Universities Superannuation Scheme
Protecting the employer covenant

Introduction

This note provides further background to the steps which the Trustee wishes to put in place to protect the covenant provided by the participating employers as part of the 2018 valuation. The Trustee's covenant advisor, PwC, has identified increases in debt being taken on by the employers and the possibility of stronger employers leaving the Scheme as threats to the strength of the covenant provided to the Scheme.

The covenant provided by employers is important as it forms a key element of the actuarial valuation and influences the options from the 2018 valuation which could be acceptable to the Trustee. The stronger the covenant and the employers' ability to address potential fluctuations in Scheme funding the more risk that the Trustee could consider taking in funding the Scheme. A weakening of the covenant could mean that less risk could be taken in funding the Scheme with the result that higher contributions may need to be paid.

Whilst the covenant has been assessed as 'strong', PwC have advised that there are factors which could lead to that assessment being downgraded and therefore the covenant should be treated as being on 'negative watch'. In order to address this and protect the covenant the Trustee has therefore proposed that:

- where security in the future is granted to third party lenders, pari passu security is provided to the Scheme for the pension liabilities;
- Employers share information with the Trustee in relation to debt taken on by employers; and
- UUK, on behalf of the employers, proposes modifications to the rules of the Scheme to clarify and strengthen the extent of employers' ability to cease participating in the Scheme.

The background to the Trustee's covenant proposals and how it proposes to work with employers to protect the covenant in future is detailed below.

Part 1: The Trustee's current evaluation of the covenant, and proposals to protect future covenant

In their analysis of the HE sector and particularly the USS participating employers as part of the 2018 valuation, PwC noted the growth of the debt being taken on in the sector and its potential to affect the covenant provided to the Scheme. Whilst the current level of debt appeared to be manageable PwC recommended steps should be taken to protect the longer term covenant to the Scheme.

The Trustee has set out below a summary, provided by PwC, of their advice to the Trustee.

1.1 Risk to covenant of increased debt

External borrowing in the sector has increased from £7.2bn in FY14 to £12.9bn in FY18, with debt as a percentage of total income increasing from 23% to 34% over the same period [Source: HESA data].

Whilst some debt has been incurred to fund income generating activities which are incremental to the institutions' core activities, PwC notes debt used to fund increased capacity relies on growth from the same pool of students. There is a risk that not all institutions will be able to realise their plans for growth. In addition, some institutions have borrowed to maintain their competitive position or to fund replacement capex – in this case the institution's income stays flat but its exposure to the financial risks associated with taking on debt is increased.

Historically, institutions who have encountered financial difficulty have either been able to reduce costs to 'right size' or have merged with another entity. This is a significant covenant strength. However, increased debt levels reduce the ability of an institution to cut costs due to fixed interest and debt repayments, and also makes merging with another institution more challenging.

Where debt is secured and there is either a restructuring of an institution or failure, PwC notes the secured lender would benefit from priority rights (and a stronger negotiating position) relative to unsecured creditors, and/or the Scheme could receive a smaller return on its s75 claim. Currently a small proportion of debt in the sector is secured but this could increase over time (and it is this potential increase, rather than the current levels, which concern the trustee).

Some institutions have long-dated debt which matures in up to 30 years' time. PwC expects that many institutions will seek to refinance debt rather than repay it, and their ability to do so will depend on market conditions which could be substantially different from the current favourable conditions.

The Scheme is reliant on the covenant for 30+ years, and is the largest individual creditor to the sector, so there is a need to put in place a process to protect the Scheme's position relative to lenders to avoid increased exposure to interest rate rises and subordination of the Scheme's position to other creditors, as these could ultimately lead to the deterioration of covenant strength.

1.2 Risk of strong employers exiting the scheme

The Pensions Regulator's guidance around reviewing covenant for multi-employer schemes places emphasis on the impact and likelihood of employers leaving when a scheme has a 'last man standing' structure [source: 'Assessing and Monitoring Employer Covenant'].

An important assumption in PwC's conclusion of a "strong" covenant in 2016, reconfirmed in 2018, was that the Scheme can rely on the support of all employers through the principle of mutuality.

There are a number of risks facing the sector, but PwC expects these will impact institutions differently across the sector. However, PwC advises that the mutual nature of the Scheme means a decline in overall sector performance would not necessarily have a material impact on the covenant strength, provided the Scheme can still rely on the strongest employers.

Based on the long term nature of the sector and its ability to adapt to change, PwC concluded in 2016 that there was reasonable visibility of the covenant outlook for 30 years. However, PwC believe that if the strongest institutions chose to leave the Scheme, this could call into question the covenant horizon.

At present, the strong employers directly support their own liabilities but also indirectly support the liabilities of other employers should those employers fail to meet their obligations to the scheme. They also underwrite the potential extreme scenario whereby the deficit materially increases and the Trustee decides to de-risk and move to a self-sufficiency target.

On its own, a single strong employer exiting the Scheme, as has recently been experienced with Trinity College, Cambridge, does not lead to a downgrade in covenant at this time. However, PwC believes that the exit, together with its rationale, may set a precedent for other employers. Whilst most employers could not afford to pay their s75 debt today, PwC notes several strong employers could do so currently. Others may be able to do so in the future if the s75 debt reduced or by raising debt.

Depending on the circumstances, if another employer with a Strong or Tending to Strong covenant exited the scheme PwC would look to downgrade the covenant from "strong" to "tending to strong".

After considering the PWC report and advice, the Trustee decided it remained comfortable with the current covenant assessment of "strong", but that in view of the 'negative watch' on the covenant a package of measures to protect that evaluation of the covenant rating should be implemented to mitigate the need to move to "tending to strong".

1.3 What would be the impact of a reduction in covenant rating to "tending to strong"?

If the employer covenant was reduced from "strong" to "tending to strong" the Trustee would need to re-evaluate the reliance that could be placed on employer covenant and the amount of risk that could be taken in funding the Scheme.

If the proposed package of measures discussed here were not to be implemented, the Trustee considers it would need to re-evaluate the options for the 2018 valuation. At a minimum it may be unlikely that the trustee could continue to support the Option 3 structure for completion of the 2018 actuarial valuation. A side effect of this would also be that the 1 October 2019 contribution rate changes from the 2017 valuation would apply, as it would be unlikely a new set of rates could be consulted on and implemented in time to replace the 1 October 2019 rates.

Further, the Trustee would need to take additional covenant and actuarial advice on what the impact on the covenant would be and how that might change the level of current and future reliance on employers, the allowance for potential future yield reversion and so on. **It is expected that these changes would be reflected in a lower valuation discount rate and as a result a higher liability valuation and a requirement for higher contributions.**

1.4 So how is the trustee proposing employers protect the covenant in future?

The Trustee is proposing a package of measures designed to address the key areas identified by PwC. The purpose of these will be to ensure the covenant standing behind the Scheme is protected in the longer term, and will have an immediate effect of ensuring the current covenant rating of "strong" can be maintained in the 2018 valuation and beyond.

These proposals also ensure that all employers are treated fairly within the Scheme, by ensuring external creditors do not take priority over any assets compared to the scheme as a result of any new secured debt. It also ensures remaining employers continue to be treated fairly as and when another employer chooses to exit the Scheme.

This package has three main elements:

- *Pari passu* security for the Scheme in relation to secured debt being taken on by employers;
- Introduction of a framework to monitor employers' debt levels; and
- Amendment to the Scheme rules to clarify and strengthen the Trustee's discretionary powers on employer withdrawal from the Scheme.

It is important to note that the Trustee's stance is that these measures need to be agreed (and in the case of the rule change, implemented) if the 2018 valuation is to be completed on the basis of Options 2 or 3 – an intention to do so is not likely to be sufficient. It is particularly important to address the risk in relation to employer exits (via the proposed rule change) as if a strong/tending to strong employer requested to exit the Scheme before this was in place that could also drive a reduction in the covenant assessment.

1.5 What if the proposed changes are not agreed?

If the proposed package of measures appears to be unacceptable then the Trustee will need to consider how to proceed. The Trustee has moved forward with the 2018 valuation on the assumption that the covenant would remain "strong", and so would need to revisit the position. This is likely to affect timescales for completion of the 2018 valuation and implementation of a new Schedule of Contributions to replace the contribution rates arising from the 2017 valuation.

It is to be noted that the concerns raised by PwC are not short term or market-related matters but rather the longer term tail risk of a reducing level of underlying support – the protection of the covenant will not improve without the actions detailed being taken. The proposed changes will also benefit future valuations of the Scheme.

Part 2: The proposed package of covenant protection measures

The proposed changes are discussed in the order in which the Trustee would expect them to be implemented, that being the rule change followed by the debt monitoring and the grant of security on a pari passu basis.

2.1 Execution of Rule change

As noted above the covenant could be impacted if another stronger employer exits the Scheme.

When any employer exits the Scheme, payment of the section 75 debt meets the statutory requirements and addresses the immediate funding of that employer's liabilities, but may not address the longer term impact on the covenant. Therefore the Trustee believes this matter needs addressing as a priority given the potential effect on the covenant if another strong/tending to strong employer were to ask to leave the Scheme.

Therefore the first of the proposals to be implemented would be the rule amendment, to clarify and strengthen the Trustee's discretionary power on employer withdrawal from the Scheme, which would be required before the 2018 valuation Schedule of Contributions is finalised on the basis of a strong covenant (i.e. to reflect Options 2 or 3) The Trustee has agreed in principle to UUK's suggested approach of an initial moratorium on employers exiting USS without the Trustee's consent, provided that any such 'moratorium' applies until at least the 2020 actuarial valuation is completed (i.e. via the signing of the Schedule of Contributions), unless the permanent rule amendment is executed by some earlier date. As part of its agreement to that approach the Trustee would expect to see formal confirmation that UUK will immediately commence work with employers in relation to the permanent rule change on employer exits.

How is this best addressed?

The Trustee's powers on employer exit should be strengthened so as to give the Trustee an express discretion to consent or not to a participating employer exiting the Scheme. This would not require all future withdrawals to be prevented (or, where consent is initially refused, to be prevented on a permanent basis), but would be a matter to be decided taking account of the relevant circumstances whenever an institution seeks to withdraw.

How might this work in practice?

Without seeking to fetter the Trustee's discretion (which must at law be unfettered), and acknowledging that any decision must be based on the circumstances at the relevant time, it may be useful to consider the circumstances in which the Trustee might seek to exercise its power to refuse consent.

Firstly, as noted above, the proposed rule is discretionary and as such would not require all withdrawals to be prevented and/or tie all institutions to the Scheme permanently. The circumstances of each employer will need to be considered individually by the Trustee at the time an employer seeks to withdraw.

The Trustee will do this by taking appropriate independent advice when an employer seeks to use, or becomes subject to, the withdrawing employer provision. This advice would include, but not be limited to, advice on the strength of that employer's covenant, the resulting potential impact on the Scheme of the long term covenant of that employer's withdrawal (taking into account any required exit payment), and the concurrent funding position of the Scheme. Having reviewed this information and taking into account any other relevant factors (whilst disregarding irrelevant factors), the Trustee will make its decision.

The purpose of the power is to protect the covenant of the Scheme and therefore, even though each proposed exit will be assessed on a case by case basis the Trustee believes that there could be some circumstances where an exit is unobjectionable. This means that there could properly be circumstances and terms on which the Trustee may be prepared to allow withdrawal but it would be express on the face of the rules that withdrawal from the Scheme is a matter for the Trustee to consider in fulfilling its wider duty to the Scheme and its beneficiaries and not simply a unilateral decision on the part of an employer.

Also, if the Trustee does exercise its discretionary power to refuse consent, that would not necessarily mean that the employer would have to remain in the scheme indefinitely. The Trustee wishes to include a power to enable the Trustee to later review any decision to refuse an employer's application to withdraw from the Scheme. At that time, the Trustee would re-evaluate all the circumstances as well as consider the same type of factors as when making the original decision.

Alternative approaches

The Trustee has welcomed the discussions with UUK around the proposed approaches and potential alternatives. As UUK is aware, the Trustee's view is that other approaches would not be either suitable or sufficient as they would, for example, not allow the trustee to consider the covenant and an employer's position at the time of exit (and revisit it later if appropriate), would not satisfy the conditions needed in order to protect the covenant, or in the trustee's view simply postpone rather than prevent the issue.

What are the proposed rule amendments?

The proposed rule amendments are considered in more detail below. Note, it may be acceptable for initial amendments to include a sunset or time-limited element, as long as the Trustee is comfortable that overall the proposals and commitments being made by UUK and employers will address the long term covenant position. In the event that such a "moratorium" approach is formally proposed by UUK and agreed by the Trustee, the proposed amendments discussed below would apply until the earlier of the completion of the 2020 actuarial valuation (i.e. via the signing of the Schedule of Contributions) and the execution of permanent rule amendments dealing with employer exits. The proposed changes could be achieved by either bespoke amendment to the various rules dealing with employer withdrawal or by means of a separate standalone provision (i.e. insertion of an additional overriding rule).

In summary the key changes would be to:

1. Make explicit that the Trustee must consent in writing to an employer becoming a "Withdrawing Institution" for the purposes of the Scheme rules. A participating employer will only become a Withdrawing Institution and cease to participate in the Scheme on the consent of the Trustee and where consent is denied, the employer will not be classified as a Withdrawing Institution (until such time as any revision of status under 3 below).

2. Confirm that employers must not breach exclusivity – a failure in relation to exclusivity should not provide an institution with a means to unilaterally precipitate withdrawal. As above, an employer which breaches exclusivity (i.e. for example, by setting up alternative pension arrangements for its eligible employees) will only become a Withdrawing Institution and cease to participate in the Scheme on the written consent of the Trustee. Where consent is denied, the employer will not be classified as a Withdrawing Employer (until such time as any revision of status under 3 below).

3. Give flexibility to change an employer's status in future to a "Withdrawing Institution"

The Trustee would have full power to re-evaluate circumstances in the future and to issue a written notice to an employer at a later date confirming the employer's subsequent transition to a Withdrawing Institution status and cessation of participation in the Scheme. So an employer who was originally retained in the Scheme could be granted withdrawal at a later date subject to proper consideration by the Trustee at the time.

2.2 Consider the potential approaches to continued participation

If the Trustee exercises its discretion to prevent an employer becoming a Withdrawing Institution, the employer will continue to participate in the Scheme. The employer will remain subject to both the rules and the statutory funding regime and benefits will continue to accrue for eligible members.

In circumstances where an employer has no further active members in the Scheme (because, for example, it has in breach of exclusivity set up alternative pension provision for its employees), a statutory exit debt may be triggered (which, if paid, would remove it from the statutory funding and debt regimes) but it would remain a participating employer and subject to the rules of the Scheme, including the rules contributions obligations.

However the Trustee will work with stakeholders to review the potential approaches to ongoing participation in the scheme, both immediately and on an ongoing basis (see 2.5 below). For example, Deferred Debt Arrangements (DDAs) are a new option for employers (provided by section 6F of the Occupational Pension Schemes (Employer Debt) Regulations 2005) and so there are still a number of questions around when they should be used and how they should work (neither we nor our advisors are aware of a DDA having yet been implemented since the legislation came into effect). However the trustee has already been considering its own approach to DDAs and will keep UUK abreast of progress.

2.3 The requirement for *pari passu* security for the Scheme with any new secured employer debt taken on by employers

Any new secured debt taken on by employers which has a priority over the Scheme serves to reduce the strength of that employer's covenant to the Scheme, by giving external creditors priority over assets compared to the Scheme. Therefore the Trustee will be seeking assurance that employers do not in future take on new secured debt which has a superior priority to the pension liability. Further, any proposal to grant security should be discussed with the Trustee concurrently with the lender negotiations, with the Scheme being granted security at the same time as completion of the debt process.

This requirement could simply be expressed to the sector, but in order to be more helpful and support employers who wish to raise capital in this way, the Trustee will seek to take a greater involvement in the process. Particularly:

- The Trustee will expect to be made aware of any employer's intentions to secure new funds or credit at an early stage, and to be kept abreast of the ongoing process. The Trustee will of course respect each and every confidentiality requirement.
- The Trustee would expect that the third party will be made aware of the employer's participation in and obligations to USS early in the proceedings so that it understands the equal priority position of the Scheme.

The Trustee will write to all employers to advise them of the requirement to ensure any new secured debt does not take priority over the employer's obligation to the Scheme, and with more detail of what it expects from employers, in due course.

2.4 Introduction of debt monitoring arrangements

Whilst overall the debt levels in the HE sector have increased in recent years, the sector overall appears to have the ability to manage its costs should income decline. However at an individual employer level there may be institutions at higher risk due to inflexible or high fixed cost bases.

As a result the Trustee will roll out an annual attestation process whereby it will contact employers and ask for the latest position in relation to their levels of debt and security. The Trustee has already started to operate an element of the attestation process with non-HEI employers (where it is currently asking for confirmations around compliance with participation terms, but also financial information), and will roll out a similar process for HEI employers in 2020.

The Trustee will then evaluate the data provided against some simple leverage metrics (those being considered include the ratios of debt to EBITDA, debt to income, debt to net assets and debt service cover) in order to determine if it has any further questions or concerns – if it does so it will contact that employer directly to discuss these, and may wish to understand more about the purpose of the debt and the employer's ability to service it.

2.5 Once in operation, how will the Trustee monitor the impact of the package of covenant measures?

Once the measures are implemented by the Trustee (the rule change made immediately, the debt monitoring introduced over 2019/20 and the *pari passu* process operating as/when required) the executive will monitor how well they work and employers' experience and feedback on them. The executive will report this experience to the Trustee and any appropriate adjustments would be considered

However the Trustee will also report on this experience to the JNC, so that the stakeholders can consider in the context of any broader participation issues arising within the sector and any actions required to address these.

2.6 Why does the Trustee believe this package of measures is the most appropriate approach for protecting the covenant?

The Trustee has taken detailed legal and covenant advice and believes that taken together these three measures will ensure that it has clear demonstrable processes to understand the employer covenant and react to any risks to it. These processes will include direct input from employers as necessary, and will be flexible enough to adapt to future circumstances.

In particular:

- the package combines proactive actions to ensure the key covenant risks are mitigated before they have an impact;
- the measures also strengthen the ability of the Trustee to prevent weakening of the covenant where independent advisers advise it is necessary;
- it is a transparent approach which will enable employers to understand how actions could change their covenant;
- it also supports continued fairness across all employers, whether securing new investment, reducing debt, leaving, or remaining in the scheme;
- the information that the Trustee will require, and the process for obtaining it, will be as simple and structured as possible, so employers know what they need to do and when;
- the Trustee will exercise its discretion to consent to an employer withdrawing having obtained appropriate actuarial and covenant advice at the time an employer seeks to exit, so that it will reflect the trustee's assessment of the covenant at that time and the employer's contribution to that (which can reflect any changes covenant or other circumstances since introduction);
- the Trustee will report to stakeholders (via the JNC) on a regular basis in relation to employers' feedback and experience of the package, allowing stakeholders to consider in the context of participation more generally;
- the Trustee believes these actions are in the interest of employers as well as members, as they reduce the risk of orphan liabilities arising which could increase the burden on the remaining employers; and
- similar approaches have been implemented across a number of other non-associated multi-employer schemes to successfully protect or improve the covenant.