

USSEmployers

MAKING YOUR RESPONSE TO THE USS METHODOLOGY AND RISK APPETITE DISCUSSION DOCUMENT

The USS trustee has produced a discussion document for employers to consider which sets out their emerging thinking on the proposed methodology for the 2020 valuation and the key factors that will drive the outcome.

The document follows feedback from USS stakeholders, lessons learnt from the previous valuation, a fundamental review of valuation methodology, and the Joint Expert Panel's (JEP) second report.

In order to encourage and focus discussions, USS has set out their emerging approach to the methodology and investment strategy. They also set out the two key factors – the covenant and risk appetites – that will have the greatest effect on outcomes, whatever the methodology.

The discussion document is specifically addressed to USS sponsoring employers. Employers' views on the issues the document covers will influence the approach USS subsequently decide to take and will help them to make clear, understandable and evidence-based decisions.

USS have not made any decisions at this early stage in the process, but are seeking to encourage discussion and to build understanding and evidence to inform their approach. Note that this discussion document is separate from, and in advance of, the formal consultation USS is required by law to undertake with UUK later in the year.

The questions in this form are as follows:

1. What are your comments on the proposed new methodology?
2. Do you support the measures to ensure the covenant is "Strong" agreed as part of the 2018 valuation on: i) the permanent rule change on employers exiting the Scheme to underpin a 30-year covenant horizon; ii) debt monitoring arrangements; and iii) pari passu security on new secured debt?
3. Do you wish to consider additional tangible covenant support measures to further strengthen the covenant and potentially support additional risk (above that outlined in the scenarios presented in the table above)?
4. Do you have initial views on whether you would be comfortable with an investment strategy that took a moderately larger amount of risk in the long term?
5. Based on the example approach to managing risk, as set out in this document, what is your risk appetite? In other words, do you have initial views as to how much of your risk capacity you are comfortable for us to rely on in supporting the Scheme, in the knowledge that there are adverse scenarios in which this may be called? (You may wish to express this as a contribution of x% of salary, or a monetary amount, paid over y years.)

In addition to questions 1-5 raised by the USS trustee in the discussion document, UUK would welcome feedback from employers on the additional views and analysis expressed in the accompanying paper.

6. Do you agree that it would be helpful if an outline proposition is developed which shows how the various components – including risk appetite, investment strategy, covenant measures, contribution rates and volatility, and benefit design – might operate together under a particular strategy (or strategies)? (Page 2 of the UUK paper)
7. Any other comments?

Please send the response from your institution to pensions@universitiesuk.ac.uk copying in valuation@uss.co.uk as appropriate, by 5pm on 17 April 2020

1. What are your comments on the proposed new methodology? (See Section 2 of the USS discussion document)

The proposed new methodology does not move significantly away from the traditional approach followed in previous valuations. We understand that the Valuation Methodology Discussion Forum (VMDF) was established to build consensus on more fundamental change, and this group must be allowed to conclude its work in this area.

We believe that the scheme's ongoing open status makes it very different from the majority of funded DB pension schemes in the UK. Contributions exceed pension payments, so the scheme is better able to withstand a reduction in asset values followed by a period of recovery. In contrast, many other DB schemes have pension payments exceeding contributions and would be continuing to liquidate assets during this sort of downturn.

We would like to see a stochastic stress test analysis of the scheme's assets and cash flows to understand the resilience of the scheme to adverse economic conditions, and for this to be core to the valuation methodology rather than sit alongside it. We understand that some funded local government schemes follow a stochastic approach to their valuations (for example when determining contribution rates).

2. Do you support the measures to ensure the covenant is “Strong” agreed as part of the 2018 valuation on: i) the permanent rule change on employers exiting the Scheme to underpin a 30-year covenant horizon; ii) debt monitoring arrangements; and iii) pari passu security on new secured debt? (See Section 3 of the USS discussion document)

We do not support covenant being assessed in a way that creates such ‘cliff edge’ changes as “strong” versus “tending to strong”. We would like to see the USS trustee move away from this approach for the 2020 valuation and believe that a stochastic approach (as set out in our response to question 1) would facilitate this. That said, we do support the measures referred to in this question on the understanding that they are used to support a fundamental change in valuation methodology.

In relation to debt monitoring arrangements and pari passu security, we are aware that work is ongoing in these areas and believe that this work can lead to proportionate arrangements that can work in practice. We would also support a permanent rule change on employers exiting the scheme.

3. Do you wish to consider additional tangible covenant support measures to further strengthen the covenant and potentially support additional risk (above that outlined in the scenarios presented in the table above)? (See Section 3 and Appendix C of the USS discussion document)

The University is committed to supporting and prioritising the scheme. As such, we welcome the exploration of all options at this early stage, provided this is in the context of a fundamental change in valuation methodology.

4. Do you have initial views on whether you would be comfortable with an investment strategy that took a moderately larger amount of risk in the long term (See Section 5 of the USS discussion document)?

As set out in our response to question 1, we believe that the scheme is better able than others to withstand a reduction in asset values followed by a period of recovery. In particular, we see no reason not to adopt a higher-risk investment strategy as long as the scheme remains open with a relatively stable liability profile.

The key is to understand the risks, and we would like to see the proposed stochastic stress test analysis of the scheme's assets and cash flows to understand the resilience of the scheme to adverse economic conditions, and for this to be core to the valuation methodology. As in question 1, we must see the conclusion of the work of the VMDF in this area.

5. Based on the example approach to managing risk, as set out in this document, what is your risk appetite? In other words, do you have initial views as to how much of your risk capacity you are comfortable for us to rely on in supporting the Scheme, in the knowledge that there are adverse scenarios in which this may be called? (You may wish to express this as a contribution of x% of salary, or a monetary amount, paid over y years.) (See Section 4 of the USS discussion document)

In order to consider our risk appetite in this way, it would be essential for the USS trustee to define, as far as possible, what such “adverse scenarios” might be. Without this we (and other USS employers) have no sense of the likelihood, and any attempt to quantify risk without considering likelihood would be meaningless.

We understand that the VMDF is aiming to develop a more practical way of explaining risk that focuses on real-world consequences so that stakeholders can better understand the consequences of the risks they are really running. It is essential, in our view, that we see the conclusion of this work before consider employers’ risk appetite.

Moreover, the proposed stochastic approach to valuation methodology would fundamentally change the way that all stakeholders understand the risks involved.

6. Do you agree that it would be helpful if an outline proposition is developed which shows how the various components – including risk appetite, investment strategy, covenant measures, contribution rates and volatility, and benefit design – might operate together under a particular strategy (or strategies)? (Page 2 of the UUK paper)

Yes. We agree that, without seeing a fuller picture, employers cannot easily understand how the different moving parts interact. This fuller picture should include a clear understanding of covenant strength, and the broad risks relating to covenant support, not just the “covenant measures” proposed in the 2018 valuation.

7. Any other comments?

Although we welcome the opportunity to respond to this discussion document, its structure and the questions it asks do not suggest a significant move away from the traditional approach followed in previous valuations.

The University is sorely disappointed that this consultation does not reflect the progress which UUK has made with the VMDF in revisiting this traditional approach to the scheme valuation methodology. The questions around covenant strength, risk appetite and contingent support are inconsistent with the Forum's objective of defining a methodology that quantifies the long-term viability of the scheme and its resilience to short-term shocks.

The University continues to support the formal incorporation of a stochastic frontier analysis into the scheme valuation methodology in order to quantify and inform the level of risk in this large, active scheme with balancing cash inflows and outflows over the foreseeable future.

In this context, the University looks forward to engaging with the consultation questions on risk appetite and commitment to further contingent support from employers once those questions have been informed by the stochastic frontier analysis commissioned by the Forum.

Please confirm if your organisation's governing body has been consulted:

Yes. This response was prepared by a working group set up by University Council to consider USS matters, and the response has been approved by Council. A draft of this response was also shared with the University's USS members for comments prior to being finalised. [*Subject to confirmation prior to being finalised and submitted.*]

RESPONSE SUBMITTED BY:

Name:

Lee Spithray

Position:

Head of Pensions

ON BEHALF OF:

Institution:

University of Oxford

Please send your completed form to:

pensions@universitiesuk.ac.uk copying in valuation@uss.co.uk as appropriate, by **5pm on 17 April 2020**

Thank you for taking the time to respond to this consultation.