

Universities Superannuation Scheme (USS)

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USS Consultation on the debt monitoring framework

Introduction

The USS Trustee is carrying out a consultation on its proposed debt monitoring framework ('the Framework').

We have been asked to provide advice covering some of the key elements of the Framework, with this paper forming a technical note to institutions as part of the consultation.

Executive Summary

Summary

The proposed Framework can be viewed as containing two main elements:

1. Covenant (and in particular, debt) monitoring requiring regular data submissions
2. Protecting USS's creditor position through pari-passu security

Before commenting further on these two elements it is important to note that the proposed Framework could have different impacts on different groups of employers.

For employers with very strong credit metrics, low debt levels and no secured debt, the proposal may have very little impact. For employers with weaker credit metrics, or high levels of secured debt (either now or planned for the future), the Framework could have significant implications which could result in enhanced monitoring and the provision of security over employer assets to USS (amongst other potential measures).

Employers' views on the proposed Framework will be influenced by which of the two groups they might currently fall into (and the extent to which the arrangements might have effect). The consultation documents set out that the Framework is central to protecting the 'Strong' covenant rating for the 2020 valuation, although this is not guaranteed. A stronger covenant rating would support the case for a higher trustee risk appetite which feeds into the value of the scheme deficit, the cost of future accrual, and the resulting overall contribution rate. However, the consequences of the Framework are likely to be borne, in greater part, by weaker employers.

Covenant Monitoring

The first element, to actively monitor the debt position of the employers between valuations, is not unreasonable and is now standard practice across many parts of the pensions industry.

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Executive Summary (continued)

The key to implementation should be to ensure it is not a burden to employers, who already operate in a highly regulated sector, and therefore the focus should be on proportionality considering the strength and breadth of the covenant.

The proposal for an annual submission based on a limited number of metrics, alongside a single self-certification for employers, is not considered unduly burdensome. The forward-looking certifications and the requirement to inform USS of any deterioration during the year against any single metric A to D will be more burdensome and potentially makes the Framework less proportionate.

Arguably of more importance than the technical details of the monitoring Framework are what actions USS may take in the event the thresholds for metrics A to D are breached and USS is concerned about the financial position of an employer after further engagement.

The worked examples prepared by USS provide some welcome clarity in this respect, but employers are likely to remain concerned that this Framework could, ultimately, result in different rates of contributions depending on the perceived covenant strength of weaker employers and whether they are willing to grant security over their assets. This could end up in a position where only stronger covenant employers benefit from the mutuality of the Last Man Standing structure and weaker employers have to provide enhanced support. This could be an unintended consequence, and employers (and UUK) will want to consider any proposed changes to the scheme's Schedule of Contributions extremely carefully - to avoid the creation of any new power for the Trustee to levy non-uniform employer contribution rates.

Pari-Passu security

It is very important for all parties to recognise the significance of putting in place security in favour of USS which is pari-passu to secured debt. If adopted, it would represent a unique industry-wide initiative. Employers could see a potential reduction in their financial flexibility, potentially higher borrowing costs, added complexity and costs during financing negotiations and the likelihood of other unsecured creditors also taking action (for example the trustees of other defined benefit pension schemes). The benefit of this arrangement to USS should not be underestimated during current and future valuation negotiations.

Employers will need to carefully consider the proposals and will potentially want to discuss them with their lenders and advisers to understand the impact they would have should they wish to raise, or refinance, secured debt in the future.

It is important that the provisions of the Framework relating to the granting of pari-passu security to USS are proportionate and aimed at protecting USS's creditor position rather than enhancing it. UUK has emphasised this to USS during its discussions. This will be finely balanced and, in reality, will vary with each employer's circumstances.

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**Executive Summary
(continued)**

Key Elements Covered in this Note

As agreed with UUK, the rest of this note focuses on the key elements to which employers should give material consideration when preparing a response to the consultation.

The key elements are ordered as they appear in the consultation documents.

We strongly encourage all employers to work through the detailed consultation documents, including the worked examples, as there may be issues arising from how the detail relates to a particular employer's circumstances which are not discussed in this note. This paper is merely intended to be a general discussion of the key points of the Framework.

**Eligibility
(Consultation Covering
Note)**

The proposed Framework will be applied to all participating employers within USS, which covers Higher Education Institutions ('HEIs') as well as a large body of 'other' employers which are typically linked to the sector and tend to have a smaller number of active members accruing benefits.

The benefit of this approach is that it treats all employers the same and there is no risk of being seen to let smaller employers 'off the hook'. The flip side of this approach is increased costs applying to the tail of smaller employers, who could absorb a disproportionate amount of time in understanding and operating these new arrangements, and who are not material to the overall covenant supporting USS.

However, the Framework, and specifically the metrics and thresholds therein, have been designed with HEIs in mind. Aon has not reviewed the implications of applying the metrics and thresholds to non-HEI employers with potentially materially different activities, finances, capital structures and business models.

**Implementation Date
(Consultation Covering
Note)**

USS has engaged closely with UUK and the employer representative group on the issue of commencement date, and the proposal from USS is for an effective date of 1 August 2020.

We recognise that an August implementation date would provide employers on the cusp of granting security little time to consider the framework and adjust plans as necessary. It could be extremely challenging to persuade lenders who consider negotiations to be well progressed to now weaken their position if there are insufficient alternative assets over which USS can be given an equal ranking charge in order to comply with the requirements of the Framework. However, we might also recognise that the Trustee has expressed its intention to introduce arrangements such as these for some time, and we understand is willing to engage with employers who are in the midst of discussions with lenders.

It should be noted that employers will not be required to provide pari-passu security if secured debt was raised before 1 August 2020, unless it is refinanced on a materially different basis which is an important point to note.

Frequency of information submissions (Requirements Document Section 3)

The completion of an online form each January appears proportionate when confined to a limited number of metrics as has been proposed. Aon is also encouraged to see a self-certification option which will reduce the burden for employers with a low perceived credit risk to USS.

The requirement to make submissions covering the next financial year, and at any point if any of the triggers A to D are breached (clause 3.5), should be carefully considered. Further engagement is only prompted if all four metrics A to D are triggered in a single year, or 3 during two consecutive years. How this interacts with the need to notify USS if any one single metric is breached during a year is not clear. Neither is it clear what USS will then use this information for. Employers will need to consider how much of a burden this could be, given it might – if the terms are literally interpreted – require continual testing against 4 metrics throughout a year if any of the metrics are close to any threshold when tested in January.

Monitoring Metrics and threshold for Pari-Passu security (Requirements Document Section 4)

While metrics A to D, and the associated thresholds, may vary from the financial covenant tests of any one particular HEI, they are generally in line with financial covenant tests used in the sector as a whole.

The proposed 5% threshold for Metric E - gross secured debt divided by net assets (as defined) - acts as the trigger to whether pari-passu security will be requested by USS. It is, therefore, a critical element of the overall Framework and employers should consider carefully whether this threshold is reasonable. In considering the level of this threshold, the following should be taken into account:

- The level of perceived covenant risk of the sector and employers as a whole and individually;
- The strength of employers' balance sheets and the size and quality of their tangible asset bases;
- Employers' ability to support secured borrowing before materially worsening the position of unsecured creditors;
- The purpose of the secured borrowing and whether it is enhancing the overall covenant provided; and
- Restricting employers' flexibility when considering raising finance

When considering the above in the context of HEIs and USS, the 5% threshold appears prudent, considerably so, and this was expressed to USS during discussions, with more reasonable alternatives of 10% and 15% proposed. The lower the threshold, the greater protection for USS but also the greater restraint on employers' options when considering the optimal financing strategy for their circumstances. Setting a low threshold will also result in more costs incurred by both USS and employers in scenarios where the detriment to USS's creditor position is arguably not material.

The consultation welcomes further comments and specific evidence from employers who believe the 5% limit is overly prudent and/or may be challenging / limiting for their institutions. USS has taken a very strong position on this aspect and through the consultation are requiring evidence to demonstrate that the 5% is other than *'fair, proportionate and*

Monitoring Metrics and threshold for Pari-Passu security (Requirements Document Section 4) (continued)

necessary'. To date Aon has not seen any specific analysis to evidence why the 5% is *'fair, proportionate and necessary'* and expect employers would welcome more transparency on how USS arrived at 5% given its importance to the overall framework. This would ideally include how 5% has been judged to be *'fair, proportionate and necessary'* and why alternative thresholds of 10% and 15% fail these tests.

The second threshold test for Metric E: gross assets over which security is granted divided by consolidated gross assets, was included by USS in the Framework at a late (pre-consultation) stage. It has not been subject to any detailed discussions with UUK. The addition of a second test on top of a prudent threshold of 5%, which UUK had lobbied to be increased, is a much stronger stance for USS to take and is likely to be much more restrictive for employers.

Floating charges and Quasi security (Requirements Document Section 4)

Floating Charges

It is proposed that the granting of a floating charge under the Framework will not be subject to the same threshold and de-minimis clauses as the granting of fixed charges. This has been requested by USS as granting a floating charge over all or substantially all assets may make the floating charge a Qualifying Floating Charge under insolvency law and so grants the holder of the charge the ability to appoint an administrator. Each HEI would need to consider how corporate insolvency law would apply to it individually.

Floating charges are uncommon in the sector and most secured lending is on a fixed charge basis. However, granting USS a floating charge would potentially give USS significant powers. However, any such charge would still be subject to the caps within the Framework. For the avoidance of doubt, the existence of a cap may not fetter the powers conferred by the floating charge. Legal advice would be required.

The proposal to grant USS a capped floating charge if a third-party lender is to be granted the same is considered reasonable in protecting USS's creditor position. Employers should carefully consider whether making floating charges exempt from the de-minis provision is practical and proportionate.

Quasi-Security

This element was added into the Framework in the consultation documents and has not been subject to discussions. It is not clear to Aon why arrangements such as sale and leaseback of assets, or the sale of receivables on recourse terms, would not be subject to the same thresholds and de-minis levels before discussions are required with USS. This would keep the Framework proportionate. In any such considerations with USS, if the transactions are on commercial terms and the proceeds are retained and invested by the employer, which would be covenant enhancing, there is a strong argument for such arrangements to be excluded from pari-passu requirements.

Costs (Requirements Document Section 5.4)

All costs incurred by USS in relation to the granting, amending and release of pari-passu security is expected to be met by the employer. The notion of employers paying for proportionate costs incurred by their specific actions is not unreasonable.

The costs could be material, especially in complex situations and employers should consider agreeing up front budgets with USS, and with regular updates.

Another alternative could be a cost-sharing agreement to ensure the Trustee also has an incentive to carefully approve and closely manage cost (i.e. 50% of the cost is recharged and 50% is financed on a collective basis).

Size of Pari-Passu Security (Requirements Document Section 6)

The level of security granted to USS is the lower of the quantum of new secured debt and the employer's share of USS's Section 75 Debt. This is subject to an underpin of the employer's share of USS's Technical Provisions deficit.

The aim of the Framework, as made clear by the Trustee, is to protect USS's creditor position rather than enhance it. The exact level of security that is required to achieve this objective will vary in each specific situation. The proposed basis is a necessary simplification and is likely to achieve a reasonable middle ground in most cases while reducing the time and cost of implementation.

The initial proposals communicated to UUK requested pari-passu security equal to the employer's full share of USS's Section 75 Debt. This would have unduly enhanced USS's position in every case and the formula in the Framework represents a material shift in position to a more proportionate proposal. Nevertheless, employers should give this provision serious consideration, as an individual employer's share of USS's Technical Provisions deficit may be large depending on the employer's individual circumstances (and dependent upon the level of the deficit on the technical provisions basis at any particular time; for example, it is at significant levels at the current time).

Release of Pari-Passu Security (Requirements Document Section 6)

The release of pari-passu security is linked to the repayment of the third party secured debt which triggered the granting of the pari-passu security in the first instance (clause 6.2). However, clause 6.3 goes further to then link the release of USS's security to the absence of any other secured debt (which would presumably include debt raised before 1 August 2020) and any breaches of metrics A to D (not purely based on the latest annual submission). This additional condition may make obtaining the release of the security granted to USS under the Framework difficult for an employer, despite the employer having extinguished the third party secured debt in full and obtained the release of the security granted to that third party.

The advantage to USS, and the collective USS covenant, of increasing the hurdle of releasing the security is to enable USS to retain an enhanced creditor position if it has wider covenant concerns in respect of an employer.

Release of Pari-Passu Security (Requirements Document Section 6) (continued)

However, the lack of certainty for an employer on exactly when the security will be released, and the fact the provisions for release are much wider than the initial trigger for granting the pari-passu security (i.e. the raising of additional third party secured debt), is unlikely to be looked on favourably by employers. It would be more conventional in any such agreements for there to be a clear and unambiguous definition of when security is to be released. From an employer perspective, this introduces the risk that the security will not be released, and USS might retain its secured position for a long period after the third party secured debt is repaid.

Implementation during Covid-19 (Policy Document Clause 3.4)

It is clear Covid-19 is having a significant impact on HEIs and it is likely financial results will reflect this in the years to come. This means implementation of this Framework needs to be approached carefully.

There could be a wide scale triggering of metrics A to D over the next two to three years if the Framework is implemented as proposed. It is not clear what actions USS would take if there is industry wide triggering of metrics A to D.

The proposed Framework is likely to incur significant additional time and costs as follows:

- Reviewing the annual data submissions from 300+ employers;
- Further engagement when metrics are breached; and
- Negotiating and implementing pari-passu security.

The above could be magnified in the short term due to Covid-19 impacts on financial positions.

This workload could be reduced by excluding employers with small numbers of active members, who (in some cases) are unlikely to be material to the overall covenant. Alternatively, the tests on metrics A to D could be waived, or thresholds increased if Covid-19 results in significantly lower Home or International students for the 2020/21 academic year.

Recent developments, such as the Corporate Insolvency and Governance Act 2020 and the University Support Package of loans and grants, will need to be considered by the Trustee and taken into account alongside the consultation feedback from employers (and we would expect the Trustee to explain their implications and allow employers further time to consider any changes which might be proposed as a result).

Implementing the Framework, if it helps to secure an overall covenant assessment of 'Strong' for the 2020 valuation, has potential benefits for all employers in supporting a higher Trustee risk appetite which feeds into the contribution rate. Such a strong status is not guaranteed – even with these arrangements. And the extent of any benefits that might be gained is not currently clear, but we understand this may be shown within the Trustee's consultation on its proposed technical provisions (due early August 2020). Aon considers that the Framework, and its implementation, should be kept under review pending the impact of Covid-19.

No change in USS powers (Policy Document Clause 5.4)

It is said by USS that the Framework is not intended to grant USS additional powers and the Framework is supported through existing legislation and the Scheme's governing documentation (Clause 5.1 of the Policy Document).

However, USS is proposing to separately include additional wording in the Schedule of Contributions to enable the Trustee to collect additional contributions from individual employers in two circumstances:

- To meet the Trustee's "reasonable costs and expenses" in operating the Framework.
- To acknowledge that one of the remedies available to the Trustee (where it decides action should be taken in an individual case) would be to accelerate the payment of Employer contributions or require an Employer to pay additional contributions.

On the first of these points, the practical effect is that an individual employer would meet the Trustee adviser costs rather than this being spread across all employers (and employees) through the general triennial valuation process.

If such a clause is included it may be appropriate to include a cap on the costs, or to include a cost-share element with the Scheme – in either case to incentivise the Trustee and its advisers to carry out a proportionate amount of work.

On the second point, this would appear to alter the usual approach of setting the contributions through the triennial valuation process with a consultation on the Schedule of Contributions being a key part of this, and the default 65:35 cost-sharing that applies (in the absence of other decisions by the JNC). While in a strict legal sense the Trustee has a unilateral contribution power, at present this is governed and bounded by consultation requirements (to the extent it is a legally 'listed' change with affected employees and their representatives when employee contributions are amended, and through UUK with all employers on any proposal to amend the uniform employer contribution rate in the schedule of contributions). In addition, moving to an approach where the Trustee can charge different employers different amounts would be at odds with the current mutual approach where every employer pays the same, uniform contribution rate.

UUK welcomes the views of employers on this issue, and believes they will be opposed to any possible extension, intended or otherwise, of the Trustee's power to levy non-uniform employer contributions, outside the very limited circumstances mentioned above in relation to the Trustee's reasonable costs (and employers might believe that further legal advice on this issue is required).

In summary, if the proposed Framework is supported by USS's existing powers, then it is not clear why additional wording is required in the Schedule of Contributions. There is a risk, from an employer perspective, that documenting USS's abilities to accelerate or set additional contributions within the Schedule of Contributions could lead to unintended consequences in the future.