USS

Pensions Review Team
HM Treasury

By email to : pensions.review@hmtreasury.gov.uk

Your ref	
Our ref	CY/JMR
Date	25 September 2024

Dear Pensions Review Team

The Universities Superannuation Scheme (USS) welcomes the opportunity to respond to the *Pensions Investment Review: Call for Evidence.*

About USS

By way of introduction, Universities Superannuation Scheme (USS) was established in 1974 as the principal pension scheme for universities and higher education institutions in the UK. We work with around 330 employers to help build a secure financial future for around 550,000 members and their families. USS is a hybrid pension scheme, which means we have both a defined benefit (DB) part – the Retirement Income Builder – and a defined contribution (DC) part – the Investment Builder. We are one of the largest pension schemes in the UK, with total assets of around £77.9bn (£74.8bn DB / £3.1bn DC at 31 March 2024).

USS has its own wholly owned investment management subsidiary, USS Investment Management (USSIM), which manages the assets of the Scheme on a discretionary basis and provides investment advice to the trustee of the Scheme. USSIM has significant internal investment capability, enabling USS to hold 34% of the DB section in illiquid assets, while within our DC default we have over 20% of the assets invested in illiquid assets.

As at 31 March 2024, we held:

- £25.9bn AUM in private markets
- £8.1bn AUM in infrastructure
- 45% of investments in the UK

Overall Thoughts

While we understand the rationale for focusing this review on DC and LGPS schemes, hybrid schemes such as USS benefit from the economies of scale of the wider trust when making investments and will potentially be impacted by any resulting policy and regulatory changes. We have provided responses to the individual questions from the consultation on the following pages. We would also like to make four wider points:

- **Government is discussing interventions and incentives to get UK DC schemes to invest in UK assets (public and private)** - however, we believe that the focus should be on the "supply" of attractive UK assets rather than attempting to stimulate or mandate "demand" from pension schemes. The DC market is already starting to mature and the "taps" are turning on to invest in private markets, but money will flow to the most attractive investment opportunities.

Head Office: Royal Liver Building, Liverpool L3 1PY Tel: +44 (0)151 227 4711 Local: 0845 068 1110 Fax: +44 (0)151 236 3173 Website: www.uss.co.uk
Registered in England & Wales No. 1167127 Registered Office: Royal Liver Building, Liverpool L3 1PY Regulated by The Pensions Regulator

- **Making the UK attractive to invest in** – government interventions and incentives rightly should be focused on making the UK an attractive place to invest. If there are attractive private or public investment opportunities in the UK, the mechanisms are already largely in place to allow for well governed asset owners to access them. Mandating investment in a particular geography or sector is wholly inconsistent with trustees' fiduciary duty.
- **The role for hybrid schemes (and single employer trusts**) - fewer larger market participants should help drive economies of scale, but there are other ways in which scale and leverage can be achieved. In USS' case, from its scale as a hybrid scheme or, in the case of single employer trusts by using third party and intermediated investment platforms and thus harnessing these platform's scale. There are also benefits to having a greater understanding of the membership, including retirement journey planning and support, bespoke communications and engagement plans, and integration with wider company benefits (e.g. savings plans, life insurance, death in service).
- **There are risks as well as benefits to a few large DC market participants** – these risks include herding or homogenous investment strategies to reduce the risk of being an outlier (potentially leading to a less vibrant ecosystem to invest in and bid for attractive assets), reduced choice (to employers, but ultimately individuals too), and barriers to entry becoming so large that new market participants cannot enter.

Responses to Questions

<u>Scale and consolidation</u>

1. **What are the potential advantages, and any risks, for UK pension savers and UK economic growth from a more consolidated future DC market consisting of a higher concentration of savers and assets in schemes or providers with scale?**

UK pension savers
A smaller number of large market participants in the DC market should bring benefits to members in the long term. This is subject to there being sufficient competition and differentiation between propositions.

Benefits to savers may include:
- Enhanced governance and effective administration.
- Greater investment in engagement and communication tools at relevant touchpoints in the saver journey.
- Lower cost of delivery, with the benefits shared with the member.
- Greater diversification within investment strategies and more rigorous oversight of risk/ controls.
- Better retirement services and decumulation journey for members.

Risks to savers may include:
- Herding or homogenous investment strategies to reduce risk of being an outlier.
- Reduced choice (to employers, but ultimately individuals too).
- Barriers to entry become so large that new market participants cannot enter.

UK economic growth
A smaller number of large market participants in the DC market could bring benefits to UK economic growth. However, there are various steps and mechanisms between DC consolidation and any benefits being realised:

- Opportunity set: UK savers likely to want a mix of inflation linked assets and more growth-oriented companies, is the ecosystem there for capital to be deployed? How do the

opportunities in the UK compare to elsewhere?
- Opportunity size: how much of a DC default strategy should be invested in these types of UK assets and companies?

2. What should the role of Single Employer Trusts be in a more consolidated future DC market?

While USS is not a Single Employer Trust, we would make the case that well governed and managed single employer schemes can still deliver value for money, both from a cost and quality perspective.

For example, Single Employer Trusts have:

- Scale, which can be leveraged by using third party and intermediated investment platforms and their combined purchasing power.
- Greater understanding of the membership, (likely be more homogenous), leading to a greater ability to cater to specific member needs. They may also have bespoke investment strategies and more customised engagement and communication plans for members.
- More flexibility in terms of implementing changes (such as changes in the investment strategy) when compared to multi-employer schemes, where the scale of change is greater and a wider employer and member base is required to be communicated to or consulted with.

3. What should the relative role of master trusts and GPPs be in the future pensions landscape? How do the roles and responsibilities of trustees and IGCs compare? Which players in a market with more scale are more likely to adopt new investment strategies that include exposure to UK productive assets? Are master trusts (with a fiduciary duty to their members) or GPPs more likely to pursue diversified portfolios and deliver both higher investment in UK productive finance assets and better saver outcomes?

Both models achieve scale through aggregating investments, therefore the impact on saver outcomes and UK productive finance could be expected to be broadly the same. We would also not expect there to be a significant difference between the types of assets their default strategies should want to invest in. If UK productive assets are attractive investments, both GPPs and master trusts could and would be able to allocate to them.

There may be a difference between the two types of scheme when it comes to consolidation and the secondary market. Master Trusts theoretically should be more agile, with employers being able to move from one Master Trust to another. This may accelerate consolidation to those higher performing/ delivering propositions. With a GPP, providers contract directly with each individual member, which renders these schemes slower in terms of implementing change; they need to update terms and conditions with each individual member in case of significant change. Additionally, the inability to operate non-consent transfers under most circumstances results in direct to member/ customer bulk offer transfers with varying take up rates. This makes the longer-term consolidation into the latest investment strategy/ proposition slower than in trust-based options.

4. What are the barriers to commercial or regulation-driven consolidation in the DC market, including competitive and legal factors?

The barriers include:
- Cost vs. Return trade off- it's hard to advise moving a scheme to a more expensive option when costs are certain and investment returns are future looking.
- Legal costs – scheme participation terms / agreements as well as bulk transfer deeds are very complex and onerous to negotiate, given the wide range of requirements from different employers and trustees, resulting in each document being unique.
- Underpins and guarantees - schemes with DB underpins and other guarantees are legally very

complex to wind up.

- Member communication costs - these should not be a deterrent, given the large developments in this space and ability of big schemes to deploy effective and sophisticated communication strategies to members.
- Scale - billion-pound transfers are riskier from a transition management perspective (the ability of the receiving provider to pre-fund investments) as well as from a member services perspective. If large number of members are involved, careful management from a new business capacity is required, as well as phasing if multiple transfers are involved.
- Bulk transfers – the inadvertent creation of defaults from transferring assets into DC schemes can create additional governance requirements for the receiving scheme. This could act as a barrier to consolidation, unless assets are able to be bulk transferred into the "flagship" default arrangement.

5. To what extent has LGPS asset pooling been successful, including specific models of pooling, with respect to delivering improved long-term risk-adjusted returns and capacity to invest in a wider range of asset classes?

While we cannot comment on LGPS pooling, we can draw some relevant points from our experience as one of the largest pension schemes in the UK with a robust governance structure. Our scale as a single fund, with participation from over 330 employers from across the wider higher education sector (c. £78bn as at 31 March 2024), coupled with our risk appetite as an open scheme, has allowed us to build strong private markets capabilities.

We have built a diversified portfolio of private markets investments that includes allocations to private equity, infrastructure, property, credit, renewables and natural capital, which we invest in via both the DB and DC part of the scheme. Our experience in private markets allows us to apply a long-term strategic view, assessing which assets we believe will deliver the best long-term risk-adjusted returns for our members. During the past year we exited a number of private investments, generally at favourable prices to where they had previously been marked in our books. This demonstrated our ability to recycle capital efficiently, and effectively buy assets with strong long-term prospects and, at the same time, gave us helpful evidence of the robustness of our private asset valuation framework. The disposals included growth-focused private equity, long duration income-generating property assets, and inflation-linked assets like renewables.

<u>Costs vs Value</u>

1. What are the respective roles and relative influence of employers, advisers, trustees/IGCs and pension providers in setting costs in the workplace DC market, and the impact of intense price competition on asset allocation?

The USS DC proposition is somewhat unique when compared to other workplace DC schemes, in that the sponsoring employers pay for the administration costs and the vast majority of most members have their Investment Management Charges ("IMC") paid for too. The IMC for the default arrangement is 30bps, which almost exclusively can be spent on delivering a high quality and diversified investment portfolio constructed across asset classes, geographies and sectors.

Employers, advisers and the trustee worked closely in setting the investment budget (in our case the IMC) at this level, which allows for investment in a mix of active listed, passive listed and active private markets.

When selecting a new or changing pensions provider, employers are reliant on their advisers to help guide them through this process. In many cases, there will be an incumbent scheme, which inevitably will be used for comparison; how does the new scheme compare across investment performance, costs and quality of services? When taking a change in benefits to the membership, employers are likely to want something that delivers across all elements when "selling" the benefit of it to their employees. Like it or not, lower costs are going to be favourable and easier to communicate, all else being equal. However, all else is not equal and we would expect, over longer periods of time, that well diversified and governed investment strategies will deliver superior outcomes for members. The challenge we currently face is that this is not borne out in practice over the recent medium term, with simple equity-only (and in particularly market cap index strategies) outperforming the majority of other investment strategies since the advent of auto enrolment.

2. Is there a case for Government interventions, aimed at employers or other participants in the market, designed to encourage pension schemes to increase their investment budgets in order to seek higher investment returns from a wider range of asset classes?

In many cases pension providers have made contractual arrangements with employers to offer services at a known price to their employees or members of a Master Trust arrangement. As such, increasing the price at which services are delivered to existing clients is challenging and is likely to be difficult to implement and communicate to employers and savers.

Government interventions are likely to have a limited impact on the larger schemes, as considerations such as the charge cap are already not biting. As outlined in the answer to the previous question, employers, advisers and trustees need to take a forward-looking view that diversified portfolios in a range of asset classes (including those sought to be encouraged as part of this review) are likely to deliver better outcomes to the majority of members over the longer term. This does not necessarily mean that they will outperform vanilla equity strategies over all time periods, but reducing the peaks and troughs and increasing certainty around outcomes can improve the savings experience and retirement journeys for entire cohorts of retirees.

<u>Investing in the UK</u>

1. What is the potential for a more consolidated LGPS and workplace DC market, combined with an increased focus on net investment returns (rather than costs), to increase net investment in UK asset classes such as unlisted and listed equity and infrastructure, and the potential impacts of such an increase on UK growth?

Consolidation is one factor that should help facilitate future developments in DC propositions as scale enables new opportunities to be explored, if they offer value for money. The current challenge that many advisers and trustees will have is justifying that investment in unlisted equities and infrastructure will lead to increased net investment returns over the longer term.

In Question 1 we outlined that herding behaviour is a potential risk when encouraging a smaller number of large DC schemes. However, if and when more diversified portfolios start to deliver superior returns over the medium term, then we are likely to see strategies start to more materially adopt these types of investments. At the moment, the commercial opportunity cost is that these strategies are more expensive and have, over the short to medium term, underperformed cheaper and more vanilla approaches.

2. What are the main factors behind changing patterns of UK pension fund investment in UK asset classes (including UK-listed equities), such as past and predicted asset price performance and cost factors?

While past performance is not a guide to future performance, it does impact the composition of indices. In turn this can have an impact on asset allocation, either by using passive investment strategies or by using indices as references when assessing how much active risk an investment manager is allowed to take.

3. **Is there a case for establishing additional incentives or requirements aimed at raising the portfolio allocations of DC and LGPS funds to UK assets or particular UK asset classes, taking into account the priorities of the review to improve saver outcomes and boost UK growth? In addition, for the LGPS, there are options to support and incentivise investment in local communities contributing to local and regional growth. What are the options for those incentives and requirements and what are their relative merits and predicted effectiveness?**

Our view is that mandating investment in a particular geography or sector is wholly inconsistent with trustees' fiduciary duty. From an asset allocation perspective, you need the underlying assets to be attractive to the entity making the investment decisions. Rather than support interventions at the scheme level and any sort of direction in terms of what types of assets to invest, we would instead be supportive of interventions at the asset level, in terms of making these more attractive to invest. Other regulatory requirements or additional incentives may lead to perceived or real conflicts between the trustee's fiduciary duty and boosting UK growth. Options that could be explored to make UK assets attractive to UK savers are:

- Regulatory environment for target companies, sectors and projects.
- Tax incentives.
- Co-investment opportunities alongside government.

We believe that Trustees must be able to operate in line with fiduciary duty, with freedom to invest in the areas that they believe will deliver the best possible outcomes for members. Mandating investment in a particular geography or sector is wholly inconsistent with trustees' fiduciary duty.

To reiterate our point from above, although Government is discussing interventions and incentives to get UK DC schemes to invest in UK assets (public and private), we believe that the focus should instead be on the assets themselves. As we note above, the DC market is already starting to mature and the "taps" are turning on to invest in private markets, but money will flow to the most attractive investment opportunities.

I hope the above is helpful as you continue to consider these proposals. We would be happy to discuss any of these points in more detail with you.

Yours sincerely

Carol Young
Group Chief Executive Officer