USSEmployers

Q&A: Consultation with USS employers on the USS Trustee's requirements to enable a conclusion to the 2018 valuation in line with option 3 – July 2019

On 7 June 2019, Universities UK (UUK) confirmed that, following a consultation, employers had indicated their wish to further explore option 3 as a potential outcome to the 2018 actuarial valuation.

A further period of consultation with employers began on 28 June, after the trustee detailed its proposed measures to allow the covenant to be confirmed as "strong" and to conclude the 2018 valuation in line with option 3. These fall into three specific areas:

- *Employers exiting from USS* – the wish to ensure that the USS trustee has powers to manage the scenario where a strong employer considers leaving the scheme;
- *Debt monitoring* – the need for employers to engage more fully with the USS trustee on institution debt, and to share information and make regular reports; and
- *Prioritisation of USS as a creditor* – the USS Trustee wishes to ensure that other creditors are not given priority over USS on new secured borrowing (sometimes referred to as USS seeking at least *pari passu* status with other creditors).

The following answers were given by USS and PwC, the USS Trustee's covenant advisers, to address questions raised by employers on the covenant analysis and the trustee's requirements.

Any further questions from employers should be submitted to pensions@universitiesuk.ac.uk

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The questions and answers have been separated into the following categories:

1. **Questions on the covenant assessment**
2. **Questions on the rule change for exiting employers**
3. **Questions on debt monitoring**
4. **Questions on prioritisation of USS as a creditor (*pari passu*)**

1. Questions on the covenant assessment

The JEP concluded in September 2018 that the sector covenant is "uniquely strong". PwC has also concluded that the covenant is Strong. So why are these conditions needed for the 2018 valuation?

The trustee has also concluded the covenant is 'strong' but if these risks are not addressed then the covenant could reduce to 'tending to strong'. Putting in place these appropriate measures seeks to protect these current unique strengths in future.

What would be the effect of moving the covenant from strong to tending to strong – does this materially matter? It seems tPR already considers the covenant is tending to strong, but in its literature does not appear to distinguish between the two assessments, perhaps with the exception of allowing a tending to strong covenant a longer recovery plan?

The trustee has evaluated the covenant as 'strong' and this has been reflected in the trustee's valuation assumptions. However, a shift from 'strong' to 'tending to strong' may lead the trustee to be more prudent in both the investment strategy and Technical Provisions assumptions, which may in turn lead to an increase in contribution requirements – it would of course need to look at the specific impact at the relevant time.

Will the covenant still be considered to be strong if the cost of USS forces an institution to fail financially on the basis that the other, stronger institutions can pick up the bill and make good the liability?

The trustee will not force an employer to fail. In the event that affordability becomes an issue for a specific employer, then the trustee will work alongside the institution to work out a solution that works for both sides.

To what extent would a substantial rise in individual scheme members opting out of the USS affect the strength of a covenant?

The strength of the covenant is about the ability of employers to support the scheme in delivering the promised benefits to members. The number of members opting out of the scheme does not impinge on the ability of the employer to provide support the scheme. A rise in the number of individuals opting may, however, cause the trustee to consider how that support is accessed. For example, deficit contributions are currently expressed as a percentage of payroll: if there was to be a large increase in opt outs this may not be an appropriate way to meet deficits.

We note that that employers are being requested to provide comments on their support for the "package" of proposed measures in order to proceed with option 3. Is it possible to determine an approximate weighting of how much each of individual measures supports the covenant strength as strong independently of each other, or is it the case that there is an interdependency which means that it is an 'all or nothing' situation, i.e. if there is less support for one of the individual elements of the package compared to the other two, does this result in having no impact upon increasing the value of the covenant?

The proposed measures work together to protect the scheme's covenant, by addressing the two key risks identified by PwC as being most likely to weaken that covenant, namely the rising debt levels in the sector and the potential for stronger employers to exit the scheme. If one or more of the protection measures were not implemented then what are currently risks could actually become events, and the covenant could be weaker as a result. Therefore, the three measures should be seen as a single protection 'package' for the scheme.

2. Questions on the rule change for exiting employers

Why would one strong employer leaving the Scheme tip the balance?

It is difficult to precisely identify when covenant tips between 'strong' and 'tending to strong'. However, if a second strong employer that is material to the scheme were to leave, it may become harder to explain why other such strong material employers wouldn't do so in future.

There will not be many institutions in a similar position to Trinity College with few USS members, and a small s.75 liability relative to the size of its balance sheet. For universities with a larger deficit, even if they could afford to buy-out (which many can't), wouldn't their s.75 debt be enough to compensate for the covenant leakage?

There are other stronger employers in the scheme who could afford to buy out, and those employers represent significant strength to the covenant. In addition, if the section 75 debt reduces in future, or employers can borrow to do so, it may become cheaper to do so. The trustee's concern is ensuring that the scheme always has the support of the entire sector and the risk of a large liability remaining with a few employers is avoided: the covenant horizon is 20-30 years and so it is important that the scheme can deal with unforeseen events during that time – the exit of other strong employers would call that into question.

Is there any evidence that any other employers are considering leaving the scheme?

It is not unusual for non-HEI employers to leave the scheme from time to time, for many reasons, often related to corporate activity (restructuring, mergers and so on). Occasionally such employers leave for other reasons, for example their workforce profile has changed and they no longer consider USS an appropriate pension offering, or they have a small number of USS members and the last one leaves employment. HEI employers sometimes make general enquires about their potential s75 liability for information/accounting purposes, but the trustee has seen no evidence to suggest that any (particularly those which could be considered as 'strong' or 'tending to strong' in covenant terms) are seeking to leave the scheme.

If the amendment to the scheme rules goes through, in practice would there ever be circumstances in which the Trustee agreed to an employer withdrawing from the scheme?

The proposed rule is to provide the trustee with discretion with respect to withdrawals. 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 legal and actuarial advice when an employer seeks to use, or becomes subject to, the withdrawing employer provision. Having reviewed this advice and having taken into account all relevant factors (whilst disregarding irrelevant factors), the trustee will make its decision.

Therefore, the trustee believes that there could be some circumstances where an exit could be agreeable.

3. Questions on debt monitoring

The information required for the USS to monitor debt is already a matter of public record so why is the formal monitoring process required?

The Pensions Regulator guides trustees to put in place monitoring frameworks for covenant and this is often standard practice for schemes – trustees are taking a more active role in this area. Rising debt levels in the sector have been identified as a key risk and so will be the focus of the monitoring.

We're concerned about restrictions on individual institution's autonomy relating to the management of debt and setting another layer of USS bureaucracy – what are your views on this?

It is important that the trustee takes an active role and regulatory guidance supports the trustee having appropriate monitoring processes in place. The trustee believes this is the right thing to do and through effective communication between employers and trustees this can be appropriately managed. The objective is to protect the strong covenant which the trustee believes is in the best interests of both members and employers.

Have the actual debt metrics been set or are they to be part of the working group discussion?

Legal documentation should be put in place for the scheme that is consistent with that prepared for other lenders. The details of implementation will be discussed as part of the proposed working group to allow for employer input.

4. Questions on prioritisation of USS as a creditor (*pari passu*)

Why is the requirement for pari passu security not time-limited, for example to the end of the 2020 valuation as is the case of the proposed moratorium on withdrawals, or at least subject to a formal review at the next valuation/covenant re-assessment?

The policy would be subject to review on an ongoing basis, and in particular at the next valuation, but experience indicates that it may be appropriate for it to remain in place until the scheme deficit is paid off.

What is the rationale for applying a pari passu requirement to all employers rather than just those with higher risk debt positions?

Generally, scheme covenant is impacted at the time security is granted and therefore this is when mitigating action should be taken. After security has been granted, additional debt may be taken on or employer performance may worsen increasing the risk exposure of the scheme. The proposal is an equitable approach across all employers.

The PwC advice is in line with Regulatory guidance, which set out: "trustees should seek mitigation where an event is materially detrimental to the covenant, defined as being if it:

- weakens an employer's ability to fund ongoing contributions; or
- reduces the potential return to the scheme in an insolvency."

This advice is relevant to the granting of any security, not just when an employer is high risk.

How will the pari passu security for USS work in practice?

Legal documentation should be put in place for the scheme that is consistent with that prepared for other lenders. The details of implementation will be discussed as part of the proposed working group to allow for employer input.

The Trustee and the UUK consultation documents both focus on the pari passu status of USS relative to lenders on new debt issued. Can you clarify that the measure would have no bearing on existing debt and/or charges on assets?

Yes – this would only apply to new debt, and wouldn't be applied retrospectively.

Is the proposal unfair on institutions that are yet to take out debt?

The trustee is not looking to prevent institutions taking on debt but it does want to reduce the scheme's exposure to highly leveraged institutions with secured debt. The proposals aren't unusual and have been introduced successfully on many other schemes.

What if an institution can only take on debt by granting lenders security?

There are certain circumstances under which the trustee can foresee this being necessary. That's why the trustee will work on a case-by-case approach: it will engage with an employer to understand the specifics of the situation and will consider what may be in the best interests of both the scheme and the employer.

Would a lender consider granting pari passu security?

In PwC's experience, yes, this is a well-established principle in the marketplace.

How likely are lenders to accept USS having first call on employer's assets? Will this not mean that HEIs are in effect unable to take on secured debt?

The trustee would not be asking for first call on an employers' assets, rather it would be asking for an equivalent position to the lender granted security.

We are concerned that this proposal will greatly increase the difficulty for employers to obtain competitively priced debt to pursue their operational objectives. What are your views on this?

The trustee is not seeking to prevent employers raising debt to pursue objectives, but is aiming to protect the scheme's position as a creditor on an equal footing with other debt. Lots of institutions already have low leverage and many do not require security to raise new debt, so we do not see this as having an impact on many institutions. However, for those it may affect the policy will not be implemented inflexibly – if an employer has a genuine issue and a requirement to raise emergency funds, the trustee will engage with the employer to understand that.

Why give security up to s75 debt levels when this may be many multiples of the security granted to the lender?

The s75 debt is the obligation to the scheme at the time of an employer failing. If security is granted to a smaller proportion of the scheme deficit than the debt lender, then the scheme is being prejudiced because returns would be favourable to the lender in an insolvency scenario.

How will pari passu security for USS be viewed by preference creditors such as HMRC?

We would expect preference creditors to view the scheme getting security in the same way as it would view a bank getting security. We want to reassure employers that it is not unusual for a pension scheme to seek to rank pari passu to other creditors and this is in line with guidance from both tPR and DWP.

What will be the potential impact on the covenant strength for university self-administered trusts (SATs)?

We would expect the trustees of university self-administered trusts to consider this scenario in the same way as when a university takes on secured debt.

Security is not only offered to lenders but also to other (smaller) pension schemes. Can we assume the pari passu measure relates only to security offered to lenders?

As other pension schemes are competing creditors, the trustee should also seek pari passu security in the future, should it be granted to another pension scheme.

What type of debt will be covered by the requirements? Will leases or other forms of project finance, commonly used for residences and which are asset-backed, be caught by the requirement for pari passu security?

The trustee wants this to be a practical, workable solution, and there is a proposal for a working group to go through the detail. However, as a general principle, if the lenders had no recourse to the university and the security was exclusively granted over a ring-fenced new asset, pari passu security may not be required.

What if an institution wants to take on secured development or project finance to develop non-operational assets whose development will improve the strength of the covenant?

As a general principle, if the lenders had no recourse to the university and the security was exclusively granted over a ring-fenced new asset, pari passu security may not be required. This will need to be worked through as part of the working group.

What about materiality – will the requirement for pari passu security apply to debt below a materiality threshold – e.g. 1% of revenue?

As noted above, the trustee will work through the detail with employer representatives. However, as an example, it's possible that where security is granted on a small specific asset, such as a lease on a car, this will not be of concern to the trustee. So, in principle a materiality threshold may be sensible.