The views and comments expressed in this Annex C (documents C1, C2 and C3) remain subject to consideration and review by the Trustee and subject to further legal, actuarial and other advice. No decision has been taken by the Trustee in respect of any of the matters discussed in this Annex C and this therefore does not constitute an offer of the trustee in a legal sense. Nothing in this Annex C constitutes advice. Accordingly it is important that UUK and employers take any necessary professional advice that they feel they need on the contents of this Annex C.

Document C1

Covenant support measures

Introduction

As part of the 2018 valuation, the importance of addressing the risks of growing sector debt and the potential for stronger employers to leave the Scheme was identified and the USS employers agreed to work towards implementing measures to protect the Scheme's employer covenant. The covenant rating of "strong" was placed on negative watch pending agreement on these measures.

The covenant, the ability and commitment of the employers to support taking risking in the Scheme's funding approach, plays a central role in the valuation and in relation to the level of contributions needed. The risks to covenant strength identified in 2018 continue, and the implementation of measures to protect the Scheme against those risks continues to be important in order to achieve the lower contribution rate scenarios.

This document, and documents C2 and C3, are provided to support UUK's consultation with employers on the issue of covenant support, and specifically on the measures which will strengthen the covenant:

1. Debt monitoring and pari passu security arrangements; and

2. A moratorium rule change on employer exits.

For the latest information on the 2020 valuation and how these covenant support measures impact its outcome, please see the 'Trustee update on the 2020 valuation' on our website. Here you will also find a suite of supporting documents, including communications to the Trustee from the Pensions Regulator which express it's view that the USS covenant is 'tending to strong', and that more demonstrable commitments from employers would be required for the covenant to go beyond this rating.

As required by the Trust deed and rules, the Scheme Actuary has provided the Trustee with his Rule 76.1 report on the financial condition of the Scheme. This includes the Scheme Actuary's advice and recommendations on the total required contributions for the current benefit structure taking account of the Trustee's selected assumptions in three different covenant support scenarios:

• **Scenario 1**: no additional covenant support. The covenant is assessed as tending to strong in this scenario. This is consistent with the bottom end of the range of outcomes specified in the TP consultation document, although the contribution rates are lower as we have a more positive view of the resilience of the sector.

• **Scenario 2**: additional covenant support as outlined in UUK's clarification of their illustrative package of 7 December. Tending to strong covenant. This is the basis for the trustee's contribution determination, which was issued to the JNC on 3 March 2021.

• **Scenario 3**: this scenario has been developed by the Trustee to illustrate sufficient additional covenant support to enable us to fund the Scheme on the basis of a strong covenant, although not sufficient to reach the top end of the range detailed in the TP consultation document.

Table 1: Summary of the additional covenant support under each scenario.

Scenario	Effective debt monitoring	Effective *pari passu*	Length of rolling moratorium	Initial moratorium to support Recovery Plan length*
1: No additional covenant support	No	No	Zero	None
2: UUK package of covenant support	Yes	No	6 years	9 years
3: Adequate to fund on a strong basis	Yes	Yes	12 years	15 years

*Assumes next valuation is as at 31/3/2023

Scenario 1 is not covered any further in these documents as it assumes no covenant support measures are provided.

Practical details on the covenant support measures for Scenarios 2 and 3 are contained in these consultation documents.

For information on how the measures drive outcomes for each scenario please see the 'Trustee update on the 2020 valuation' document on our website.

1. Monitoring of debt levels in the sector for USS employers

Through Universities UK, the Trustee consulted with employers in 2020 about a proposed detailed Framework for monitoring the debt levels of USS participating employers and for protecting the scheme's creditor position. The Trustee has reviewed the responses to that consultation and had further discussions with both Universities UK and individual employers.

It is clear that whilst many employers would prefer not to have additional controls on their financing activities, a balanced Framework which is broadly acceptable to employers, and also provides significant support for the USS covenant is possible.

The Trustee's approach to operating a Framework

Before going into the detail, we feel it is important that employers understand the approach the Trustee proposes to take in operating the Framework.

1. In relation to the debt monitoring proposals, the initial metric calculations and the thresholds which trigger further engagement with employers are defined. But any breach of the metrics does not trigger any unilateral Trustee action – it would trigger engagement between the Trustee and employers so that the Trustee can get a more informed picture of the employer's financial position and understand how that may affect its covenant to the scheme (if at all). After that, each case will develop in its own, bespoke way.

2. The Trustee will be open, co-operative and transparent in all its discussions with an employer and will, where appropriate, share with an employer any relevant analysis of the employer's position or information it has received and any key factors or considerations it has made in reaching its conclusions. The Trustee will listen to any employer views and representations and consider them fairly. The Trustee will also set up an 'appeals' process for employers if they do not agree with any action the Trustee proposes to take.

3. The Trustee will be pragmatic in its application of the Framework. For example, an employer may exceed the specified level of metrics, but if it becomes clear to the Trustee that the actual levels of debt (or the employer itself) are not a concern to the Trustee at that time – or are temporary in nature - the Trustee would likely not take any action beyond a monitoring action for the following year.

4. The Trustee also understands employers will want to be pragmatic in implementing the Framework themselves. For example, whilst it expects employers to notify the Trustee of any metric breaches as they happen (see below), it doesn't expect employers to put into place complex systems to do so; instead it assumes relevant staff will familiarise themselves with the basic metrics and be aware when a significant business decision (e.g. taking on significant new debt) may cause them to exceed one of the metrics.

5. Any data or information received as part of the Framework or subsequent discussions will be treated as confidential and will not be disclosed beyond the Trustee and its advisers without explicit permission (or unless required by law).

The updated proposals: Scenario 2 and Scenario 3

The Policy and Requirements Documents employers reviewed in last year's consultation have been updated following the consultation and to reflect discussions with Universities UK since then. These updated versions are attached as document **C2** for review and comment. However, the proposals are summarised here:

- Employers will be asked to submit the relevant financial information to the Trustee annually, using an online survey tool.
- There will be an agreed *de minimis* level, and for any employers below that level we will use the data provided to monitor trends only – we will not seek to engage further on an individual basis, including not requiring ad hoc notifications.
- For non-*de minimis* employers, the data provided will be used to assess against the metric thresholds below:

		Thresholds	
Metric	**Metric**	**Scenario 2**	**Scenario 3**
A	Gross debt / Net assets	>50%	>50%
B*	Gross debt / total income	>50%	>50%
C*	Gross debt / Net cash flow	>5 times	>5 times
D*	Interest cover	<4 times	<4 times
E	Secured debt / net assets Secured assets / gross assets	>20% n/a – no test	>10% >10%

*N/A for some institutions with a low result for Metric A.

Metrics A to D:

- The proposals in relation to metrics A to D are the same under Scenario 2 and Scenario 3;
- If Metric A shows an employer has gross debt of less than 25% of net assets (including pension provisions) and that employer has only a small share of the total scheme section 75 debt (less than 0.1% of the total), then that employer will not be tested against Metrics B to D in that year.
- If an employer exceeds all four metrics A to D (or is exceeding any three of metrics A to D for a second consecutive year) the Trustee will consider whether further engagement is needed to evaluate the employer's covenant position and (if it has materially weakened) agree mitigating action to protect the covenant.
- Where an employer becomes aware of a change, or plans to implement a change (actual or proposed), in its debt position since its last annual submission that has resulted (or is expected to result) in any of metrics A to D being breached, it should notify the Trustee within one month of the Employer becoming aware of the relevant event occurring or relevant decision being taken (as applicable).

Metric E/pari passu security:

- If an employer exceeds metric E, or has a new Floating Charge, the Trustee will expect to arrange with the employer to take an equivalent charge (pari passu security) on new debt, subject to certain exceptions.
- Under Scenario 2, UUK has proposed that secured debt will only be compared to net assets, and the threshold for pari passu security will be 20%.
- Under Scenario 3 the Trustee requires that secured debt will be compared to net assets, and the assets over which security is granted will be compared to gross assets, with the threshold test for pari passu security being set at 10% on either measure.
- The Trustee will release pari passu security as soon as reasonably practicable once the secured debt it originally related to has been repaid, unless that would leave the Trustee materially worse off than prior to the original pre-pari passu security position.
- Pari passu will not apply to defined circumstances of covenant-enhancing project financing and in some other cases pre-agreed with the Trustee.

De minimis thresholds:

- Under Scenario 3 the Trustee's proposed *de minimis* level would exclude employers who have both a total income in the relevant year of £50m or less and gross assets of £50m or less.
- Under Scenario 2 a threshold using a combination of wider criteria is assumed to apply (not just assets and income but for example also share of section 75 deficit, proportion of employees in USS etc) consistent with a tending-to-strong covenant rating.

- Note any impact on the covenant of employer default would fall to the remaining employers, and so we would look to employers to confirm that they do wish the Trustee to operate the relevant *de minimis* test.

Effective date:

- This revised Framework is proposed to take effect from 1 August 2021, although we continue to encourage any employers taking out new secured debt to contact us at the earliest opportunity so that the Trustee can continue to build its picture of debt in the sector.

Finalising a Framework

Once the Framework is finalised the Trustee will keep it under periodic review and may consider making changes in light of experience or employer feedback received in the future. However, before it makes any changes it will again discuss these with Universities UK.

2. Moratorium rule change on employer exits

In document **C3** we have:

- outlined the alternative moratorium proposals under Scenarios 2 and 3;
- set out the policy and process which the Trustee would follow upon receipt of an exit request from an employer;
- make clear the Trustee's commitment to transparency in its decision making;
- clarified how a moratorium would interact with the Scheme's 'Exclusivity' provision;
- provided examples of exit scenarios; and,
- provided examples of the circumstances in which an employer who does not receive Trustee consent to exit the Scheme may be called on for contributions in the future.

Moratorium next steps

Following its consultation with employers, Universities UK will finalise its position on the package of covenant support measures it will support, including the detail of a moratorium rule change. As with any stakeholder-sponsored rule change, the change itself will be submitted to the JNC and, if appropriate, the JNC will resolve to recommend to the Trustee that it amends the Scheme Rules. The Trustee will then amend the Scheme Rules, unless it appears to the Trustee, acting on the advice of the Scheme Actuary, that there is some reason that it cannot (as set out in Rule 79.7 of the Scheme Rules).

Of course, while these documents focus on the covenant support measures, we appreciate that they will be considered holistically alongside potential changes to benefits. It's anticipated that any potential benefit changes put forward by stakeholders will be considered by the JNC as the same time as these covenant support measures, so as to allow future benefit provision and contribution rates to be priced.