Consideration of covenant support measures in future valuations

16 June 2021

Background

The Trustee and its advisors consider that the fundamentals of the covenant can be viewed as Strong, taking account of factors such as:

- The deficit is supported by the UK university sector, which is well-positioned in a growing global market;
- The Scheme operates on a last man standing basis and employers have joint & several liability, allowing the USS to rely on the full support of the sector;
- USS contributions flex with the size of an employer's USS payroll, meaning an employer's contributions generally shrink as its size decreases, which helps mitigate distress at the employer level; and
- The sector has shown itself to be flexible and adaptable in the past (which has been reinforced by the resilience shown by the sector in response to COVID-19) and we are not aware of any insolvencies in the UK university sector.

There are, however, concerns about the covenant deteriorating over time (reflected in the covenant rating and risk capacities). In particular, the Trustee and its advisors have concerns about the risk of increasing debt/secured debt and the potential for stronger employers to leave the Scheme. A weaker covenant results in the Trustee being less able to take risk which, all other things being equal, drives higher contributions.

The support measures provide protection to the covenant allowing the Trustee to place more reliance on the covenant over the longer term.

Implementing additional covenant support measures was agreed as a goal of the parties at the time the 2018 valuation was completed and helped secure a strong covenant rating (albeit on negative watch). Expected measures included a rule change to grant the Trustee discretion on employers exiting the Scheme, a debt-monitoring framework and arrangements for *pari passu* security with respect to future secured debt raised by employers.

The 2020 valuation

In the current valuation, employers have been consulted on the details of these measures and the extent to which they are willing to support them in order to protect the covenant provided to the Scheme in the face of increasing levels of risk, rising sector debt, and an increased self-sufficiency deficit. The Trustee has illustrated the effect of covenant support packages in alternative scenarios reflecting differences in:

- the length of the moratorium on employer exits without Trustee agreement; and
- the effectiveness of the debt management measures.

UUK has proposed an alternative package in its consultation with employers and we continue to work with them on the balance between the support employers are able and prepared to provide and the level of risk the Scheme is able to take.

Subsequent valuations

Once agreed, the covenant support measures will have ongoing value in managing the associated risks to the covenant and the Trustee will continue to take them into account in its risk framework and its assessment of the covenant. The Trustee will in the next formal valuation include, as part of the covenant review in its Discussion Document, its assessment of the effectiveness of the covenant support measures as implemented. Feedback will be sought from employers on the extent to which they perceive the measures to have been unduly burdensome or to have constrained their operations.

The value of the covenant support measures (if rolled over) will be recognised in future valuations and the Trustee intends to assess those measures consistently over future valuations. At the employers' request, the Trustee will be willing to include analysis demonstrating the impact of any proposed changes to the covenant support measures on future valuations.

Whilst the Trustee can commit today that the covenant support measures will continue to be taken into account in future valuations and to consider alternative approaches in future valuations, the extent to which the covenant support measures will benefit the outcome of future valuations will be dependent on circumstances prevailing at the time. Covenant reviews in the future, as now, will take in a wide range of factors and will be affected by changes in the external environment.

The benefit of the measures agreed in the 2020 valuation, will reflect the position at future valuations in respect inter alia of the following:

- The size of the Scheme deficit both on a Technical Provisions and Self-Sufficiency basis
- The required deficit recovery plan
- Any change in the benefits being accrued into the future
- Prevailing and prospective market conditions for risk and return in the Scheme
- Macro changes likely to affect the sector (positive or negative factors)
- The employers' ongoing commitment to the Scheme or appetite for further changes to its structure
- Changes in the employers' risk appetite
- The employers' commitment to continuing with and/ or desire to amend the measures
- Any other significant changes affecting the Scheme

The extent to which any changes to the covenant support measures are proposed will be an important part of the process of future valuations.

Further detail on how the measures have been reflected in the Trustee's scenarios in the 2020 valuation are described in [Briefing note: Additional covenant support scenario] (29 March 2021).

Further comments on implementation of the debt monitoring framework

Whilst the moratorium on employer exits will be executed through a change to the Scheme rules, the debt framework is essentially a policy document of the Trustee. However, the Trustee believes that effective operation of its policy in relation to debt monitoring and *pari passu* is in practice best achieved by creating a framework collaboratively with employers. To this end we believe it is in our mutual interest that the framework is seen – and continues to be seen in practice – to be both proportionate and effective.

The powers the Trustee could use in the case of non-compliance with the framework by an individual employer include:

(i) Under Scheme rule 6.1 to require accelerated contributions (i.e. to bring forward the balance of contributions expected from an employer over the remainder of the Recovery Plan)
(ii) To remove an employer from the Scheme by designating it as a “Withdrawing Institution” triggering an immediate statutory section 75 exit debt obligation; or
(iii) To approach the Pension Regulator to intervene and help to secure appropriate mitigation for the Scheme.

Option (i) is seen as a significant power in the event that the circumstances of an individual employer were seen to pose a risk to the covenant through non-compliance. The Trustee will consult UUK on including specific reference to the power accelerate contributions within the provisions of the Schedule of Contributions (SoC) – see attached Schedule. The process of reviewing and consulting on the SoC at each valuation can be seen by employers as an effective mechanism to ensure that the framework is re-validated at future valuations.

In the event of the framework failing to continue to achieve employer support in future valuations, the Trustee would have to revert to reliance on the unilateral exercise of its legal and regulatory powers.

The views and comments expressed in this Schedule remain subject to consideration and review by the Trustee and subject to further legal, actuarial and other advice and consultation with UUK. No decision has been taken by the Trustee in respect of any of the matters discussed in this Schedule and this therefore does not constitute an offer of the trustee in a legal sense.

Schedule

It is currently anticipated that the wording for inclusion in the 2020 SoC will include the elements set out below:

Acceleration of employer contributions in certain circumstances

- Where the Trustee determines in accordance with the framework that an employer should accelerate its payment of deficit contributions, the employer will be required to pay accelerated deficit contributions starting from a date specified by the Trustee for [x][1] number of years or such shorter period remaining on the Recovery Plan (the "Acceleration Period").

- During the Acceleration Period the employer will pay such percentage of Salary as the Trustee determines (on the advice of the Scheme Actuary), such that the value of these contributions over the Acceleration Period[2] is equal to the value of the standard deficit contributions that would otherwise be paid by that employer under the SoC.

- After the Acceleration Period, the employer would pay no further deficit contributions relating to the deficit addressed by the 2020 SoC.

- The amounts of any additional deficit contributions paid each month by an employer will be recorded by the Trustee (see last bullet below).

Early cessation of arrangement for acceleration of contributions

- Where an employer has paid accelerated contributions as set out above, then with effect from such date determined by the Trustee in its sole discretion (e.g. in circumstances where the Trustee considers the employer is no longer in breach of the framework), the deficit contributions due from that employer until the end date of the Recovery Plan may revert to the standard deficit contributions payable over the full Recovery Plan.

- Such amount to be reduced (by reference to the aggregate of the accelerated contribution payments paid by the employer) by such amount or percentage of salary, as determined by the Trustee on the advice of the Scheme Actuary.

[1] To be determined and specified in the 2020 SoC. The period over which such accelerated contributions will be required will be further considered by the Trustee following receipt of Actuarial and other advice, as appropriate.

[2] Based on the assumptions in the underlying Recovery Plan.