USS

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Briefing note: Additional covenant support scenarios

Three scenarios for different levels of covenant support have been considered to date for the 2020 valuation. In each case, the resulting covenant position is considered weaker than we assumed for the 2018 valuation. A weaker covenant corresponds with taking less risk which, all other things being equal, means higher contributions.

1. Why additional covenant support is necessary

Additional covenant support measures were discussed as a condition for completing the 2018 valuation, which secured a strong covenant rating. These measures included a permanent rule change to prevent strong employers exiting the Scheme without our agreement, a debt-monitoring framework and arrangements for *pari passu* security with respect to future secured debt raised by employers.

These measures would seek to protect the covenant provided to the Scheme by employers in the face of increasing levels of risk and a growing self-sufficiency deficit. They would signal the employers' commitment to the Scheme and evidence their willingness to support risk-taking in the way it is funded. As above, all other things being equal, contributions would be lower *with* such measures in place than without.

The self-sufficiency deficit directly measures the reliance on the employers' collective financial strength in funding the Scheme over the long term. The support provided to the Scheme by the HE sector as a whole is an important strength of the covenant. Without suitable protections over employer exits there is uncertainty over the Scheme's ability to rely on the support from the sector as a whole over the long-term. At the same time, should employer debt levels continue to rise, debt service obligations could in the future threaten the ability of employers to fulfil pension funding obligations – unless a suitable debt monitoring framework is out in place. The arrangements for *pari passu* security protect the Scheme in the event an employer becomes distressed and the employer's lenders seek to take security. Without *pari passu* security arrangements the potential recovery to the Scheme from a failed institution could be substantially lower.

In November 2020, UUK shared an illustrative package of additional covenant support measures with us that is significantly weaker than we assumed for the 2018 valuation. UUK noted that they did not yet have employer backing for this package but expected to consult employers in the coming weeks, alongside consultations on benefit reforms and contributions. As a result, we have considered three different scenarios, two of which allow for additional covenant support.

2. Comparing the scenarios

The scenarios range from no additional covenant support through to the minimum required by us and our covenant advisors (PwC) to secure a strong covenant rating (Scenario 3).

Table 1, below, summarises the key characteristics of each scenario, with the covenant-related metrics given in the top part of the table.

Scenario 1 features no additional covenant support. It has been given a tending to strong (TTS) covenant rating by PwC. With no constraints on employers exiting the Scheme, no debt monitoring and no *pari passu* security arrangements, the overall risks facing the Scheme and the size of its self-sufficiency deficit would limit the amount of risk we could take. This points to a higher technical provisions (TP) liability, a higher TP deficit, a shorter Recovery Plan and higher contributions than would be the case if sufficient additional covenant support were provided.

Scenario 2 reflects the illustrative package that was provided by UUK in November. It lies between Scenarios 1 and 3, falling short of providing the level of covenant support needed for a strong covenant rating. It features an initial moratorium on employer exits of nine years, then a rolling six-year period

thereafter, plus a debt management framework that provides protections but with some limitations. PwC rates the covenant under Scenario 2 as TTS. It does, however, provide some additional covenant support value, and can justify an increase in risk compared to Scenario 1. However, because the initial moratorium on exits is just nine years, it cannot justify a deficit Recovery Plan longer than 10 years.

Scenario 3 is the minimum acceptable package of measures that PwC would regard as sufficiently comprehensive to achieve a strong covenant rating. It falls short of the package envisaged as part of the 2018 valuation, but still delivers a significant amount of covenant support value. As such, it can justify an increase in risk taking in the valuation, and a longer deficit Recovery Plan than the other scenarios. It features a moratorium on employer exits for at least as long as the Recovery Plan, initially lasting 15 years, then a rolling 12-year period thereafter, plus an effective debt management framework (with fewer limitations than under Scenario 2).

3. How the valuation outcomes reflect the covenant support

As set out above, the levels of covenant support in the scenarios differ in two respects: the length of the moratorium on employer exits and the effectiveness of the debt management measures.

Moratorium on employer exits

A longer moratorium on employer exits protects the Scheme against the erosion of its covenant should strong employers decide to leave. It gives us time to amend our funding strategy if the moratorium is not renewed. It also protects against the destabilising impact of stronger employers leaving publicly with associated press commentary. There are important benefits of maintaining the mutuality of the Scheme by keeping these strong employers in the Scheme for longer, such as:

- A longer deficit Recovery Plan can be considered. In particular, we believe it makes sense to link any lengthening of the Recovery Plan beyond 10 years to a corresponding increase in the initial period for the moratorium. For example, by increasing the initial period for the moratorium to 15 years, as in Scenario 3, we can feel comfortable increasing the Recovery Plan out to 15 years. (Note, however, that given the level of risk the Scheme is facing we would be uncomfortable pushing the Recovery Plan beyond 15 years, even with a longer moratorium, without further additional covenant commitments.)
- A longer moratorium also can support a higher level of risk during the deficit Recovery Plan than in Scenario 1, enabling it to incorporate either a higher level of assumed investment outperformance (as in Scenario 2) or the same level of assumed investment outperformance for a longer period (as in Scenario 3).
- With a longer moratorium, there is less risk associated with the employer contributions assumed in the affordable risk capacity calculation (modelled as contributions of 10% of payroll over 30 years) and they are therefore more valuable. Hence, we can use a lower discount rate to obtain a higher value for affordable risk capacity. This means that, all other things being equal, more risk can potentially be taken in funding the Scheme.
- The financial assets of all employers are part of our available risk capacity measure – regardless of their respective shares of the deficit (see Appendix B of the Trustee Update for more detail). Here, some employers with substantial assets but a relatively small share of the deficit contribute proportionately more to the covenant than others in underwriting the risk of an extreme downside scenario. Some could afford to pay their Section 75 debt and leave the Scheme, weakening the collective financial strength of the remaining employers.

A longer moratorium essentially enables more risk to be taken, because the moratorium period is available to recoup any incremental losses from this additional risk.

Debt management measures

The benefits of an effective package of measures to monitor employer debt and grant the Scheme *pari passu* security, where appropriate, are:

- We can have more confidence in the employers' ability to pay deficit contributions during the Recovery Plan. As for a longer moratorium, compared with Scenario 1 this enables the Recovery Plan to incorporate either a higher level of assumed investment outperformance (Scenario 2) or the same level of assumed investment outperformance for a longer period (Scenario 3).
- The arrangements for *pari passu* security protect the Scheme in the event an employer becomes distressed and the employer's lenders seek to take security. Without *pari passu* security arrangements the potential recovery to the Scheme from a failed institution could be substantially lower.
- There is less risk to the employer contributions associated with the affordable risk capacity and they are therefore more valuable. As for a longer moratorium, this means that a lower discount rate can be used to obtain a higher value for affordable risk capacity. As a result, all other things being equal, more risk can potentially be taken in funding the Scheme.

An effective package of debt management measures essentially enables more risk to be taken in the valuation, because there is less risk to the future affordability of employer contributions and less risk of the covenant weakening over time.

4. Managing risk

Importantly, the two elements detailed above lead to a higher affordable risk capacity (see Table 1). This is a key part of the way we measure and manage the amount of risk we can take in the valuation.

Under our integrated risk management framework (IRMF), Metric A tests how the distance between the TP and self-sufficiency liabilities compares with our assessment of the employers' affordable risk capacity. This metric is 'green' if the affordable risk capacity exceeds the TP distance to self-sufficiency by more than the combination of (i) an allowance for asset transition risk in moving to a self-sufficiency investment strategy and (ii) an allowance for demographic risk.

So, a higher affordable risk capacity allows for additional 'headroom' or 'buffer' in Metric A. Some of this additional buffer could effectively be exchanged for a lower TP liability (with associated reductions in deficit recovery and future service contributions). This is the case with Scenarios 2 and 3, and it leaves buffer before Metric A turns to 'amber' as shown in Table 1.

Metric A, by definition, relates to the TP liability and does not fully reflect risks relating to the Recovery Plan. This is because the latter's objective is to become fully funded on a TP basis, whereas Metric A considers the longer-term risk position once the Scheme reaches full funding on a TP basis, and only reflects the risks in moving from full funding on a TP basis to full funding on a self-sufficiency basis. So, the risks associated with getting to full funding on a TP basis (such as the risks associated with assumed investment outperformance and a longer Recovery Plan) are not fully reflected in the figures in Table 1 corresponding to 'Metric A buffer to 'Green''.

Under the IRMF, Metric B is a shorter-term risk measure that also captures additional Recovery Plan risks. Metric B is based on the current self-sufficiency deficit, which is equal to the sum of the TP deficit and the distance between the TP and self-sufficiency. As shown in Appendix D of the Trustee Update, Metric B is 'red' in all three scenarios at 31 March 2020. This reflects the large self-sufficiency deficit on the valuation date, indicating we should take action to improve the Scheme's funding level.

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5. Outcomes for the three scenarios

Scenario 1 is very similar to the TTS case in the TP consultation document, with the same TP discount rates, but a lower overall contribution rate of 56.2%. The TP consultation document illustrated possible eight-year Recovery Plans and a 10-year Recovery Plan without any assumed investment outperformance for the TTS case. Scenario 1 corresponds to a 10-year Recovery Plan with a significant element of assumed investment outperformance (0.5% p.a.). This is justified by the resilience of the employers' covenant reported in our recent covenant review, which considered the initial impact of Covid-19.

Scenario 2 also reflects the resilience of the employers' covenant to the initial impact of Covid-19 and would allow us to adopt a higher overall discount rate (single effective discount rate or 'SEDR') and higher assumed investment outperformance (0.75%), relative to Scenario 1. The 10-year Recovery Plan is maintained, supported by the initial moratorium of nine years. The overall contribution rate is 49.6% of payroll – 6.6 percentage points lower than in Scenario 1.

Scenario 3 assumes a strong covenant, based on the resilience of the employers' covenant to the initial impact of Covid-19 and the strength of the support measures involved. It has a higher discount rate and a lower overall contribution rate (42.1% – 14.1 percentage points lower than in Scenario 1 and 7.5 percentage points lower than in Scenario 2). The longer moratorium (with an initial period of 15 years) supports a longer Recovery Plan (15 years) and some assumed investment outperformance (slightly lower than for Scenario 2 due to the longer recovery period).

All three scenarios show a modest degree of buffer to 'green' on Metric A, demonstrating that (through this particular lens) the long-term funding risk is acceptable in each scenario. The buffer to 'green' helps to support the incremental risks associated with the assumed investment outperformance that is built into each scenario's Recovery Plan. In Scenario 3, the buffer to 'green' also helps to support the longer Recovery Plan and the longer time for Metric B to transition from 'red' to 'green'.

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Table 1: Comparing the three scenarios

	Scenario 1	Scenario 2	Scenario 3
<u>**Covenant**</u>			
Moratorium on employer exits	None	6-years rolling, 9 year initial	12-years rolling, 15 year initial
Debt management measures			
De minimis employer test	None	To be agreed	>£50m income / >£50m gross assets
Pari passu threshold test on secured debt	None	>20% net assets charged	>10% net assets / >10% gross assets charged
Covenant rating	TTS	TTS	Strong
Covenant horizon (yrs)	30	30	30
Affordable Risk Capacity (£bn) (10% contributions over 30 years)	**26 – 28**	**27 – 30**	**30 – 33**
Discount rates for calculating ARC	Gilts + 2.2%	Gilts + 1.9%	Gilts + 1.2%
<u>**Contribution & Recovery Plan**</u>			
Total contribution (% of payroll)	**56.2%**	**49.6%**	**42.1%**
Future service contribution	37.0%	34.7%	33.6%
Deficit recovery contribution	19.2%	14.9%	8.5%
Recovery Plan length	**10 years**	**10 years**	**15 years**
Investment outperformance	0.50%	0.75%	0.50%
<u>**TP**</u>			
Pre-retirement TP discount rate	Gilts+2.0%	Gilts+2.3%	Gilt+2.5%
Post-retirement TP discount rate	Gilts+1.0%	Gilts+1.0%	Gilt+1.0%
Single equivalent discount rate (SEDR)*	**Gilts+1.36%**	**Gilts+1.47%**	**Gilts+1.53%**
TP liabilities / SS liabilities	83%	81%	80%
TP deficit	17.9	16.1	14.9
<u>**Integrated Risk Management Framework**</u>			
Metric A buffer to 'Green' (£bn)**	1 – 3	0 – 3	2 – 5

* *The single-equivalent discount rates are without the allowance for investment outperformance for the Technical Provisions. The SEDRs would be higher for the future service contribution rate and higher when including allowance for investment outperformance.*

** *Note that the buffer figures assume a 55% growth investment strategy, which corresponds to a total adjustment for asset transition risk and demographic risk of c. £8bn. For a 40% growth strategy the buffer figures would be c. £1bn higher.*

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