

Universities Superannuation Scheme (USS)

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Prepared for: Universities UK
Prepared by: John Coulthard FIA
Andrew Claringbold FIA
Joanna Davies FIA

USS – Debt monitoring and *Pari passu* request

Introduction

Based on Bill Galvin's [letter](#) of 26 June 2019, Option 3 would be acceptable to the USS Trustee subject to:

- Receiving a formal proposal on a “moratorium” approach for the Rule Change.
- A firm commitment to meet the trustee's requirements around debt monitoring and for USS to receive *pari passu* (equal ranking) protection where secured debt is issued.

We set out our thoughts on the second bullet. The first bullet is covered in a separate note by Eversheds Sutherland (International) LLP.

Option 3 – recap

As a reminder, Option 3 requires the following contributions:

	Employer ⁽¹⁾	Member ⁽¹⁾	Total
1 April 2018 to 31 March 2019	18%	8%	26%
1 April 2019 to 30 September 2019	19.5%	8.8%	28.3%
1 October 2019 ⁽²⁾ to 30 September 2021	21.1%	9.6%	30.7%
1 October 2021 onwards ⁽³⁾	23.7%	11%	34.7%

Notes:

(1) Employer and member figures assume 65:35 cost-sharing adopted to increases from 1 April 2019.

(2) This assumes the 2018 valuation is completed by the payroll cut-off date of 31 August 2018 (the date advised by the USS Trustee).

(3) The length of the recovery plan will be confirmed by the USS Trustee when it provides the proposed recovery plan. Assuming the deficit to be corrected is £2.2Bn, the recovery plan could be quite short.

As explained in our 14 May [note](#), Option 3 is reasonably close to the JEP recommendation. If the USS Trustee does not receive sufficient comfort on its additional asks, then the likely outcome is Option 1 – i.e. employer (employee) contributions of 22.5% (10.4%) from 1 October 2019.

Debt monitoring process

The USS Trustee has expanded on its request for an annual attestation process in section 2.4 of this [note](#). In short, the USS Trustee will contact employers once a year and ask for the latest positions on their levels of debt and security granted to other parties. These will be evaluated against some covenant metrics to determine whether the USS Trustee has any further questions.

The Aon Centre | The Leadenhall Building | 122 Leadenhall Street | London | EC3V 4AN
t +44 (0) 20 7086 8000 | f +44 (0) 20 7621 1511 | aon.com
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In our view, many employers may be comfortable giving this information to the USS Trustee provided that the requests are proportionate and do not lead to unnecessary discussions. Some employers may already provide similar information to other schemes they sponsor. In addition, employers have a legal requirement to provide information that the USS Trustee reasonably requires.

We would suggest that, before this is implemented, the USS Trustee should provide further colour on the circumstances where the USS Trustee will determine it has further questions, and what would then happen. This should form part of the joint USS / employers working group mentioned below. The information requested could also be tested against any evolving OfS requirements on debt reporting.

Assuming the debt monitoring process is put in place, we suggest that UUK collects information from employers in future about how the process has worked for them – with a view to refining the process and ensuring it is not disruptive and that it avoids unnecessary costs.

***Pari passu* request**

The USS Trustee has expanded on its request for the granting of *pari passu* security in section 2.4 of this [note](#).

The USS Trustee will be seeking assurances that employers do not take on new secured debt with a superior priority to the USS. We understand from PwC's presentation to the EPF that this would mean granting *pari passu* security at the section 75 debt (i.e. an institution's share of the buyout deficit). Furthermore, the USS Trustee expects to be made aware of any employer's intentions to seek secured debt at an early stage and to be kept abreast of the ongoing process, and for the potential lender to be made aware of the employer's obligations to the USS early in the process.

We set out our comments below.

Potential advantages:

- The proposal requires the USS Trustee's creditor position to be elevated from unsecured creditor for any employers that issue new secured debt going forward. However, most of the debt raised by institutions so far has been unsecured, so many may not see this as an issue, or it would be outweighed by the lower contributions this enables in the short term. This may be especially true for the stronger employers that underwrite most of the USS liabilities.
- Trustee boards are being increasingly directed by the Pensions Regulator to ensure that they are treated equitably compared with other stakeholders. The proposed approach makes it more credible for the USS Trustee to continue with a "strong" covenant rating and for this to be robust over time. We believe that a strong rating is in the employers' (and members') best interests.
- The *pari passu* requirement may help reduce the cross-subsidy risk (i.e. protecting individual employers from the insolvencies of others), by increasing the recoveries available to USS in event of an individual institution's default and by strengthening its negotiating position during insolvency proceedings to the benefit of other employers.
- The USS Trustee has not set out full details, requiring only a firm commitment at this stage, which paves the way for the important details to be discussed by a joint USS / employer working group as suggested by UUK.

- The solution appears relatively straightforward (in concept at least) – the USS Trustee is not proposing any constraints or arbitrary limits on debt levels.

Some issues to work through in due course:

- We expect that most institutions will want to know their share of the section 75 debt, as calculated by the USS Trustee, with appropriate updates of how this amount changes over time.
- For institutions that are planning to issue secured debt, it may now be more expensive as the potential recovery in an insolvency may be lower for the lender. In particular, the section 75 debt commitment may far exceed the amount of borrowing the employer is seeking. Any increased cost of borrowing would need to be outweighed by the benefits of a lower contribution rate in the shorter term.
- The request for lenders to be notified of the USS Trustee's requirements is likely to make discussions more complicated, and may lead some lenders to decide not to offer secured debt.
- We think there is a need to engage further with the USS Trustee on the issue of a limit on the amount of security given *pari passu* status when secured borrowing takes place, in particular in the situation where employers with a large section 75 debt take on a much lower level of secured borrowing. We think it inappropriate that any arrangements lead to the potential recoveries in an insolvency scenario being materially higher for the USS compared with the position before secured debt was issued.
- Some lenders require security, not because of the potential value it will provide in an insolvency, but to give them greater control (i.e. voting rights) over any debt restructuring. Granting the USS Trustee *pari passu* security may make it difficult for banks to achieve this protection, again potentially increasing borrowing costs.
- Institutions that have already issued long term secured debt are now in a potentially advantaged position compared to those who do so in the future. Although if such institutions need to refinance their debt, they would be covered by the proposed requirements.
- For some “weaker” institutions, it could become difficult to raise funding, either on the public markets or from a bank or private institution. These lenders may only be willing to lend if they have first charge over assets, and are unlikely to be willing to accept USS as ranking *pari passu*.
- Other unsecured creditors will be at a disadvantage under this arrangement. This includes other defined benefit pension schemes such as the SATS for non-academic staff. This arrangement will potentially weaken the other schemes' employer covenant, and similar issues may surface from the trustees of these schemes. However, as a balancing comment, some employers already have given contingent assets to other schemes they sponsor, which may disadvantage USS absent its own contingent asset arrangements.
- There is merit in having a *de-minimis* level for small level secured borrowing (e.g. lease financing, or relatively small loans). We would expect employers to comment on this as part of the UUK consultation.

- How will project financing be treated? Lenders can require security against assets under construction during the build phase. If this is only over new assets, then there is a case for exempting this from the USS *pari passu* requirement. Further considerations may also be needed for joint ventures, where security is a fixed charge, where new security is offered to other schemes, and more generally where the legal entity borrowing is different to the participating employers.
 - What is the time-period of the proposed security? Presumably it would be aligned to the time period of any new security granted (rather than permanent security for the USS Trustee), and this is another detail to be clarified.
 - How is the whole approach documented?
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Conclusion

There are clearly a lot of detail issues to work through in due course. Individual employers may well have additional issues to consider that are not raised in this report, as their circumstances are so varied, and individual employers should be consulted once the details are clear.

At this stage we would suggest that, at best, employers will be able to provide “agreement in principle” to the USS Trustee’s proposals, subject to the practicalities being worked through so that employers can consider fully the detail of the proposed implementation. We agree with the UUK consultation document that potentially a joint USS / employer working group should be established involving institutions’ finance directors and other specialists from the sector.

Compliance

The advice in this report and the work relating to it complies with ‘Technical Actuarial Standard 100: Principles for Technical Actuarial Work’ (‘TAS 100’) and ‘Technical Actuarial Standard 300: Pensions’ (‘TAS 300’). We have been asked by UUK to set out our comments on the Trustee’s proposals in our role as actuarial adviser to UUK for the 31 March 2018 actuarial valuation.
