities, typically because it would reduce volatility in the funding level and, in turn, reduce volatility in the required contribution rate. Employers representing 8% of active members and 7% of the liabilities needed more information or could not comment. Employers representing fewer than 1% of either measure explicitly did not support the proposed hedging strategy.

Employers representing 13% of active members *and* liabilities supported (or conditionally supported) the approach to **leverage**. Comments from this group included that the amount of leverage was "modest" by reference to other schemes (conceding that most were more mature than USS, if not already closed). In contrast, employers representing 7% of active members and 8% of the liabilities raised concerns. Comments from this group included that the level and type of leverage imports "significant risks into the scheme".

Several employers wanted more information and/or reassurance that USSIM was capable of managing the level of leverage involved. Employers also want more information on other risks – including counterparty risk, currency risk and longevity – and how they would be managed. Several employers wanted more information and/or reassurance that USSIM was capable of managing the level of leverage involved. Employers also want more information on other risks – including **counterparty** risk, **currency** risk and **longevity** – and how they would be managed.

[1] University Alliance is the voice of professional and technical universities. Its members are: Anglia Ruskin University; Birmingham City University; University of Brighton; Coventry University; University of Derby; University of Greenwich; University of Hertfordshire; Kingston University; Leeds Beckett University; Middlesex University, Oxford Brookes University; University of South Wales; Teesside University; and University of the West of England, Bristol. Collectively, they represent around 400 active members.

A significant minority (representing 23% of active members and 22% of the liabilities) questioned the relevance of **self-sufficiency** (a central pillar of the Integrated Risk Management Framework, or IRMF, used in the 2020 valuation) to an open and immature scheme with USS's unique covenant and called for alternative approaches to be explored instead.

Of the responses that made comments on **ESG and Responsible Investment**, the majority were neutral or offered conditional support (covering 15% of active members and 16% of the liabilities) – calling for more detail in the SIP, and regular reporting, on the scheme's voting policy and how ESG considerations have impacted decisions made by investment managers. Some queried the removal (from paragraph 1.4.12 of the 2019 SIP) of the reference to "regularly reviewing ESG policy". Others queried the implication of deleting references to the UN backed Principles for Responsible Investment and the UK Stewardship Code (para 1.4.10). A small minority, covering 5% of active members and 4% of the liabilities, were critical and felt more could be done.

Employers covering 24% of active members *and* liabilities were supportive (or conditionally supportive) of the Trustee's **Net Zero ambition**, with calls for regular reporting on performance against the plan to achieve it. A relatively small number of comments (from employers covering 3% and 4% respectively) were explicitly critical in calling for USS to be a leader in this space and set a more ambitious target.

In line with a recommendation from Aon, employers covering 16% of active members and 17% of the liabilities called for **the VIS' asset allocation to be stated in the SIP** (*"…a schedule of targets and ranges…"*). In doing so, some inferred that they had concerns with the degree of flexibility/autonomy the SIP would otherwise give USSIM and the Trustee to deviate from the plan in this respect.

Performance and oversight (of the VIS and/or USSIM) was another common theme, with employers covering 12% of active members *and* liabilities asking for information out how this will be monitored and managed – and/or for regular reports and updates to be provided to employers (and members).

"More information" was a broad and common theme across the responses. There was notable support (from employers covering 28% of active members *and* liabilities) for UUK's suggestion of **a new forum** to provide regular, ongoing engagement with employers on the implementation and performance of the investment strategy.

A small number of responses (from employers representing fewer than 6% of active members *and* liabilities) raised comments about **governance**.

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Overview of our response

We have considered the oral and written feedback received via our informal VIS engagement programme (January to March 2022), and the formal SIP consultation with employers (April 2022).

Our response to this feedback involves a package with four components:

- New, regular engagement events for employers on investment strategy
- Some minor changes to the SIP
- Additional information on investment strategy
- Improving ease of online access to documents referenced in the SIP that provide more detail

Engagement events
The new engagement events that we are planning are an important part of our response to the feedback. The need for such events was expressed explicitly by many employers and implicitly by others. This additional engagement will involve three types of event:

- An initial investment discussion forum in July, primarily targeted at those employer CFOs who have expressed an interest in a deeper discussion, following the finalisation of the SIP. This will discuss the feedback from the consultation and the Trustee's response to that feedback on key thematic areas.
- Quarterly briefing sessions for employers. These sessions will provide regular briefing updates on matters of investment strategy, execution and performance, funding monitoring, covenant and regulatory developments, ESG strategy and other topics of interest to employers. These are planned to begin in the autumn of 2022.
- Six-monthly investment discussion forums for employer CFOs and sector body representatives. These will provide an opportunity for more in-depth discussion of investment strategy following the initial July forum.

SIP changes
The key feedback items that have now been implemented in the updated SIP are:

- Reference to the basis risk between sterling and non-sterling assets (i.e., between UK index linked gilts and similar instruments issued by foreign governments).
- Reference to the counterparty risk that the Scheme faces in transacting with other financial institutions.
- Reference to the regular review by the Trustee Board of ESG-related policies to ensure they are in line with good practice.

The key feedback items that were implemented elsewhere include:

- Providing the ranges of allocations around the VIS.

Additional information
Ranges will be provided of the allocations around the VIS that are permitted in relation to USSIM's investment implementation (see above comment).

Improving accessibility of information
A new hub has been provided on the USS website to make it easier for employers to find specific documents in relation to investment strategy in particular, as well as other related and relevant documents.

Response to the key feedback themes

As mentioned above, the feedback from the consultation has been analysed in terms of 10 different ‘themes’. These are explained in detail in the accompanying document ‘Analysis of SIP consultation feedback’. Below we explain our response with respect to each.

More information and engagement: We have committed to setting up regular updates and engagement sessions on investment strategy and related topics. We hope our (separate) response to Aon’s briefing note provides a helpful guide as to where relevant additional information has been provided outside of the SIP itself. We have also made relevant documents easier for employers to find on our website.

Allocation to growth assets: We have maintained the allocation at 60%, per the feedback received during our informal pre-consultation engagement and confirmed since in the SIP consultation.

Risk appetite: We acknowledge there is a broad range of views on this issue but believe we have provided adequate explanation and documentation of our approach to developing our risk appetite (for example, the Discussion Document and Technical Provisions consultation). We would be happy to discuss this at the planned engagement sessions, particularly in relation to the approach for the 2023 valuation.

Hedging of liability-related risks: We have decided not to change the approach to liability hedging outlined in the draft SIP and VIS documents, but will provide regular updates and discussion opportunities to employers (and other stakeholders)

The use of investment leverage: We have has decided not to change the approach to leverage outlined in the draft SIP and VIS documents, but will provide regular updates and discussion opportunities to employers (and other stakeholders)

Role of self-sufficiency in investment strategy: No change is feasible at this stage, given how self-sufficiency is at the heart of the IRMF and the overall valuation methodology. However, this will be reviewed at the next valuation.

ESG: The wording on “regular review of ESG policies” has been restored. This remains important to the Trustee.

Net Zero ambition: The ambition is included in the SIP to reflect the importance to the Scheme and the Trustee. Progress will be reported annually in our TCFD reporting and Implementation Statement.

Defined contribution: We continue to monitor the risks associated with the DC section. While there are more members in the DC section from 1 April 22, the risks are unchanged.

VIS: Having reflected on the feedback received, we have confirmed the composition of the VIS. We have also added information on the ranges around the VIS in which USSIM can invest – and will outline where the implemented portfolio sits, within these ranges, at the engagement events noted on page 4. More detail on our response to feedback on the VIS is given in the next section.

Detailed responses to feedback on elements of the VIS

Growth assets
The feedback received in our informal engagement with employers over the past six months was reflected in the VIS on which we subsequently consulted – specifically maintaining the allocation to growth assets at c.60%. Following the positive feedback received from employers in the SIP consultation, the level of growth assets in the VIS will be maintained at 60%.

Hedging
We have decided not to change the approach to liability hedging outlined in the draft SIP and VIS documents but will provide regular updates and discussion opportunities to employers (and other stakeholders). These will provide frequent opportunities for stakeholders to review and better understand the rationale and performance of the liability hedging strategy.

Increasing the liability hedging responds to the challenging nature of the current investment outlook *and* the recent increase in the size of the Scheme relative to the size of the Higher Education (HE) sector.

The outlook for future investment returns is more challenging than at past valuations – so there is a greater focus on downside risks. There are very plausible scenarios in which 'real' interest rates could fall. (By 'real' interest rates we mean *after allowing for inflation*: if interest rates rose by less than the increase in inflation, this would correspond to a fall in 'real' interest rates.) Current UK interest rates are low by historical standards, and the UK 'real' interest rate curve is likely further depressed by the well-documented imbalance between supply and demand for index linked gilts (UK government bonds that give protection against inflation). These observations are reflected in our Base Case Fundamental Building Blocks (FBB) expected return assumptions, which allow for an upward evolution of UK nominal and real interest rates over a 10-year period. However, this assumption is subject to a wide margin of uncertainty and there are plausible scenarios in which such migration would not happen for an extended period or would not be sustained.

There remains a distinct possibility of further falls in UK real interest rates, which would put further pressure on the funding position relative to the size of the sector. While there has been a degree of volatility, the size of the DB section of USS (in terms of the self-sufficiency liability) has grown at a faster rate in recent years than the HE sector (in terms of net balance sheet assets). So, the covenant of the sponsoring employers is now supporting a much larger scheme with a much larger risk exposure than in the past (see Q1 of the VIS Questions and Answers document). The interest rate and inflation risks associated with the liabilities account for approximately two-thirds of the total financial risk to the deficit. The risks associated with growth assets account for only a third. This is discussed in detail in the documentation provided as part of the SIP Consultation (see the webinar presentation and the VIS Questions and Answers). Hedging the liability risks rather than the growth asset risks has a greater impact on overall risk reduction. It also redresses the large imbalance between the different types of risks. In addition, we believe the risks associated with growth assets are more reliably rewarded (the so-called 'equity risk premium') than the liability-related risks.

We are comfortable with the potential for reduced upside coming from hedging by considering the trade-offs between the various risk and return (and hence cost) metrics. In particular, this cost is only realised in scenarios in which real interest rates rise (for example, in the scenario in which FBB expected returns are realised) and in those scenarios the funding level of the Scheme would be much higher than at the valuation date. This increase in the funding level when the cost of hedging is highest was important for us to be comfortable with the level of hedging. By contrast, in scenarios in which real interest rates fall, additional hedging would actually generate a profit. In this case, the fall in the funding level would be more limited because of benefits from the liability hedging.

Since the start of 2022, we have seen considerable volatility in the financial markets: growth assets have fallen in value and gilt yields have risen significantly. In particular, since 31 December, 30-year index linked gilt yields have risen from –2.28% to –1.04% to 31 May. This has reduced the value of the gilts that the DB section of the Scheme holds as hedging assets. However, this increase in yields has reduced the value of the self-sufficiency liability by an even greater amount. So, the net impact on the funding position has been positive (which will be reflected in the next FMP monitoring report). We expect gilt yields and the value of growth assets to continue to be volatile.

Leverage

We have decided not to change the approach to leverage outlined in the draft SIP and VIS documents but will provide regular updates and discussion opportunities to employers (and other stakeholders). These will provide frequent opportunities for stakeholders to review and better understand the rationale and performance of the approach to leverage.

As we explained in our webinars on the VIS, the leverage used in the Scheme brings greater efficiency to risk management and capital management. Managing leverage involves managing cash, managing collateral and managing counterparties, along with the associated risks. USSIM is very experienced in managing these.

In terms of managing cash, USSIM takes a conservative approach because the impact of not having sufficient cash is highly undesirable. This approach involves a daily cash forecasting process of cash inflows (like contributions, investment income and investment redemptions) and cash outflows (like benefit payments, new investments and cash collateral posting) over a six-month horizon. We then stress the cash requirements by considering what have been the worst historic moves in market levels over a two-week horizon and hold enough cash to meet these. This is repeated every business day.

Managing collateral involves planning to ensure that sufficient collateral (typically in the form of cash and gilts/government bonds) is available when it is required. The process used involves, first, determining the collateral requirements corresponding to the worst possible market movements observed over a three-month horizon as well as those that have occurred over a 12-month horizon.

The second step is to then ensure that sufficient collateral will be available over these horizons to meet these worst possible requirements. This approach takes an historical approach to determining the worst case, rather than a stochastic approach, because the stochastic approach generally does not adequately capture the probability of such extreme outcomes. (In reality, extreme events in the tails of the distribution of outcomes are more probable than the estimations coming from most stochastic models, and these are better captured by using historical data directly.)

Managing counterparty risk involves several elements: first, picking only high-quality counterparties and, second, diversifying over a number of different counterparties. Thirdly, we use collateralisation where possible to limit the impact of counterparty default, should it occur. (An example of where we cannot use collateralisation is in the bank account that we use to pay pensions each month. The cash in the account is exposed to counterparty default risk.)

USSIM analyses how much the Scheme could lose from counterparty defaults over a five-day period, which is a period of time over which collateral might not be adequately updated due to operational reasons. This approach is similar to that of investment banks and asset managers. USSIM also evaluates the tail risk of leverage overall by looking at the worst possible 12-month market movements over the past 70 years.

The cost of leverage is low because the “borrowing” takes place via financial instruments that are collateralised. USS is able to fund in US dollars and Euros as well as sterling and leverage can be achieved in both equity and bond markets, and in the currency that is cheapest at the time.

Furthermore, we have government bonds in the investment portfolio that are available as collateral when needed, which enables USS to keep the cost of leverage low.

Self-sufficiency

We have decided to retain self-sufficiency as the benchmark for risk. This is consistent with guidance from The Pensions Regulator, and the view of UUK and UCU’s Joint Expert Panel (report 1, page 8) – but it will be reviewed at the next valuation.

The primary reason for this is self-sufficiency is a central element in the IRMF of the 2020 valuation. Changing its role as a risk benchmark would require the entire 2020 valuation to be re-opened and re-engineered. This is clearly not feasible at this stage.

Self-sufficiency is a low-risk strategy for funding the Scheme in the situation in which there were no employer covenant. Without a covenant, there would be no way to repair any shortfall that might arise in paying pensions (other than through investment returns) and as a result we would have to pursue low-risk self-sufficiency approach to reduce the probability of a future shortfall arising.

We do not target the self-sufficiency liability as the funding level and neither do we aim to pursue a low-risk self-sufficiency investment strategy. The funding level we target remains the Technical Provisions (TP) liability (which is a lower funding target than self-sufficiency) and the investment strategy assumed in the valuation is the VIS (which is a higher-risk investment strategy than self-sufficiency).

Self-sufficiency plays a fundamental role in the 2020 valuation in relation to managing risk. This role is much broader and more fundamental than just managing investment risk. Self-sufficiency is a concept that helps the Trustee evaluate whether or not the employers have sufficient resources (risk capacity) to support the risk associated with running the DB section of the Scheme.

In order to ensure that there is a high probability of paying any financial obligation, the risks attached to that obligation must be consistent with the risk capacity of the organisation responsible for that obligation. This is the case, for example, with banks and insurance companies, which under regulatory rules must explicitly set aside capital to support the risks associated with their businesses and ensure that there is a high degree of certainty of meeting their future financial obligations. Setting aside this capital demonstrates that these organisations have adequate risk capacity.

USS is not required to hold explicit capital for the Scheme in the same way as a bank or insurer. But by virtue of its covenant, USS has recourse to additional contributions from its sponsoring employers, which constitutes a form of such capital. We measure the amount of capital that employers are willing and able to provide in terms of the Affordable Risk Capacity (ARC), which is calculated as the present value of contributions of 10% of payroll over the next 30 years.

Self-sufficiency is how we check whether this capital (i.e., the ARC) is adequate to support the risks being taken within the Scheme. By comparing the self-sufficiency deficit to the ARC we can check that we are not taking too much risk and the capital is adequate.

We have explored the possibility of using alternative approaches to risk management that do not involve self-sufficiency, both with stakeholders and advisors during the 2020 valuation and other recent valuations. So far, no credible alternative has been found that plays the role described above as effectively.

For example, some stakeholders have suggested an alternative approach that ignores the self-sufficiency deficit and other solvency metrics, such as the TP deficit, and focuses primarily on cash flow. Specifically, this approach advocates focusing on meeting future benefit payments over time and ignoring the need to demonstrate solvency over time.
This alternative is however not acceptable to the Trustee. First, the management of DB pensions in the UK is regulated and the ability to demonstrate solvency is a key element of that regulation. (Note that other countries' regulations also focus on solvency). Second, it is economically sensible to monitor the solvency position, as solvency: (i) makes it clear what the Scheme is relying on for funding (assets or the sponsor covenant, or a specific mixture of both) and (ii) provides a single-figure summary of the ability of the Scheme's assets/investments to meet all of the future benefit payments. This is helpful in that it can provide an early warning of the potential for future difficulties in meeting these payments.

As noted above, the role of self-sufficiency will be reviewed at the next valuation.

Several, but by no means all, of the risk-return metrics considered by the Trustee in its analysis of investment strategy involved self-sufficiency. These metrics included the probability of the self-sufficiency deficit exceeding 150% of ARC, reverse stress tests on the self-sufficiency deficit and the worst-case self-sufficiency deficit at a 95% confidence. But because risk is multifaceted, we have used a broad set of different risk metrics, which includes other metrics not related to self-sufficiency, such as the probability of full funding of the TP deficit in 10 years' time and the volatility of contributions.

So, in arriving at its decision on the VIS, the Trustee evaluated different potential investment strategies in terms of this broad set of metrics, including some related to, and others unrelated to, self-sufficiency.