

USS Review Working Group
10.30am – 12.00pm, Tuesday 16 July 2019
Venue: Room 4, Wellington Square

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Date of next meeting – 15th August 2019

Invitees:

Professor Richard Hobbs (Chair)	Professor Sam Howison
Dr Martine Abboud	Professor Jane Humphries
Mr Charles Alexander	Professor Tim Jenkinson
Professor Danny Dorling	Mr Jaya John John
Mr Julian Duxfield	Professor Sophie Marnette
Professor Fabian Essler	Mr Lindsay Pearson
Mr Charles Harman	

In attendance:

Prof Anne Trefethen
Mr Russell Powles, Aon
Ms Judith Finch, Conference of Colleges
Mr David Cook, Mr Stephen Rouse, Mr Lucian Hudson, Mr James Colman, Ms Anna Myers

Apologies:

tbc

USS Review Working Group

Room 6 Wellington Square, 11:00 am – 12.30 pm

Minutes of the meeting of 21 June 2019

Present: Professor Richard Hobbs (Chair), Mr Charles Alexander, Mr Charles Harman, Mr Jaya John John, Mr Julian Duxfield, Professor Sophie Marnette, Professor Fabian Essler and Mr Lindsay Pearson

In attendance: Mr Russell Powles (Aon), Mr Stephen Rouse, Ms Judith Finch and Professor Anne Trefethen

1. Apologies for absence and welcome

Dr Martine Abboud, Professor Jane Humphries, Professor Tim Jenkinson, Ms Jan Killick, Mr James Coleman, Mr Lucian Hudson and Professor Danny Dorling sent their apologies.

2. Conflicts of interest

There were no new conflicts of interest declared.

3. Minutes of the previous meeting

The minutes of the meeting on 20 May 2019 were agreed.

4. UUK employer consultation findings and response to USS on 2018 valuation – to note

Prof Hobbs briefly summarised the results of the employer consultation response from UUK. He noted that 98 employers responded covering 90% of the active USS membership. The responses set out an overwhelming support of option 3, albeit a number of employers, including Oxford, saw this as a 'least worse option'. Prof Trefethen noted that the response from UUK provided a lot more detail than previous consultation responses and provided good context on the breadth of employer responses. Prof Hobbs agreed it was more granular and looked like UUK had taken on some of the feedback provided by employers to provide a more detailed breakdown of responses.

5. University's response to UCU letter to VC re dispute – to note

Prof Hobbs briefly summarised the USS Trade Dispute letter from UCU and noted the stated UCU policy position of 'No Detriment'. The letter highlights UCU's view that 'No Detriment' means no increases in contributions and no cuts to pension benefits. Prof Hobbs asked the Group how many employers this was sent to. Prof Trefethen confirmed around 70 universities which covered those with larger memberships in the USS. A full list of employers is set out on the website.

Prof Essler questioned if there were any conversations with the Pensions Regulator between UCU or UUK. Prof Trefethen thought the JNC had met the Regulator but was not sure about any other party other than USS Trustees. Prof Hobbs suggested that employers have not been made aware of all the issues throughout the valuation process and do not have the latest Regulator documents available in the pack to understand if USS had misused a letter from the Regulator when communicating the Regulator's views to UUK. Prof Trefethen then accessed the letter in question from the Regulator and highlighted:

- The Regulator's position on the derivation of the discount rate had been mis-communicated via USS.
- The advice provided via Aon (UUK's advisor) used the accurate information on the discount rate.

Ms Finch asked if we know the latest position on USS response. Mr Powles confirmed that the USS board had met the previous day and should provide a response early in the following week.

Prof Essler questioned why UCU would comment that employers were not acting in good faith towards members. Mr John added that USS should provide information on the process as to why the JEP findings had not been fully allowed for in the valuation. Prof Hobbs confirmed that Oxford remain fully supportive of the JEP findings and have noted this in all key communications.

Mr Alexander asked if anyone was currently lobbying USS and Prof Trefethen commented she was not aware of anyone. Mr Alexander also asked how could an employer influence the USS Trustee Board. Prof Hobbs confirmed this would be done via UUK.

Prof Hobbs confirmed that the group should gather information on the timelines relating to these issues and what was issued in the press, understand why the issues were raised and consider whether it would have made any difference to what was agreed by the Working Group.

Action: JD

6. UUK Q and As on 2018 valuation and UCU's position – to note

The Q and A document was noted by the Working Group. Prof Hobbs confirmed that Council's commitment is to maintaining benefits and not to maintaining current levels of employee contributions. Prof Essler highlighted this was the existing commitment from Council and that Council had not specifically ruled out a new commitment. Prof Hobbs confirmed this was not in the Working Group's remit to discuss as it is a Council issue.

Prof Hobbs suggested it would be worthwhile highlighting what the employee and employer impact would be for increases in contribution levels and re-supply an addendum to the minutes setting out an example for the next meeting. It was also agreed to include a slide within the upcoming Webinar covering this.

Action: LP/RP/JD

7. Letter to FT on USS governance – for information

The document was noted by the Working Group.

8. USS update on 2017 valuation formalities – to note

The document was noted by the Working Group. Mr Pearson highlighted that the current deficit contribution allocation following the 2017 valuation would lead to an additional c.£230M accounting impact on the balance sheet.

9. Communication update

Mr Pearson questioned whether a FAQ document would be useful for members, particularly for setting out useful information and including responses to any questions raised by members at Forums/Webinars. Prof Hobbs confirmed that would be worthwhile and an initial draft can be reviewed at the next Working Group meeting. Prof Trefethen also suggested putting Council's response to the UCU letter on the website as well.

Action: LP/JD

10. JEP – verbal update

Prof Trefethen discussed the University's response to the request for input into JEP 2. The Group discussed at the time that there was not enough expertise for the Group to formulate

a response but if individuals felt they had the relevant knowledge and expertise then they were encouraged to do so. The Group felt input should be made where possible for any follow up requests in respect of JEP2. Prof Hobbs suggested that a list of people with appropriate knowledge and expertise to input into the JEP2 work should be formulated, with the intention of forming a separate JEP2 Working Group along with support from Aon.

Action: all

11. Any other business

There was no other business.

11. Next meeting

The next monthly meeting: Tuesday 16 July 2019, 10:30 am, to 12.00pm, Meeting room: Bannister Room, 6 Worcester St.

The meeting closed at 12:40 pm

A consultation by Universities UK (UUK) with USS employers on the requirements set out by the USS trustee which would enable the conclusion of the 2018 actuarial valuation in line with option 3

You will recall that UUK wrote to the USS trustee on 6 June 2019 to confirm that, following a consultation, employers had [indicated their wish to further explore option 3](#) as a potential outcome to the 2018 actuarial valuation. We thank employers for their careful consideration of those issues and for their responses.

As anticipated, we begin a further period of consultation with employers now that we have heard more from the trustee on its requirements for finalising the valuation on the option 3 basis.

In recent weeks, discussions have taken place with the USS team regarding the USS trustee's requirements, and as initially indicated these fall into three specific areas:

- *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;
- *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), and
- *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.

The initial discussions with the USS team have been constructive, and have included a presentation from the trustee's covenant advisers PwC on their assessment of the scheme's covenant and the rationale for the trustee's requirements. The USS trustee board met on 20 June 2019 and two documents have been prepared by USS – comprising a letter from Bill Galvin to UUK dated 26 June 2019 and an explanatory note – which are attached.

The discussions with USS have at this stage primarily focussed on the third of the above issues, of employers exiting from USS – and specifically to consider the trustee's wish to protect the employer covenant through rule amendments which would give it greater control over the ability of employers to leave the scheme. A number of potential options have been discussed; we believe the response from the USS trustee to a potential alternative has been positive.

After having heard the detailed rationale for the trustee's requirements, UUK believes that employers need time to consider the issues more fully before deciding whether they would be willing to support any enduring changes to the scheme in this area, and if so in what form they might be acceptable. This period of time would allow structured communications to take place with employers on the importance of covenant, on the current challenges, on the legal structures within which USS operates and on the views of the USS trustee's covenant advisers. These communications, and this period of consideration, would give employers the opportunity to engage with their leadership and governing bodies as appropriate, to potentially take their own legal advice, and to consider the implications of what might emerge from the Joint Expert Panel's second phase of work.

There is, however, a need for the USS trustee to be reassured that there are sufficient measures in place now to protect the covenant provided by employers to the scheme, so that a continuing strong covenant can be confidently asserted – something which UUK believes is appropriate – and for the 2018 valuation to be concluded. For these reasons, UUK has put forward to the USS trustee a suggestion – on a without prejudice basis, and which the USS trustee considered at its meeting

on 20 June 2019 – that a moratorium be agreed which would give the trustee discretionary control over any employer exits over the period to the next valuation. A copy of the proposal letter is attached. We believe this would meet the USS trustee's objectives in providing the necessary protection for the covenant, and is something which employers would be willing to consider and which might potentially gain their support.

You will see from the attached letter and explanatory note from the USS trustee that it is willing to consider favourably a moratorium proposal – alongside the other measures on debt monitoring and its status as a creditor in cases of secured borrowing – to conclude the 2018 valuation. We are now engaged in further detailed exchanges with USS on the specifics. However, the timescales are tight, more of which is set out in the annex to this letter. Detailed texts are not available at this point, but nevertheless we felt it important to begin this next round of consultation with the focus for the time being on the headline principles, on the basis that we will provide fuller definition over the coming weeks and indeed months.

We welcome the views of employers on whether they would find it acceptable to put in place, in legal form, a moratorium on employers leaving USS without the consent of the USS trustee for the period through to the completion of the next actuarial valuation (as at 31 March 2020). We also seek the views of employers on the trustee's requirements relating to debt monitoring, and to giving priority to USS on secured borrowing. We recognise that such views might only be expressed in principle at this stage, as fuller definition of the precise terms for these requirements is yet to be finalised. Indeed – as we explain further in the annex – we would envisage that a joint USS / employers working group might be appropriate to develop the debt monitoring and prioritisation arrangements fully and transparently.

We have been engaged with our actuarial and legal advisers in the development of the moratorium suggestion and analysis of USS's responses, and in the next few days we will send to employers a copy of their respective comments and advice. We also plan to publish some Q&As on these issues on www.USSEmployers.org.uk.

The initial views of employers on these issues are invited **by no later than midday on Tuesday 16 July 2019**; as we need to express a view to the USS trustee ahead of its meeting on 17 July 2019.

We would then plan to take these views in their collective form into the planned meeting of the Joint Negotiating Committee on 24 July 2019, so please ensure we have your formal view by this date.

We apologise once again for the imposition of such short timescales, but we hope that employers will understand the circumstances and the importance of securing an outcome to the 2018 valuation in line with the USS trustee's option 3. We believe this represents the best available path to a conclusion of these issues, and to allow the second report of the Joint Expert Panel to be published and taken into account at the 2020 valuation.

Please feel able to be in contact with UUK's pensions team – at.pensions@universitiesuk.ac.uk – if you would like any further information, and for example if there are particular questions which you believe we should cover in the Q&As. We are grateful for, and look forward to, your continued engagement on these important issues.

Annex

A consultation by UUK with employers on the requirements set out by the USS trustee which would enable the conclusion of the 2018 actuarial valuation in line with option 3 - further information

The rationale for these changes, and consideration of the alternatives

It is UUK's view that employers wish to conclude the 2018 valuation on the basis of the USS trustee's [option 3](#), as it would allow the second report from the Joint Expert Panel to be published and then taken into account in the run up to the next actuarial valuation (as at 31 March 2020). Employers are aware from the earlier UUK consultation of the limited options available for the timely conclusion of the 2018 valuation; their general view was that the best of the available paths is the trustee's option 3. It is recognised that a number of employers considered that none of the options put forward by the trustee were desirable, however a pragmatic route to the conclusion of the 2018 valuation was, and is, needed.

The USS trustee has made clear that should it not be possible to reach a decision on option 3 – and importantly if the requirements to protect the covenant cannot be secured – it would cause the USS trustee to revisit its overall covenant assessment as (potentially) “tending to strong” rather than “strong”. As the USS trustee states, this is likely to mean that this would be reflected in a “lower valuation discount rate, and as a result a higher liability valuation and a requirement for higher contributions”.

In short, employers should be aware that if it is not possible to secure support for the option 3 outcome, then a valuation conclusion in line with the USS trustee's option 1 – upper bookend – is likely. This would mean an aggregate contribution rate of at least 33.7% of salary – and, as indicated, potentially higher due to the revised covenant opinion which might be decided by the USS trustee.

The effect of the changes which are being proposed

The proposed changes would, if implemented, prevent an employer leaving USS without the trustee's consent for the period of the moratorium. The moratorium is planned to run until the completion of the next actuarial valuation in 2020 (to a precise date which is to be specified).

The material attached to this consultation

- (a) A letter from Alistair Jarvis to USS's CEO, Bill Galvin dated 19 June 2019, which put forward a suggestion to the USS trustee for a moratorium on employers leaving USS.
- (b) A letter from Bill Galvin to Alistair Jarvis dated 26 June 2019 which sets out the USS trustee's response to the suggestion from UUK, along with other comments regarding the potential next steps.
- (c) An explanatory note, attached to (b) above, which explains the USS trustee's latest thinking on its requirements for conclusion of the 2018 valuation.

The material which will be issued by UUK in the coming days

- (a) Advice note and supplementary comments from UUK's advisers, Eversheds Sutherland and Aon.

(b) Q&As for employers on www.USSEmployers.org.uk.

The key questions for employers at this stage

- (a) What are the views of employers on the principle of a moratorium on employers leaving USS, so that the USS trustee is given the consent in legal form to decide whether or not an employer can withdraw from USS? This moratorium would run until the completion of the next actuarial valuation as at 31 March 2020 (with the precise date to be decided), with a commitment to work to secure longer-term rule amendments.
- (b) Are employers supportive of providing a “firm commitment” to meet the USS trustee’s requirements in relation to debt monitoring and the prioritisation of USS as a creditor on any new secured debt (on the basis that the details and practicalities will be further defined in the coming period following detailed engagement, and potentially a joint USS / employer working group involving institutional finance directors and other specialists)?
- (c) Do employers wish to express any other comments on the trustee’s requirements as set out in the letter and explanatory note from USS’s CEO dated 26 June 2019?

Consultation question

Is your institution willing to accept and support the package of proposed measures to allow the covenant to be confirmed as “strong” and to conclude the 2018 valuation in line with option 3?

Please respond to the consultation on behalf of your [institution to pensions@universitiesuk.ac.uk](mailto:institution.to.pensions@universitiesuk.ac.uk). The

indicative timeline

The following is the indicative timeline to which UUK is working to at this stage:

17 July 2019	The USS trustee meets, and the preliminary responses of employers to the questions set out in this consultation would be welcomed before this date.
Midday on 23 July 2019	The closing date and time for formal responses to this consultation.
24 July 2019	The Joint Negotiating Committee meets, and it is anticipated that it will be asked to decide on the proposed approach for the conclusion of the 2018 valuation including any proposed rule amendments.
□ 29 July 2019	The commencement of a consultation by the USS trustee with UUK (and through it, to all employers) on the proposed recovery plan and schedule of contributions for the 2018 valuation. <i>NB: There is also likely to be a consultation with employers on the statement of investment principles, which may run concurrently.</i>
□ 23 August 2019	Closing date for consultation on proposed recovery plan and schedule of contributions.
□ early September 2019	Formal notification to employers of the employer and member contribution rates which are to apply from 1 October 2019 under the 2018 actuarial valuation.
1 October 2019	New contribution rates come into effect.

Private and Confidential

Mr B Galvin
Group CEO
USS Limited
Royal Liver Building
Liverpool
L3 1PY

19 June 2019

Dear Bill

Rule changes required for the 2018 valuation

Thank you for making your team available for discussions on the rule changes and requirements associated with the potential completion of the 2018 valuation under Option 3. Representatives from the Employers Pensions Forum also appreciated the opportunity to hear the presentation from Jeff Rowney and colleagues from PwC, on the covenant review and the recommendations made to the trustee.

After discussing, with your team, our concerns over securing collective support from employers in such a short timescale, and also exploring potential avenues for achieving the covenant reassurance sought by the trustee, UUK would like to take up the opportunity to put forward a potential alternative proposal. We hope this is a way forward that could be accepted by all parties and enable the conclusion of the 2018 valuation.

The consistent feedback from employers demonstrates a clear concern and many questions on the details of the requirements associated with Option 3. The EPF session with PwC showed that detailed explanation is vital, to enable employers to fully consider this issue and understand the covenant support recommendations. We believe that, from this meeting, the USS Executive and PwC will be able to see the value in providing detailed papers and presentations (including webinars) to employers, and we would like to facilitate this as soon as possible. Crucially, we need to allow key staff at institutions, including senior management teams and governing bodies, the opportunity to fully consider the proposed changes. We are concerned that UUK would not receive sufficient consensus from employers on any long-term changes within the current timescales.

One possible way forward is a moratorium on employers exiting USS without the trustee's consent. The moratorium would apply for a period of months, during which time the formal, longer-term rule amendments might be communicated to employers, explained, and defined in further detail. In the annex to this letter we set out further information on our proposal, and we would like to take up the offer for this to be tabled at the board meeting on 20 June 2019 for the trustee's consideration.

The voice of universities

Chief Executive
Alistair Jarvis

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I must state that we do not have a mandate from employers for this proposal, and we would need to consult with employers after this has been considered by the board, but I hope it is helpful to have at least this outline available to you. If acceptable to the trustee board, we would then consult formally with employers.

Yours sincerely

A handwritten signature in black ink, appearing to be 'A. Jarvis', with a long horizontal flourish extending to the right.

Alistair Jarvis
Chief Executive

Enc: Annex

Maintaining support for the covenant – a proposal

item 4b

- (1) The trustee has indicated, in the letter from Bill Galvin to Alistair Jarvis dated 7 May 2019, that it would wish to introduce a clarification to the USS rules which would “strengthen the trustee’s discretionary powers to determine whether an employer can exit the scheme”. The objective would be to “support maintaining the current covenant rating”.
- (2) UUK wishes to engage constructively with the trustee on this issue, and has a mutual interest in finding a solution which can provide comfort to the trustee (and to its covenant advisers) regarding the support for the covenant, in order to enable an outcome to the 2018 valuation in line with option 3. Employers have stated their indicative support for this option.
- (3) We do however wish to ensure that the rationale for such changes to the rules – which in UUK’s view (and that of its advisers) could not be considered to be clarifications – is clear to employers, that the precise formulation of the rule changes is known and understood, that they have time to examine the details of any proposals and if appropriate take their own advice, and crucially secure the view of their senior / governing bodies to what would be material changes to the provisions of their workplace pension scheme.
- (4) It seems reasonable for employers to expect the fullest information, and the necessary time, to consider and – we hope and anticipate – signal their support to such important changes to the scheme. It is UUK’s view that if employers are not given an appropriate period to decide on these issues, and/or the process is rushed, there will not be sufficient consensus on the changes and it will not be possible for UUK to back any lasting rule amendments at the Joint Negotiating Committee.
- (5) UUK understands that the trustee seeks reassurance, now, on the support of employers which underpins the covenant. We understand that the prospect of one strong employer exiting from USS has raised concern that, should another strong employer do likewise, the trustee would, based on its covenant advice, downgrade the covenant from strong to tending to strong. We do not have any sense that such a pattern might emerge, but we understand the trustee’s wish to secure some form of tangible measure.
- (6) It is proposed that agreement is reached on a moratorium on employers exiting USS, which would last for a period of months – during which time the formal, longer-term rule amendments might be communicated to employers, explained and defined in further detail, and within which employers would have the opportunity to engage with, and gain the formal support of, their senior / governing bodies. We think it helpful not to specify the period of such a moratorium at this stage, but we hope that might be decided as these moratorium arrangements are themselves considered and finalised.
- (7) It is expected that the moratorium provisions would have appropriate legal status, and be enshrined within a separate legal document or potentially in the form of short-term rule amendments, to give them legal effect. Effectively, we see that employers would be unable to leave USS during the moratorium period without the trustee’s consent.
- (8) The moratorium proposal has some further distinct advantages, in addition to those expressed in paragraphs (3) and (6) above. We think these include:
 - (i) We think we would have the ability to move more quickly with a moratorium provision, which given its nature UUK believes would gain the support of employers;
 - (ii) The ability to move quickly is helpful in creating a path to the timely conclusion of the 2018 valuation, if that is the wish of the trustee and of the stakeholders at the JNC;
 - (iii) We would wish to use, wherever possible, the drafting of any legal texts already developed by the USS team for the moratorium provision;

- (iv) We think there would be an opportunity to discuss the prospect that UUK initiates and promotes the moratorium within the JNC (which we understand is the trustee's preferred sequence), something which may be more acceptable than if these changes were other than in the form of a moratorium provision;
 - (v) We think that any final changes will have the benefit of being developed and defined over a longer period; it will transmit confidence about the changes and avoid any sense (in the minds of employers) that modifications of importance are being made in haste;
 - (vi) We believe this will meet the trustee's objectives – and those of its covenant advisers – in avoiding a sequence of employers choosing to exit from USS under the current terms (when crucially they might not have otherwise planned to do so).
- (9) We should make clear that this is an initial proposal at this stage, provided on a without prejudice basis. For the avoidance of doubt, we still believe that it will be a very significant step by employers to support the changes sought, even for a moratorium period at least initially, and whilst we cannot guarantee their support, we will do our very best to build an appropriate consensus and believe we will have a chance of doing so.
- (10) Clearly further work will need to be undertaken, and indeed a fuller definition of the moratorium provisions and how they would conclude will need to be decided on to give it legal form and effect. We have not inserted any of those further details into this note at this stage, in the hope that agreement can be reached on the broader approach.
- (11) We believe that the moratorium approach is the best formulation to meet the trustee's concerns at this time, whilst also allowing an appropriate communications plan to be developed and delivered, and also allowing employers time and space to understand the rationale for the changes, to consider the proposed changes, and to debate the issues more fully. We were particularly grateful to hear the presentation from Jeff Rowney and colleagues from PwC to a recent meeting of the Employers Pensions Forum and, for example, we would welcome similar engagement with employers more widely during the period of moratorium. Crucially, we need to allow senior / governing bodies a full opportunity to consider the proposals in good time. Without this moratorium, we believe there may be difficulties, potentially insurmountable, in securing support for the rule changes sought by the trustee, and therefore putting at risk what we believe can be an effective outcome to the 2018 valuation.



Dear Alistair

2018 valuation – employer covenant

Thank you for your letter of 6 June, confirming the clear preference of employers to pursue Option 3 as the route to concluding the 2018 valuation, and for your subsequent letter of 19 June in relation to the rule changes and other requirements associated with the completion of the 2018 valuation. The Trustee Board, at its meeting on 20 June, considered your without-prejudice proposal for a moratorium on employers exiting USS without the trustee's consent whilst steps are taken to build consensus for a permanent rule change and its views are summarised below.

The board considered UUK's view that allowing an interim approach to employer exits would enable UUK, with the support of the trustee, to better communicate the proposals (both in respect to the rule change, *pani passu* status on new secured debt, and debt monitoring). Further, the interim approach provides more time for employers to build understanding and consensus within their senior staff and governance committees and would allow employers to develop more informed views. This in turn will allow UUK to build consensus on support for the introduction of the required rule changes.

The trustee board recognised the challenging timeframes under which employers are being asked to consider proposals and acknowledged the good faith with which this alternative proposal was being put forward by UUK, and the commitment to work with the employers to secure commitment to the longer-term rule amendments.

After consideration, the trustee board agreed in principle that it would be prepared to accept an interim proposal along the lines put forward in your letter if UUK made it formally, through the JNC. Such acceptance, however, would be on the basis that the proposed 'moratorium' would apply until the 2020 actuarial valuation is completed (through the signing of the Schedule of Contributions), unless the permanent rule amendment is completed and executed by some earlier date. For the avoidance of doubt the trustee expects the rule change to be implemented in advance of the valuation being completed so that it can be reflected in the consideration of a 2020 valuation.

The board also considered the recovery plan for the 2018 valuation at the meeting, and is writing to you separately regarding this matter.

The board will meet to reach its final position in relation to the 2018 valuation, including finalising its views on the recovery plan, at its meeting on 17 July, and ahead of the JNC on 24 July. It will therefore require a formal proposal in relation to a 'moratorium' approach, reflecting the timescale above, alongside a firm commitment to meet the trustee's requirements around debt-monitoring and *pani passu* arrangements, to be received prior to that meeting. As part of that proposal the board would also expect to see formal confirmation that UUK will immediately commence work with employers in relation to the permanent rule change.

To support UUK's engagement with employers on these matters, the trustee is providing an accompanying explanatory note "Protecting the employer covenant", which provides more context on the rationale for the proposals for supporting and protecting the covenant.

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The USS team and I will continue to provide support and assistance to you and your team in the coming weeks as you contact employers to seek agreement to the proposal. Thank you also for the positive feedback on the discussions between the executive, PWC and the representatives of the Employers Pensions Forum. We are of course very happy to continue to facilitate such discussions to assist employers in forming their views.

Finally, it would be useful if UUK would confirm as soon as possible how they would prefer to see the provisions around such a moratorium to be structured in the Rules i.e. does UUK envisage that the moratorium is documented as a separate standalone clause with its own sunset mechanic or as amendments to the existing employer exit provisions (as USS had initially envisaged)? It would perhaps be most expedient if your officials could speak directly with the executive on this so that the drafting can be progressed as soon as possible.

Yours sincerely

Bill Galvin

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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 *pani 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.

Universities Superannuation Scheme (USS)

Date: 3 July 2019

Prepared for: Universities UK

Prepared by: John Coulthard FIA
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USS – Debt monitoring and *Pari passu* request

Introduction

Based on Bill Galvin's [letter](#) of 26 June 2019, Option 3 would be acceptable to the USS Trustee subject to:

- ☐ Receiving a formal proposal on a “moratorium” approach for the Rule Change.
- ☐ A firm commitment to meet the trustee's requirements around debt monitoring and for USS to receive *pari passu* (equal ranking) protection where secured debt is issued.

We set out our thoughts on the second bullet. The first bullet is covered in a separate note by Eversheds Sutherland (International) LLP.

Option 3 – recap

As a reminder, Option 3 requires the following contributions:

	Employer ⁽¹⁾	Member ⁽¹⁾	Total
1 April 2018 to 31 March 2019	18%	8%	26%
1 April 2019 to 30 September 2019	19.5%	8.8%	28.3%
1 October 2019 ⁽²⁾ to 30 September 2021	21.1%	9.6%	30.7%
1 October 2021 onwards ⁽³⁾	23.7%	11%	34.7%

Notes:

(1) Employer and member figures assume 65:35 cost-sharing adopted to increases from 1 April 2019.

(2) This assumes the 2018 valuation is completed by the payroll cut-off date of 31 August 2018 (the date advised by the USS Trustee).

(3) The length of the recovery plan will be confirmed by the USS Trustee when it provides the proposed recovery plan. Assuming the deficit to be corrected is £2.2Bn, the recovery plan could be quite short.

As explained in our 14 May [note](#), Option 3 is reasonably close to the JEP recommendation. If the USS Trustee does not receive sufficient comfort on its additional asks, then the likely outcome is Option 1 – i.e. employer (employee) contributions of 22.5% (10.4%) from 1 October 2019.

Debt monitoring process

The USS Trustee has expanded on its request for an annual attestation process in section 2.4 of this [note](#). In short, the USS Trustee will contact employers once a year and ask for the latest positions on their levels of debt and security granted to other parties. These will be evaluated against some covenant metrics to determine whether the USS Trustee has any further questions.

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In our view, many employers may be comfortable giving this information to the USS Trustee provided that the requests are proportionate and do not lead to unnecessary discussions. Some employers may already provide similar information to other schemes they sponsor. In addition, employers have a legal requirement to provide information that the USS Trustee reasonably requires.

We would suggest that, before this is implemented, the USS Trustee should provide further colour on the circumstances where the USS Trustee will determine it has further questions, and what would then happen. This should form part of the joint USS / employers working group mentioned below. The information requested could also be tested against any evolving OfS requirements on debt reporting.

Assuming the debt monitoring process is put in place, we suggest that UUK collects information from employers in future about how the process has worked for them – with a view to refining the process and ensuring it is not disruptive and that it avoids unnecessary costs.

***Pani passu* request**

The USS Trustee has expanded on its request for the granting of *pani passu* security in section 2.4 of this [note](#).

The USS Trustee will be seeking assurances that employers do not take on new secured debt with a superior priority to the USS. We understand from PwC's presentation to the EPF that this would mean granting *pani passu* security at the section 75 debt (i.e. an institution's share of the buyout deficit). Furthermore, the USS Trustee expects to be made aware of any employer's intentions to seek secured debt at an early stage and to be kept abreast of the ongoing process, and for the potential lender to be made aware of the employer's obligations to the USS early in the process.

We set out our comments below.

Potential advantages:

- ☐ The proposal requires the USS Trustee's creditor position to be elevated from unsecured creditor for any employers that issue new secured debt going forward. However, most of the debt raised by institutions so far has been unsecured, so many may not see this as an issue, or it would be outweighed by the lower contributions this enables in the short term. This may be especially true for the stronger employers that underwrite most of the USS liabilities.
- ☐ Trustee boards are being increasingly directed by the Pensions Regulator to ensure that they are treated equitably compared with other stakeholders. The proposed approach makes it more credible for the USS Trustee to continue with a "strong" covenant rating and for this to be robust over time. We believe that a strong rating is in the employers' (and members') best interests.
- ☐ The *pani passu* requirement may help reduce the cross-subsidy risk (i.e. protecting individual employers from the insolvencies of others), by increasing the recoveries available to USS in event of an individual institution's default and by strengthening its negotiating position during insolvency proceedings to the benefit of other employers.
- ☐ The USS Trustee has not set out full details, requiring only a firm commitment at this stage, which paves the way for the important details to be discussed by a joint USS / employer working group as suggested by UUK.

- The solution appears relatively straightforward (in concept at least) – the USS Trustee is not proposing any constraints or arbitrary limits on debt levels.

Some issues to work through in due course:

- We expect that most institutions will want to know their share of the section 75 debt, as calculated by the USS Trustee, with appropriate updates of how this amount changes over time.
- For institutions that are planning to issue secured debt, it may now be more expensive as the potential recovery in an insolvency may be lower for the lender. In particular, the section 75 debt commitment may far exceed the amount of borrowing the employer is seeking. Any increased cost of borrowing would need to be outweighed by the benefits of a lower contribution rate in the shorter term.
- The request for lenders to be notified of the USS Trustee's requirements is likely to make discussions more complicated, and may lead some lenders to decide not to offer secured debt.
- We think there is a need to engage further with the USS Trustee on the issue of a limit on the amount of security given *pari passu* status when secured borrowing takes place, in particular in the situation where employers with a large section 75 debt take on a much lower level of secured borrowing. We think it inappropriate that any arrangements lead to the potential recoveries in an insolvency scenario being materially higher for the USS compared with the position before secured debt was issued.
- Some lenders require security, not because of the potential value it will provide in an insolvency, but to give them greater control (i.e. voting rights) over any debt restructuring. Granting the USS Trustee *pari passu* security may make it difficult for banks to achieve this protection, again potentially increasing borrowing costs.
- Institutions that have already issued long term secured debt are now in a potentially advantaged position compared to those who do so in the future. Although if such institutions need to refinance their debt, they would be covered by the proposed requirements.
- For some "weaker" institutions, it could become difficult to raise funding, either on the public markets or from a bank or private institution. These lenders may only be willing to lend if they have first charge over assets, and are unlikely to be willing to accept USS as ranking *pari passu*.
- Other unsecured creditors will be at a disadvantage under this arrangement. This includes other defined benefit pension schemes such as the SATS for non-academic staff. This arrangement will potentially weaken the other schemes' employer covenant, and similar issues may surface from the trustees of these schemes. However, as a balancing comment, some employers already have given contingent assets to other schemes they sponsor, which may disadvantage USS absent its own contingent asset arrangements.
- There is merit in having a *de-minimis* level for small level secured borrowing (e.g. lease financing, or relatively small loans). We would expect employers to comment on this as part of the UUK consultation.

- ☐ How will project financing be treated? Lenders can require security against assets under construction during the build phase. If this is only over new assets, then there is a case for exempting this from the USS *pari passu* requirement. Further considerations may also be needed for joint ventures, where security is a fixed charge, where new security is offered to other schemes, and more generally where the legal entity borrowing is different to the participating employers.
 - ☐ What is the time-period of the proposed security? Presumably it would be aligned to the time period of any new security granted (rather than permanent security for the USS Trustee), and this is another detail to be clarified.
 - ☐ How is the whole approach documented?
-

Conclusion

There are clearly a lot of detail issues to work through in due course. Individual employers may well have additional issues to consider that are not raised in this report, as their circumstances are so varied, and individual employers should be consulted once the details are clear.

At this stage we would suggest that, at best, employers will be able to provide “agreement in principle” to the USS Trustee’s proposals, subject to the practicalities being worked through so that employers can consider fully the detail of the proposed implementation. We agree with the UUK consultation document that potentially a joint USS / employer working group should be established involving institutions’ finance directors and other specialists from the sector.

Compliance

The advice in this report and the work relating to it complies with ‘Technical Actuarial Standard 100: Principles for Technical Actuarial Work’ (‘TAS 100’) and ‘Technical Actuarial Standard 300: Pensions’ (‘TAS 300’). We have been asked by UUK to set out our comments on the Trustee’s proposals in our role as actuarial adviser to UUK for the 31 March 2018 actuarial valuation.

Privileged and confidential

Universities UK

Advice Note for employers on USS Proposals



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Advice Note for employers on USS Proposals

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1. **Background**

- 1.1 Unless and until the 2018 valuation of the USS is finalised, the contribution changes previously announced under the 2017 valuation will be applied. As part of the 2018 valuation process, the Trustee has put forward three options:

Option 1 - 33.7% fixed rate and reviewed in 2021/22

- 1.2 This is the rate the Trustee would require in the absence of sufficiently strong contingent contribution arrangements. In the event that the Joint Negotiating Committee (JNC) could not decide on an alternative approach, the default cost-sharing rule would see members paying 10.7% of salary and employers paying 23% from 1 April 2020. The next scheduled valuation would be as at 31 March 2021 (the outcome of which would be expected in 2022).

Option 2 - 29.7% increasing in certain conditions and reviewed in 21/22

- 1.3 If sufficiently strong contingent contribution arrangements can be agreed, members would pay 9.3% of salary under the cost-sharing rule and employers would pay 20.4%. Contingent contributions could be triggered in certain conditions. The next scheduled valuation would be as at 31 March 2021.

Option 3 - 30.7% fixed rate until October 2021 and reviewed in 20/21

- 1.4 This rate could be applied as an alternative to contingent contributions but is subject to a valuation in 2020 – a year earlier than scheduled. Under cost-sharing, members would pay 9.6% of salary and employers 21.1% until October 2021. If the contribution rate arising from a 2020 valuation cannot be agreed and implemented before 1 October 2021, the rate would then rise to 34.7%.

Advice Note for employers on USS Proposals

2. Option 3 Conditions

- 2.1 UUK has received an indicative preference from employers representing a significant number of the active membership to further explore Option 3 with the Trustee.
- 2.2 As part of Option 3, the Trustee is proposing a package of measures designed to address the key areas identified by PwC, its covenant advisers. The purpose of these measures is to ensure the covenant standing behind the USS is protected in the longer term, and will have an immediate effect of ensuring the current covenant rating of “strong” for the 2018 valuation.
- 2.3 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 (and, it is indicated, the contribution levels set out in section 1 of this note) if the measures are not agreed. 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.
- 2.4 The Option 3 measures include:
 - 2.4.1 *pari passu* security for the USS in relation to secured debt being taken on by employers;
 - 2.4.2 the introduction of a framework to monitor employers’ debt levels; and
 - 2.4.3 an amendment to the scheme rules which it is stated would “clarify and strengthen” the Trustee’s discretionary powers on employer withdrawal from the USS.
- 2.5 UUK wrote to the Trustee on 19 June 2019 raising the challenging timeframes under which employers are being asked to consider the proposals and therefore put forward an alternative proposal of a ‘moratorium’ on employers exiting the USS without the Trustee’s consent. This would give greater time for the employers to consider the suggested permanent rule amendments in more detail so that UUK can receive greater consensus from employers on long-term changes.
- 2.6 After consideration, the Trustee has agreed in principle that it would be prepared to accept an interim moratorium proposal on the basis it would apply until the 2020 actuarial valuation is completed (through the signing of the new Schedule of Contributions), unless the permanent rule amendment is completed and executed before this date. The Trustee expects the rule change to be implemented in advance of the valuation being completed so that it can be reflected in the consideration of a 2020 valuation.
- 2.7 It is not clear if the USS is intending for the permanent Rule amendments to be effective as soon as the moratorium ends or whether there will be a window of opportunity for employers to potentially exit the USS, without requiring the consent of the Trustee, before any final Rule amendments are introduced.

Advice Note for employers on USS Proposals

3. **Introducing the Moratorium**

3.1 Whilst we understand that UUK would like to keep open the option of agreeing the moratorium in some form of legal agreement (like the 2015 contributions letter), in reality a formal rule amendment appears to be the only way to make the moratorium legally binding.

3.2 It is unclear whether the Trustee has the unilateral power under the existing Rules to prevent an employer from becoming a withdrawing institution and triggering its Section 75 debt. In particular under the proviso (B) within the "withdrawing institution" definition states:

"if at any time it appears to the trustee company that the fulfilment by the institution of the conditions in any of paragraphs (a) to (h) above has not resulted, and is unlikely to result, in the occurrence in relation to that institution of a "relevant event" (as defined in (A) above), it may treat any such conditions as not having been so fulfilled."

3.3 If the Trustee is to have a permanent power to prevent an employer from becoming a withdrawing institution without its consent then there should be an amendment to the Rules to clarify this.

3.4 A moratorium would therefore be an interim measure to stop employers from leaving the USS for a limited period.

3.5 The Trustee has already asked UUK to confirm as soon as possible how it would prefer to see the moratorium structured in the Rules. This suggests the Trustee also believes that a Rule amendment is necessary to introduce a moratorium. They refer to a separate standalone clause with its own sunset mechanic or amendments to the existing employer exit provisions.

Advice Note for employers on USS Proposals

4. Rule Amendment

- 4.1 A separate standalone clause with its own sunset mechanic inserted as part of Rule 46 or new Rule 46A would be the most straightforward way of introducing the moratorium by effectively freezing the “withdrawing institution” provisions (without Trustee consent) for an interim period.
- 4.2 In terms of the sequencing of the amendment process, the Trustee has suggested that UUK proposes the necessary amendments to the JNC.
- 4.3 Under Rule 64.1, one of the functions of the JNC is to initiate or consider amendments to the Rules. Rule 79.7 gives the JNC the specific power to recommend Rule amendments to the Trustee. This power sits with the JNC as a whole and not with any individual members of the JNC such as the UUK appointees.
- 4.4 It should be noted that any proposals whether for an interim moratorium or for permanent rule changes to give the Trustee a power to stop employers from becoming withdrawing institutions and/or extending employer contribution rules to allow the Trustee to seek further employer contributions after a Section 75 debt has been paid, would be significant rule amendments which would fundamentally change the employers’ position within the USS and grant the Trustee with more explicit and potentially new powers.
- 4.5 Whilst few USS employers may actually have the financial ability to exit the USS, the impact of the proposals on any employers who may be considering this option should still be considered.
- 4.6 In order to take a proposal for the approval of the JNC, the UUK appointees would ideally have a strong mandate from the employers which has been given from an informed position. In practice, this would come through engagement with employers undertaken by UUK.
- 4.7 Given the number of employers in the USS, it seems highly unlikely that unanimous support would ever be provided for such proposals. However, the JNC members would be able to take into account the extent of the consensus which exists across the USS employers, for example in terms of employer numbers and also liability share, for a particular view or proposal.
- 4.8 Where the JNC recommends to the Trustee any amendment of the Rules under Rule 79.7, the Trustee shall, in accordance with that Rule, take steps to implement the recommendation, unless it appears to the Trustee, acting on actuarial advice, to breach any of the caveats to that Sub-Rule.
- 4.9 In particular, these caveats include any amendment which impose any unfair liability upon any one or more of the institutions or upon the Trustee or is undesirable for any other reason which the Trustee notifies in writing to the JNC. We understand that the Trustee is unlikely to raise any issue with such a recommendation from the JNC.

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Joint Expert Panel (JEP) on the Universities Superannuation Scheme – focus group consultations

Introduction

The JEP has commissioned a research project to find out more about USS members' views with the work to be conducted for the JEP and its two sponsors: Universities UK (UUK) and the Universities and College Union (UCU). The results of this research will provide the JEP with a more informed view of the needs of scheme members and non-members and will help the JEP meet its objective to secure the long-term sustainability of the scheme.

The brief from the JEP is that we should try to get about half of participants to be union members. (They also want an age and gender mix).

An external company, Ignition House have been commissioned will run a couple of focus groups in Oxford on 15th July. Alan Cunningham has written to a random selection of departments and individual members to invite them to attend.

Details of Sessions

The group sessions will be held with around with around 8-10 members each and will last 2 hours.

It is intended the sessions will reflect a broad spectrum of membership, and particularly if we can hear the voices of members who are less engaged with their pensions and are therefore unlikely to have made their views known to the JEP through other channels. Ideally looking for groups to contain:

- One, but no more than two, non-UK nationals
- Approximately half to be union members, half to be non-members (where possible and applicable)
- A roughly 50/50 gender split
- 6 to self-report low to medium knowledge of pensions/retirement planning generally. I have provided a set of questions at the end of this email for you to use if you so wish to help you identify levels of interest.
- No more than 2 to self-report taking an active interest in influencing the future of the USS scheme. Again, I have provided a set of questions at the end of this email for you to use if you so wish to help you identify this.
- A rough 50/50 split between academic and non-academic staff

In addition ideally it was intended to exclude current or past USS trustees, union representatives and those that have participated in past working groups, pensions forums or negotiating committees and those who have an academic interest in the area, although one or two exceptions could be made.

A £30 M&S voucher has been offered to encourage participation

It is intended to audio and video record the session for later review. Small video clips will be used as part of the final presentation to the Joint Expert Panel in August.

David Cook
The Pensions Office

UCU DISPUTE UPDATES – 28 JUNE & 1 JULY 2019

RESPONSE POINTS FOR USS EMPLOYERS

Is it true that employers have not challenged the USS Trustee to implement the JEP's first report, and are refusing to hold the USS Trustee to account?

It would be entirely inaccurate to suggest that.

Over the course of many meetings, many emails, and many phone calls, Universities UK (UUK) has, on behalf of employers, continuously pushed the USS Trustee to incorporate the Joint Expert Panel's (JEP) first set of recommendations.

Employers have also regularly questioned senior members of the USS executive over their response to the JEP's recommendations, and made clear the need for better information to understand some of the decisions the Trustee has made during this valuation, including on the level of deficit recovery contributions. These views have been expressed by employers through various consultation responses, summaries of which have been published online and formally sent to the USS Trustee by UUK.

UUK has invested considerable time and resource to develop a credible contingent contributions proposal that employers could support, in order to try and convince the USS Trustee to agree to set contributions at the 'lower bookend' of 29.7%. Although the Trustee did not accept the proposal, they subsequently put forward Option 3 in response to the pressure applied by UUK and individual employers. Option 3 adopts the majority of the JEP recommendations and – as this Aon advice note explains – provides a solution to the 2018 valuation that is 'largely in line' with what the JEP recommended.

The Trustee has also agreed to UUK's recent proposal for a moratorium on employers leaving the scheme, instead of a change to the scheme rules that they had initially stipulated was required for concluding the valuation under Option 3.

Following this work by employers to influence the USS Trustee since the publication of the JEP's first report, a solution is now within reach that requires total contributions of 30.7% of salary, as opposed to 35.6% filed under the 2017 valuation. That is a great deal of movement and much of it is down to the pressure applied by UUK, and the Trustee's positive engagement with the JEP's recommendations.

If the full JEP is not implemented, UCU want employers ‘to meet the full cost of contribution increases above the rate of 26%, rather than forcing some of them on to members.’ Is that possible, or fair?

Since the Joint Negotiating Committee (JNC) was unable to decide how to conclude the 2017 valuation, the scheme’s default position of sharing the cost of contributions increases 35:65 between scheme members and employers was enacted. The 2017 valuation documentation – including the schedule of contributions – was subsequently filed with The Pensions Regulator and cannot now be altered.

A decision on how any contributions increases arising from the 2018 should be met is a matter for the JNC, but scheme members should note that the Committee will first need to decide how to conclude the valuation. While employers have indicatively expressed support for Option 3, UCU have not, to date, indicated support for any of the options proposed by the USS Trustee.

By supporting Option 3, employers are committing to increase their contributions from 18% to 21.1% of salary – equating to an extra £250 million per annum over the next two years, and 65% of the overall increase required by the USS Trustee. For many employers this level of contribution is already beyond what is considered sustainable, but it has been agreed to in response to the clear view expressed by UCU that maintaining the current level of benefits is the priority.

In light of this commitment to maintain existing benefits, it is reasonable to ask employees to bear 35% of the increasing costs (equating to an additional 1.6%; 0.8% on current rates – before tax relief). Employers appreciate that the cost of the scheme is increasing for members (and is indeed higher than many employees would choose to pay), but to date UCU has not been prepared to discuss reforms that might suit those members who would prefer to pay less for a different level of benefit.

Without a decision, it is highly likely that the USS Trustee will opt to conclude the valuation under Option 1, with a contribution rate of *at least* 33.7% of salary. The scheme’s default cost sharing provisions would then apply, resulting in rates of 10.7% of salary for members, and 23% for employers. Preventing this scenario is one of UUK’s highest priorities.

What are the latest developments regarding the allegations made by Professor Jane Hutton?

UUK understands that ongoing investigative work is examining the allegations made by Professor Jane Hutton, a USS board director.

Separately, we understand that a decision to suspend Professor Hutton was taken unanimously by the USS Trustee board – which has other UCU-nominated directors – pending the outcome of a ‘separate, independent investigation into her conduct over an extended period of time.’

Without the full details of either investigation it is difficult to comment further, and doing so publicly may prejudice the investigations taking place. UUK has asked The Pensions Regulator and the USS Trustee to keep us updated on these investigations.

USS refused to implement JEP 1; why are employers confident that they will pay heed to JEP 2?

It is not the case that the USS Trustee refused to implement the JEP's first report. In their view, five out of the seven recommendations have been fully or partly incorporated into the 2018 valuation. The Trustee subsequently clarified their reasons for not adopting all the recommendations, but in proposing Option 3 put forward an alternative solution that is 'largely in line' with what the JEP recommended.

UUK and UCU will need to work together to consider and assess the JEP's next set of recommendations, and agree proposals on governance reforms and the 2020 valuation. By working together, employers and UCU will be able to have a significant influence over the future of the scheme, and ensure that the USS Trustee further engages with the JEP's recommendations.

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