USS
UNIVERSITIES SUPERANNUATION SCHEME LIMITED

NOTE: This consultation document was first circulated to stakeholders in September 2016 as part of the Trustee's preparations for the 2017 valuation.

In December 2017, a formal actuarial report was submitted to the Joint Negotiating Committee. This report set out the Trustee's conclusions on the scheme's funding position (based on the existing level of scheme benefits).

Covenant Review for the 2017 Valuation

Summary of Initial Conclusions for

Consultation with Sponsoring Employers

Summary

This document sets out the trustee's initial conclusions from its review of the employer covenant, that is, the degree of financial support available from employers for the scheme. This review involved a comprehensive analysis of the higher education market, both global and domestic, the key economic, social, political and competitive trends impacting the market, and the ability of the scheme's sponsoring employers to continue to prosper within it. This analysis draws on data collected from the inputs you provided to the covenant questionnaire issued in May, combined with the data we have gathered from the Higher Education Funding Councils (HEFC) and the Higher Education Statistics Agency (HESA).

The trustee welcomes comments from sponsoring employers on the process and conclusions set out in this document by 27 October 2016. If you have any feedback please send to [redacted] so that Universities UK, as the employer representative identified within the scheme rules, can compile a sector-wide response. Please feel free to copy your response to USS at [redacted].

1. Introduction

This document describes the trustee's review of the employers' covenant that was recently undertaken for the 2017 actuarial valuation. The covenant is of particular importance to the funding of the Defined Benefit (DB) section of the scheme, the USS Retirement Income Builder. Given this importance, we begin with a recap of the role the covenant plays in underpinning the valuation, and describe in some detail the work that was carried out to reach the initial conclusions described below.

The document contains the following sections:

- Purpose of covenant review;
- Scope of the covenant review;
- Work undertaken for the covenant review;
- High-level conclusions.

2. Purpose of the covenant review

The covenant of the scheme's sponsoring employers is fundamental to the funding of the scheme, it is the foundation on which the valuation is built. The covenant reflects the degree to which sponsor support can be relied upon to fund the scheme and pay future pensions. This support reflects the ability and willingness of sponsors to make contributions into the scheme not only on a regular, planned basis, but also on a contingent basis should certain adverse events materialise

Understanding the covenant and deciding how much reliance can be placed on the covenant of the sponsoring employers is the first step in the valuation process. Broadly speaking, the stronger the employer covenant, the more risk can be taken in the funding of the scheme: for example, in the investment strategy, or in the level at which technical provisions are set.

Simplistically, a scheme where there is no significant covenant (i.e., the sponsor cannot be relied upon to fund the deficit) would require sufficient funds to meet all future benefit payments with a high degree of certainty and low investment risk (known as the 'self-sufficiency' position). Where there is a substantial covenant, the assets held (or more exactly the assets targeted to be held equal to the technical provisions) can be lower than those needed to be self-sufficient – as was the case at the time of the 2014 valuation.

A strong covenant allows a scheme to take more risk and hold less assets, leading to a lower level of technical provisions than would otherwise be the case. The weaker the covenant the higher the technical provisions need to be, as the scheme needs to be closer to being self-sufficient.

When forming a view of the covenant provided to the scheme by the sponsoring employers, consideration is given to:

- The ability of the sponsoring employers collectively to make the necessary contributions to the scheme measured by tests of the future financial performance, free cash flow and robustness (affordability);
- The time horizon over which there is good visibility of the employers' ability to support the scheme. We call this the "covenant horizon";
- The assets that might be available to the scheme that are held by the sponsoring employers;
- The willingness of sponsoring employers to support the scheme, now and in the future; and
- How the covenant is expected to develop over time.

In practice there is no single answer to the each of these questions. For example, the question of affordability involves a trade-off for both the employers and the trustee. As the contribution required of employers increases, there comes a point beyond which their plans for future investment (in new facilities and infrastructure) must be curtailed and/or the financial flexibility necessary to help them weather a downturn in fortunes is significantly reduced. At this point the size of contributions begins to weaken the covenant, particularly if the covenant horizon is long. Of course there is not a sharp transition point at which this happens and therefore the answer to the question of what level of contributions can be sustained is actually a range. At the start of the range there is little or no impact on future investment plans and at the end of the range all but the most important strategic projects may be curtailed.

It is important also to note that different employers have different risk absorbing capacities. The trustee's judgement is required to set an overall risk budget that is not determined by the risk capacity of the weakest employers, but on an aggregate assessment of the employers' collective ability to support risk. This may lead to some weaker employers bearing (and benefiting from) more risk than they might be able to do independently. This is a key feature of the mutualisation of risk in the scheme.

The covenant review is intended to establish the capacity of employers to collectively support the scheme. This will inform the trustee's consideration of the **maximum** amount of risk that they could consider taking, confident that the sponsoring employers could, if necessary, make good any funding shortfall that might result from assumptions that proved inadequate to meet the scheme liabilities. The question as to how much of this capacity should be relied upon in the funding arrangements of the scheme is a separate matter for a subsequent discussion with the employers.

3. Scope of the covenant review

The nature of the covenant review undertaken by the trustee for the 2017 valuation is very different from that undertaken for the 2014 valuation, building upon and significantly extending that work. This was possible for several reasons, in particular:

- USS now has internal expertise in its Group Risk team, which led the covenant review project;
- USS has put in place a detailed covenant monitoring framework, which has embedded into risk reporting much of the work carried out last time by the external advisor (specifically the deep dive into the detailed financial situation of individual employer institutions);
- The financial and operational data upon which the covenant assessment is made is much better understood.

This has allowed USS to build on the solid foundation of the previous covenant review with a more strategic and collaborative approach for the 2017 valuation. As such, for the 2017 valuation, the trustee focused the covenant review work not just on evaluating current affordability, but also on developing a deeper understanding of how sponsoring employers would be affected by, and react to, potential future changes in the economic, social, political and competitive environment in which they operate. The focus of the review was on the ability, rather than the willingness, of employers to support the scheme.

The trustee engaged PwC to be the lead covenant advisor and EY Parthenon, a specialist consultant to the higher education sector, to work with its Group Risk team on the review. This combination brought together different complementary skillsets to work on the project in three key workstreams involving the development of long-term economic scenarios, analysis of the global market for higher education and finally evaluation of the covenant (see Figure 1).

Figure 1. The key workstreams of the covenant review for the 2017 valuation.

Future economic environment	• Scenarios and context in which the sector will operate • Medium- and long-term focus
Higher education sector dynamics	• Strengths, weaknesses, opportunities and threats • Ability and flexibility of employers to respond
Ability of employers to support scheme	• Customised segmentation of the sponsoring employers • Assessment of 8 segments and the sector overall • Regular contributions and contingent support

4. Work undertaken on the covenant review

The covenant review process is summarised in Figure 2, which illustrates how the three workstreams are interlinked and the role of each of the trustee's advisors in supporting the review. Specifically, the workstreams involved:

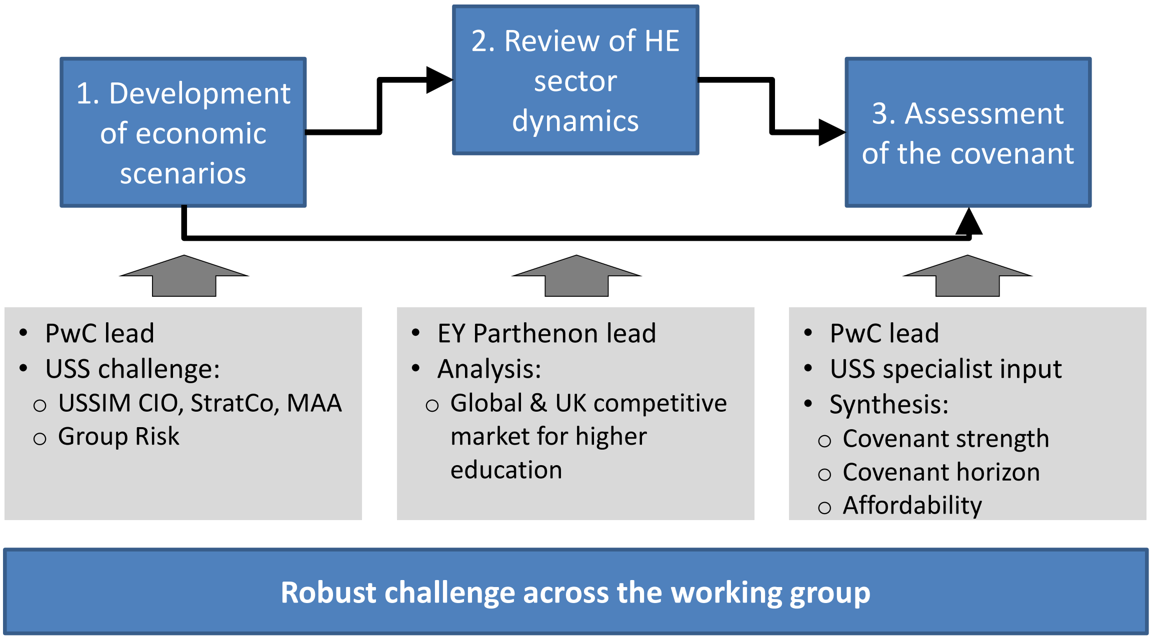
i. Development of scenarios for the future economic environment. These form the backdrop against which the sponsoring employers will be operating and the pension scheme investing;
ii. Analysis of the dynamics of the market for higher education both domestically and globally. This provides an assessment of supply and demand, the current competitive landscape, as well as the future trends, challenges and potential evolution of the industry. It also assesses the current positioning of employers, as higher education institutions, in terms of their strengths and weaknesses relative to competitors from abroad and the private sector. An important output from this stage is an assessment of the sponsoring employers' ability to respond to threats and unanticipated developments;
iii. Evaluation of the sponsoring employers' ability to support the scheme. This involved a detailed analysis of the ability of UK higher education institutions generally, and specifically sponsoring employers, to flourish in the higher education marketplace and deliver strong financial performance to support the scheme.

The latter two stages of the review were informed by data from funding bodies, questionnaire responses, interviews with employers and the trustee's knowledge of the nature of the covenant.

More specifically, the data sources were:

- HESA published financial data for 2015;
- HEFCE data modified for USS requirements on customised segmentation of the sector;
- Replies to a questionnaire issued by USS to employers covered in the HESA data: 116 replies were received, including 42 from the 50 top-ranked HE employers (according to The Times HE ranking);
- Output from interview meetings with 18 individuals from employers across the sector;
- Output from three group meetings with representatives of other employers.

Figure 2. The covenant review process



The data on the sector were analysed at three different levels: at the level of the sponsoring employers as a whole, at the segment level and at the individual level for the key institutions. The segment-level analysis reflected a customised segmentation of employers which grouped together institutions with similar characteristics from a covenant perspective. These segments are listed in Appendix A.

The analysis also considered the impact of seven different developments that might threaten the strength of the covenant, in particular:

- Privatisation and new competition;
- Growth of apprenticeships;
- Changes to immigration rules and the impact on the numbers of international students;
- Research consolidation;
- Growth of on-line education;
- The UK government's Teaching Excellence Framework;
- The student loan book.

A summary of the key contributions to the project from the different members of the project working group is provided in Appendix B. Throughout the process there has been robust challenge across all the members of the working group.

5. High-level conclusions

The key conclusions from the review of the covenant provided by the sponsoring employers are summarised in the following four points:

1. ***The covenant is uniquely robust***
   The covenant is very different from that of a typical commercial corporation. This is for many different reasons, including but not restricted to the following. First, UK higher education institutions have far greater international brand recognition than UK corporations. Their performance objectives are also very different, being not profit-oriented and with a much longer term horizon. The crystallisation of any potential insolvency event will be very different from a corporate insolvency. Sponsoring employers face "right-way risk" in relation to the covenant, meaning that because contributions scale with the size of the payroll, the burden on employers that are forced to contract their operations diminishes over time. Moreover, the mutuality of the covenant means that the scheme is supported by a large number of diverse institutions, a significant proportion of which have strong covenants on an individual basis.

2. ***The covenant strength is rated "strong"***
   This is the highest possible covenant rating. The UK higher education sector, with its strong international brand, is well placed to exploit positive market dynamics with global demand expected to outstrip supply over the long term. The sponsoring employers collectively are in a strong financial position, with a large balance sheet relative to the self-sufficiency liability, even in a stressed market. Threats from different sources (such as the growth of on-line learning, new entrants into the higher education market, the developing reputation of overseas universities, the growth of apprenticeships, changes to immigration policy, research consolidation, etc.) are expected to have a relatively limited impact on the sector as a whole, although particular employers may be vulnerable. The outcome of the EU referendum (Brexit) is expected to have a minimal impact, especially over the medium-to-long term. Employers have diversified sources of funding and an established track record in managing costs to revenues, even in difficult times.

3. ***The covenant horizon is at least 30 years***
   The time period over which there is visibility of the continued strength of the covenant is at least 30 years. This is supported by global and domestic demographic projections, the projected growth of global demand, the time required for new competitor institutions to develop the reputation necessary to compete effectively on the international stage, and the UK sector's historical record of resilience going back hundreds of years. Moreover, the market view of university credit ratings is strong over the long term, with several having high long-term credit ratings and some having issued 50-year unsecured debt.

4. ***Employers have the ability to increase contributions***
   Any increase in contributions would be more manageable if implemented over a two-to-four year period. Most employers could afford an increase in contributions from the current 18% of pensionable salary to 21%, albeit not without changes to business plans and/or prioritisation of pension contributions. Many would also be able to afford up to 25%; however, coming at a time when many employers are trying to increase investment and offset falling grant funding, this would impact investment opportunities to varying degrees and require significant strategic change. It is important to emphasise that this affordability analysis reflects

the assessment of the sponsoring employers' ability to pay increased contributions, not the willingness to make the required trade-offs to do so.

Finally, there are two issues that emerged in the covenant review in the context of risk management. The first of these relates to contingent assets. The use of contingent assets as a potential method of allowing the trustee to take more risk has been raised with several employers. Whilst acknowledging that the provision of contingent assets is possible, there is a general reluctance to do so. Furthermore there are challenges in terms of implementation.

The second issue concerns a specific medium-to-long term risk to the covenant. Future large-scale debt issuance by employers, if not used for revenue increasing investment, could lead to a weakening of the covenant provided to the scheme. In order to protect the scheme's position, the trustee will be monitoring the debt position of employers and would like to consider the possibility of a package of measures to ensure that the covenant is not weakened by excessive debt. This may include, for example, a limit on leverage measured by the ratio of debt to EBITDA.

6. Next Steps

The trustee would welcome your comments by 27 October 2016 on the conclusions which have been drawn from the work that has been undertaken.

Any comments received will be considered by trustee at the November board meeting as part of finalising the trustee's view of covenant for the 2017 valuation. Once this has been finalised, it will be used to inform the tests and the parameters for determining the amount of risk which the trustee is able to accept in funding the scheme's benefits and used as an input for determining the assumptions for the valuation.

Appendix A: The customised segmentation of the sector used to inform the covenant analysis.

Higher Education Segment	Segment Definition	Liability Share of USS
Broad-based Research	UK universities with research focus	54%
“Cusp” University	Universities with mid-ranked research and significant vocational enrolments	18%
Scotland Research	Scottish universities with research focus	12%
Specialist Teaching	Niche institutions with teaching focus	4%
Teaching University – International	Universities with majority vocational enrolments / income from tuition and large numbers of international students	4%
Teaching University	Universities with majority vocational enrolments / income from tuition	2%
Specialist Research	Niche subject institutions with research focus	2%
Scotland Teaching	Scottish universities with teaching focus	<1%

Appendix B: The contribution from each team within the project working group.

Team	Area of focus and leadership	Key contributions
PwC: Economics team	Development of economic scenarios	Base and downside economic projections including: • Real GDP growth; • CPI; • Number of people of student age; • Effect of Brexit.
EY Parthenon: Specialist HE sector consultancy	Review of HE sector dynamics	Overview of the UK HE sector and the potential challenges affecting USS sponsoring employers by type of institution (based on customised segmentation), including: • Global demand and supply for HE; • Ability of employers to manage their cost base; • Impact of seven potential threats to sector (privatisation and new competition, immigration, apprenticeships, research consolidation, online, Teaching for Excellence, student loan book.) • Impact of Brexit.
PwC: Covenant team	Covenant review and assessment	Overview of the covenant covering: • Strength of the covenant; • Covenant horizon; • Affordability; • Availability of contingent assets and future monitoring.
USS: Group Risk team	Project vision, coordination and specialist scheme knowledge	Context, detailed knowledge and coordination: • Nature of the covenant; • Details about the scheme.