Universities Superannuation Scheme

Financial Management Plan

30 September 2015

Version 1.1

Contents

1. Introduction

This document describes the Financial Management Plan (FMP) for the Universities' Superannuation Scheme, which has been developed as part of the formal valuation of the scheme as of 31 March 2014. The FMP sets out an integrated approach to the management of the scheme's funding and investment strategies in light of the strength of the employer covenant.

The objective of the FMP is to ensure the ongoing financial viability of the scheme over the long term. The FMP is owned by the trustee and was developed in consultation with the employer and member representatives and other stakeholders. As part of the development process, the trustee has also taken advice from two external advisors:

- Mercer as the appointed funding advisor and investment advisor (including Ali Tayyebi as Scheme Actuary);
- Ernst and Young (EY) as the appointed covenant advisor.

The FMP will be reviewed at least every three years as part of the triennial actuarial valuation cycle, or more frequently if any material changes in the scheme's circumstances are highlighted by the regular FMP monitoring.

2. Governance

The development, monitoring and review of the FMP are the responsibility of the trustee board. The USS executive regularly monitors progress against the FMP and reports to the trustee at each board meeting. The FMP is a standing agenda item for all board meetings, at which the board will consider:

- The three key components of the FMP, namely:
  - *Covenant:* An assessment of whether the covenant provided by the participating institutions remains adequate for the reliance being placed on it by the trustee in its adopted funding and investment strategies.
  - *Funding:* Monitoring of the funded position of the scheme and the costs of providing the promised benefits.
  - *Investment:* Monitoring the asset growth, the de-risking of the scheme's investment strategy and the progress compared with the path agreed as part of the FMP.
- Whether or not additional advice needs to be commissioned; and
- Whether any action needs to be taken in relation to the funding of the benefits promised by the Scheme.

Annually the trustee will review the Guiding Principles for the FMP (discussed below) and confirm whether or not they remain applicable.

At least every three years and prior to the regular triennial valuation, the full FMP shall be reviewed by the trustee and, whether or not any changes are made, a consultation shall be carried out with the employers to confirm it remains appropriate.

The FMP is a key element of actuarial valuations and reviews of investment strategy.

3. Framework for the FMP

The framework for the FMP is built on three guiding principles which are reflected in a series of three tests described below.

3.1 Guiding Principles

The trustee's overriding objective is to manage the scheme in such a way to ensure that the benefits are paid as they fall due. The approach to the financial management of the scheme (and in particular the funding and investment strategy) will be driven by the trustee's view of the covenant provided by the participating institutions. The strength of the employer covenant impacts the amount of risk which can be prudently taken by the trustee. Risk is inherent in the funding of the scheme and in the investment of the scheme's assets. The total amount of risk the trustee feels it is prudent to take has an impact on contribution requirements.

Three guiding principles have been adopted by the trustee in order to manage scheme funding. These principles draw a very clear line between the support available from the participating employers and scheme risk over the covenant horizon (currently estimated to be 20 years from 31 March 2014). The guiding principles are:

- **Principle 1:** Over the period for which there is visibility of the covenant (estimated to be 20 years) there should be no increase in USS's reliance on the covenant of the sector and, where opportunities arise, the reliance on the covenant should be reduced.
- **Principle 2:** There should be a high and very high probability that the institutions' contribution rate will not exceed 18% and 21% of salaries respectively.
- **Principle 3:** The balance sheet of the participating employers should be able to cover the impact which a rare set of adverse circumstances (tail risk) may have on the funding position of the scheme.

Associated with these principles are three tests which inform the trustee's decision making and which drive the level of Technical Provisions and the underlying discount rates for the liabilities.

The tests use a number of key concepts in particular:

- *Technical Provisions basis:* This is an approach to measuring the value of the scheme's liability, based on the amount of assets required to make provision for the scheme's accrued, or past service, benefits as they fall due. As such the discount rate for USS' Technical Provisions is the scheme's expected return on assets (allowing for anticipated changes to the investment strategy) adjusted by a prudence margin.
- *Self-sufficiency basis:* This is an approach to measuring the value of the scheme's liability assuming the scheme is self-sufficient. In this approach the liabilities of the scheme are calculated using a discount rate consistent with a low investment risk approach, where minimum reliance is placed on the participating employers to provide further financial support to the scheme given the investment risk being taken. The low investment risk approach is one that could, in appropriate scenarios, be adopted by a trustee to reduce the longer term reliance on the sector and to ensure the security of members' benefits.
- *Economic basis:* This is an approach for calculating the liability of the scheme which uses a discount rate based on assets that most closely match the nature of the liabilities. As pension liabilities are bond–like and backed with assets this implies using the interest rate on government bonds.

- *Value at Risk (VaR):* This is a measure of downside risk. It reflects a worst case outcome at a particular confidence level. For example 95% VaR measures the downside (relative to expectation) at 95% confidence level, essentially the one in 20 worst case event.

3.2 The Tests

The trustee has adopted three specific tests which will be used to assess whether, and the extent to which, its guiding principles are satisfied in the light of the level of future benefits to be provided under the scheme. The trustee uses these tests as a guide to determine the nature and timing of any responses that might be required.

Test 1: Benefit security and additional contribution cover

The difference between the liabilities assessed on a self-sufficiency basis (i.e. using a discount rate of gilts plus 0.5%) and the actual Technical Provisions basis should be comparable to, or lower than, the difference between the maximum desirable contribution of 18% payable by the institutions and the maximum affordable contribution of 25% over a long period such as 20 years, as detailed in the EY covenant review.

The rationale for this test is that, at any given time, the trustee could in principle remove the investment risk currently being run in respect of past service accrued benefits and replace the higher expected return by additional contributions from the participating institutions, without violating the principle of mutuality. These additional contributions would still be required over a relatively long period, and would augment the existing contribution components.

In considering the development of the relationship between the self-sufficiency liability and the Technical Provisions, the position at the end of a 20-year period will be used. The required discount rate on the Technical Provisions at the end of 20 years will be established such that the desired relationship between the self-sufficiency liability and the Technical Provisions is maintained. The required discount rate at that time will be factored into the discount rate structure which is used to establish the current value of Technical Provisions and inform the required investment strategy.

Test 2: Stability of contributions

Modelling will be carried out to quantify the range of contribution requirement outcomes on a Technical Provisions basis over a three year period. It is proposed that the contribution requirements to meet the cost of benefits accruing and any deficit on the Technical Provisions basis at the end of a three year period should have a high probability of not exceeding 18% of salaries and a very high probability of not exceeding 21% of salaries.

In assessing the risk parameters the following will apply:

- A high probability will be 70% or above.
- A very high probability will be 90% or above.

Test 3: Benefit security and the asset base of the participating employers

The net asset value of the sector should be compared to the deficit on an economic basis (i.e. using a discount rate equal to the yields on gilts) plus the amount of additional assets required to meet a tail risk, one in one-hundred, funding event (measured using a value at risk, or VaR, at a 99% level over a one year period). This will be a guide to the extent to which, in extremis, the scheme would have access to sufficient funds, in all but the most extreme circumstances, to secure the benefits promised by the scheme.

The trustee acknowledges that the net asset value of the sector is not precisely quantifiable. As such the trustee will monitor the ratio of (i) the deficit on an economic basis plus VaR at 99% level to (ii) the net asset value of the sector. Should the ratio rise above 90%, then the trustee will review what risk mitigation action may be required. In this context, the net asset value of the sector would be assessed on a realistic basis, which may include the use of insurance replacement value measures if this is judged to be more representative of fair value than book value.

4. Covenant

The employer covenant is the bedrock on which the FMP is based and, as a result, is carefully monitored and reviewed by the USS executive and the board as part of the overall FMP monitoring process. This monitoring covers a number key metrics which fall into three categories, namely:

- Income and expenditure
- Assets and liabilities
- Scheme and sector measures.

The monitoring also includes:

- The three tests outlined above
- Monitoring of the media for developments in higher education and other areas that may impact the strength of the covenant over the near term or over the long term.

At least every three years and in advance of the triennial valuation of the scheme, the trustee will commission a detailed deep-dive and report on the strength of the covenant. For the 31 March 2014 valuation this was provided by EY. The main conclusions from their work are:

- The sector provides a substantial covenant to the scheme.
- The vast majority of the participating institutions could increase their contribution rate to 21% of payroll, albeit not without some change to their business plan and/or prioritisation of pension contributions.
- An increase to 25% of payroll could also be met by the majority of participating institutions, but this would undoubtedly require further, more significant, changes to the institutions operations and may place greater reliance on mutuality of the scheme.
- Generally speaking there is good visibility of the key income streams for the periods of up to 20 years. Beyond 20 years there may be threats to the sector and revenue levels but the sector itself will continue though potentially changed.
- Net assets adjusted for properties from book value to the insurance reinstatement value is of the order of £44bn as at 31 March 2014.

5. Funding

The trustee's aim is to hold assets equal to the value of the scheme's Technical Provisions. To the extent that the assets held at each valuation are less than the Technical Provisions, the trustee will put in place a recovery plan to make good the shortfall. Any shortfall will be met by a combination of investment returns and additional contributions from the institutions over a term:

- with which the trustee is comfortable given the covenant, and
- which is reasonably affordable by the institutions.

In calculating the contribution required under the recovery plan, allowance will be made for incremental investment returns during the recovery period which are over and above the discount rate used for the technical provisions. These incremental investment returns are equal to half the difference between the expected return on investment and the discount rate.

Full details of the trustee's approach are set out in the Statement of Funding Principles, a copy of which is available on the USS website ww.uss.co.uk. This statement will be reviewed at least every three years as part of the triennial valuation.

Along with the covenant, the funding position of the scheme is carefully monitored on a regular basis. Reports are produced daily and monthly which are reviewed by the executive and the board as part of the overall FMP monitoring process.

At each board meeting the trustee reviews:

- Progress of the scheme against its funding target;
- Costs of benefits accruing;
- Investment returns and contributions required to meet the scheme's long term funding targets;
- Sensitivities to changing assumptions.

The trustee will then agree any actions that should be put in place to address any issues identified.

6. Investment

The trustee's approach to investment is set out in the Statement of Investment Principles, a copy of which is available on the USS website at www.uss.co.uk. This statement will be reviewed at least every three years, to coincide with the triennial valuation process, or sooner if there are any significant changes in investment policy, or there is a material change in the scheme's funding position or other circumstances which, the trustee determines, warrant a reconsideration of strategic asset allocation and risk tolerance beyond responses envisaged in the latest Statement of Investment Principles.

The FMP incorporates a gradual reduction of the investment risk (relative to liabilities) over a 20-year horizon. This risk reduction programme will be implemented on a flexible basis when certain triggers related to the scheme's funding ratio and contribution requirements are hit.

As part of the FMP monitoring process, the executive and board regularly monitor the scheme's investment strategy, investment performance and risk reduction programme against the FMP path. This is reviewed in detail at each board meeting.