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Rationale for a long-term rule change for USS sponsoring employers

The purpose of this note is to confirm the rationale and requirement for a long-term rule change on employer exits in order to support a covenant strength rating of 'strong'. This note includes a summary of the advice to the Trustee received from PricewaterhouseCoopers ("PwC"), the Trustee's covenant adviser.

We are arranging for PwC to support a webinar for all employers on this topic. Details will follow shortly.

1. Current context

The global Covid-19 pandemic has caused immediate disruption to the higher and further education sector with some 1.25bn students forced to stay at home as governments around the world put in place protective measures. Higher education institutions are working hard to adapt their models to cope in the short term and to plan for the ongoing impact. Based on what we know today – and clearly that could change – we expect in the long term that the sector will recover from the short-term shock, will be resilient in the long-term and hence have the potential to continue to be considered as 'strong'. However, there is clearly material uncertainty in the short term and some individual institutions will find this extremely challenging. Against that backdrop, securing the long-term support of the strongest employers is more relevant than ever in order to ensure the Trustee can take a long-term view of the covenant horizon and to provide greater security around covenant visibility.

2. Trustee position

2.1 The importance of a long-term rule change for the valuation

For the 2018 valuation the employer covenant was rated as 'strong', but on negative watch due to the risks of potentially higher debt levels and strong employers exiting the Scheme. The risk of strong employers exiting the Scheme is discussed in more detail in the section on 'PwC advice in summary' below.

The risk of strong employers exiting the Scheme is currently mitigated by the temporary 'moratorium' secured as part of the commitments obtained during the 2018 valuation, which requires the Trustee's written consent for an employer to exit the Scheme. The moratorium expires on the earlier of the date of signature of the next (i.e. 2020) valuation, and the date the Scheme Rules are amended to include permanent provisions in respect of employer exits.

The unique nature of the Scheme – including its mutuality, the sector, and the potential to rely on a 30 year covenant horizon – is taken into account by PwC and the Trustee when considering the covenant rating.

In summer 2020, the Trustee intends to formally consult with employers on the assumptions for the Technical Provisions for the 2020 valuation. That consultation needs to reflect the appropriate covenant strength rating, which – assuming that the good work we and the employer working group have begun on the debt monitoring framework is successfully concluded – will be decided by the Trustee taking into account PwC’s advice and will be influenced by whether or not a long-term rule change will be in place.

If a rule change is expected, the Trustee will be able to take the long-term commitment to support the Scheme into consideration in its covenant rating but also remains subject to assessing the prevailing economic conditions at that time. If a rule change is not expected, PwC’s opinion is that the Trustee could reflect a covenant strength rating of ‘tending to strong’ in the TP consultation. Given the challenging environment the Scheme and sector currently face, it could be more difficult to later upgrade the covenant strength rating to one different to that used in the TP consultation unless prevailing economic conditions changed significantly absent the Covid-19 pandemic. The Trustee will consider carefully the assumptions made in preparing the TP consultation to ensure that it is as meaningful as possible, and the covenant assessment is critical to these assumptions. If the Trustee concludes that it must prepare the TP consultation on a “tending to strong” covenant, it will be very difficult subsequently to justify why that is no longer so. Therefore, it cannot be assumed that the rating used in the TP consultation can be later changed for the purpose of completing the 2020 valuation.

2.2 Covenant impact in the absence of a long-term rule change

In the absence of an expected rule change, the Technical Provisions consultation will most likely reflect a covenant strength rating of ‘tending to strong’ as a result of the longer-term uncertainty this would cause for the Scheme.

On a ‘tending to strong’ basis, the ability for the Trustee to continue to take risk over the longer term will be significantly reduced. This will directly impact the discount rate, the magnitude of the technical provisions deficit and the cost of future service. Employer contributions would be significantly higher.

PwC’s original advice from summer 2019 indicated that the covenant should be downgraded in the event that there was no long-term employer exit rule change **and** a strong employer elected to leave the Scheme. At the time this advice was provided, November 2019, PwC’s understanding was that employers had agreed in principle to consider a long-term rule change, subject to further consultation with employers and making an amendment to Scheme Rules. As discussions for the 2020 valuation have developed, and there is uncertainty around employers’ commitment to propose a long-term rule change, PwC has considered further its advice on this issue having regard also to current market conditions. It now considers that the covenant should be downgraded if there is no long-term rule change.

Assessment of the employer covenant is complex and not easily reduced to a simple classification system. The broad nomenclature used by TPR is intended as a tool to help frame an assessment of employer covenant strength and cannot capture all the nuances and potential scenarios relevant to the unique group of employers supporting USS. However, in order to indicate the potential impact of a reduced assessment of the covenant, the Trustee uses the TPR categories as a guide.

In presenting the indicative figures in the Trustee’s ‘Methodology and risk appetite for the 2020 valuation’ discussion document (reproduced below) we chose to show two scenarios – the first assuming that all of the covenant-related measures identified in the 2018 valuation are implemented and the second assuming that they are not, and assuming all other things equal. The discussion document was finalised before current developments regarding the Covid-19 pandemic. PwC’s final

assessment of covenant strength will consider a wide range of factors and available information. This in turn will influence the amount of risk the Trustee believes to be appropriate. The rule change is a particularly relevant factor as it would be a clear demonstration of long-term commitment, without which it would not be appropriate to rely on a covenant horizon as long as 30 years. Reluctance to back a long-term rule change can be perceived as a lack of commitment to the Scheme.

The following table uses indicative figures prepared for the Trustee’s ‘Methodology and risk appetite for the 2020 valuation’ discussion document (published in March 2020) to illustrate the potential outcomes as at 31 December 2019 for both a ‘strong’ and a ‘tending-to-strong’ covenant under our proposed approach for the 2020 valuation, which is currently being discussed with employers. We compare these with the approach taken for the 2018 valuation.

31 Dec 2019 New Methodology	TP Liability (£bn)	TP Deficit (£bn)	FSC (Future Service Cost) ¹	TP Discount Rate ² (Gilts+)	FSC Discount Rate ² (Gilts+)	Covenant support requirement ³ in 2040 (£bn)
2018 methodology (with RPI allowance)	78.3	5.4	32.5%	1.33%	1.48%	17
“Strong” covenant	78.0	5.1	30.0%	1.35%	1.76%	32
“Tending-to- strong” covenant	81.9	9.0	34.0%	1.10%	1.33%	25

¹ Future service cost (FSC) is given as a percentage of payroll.
² The dual discount rate is expressed as a single equivalent discount rate for the purpose of comparison.
³ Covenant support requirement is given by the projected self-sufficiency deficit plus a risk buffer.
Notes: We have expressed the discount rates relative to gilts purely for ease of comparison. They were not calculated from a so-called ‘gilts+’ approach, but based on our [FBB model](#). The final column assumes gilt yields revert in line with our expectations and that the Scheme is fully funded on a TP basis. Should gilt yields remain at levels similar to those at 31 December 2019, covenant support requirements at 2040 would be considerably higher.

2.3. Increased focus on Withdrawing Institutions from the time of the 2018 valuation

The covenant impact of a strong employer exiting the Scheme was brought into sharp focus for PWC and the Trustee with the withdrawal of Trinity College, Cambridge which occurred on 31 May 2019 (although conversations around its exit including their own consultation processes and agreeing the terms of their exit were initiated before this date). This was the first time an employer with such a strong covenant had given notice to leave the Scheme. The timing of this withdrawal occurred alongside PWC’s review of the strength of the employer covenant as part of the 2018 valuation which also required detailed consideration of the trustee’s powers under legislation and the Scheme Rules in relation to employer exits.

Having taken extensive legal advice and the advice of PWC in 2019 the Trustee’s view was that in order to support a ‘strong’ covenant rating for the 2018 valuation, the Scheme Rules would need to be updated to clarify and strengthen the position on employer withdrawal. Please see paragraph 3.3, below, for further details of its updated advice, which has progressed since 2019 and applies in relation to the 2020 valuation.

Neither PWC nor the Trustee has sight of the likelihood of employers exiting, and it is not appropriate for either to assume that strong employers would not request to withdraw from the Scheme. It is worth noting that the executive received several requests from strong employers for section 75 debt quotations both prior to and in the aftermath of Trinity College, Cambridge’s exit. Therefore, it cannot be assumed that the exit of strong employers would not occur either in the near term (once the moratorium expires in the absence of a longer-term rule change) or over the full length of the covenant horizon.

3. PwC advice in focus

This section is a summary of PwC's advice to the Trustee.

3.1 The Pension Regulator's ("TPR") guidance

TPR guidance states that trustees should consider the impact and likelihood of employers exiting a scheme when assessing covenant for multi-employer schemes, which have a 'last man standing' structure (source: 'Assessing and Monitoring Employer Covenant').

In particular, TPR states that trustees of multi-employer schemes should consider the following when assessing covenant:

- The mechanics of employer withdrawal;
- The trustees' powers under the trust deed and rules to:
 - impose contributions;
 - require participating employers to remain in (or contribute to) the scheme even after they have paid their section 75 debt; and
- The likelihood of employer withdrawal and its impact.

3.2 Importance of mutual nature of the Scheme

The USS covenant was rated as 'strong' in 2016 and this rating was reaffirmed in 2018 (see section 2.3 for further details of the change in position as part of the 2018 valuation). An important assumption in coming to a 'strong' conclusion was that employers are jointly and severally liable and the Scheme is "last man standing" and can rely on the continued support of all strong employers.

Despite the 'strong' rating, the sector is not without risk. Risks include increasing debt levels, public policy, competition for students and, in the current environment, threats to the numbers of overseas students. The expectation is that these risks will impact institutions differently across the sector, however the work PwC has undertaken to date suggests that the stronger employers would continue to maintain their position and potentially grow even in challenging times.

The last man standing and joint and several nature of the Scheme means a decline in an individual institution's performance or overall sector performance would not necessarily have a material impact on the Scheme's ability to deliver the promised benefits, provided the Scheme can continue to rely on the strongest employers.

3.3 Risk of strong employers exiting

If strong employers elect and are able to leave the Scheme, without the consent of the Trustee, then it will have implications on covenant strength and covenant horizon.

The primary risk of a strong employer leaving the Scheme is not a short-term risk around affordability, but rather the longer-term tail risk of reducing the level of underlying support provided by the strong employers in the future. This would limit the extent of the covenant horizon and in turn the level of risk which the Scheme can afford to take in funding the benefits. The rules in place prior to the moratorium amendment provided that where an employer met the criteria for a Withdrawing

Institution (“WI”), it would become a WI and leave the Scheme. It is understood that a number of small employers with a small deficit share have withdrawn from the Scheme by giving notice to cease participation. However, to our knowledge, no employer offering a ‘strong’ covenant that was material to the Scheme had sought to leave the Scheme prior to Trinity College, Cambridge (Trinity). As such, it was assumed that reliance, particularly on strong employers, could continue indefinitely.

However, the departure of other strong employers could have the following implications:

- It could set a precedent for other strong employers choosing to leave the Scheme;
- The exiting strong employer(s) would, by virtue of not being a participating employer, no longer support future orphan liabilities arising in the event that a remaining employer is unable to meet its obligations i.e. as a result of the insolvency of another employer;
- The strong employer(s) could no longer be relied upon in a downside scenario to underwrite the Scheme should the deficit materially increase, and the Trustee decide to move to a self-sufficiency target; and
- By removing its exposure to USS, the strong employer(s) could be considered to be exposed to less risk than other institutions. The employer(s) may therefore attract more funding, having the impact of reducing funding available to other universities/colleges whose individual covenants may weaken as a result.

Whilst most employers could not afford to pay their section 75 debt today, there are strong employers that could do so. Others may be able to do so in the future if the section 75 debt reduced or by raising debt.

The attached annex presents the executive’s sector analysis of employers’ free cash flow in comparison to their section 75 debt, and of those with the capacity to fund their section 75 debt. A key concern is that the minority of sponsoring employers who could afford to pay their section 75 debt and exit the scheme account for over 20% of the free cash flow calculation made as part of the covenant analysis.

3.4 Recommendation to change the Scheme Rules

As a condition of completing the March 2018 valuation assuming a ‘strong’ covenant, the Trustee required a rule change clarifying and strengthening the Trustee’s power to restrict employers leaving the Scheme. UUK requested that the JNC recommended to the Trustee an amendment to the Scheme Rules in the form of the current moratorium. The JNC made this recommendation, and the Trustee then amended the Scheme Rules in accordance with the requirements of Rule 79.7 (Power of JNC to recommend amendment). The Trustee understood that this amendment, along with the employer debt monitoring framework and pari passu measures, would ensure that a covenant rating of ‘strong’ could be maintained for the 2018 valuation.

3.5 Protecting the employer covenant

In order to protect the current covenant rating, there will need to be a long-term rule change such that the Trustee has discretion over whether an employer may exit the Scheme, notwithstanding that it has paid its section 75 debt.

There may be circumstances in which the Trustee uses this discretion to allow an employer to exit the Scheme, and the relevant employer's covenant rating and the impact of exit on the overall strength of the Scheme covenant will be taken into account in the Trustee's considerations.

Although the covenant is rated as 'strong', it has been placed on negative watch. PWC are recommending that the covenant will be downgraded to 'tending to strong' if a long-term rule change is not put in place ahead of the moratorium expiring (i.e. completion of the March 2020 valuation) to ensure the Trustee has unilateral discretion to prevent an employer from withdrawing from the Scheme.

3.6 Impact of a covenant downgrade

If the employer covenant strength rating is downgraded from 'strong' to 'tending to strong', this will impact the level of risk the Trustee is able to take, leading to a lower discount rate, a higher liability valuation and a requirement for higher contributions.

Sector analysis of free cash flow (“FCF”) valuation vs s75 deficit

The table below illustrates that some sub-sectors represent significant value to the covenant, but have a relatively small share of the s.75 debt. As such, there is a greater chance institutions in these sub-sectors would have the capacity to pay their s.75 debt and exit the scheme, resulting in a material reduction in the value of the covenant

USS

	Broad-based Research	Oxbridge colleges	Scotland Research	Cusp	Teaching	Other*	TOTAL
Number of institutions	24	65	7	22	38	32	188
Share of FCF valuation	57.0%	9.4%	8.0%	8.0%	9.2%	8.4%	100.0%
Share of s75 debt	55.0%	1.9%	11.7%	17.8%	2.6%	11.0%	100.0%

- The free cash flow model is a valuation technique which we can use as one of the range of measures to assess the employer covenant. It arrives at a valuation of the overall financial capacity of the sector and is used here to illustrate the relative proportion of support which may be attributed to certain institutions. It is a projection and doesn't fully reflect the possibility that some institutions may in the future absorb a greater or lesser share of the overall market in certain scenarios. Further information on this model and its limitations is set out in the Discussion Document
- Number of institutions are those included within the free cash flow valuation model (representing c98% of the deficit)
- Valuation is the indicative free cash flow valuation of covenant, excluding USS contributions (total estimated at £77bn using the methodology described in the 2020 Valuation Discussion Document). Base data from July 2018.
- s75 debt is analysis by sector of the s75 debt at 31/3/19
- *Other EY Parthenon sectors: Scotland Teaching, Teaching – International, Specialist Teaching, Specialist Research

Institutions with capacity to fund s75 debt

This table considers the capacity of institutions (based on their net cash and financial investments) to pay their s.75 debt. It illustrates there are 88 institutions with capacity to do so when financial investments are included, and 29 institutions who could do so from cash and cash equivalents alone.

USS

	Broad-based Research	Oxbridge colleges	Other	TOTAL
Number of institutions with capacity to fund s75 debt	2	64	22	88
Of which: Number with cash and cash equivalents > s75 debt	-	10	19	29
Share of FCF valuation attributable to institutions with capacity to fund s75 debt	12.8%	9.4%	Not separately calculated for all institutions	>22.2%
Share of total s75 debt attributable to institutions with capacity to cover it	8.2%	1.8%	1.1%	11.1%

- “Capacity” defined as net cash + financial investments
- Not all cash/ investments available to the Scheme due to restrictions
- Net cash adjusted for all external borrowing – assumes all external debt paid first/ no new debt to fund s75. Cash and cash equivalents includes bank overdrafts
- This analysis is of ability to exit the Scheme at a point in time – asset values and s75 debt and the order of magnitude relative to each other can vary materially
- Asset data is from HESA, as at 31/7/2018 (Oxbridge college data from accounts); s75 deficit data as at 31/3/19

Note: the % of net cash and long-term investments required to fund the s75 debt for the institutions in the table above ranges from 4% to 97% with the average being 26%.

In addition, 20 out of 88 institutions have capacity to leave the Scheme using less than 10% of their net cash and long-term investments.

Advice from PwC is provided solely to the Trustee, it accepts no liability to any other parties in relation to its advice and employers should not rely on the summary of this advice.