

Self-sufficiency transition risk

The Trustee's 'reliance' risk metric measures the collective ability of the employers to fund a move to a 'low risk' self-sufficiency investment strategy over 30 years, should it prove necessary. So why does the metric include a margin for an 'asset transition risk', involving the purchase of such a portfolio as soon as possible? How can we square these different timescales?

(By way of background, 'reliance' is a measure of the extent to which the funding plan for the Defined Benefit section of the Scheme is relying on the collective financial resources of sponsoring employers.

Reliance is measured by reference to the cost of moving to a 'self-sufficiency' investment strategy, under which the probability of being able to pay all the pensions promised to USS members and maintain a high funding level, without requiring any additional contributions is around 95%.

Self-sufficiency is, at face value, riskier than what insurance companies and banks would consider to be 'low risk', but we would be sufficiently confident that the pensions already promised to our members could be paid.)

The starting point for explaining the answer to this question is the Scheme's Integrated Risk Management Framework (IRMF). According to the IRMF, the amount of reliance that the Scheme places on the employers' covenant must be consistent with the ability of employers to deliver on that reliance.

So, the risk metrics used in the IRMF compare the Scheme's reliance on the covenant with the capacity of employers to provide tangible support.

In particular, this means comparing self-sufficiency (the level of assets and investment strategy for which the Scheme would no longer have any reliance on the covenant) with the affordable risk capacity of the employers.

This comparison addresses the following question: *Is the affordable risk capacity adequate to get the Scheme into a position of zero reliance on the covenant, should it be necessary to do so?*

How might this reliance on the covenant be transformed into tangible support for the Scheme?

Well, in the very unlikely event that the Scheme needs to move to a self-sufficiency strategy, it would require us to do two things:

- (i) call on the employers' affordable risk capacity (in the form of contributions of 10% of payroll over 30 years), and;
- (ii) transition the investment strategy to the low-risk self-sufficiency strategy.

In **calling on the employers' affordable risk capacity**, we would be accessing cash flows from employers over the long term (10% of payroll over 30 years) specifically to fund the higher level of assets required to shift to self-sufficiency.

These cash flows are equivalent economically (but not legally) to an investment in an inflation-linked bond issued by the sector. So, from an economic (but not a legal) perspective, the assets of the Scheme could be considered to be augmented by the value of this 'bond' (i.e., the present value of the cash flows of 10% of payroll over 30 years discounted at a rate consistent with the credit quality of the employers). The 'augmented value' of the Scheme's assets would ideally be at, or above, the level required for self-sufficiency.

The **transition** from the prevailing investment strategy to the low-risk self-sufficiency investment strategy is not something that can take place instantaneously, given the size of the Scheme relative to the depth of the financial markets. So, the transition will take some time, during which the Scheme would be exposed to a level of investment risk that is higher than that associated with the self-sufficiency investment strategy.

As a result, there is a risk that the market might move adversely during this transition period, increasing the distance to self-sufficiency. During this period of higher investment risk, the need to maintain the same high probability of paying all accrued benefits whilst maintaining a high funding level requires a risk margin (specifically a margin to cover asset transition risk) to be built into the funding approach.

This **asset transition risk** margin, like any risk margin, can be computed in different ways. For simplicity, we have taken the following approach:

1. Calculated the level of assets required to fulfil self-sufficiency, assuming we start with the low-risk self-sufficiency Investment strategy. This is just the normal calculation of the self-sufficiency level.
2. Calculated the level of assets required to fulfil self-sufficiency, assuming we start with the current Investment strategy and this transitions to the low-risk self-sufficiency investment strategy over a reasonable transition timeframe – see Annex 1¹.
3. Calculated the difference of (2) – (1).

Note that we compare all the relevant quantities on the same basis (as capitalised metrics in present value terms). So, the potential complexity relating to the different timescales associated with the definition of affordable risk capacity, the self-sufficiency run-off horizon, and the self-sufficiency investment strategy transition period is avoided.

Annex 1

We apply the following transition speed when arriving at the required asset transition risk margin:

Asset Class	Public	Private
Growth (Disposals)	1 Year	3 Years
Credit (Purchases)	5 Years	10 years
LDI (Purchases)	5 Years (Interest Rates) 10 Years (Inflation)	NA

¹ Because the investment strategy is higher risk than the self-sufficiency strategy during the transition period, it requires an initial asset level higher than the self-sufficiency level to achieve the same 95% confidence level of paying all pensions and maintaining a high funding level without additional contributions.