USS

Q&A: Debt monitoring and *pari passu* proposals (21 May 2021)

We know from our recent meetings with institutions and with UUK that the debt monitoring and *pari passu* proposals are an area of particular focus for employers when considering their response to UUK's consultation.

We appreciate there is naturally a concern about the way in which the proposals might be operated in practice. We want to allay those concerns but, at the same time, we can't pre-judge the range of situations which might occur. The framework needs to work in a pragmatic and efficient manner for all stakeholders and not hamper effective decision making in the sector.

We have compiled a set of FAQs (below) to answer some of the more immediate questions that have been raised. We will work on publishing a more complete statement of principles to provide employers with a clear and enduring point of reference on how we will apply the framework in practice. We will not be able to be able to model all possible scenarios, but we will be as open and transparent as we can.

In particular, we would like to emphasise that the levels in the relevant metrics are not set to automatically trigger any unilateral action. We would instead seek to get a more informed picture of an employer's financial position and how that may affect its covenant to the Scheme (if at all). Each case would then develop in its own, bespoke way, according to principles that will include:

- We will be open, co-operative and transparent in all its discussions with an employer and will share with an employer any relevant analysis of the employer's position or information it has received and the considerations it has made in reaching its conclusions.
- We will listen to the employer's views and representations and consider them fairly.
- We will be pragmatic in its application of the framework. For example, an employer may exceed the specified level of metrics, but if it becomes clear that the actual levels of debt (or the employer itself) are not a concern to us at that time – or are temporary in nature – we would likely not take any action beyond a monitoring action for the following year.
- Any data or information received as part of the framework or subsequent discussions will be treated as confidential and will not be disclosed beyond the Trustee and its advisers without explicit permission (or unless required by law).
- We are working with UUK on the best way to implement a review process so that where, despite the above, an employer believes our approach isn't in line with the goals of the framework or the details of the case then there is the opportunity for a reassessment. We hope this will give employers confidence that we will operate the framework objectively and that our decisions would be subject to scrutiny.

We also understand employers would want to be pragmatic in implementing the framework themselves.

For example, whilst we would expect employers to notify us of any events expected to change the metrics as they become aware of them, we wouldn't expect employers to put into place new systems to do so.

We instead assume relevant staff would familiarise themselves with the basic metrics and be aware when a significant business decision (such as taking on significant new debt) may exceed the metrics.

Similarly, it may be helpful for employers to engage with us early in their decision-making process and we aim to make that as easy and timely as we can.

Has the Trustee taken account of the differing types of employer which support the Scheme? Why can't you just use the same criteria as my bank?

In order to reduce complexity, the metrics have been developed to be the same across all employers and they act solely as an alerting mechanism.

If and when the metrics indicate we need to engage with an employer, we will focus on their particular circumstances.

What action would be taken by the Trustee if Metrics A-D are exceeded?

The metrics A-D have been developed as a set of measures and no action would be taken when individual metrics are exceeded.

Further engagement would be triggered if all four of metrics A-D are exceeded (or expected to be exceeded) or if three or more of those metrics are exceeded in two consecutive years.

What is the process of further engagement if triggered by metrics A-D?

In the first instance, we would contact the employer to discuss their particular circumstances in more detail.

Following this, we might decide that no action is necessary. An example might be short-term financial pressure caused by dealing with the effects of COVID-19.

If, however, following discussions with the employer we believe there is a material weakening of the covenant, we would work with them to agree further suitable mitigation measures.

If the Trustee is looking only to protect its position, shouldn't metrics A-D only apply if debt is increasing?

Engagement under the framework in relation to metrics A-D in many cases may involve no more than a request for further information.

Each case would consider the particular circumstances of the employer. For example, a near-term decline where no new debt has been taken on might result in agreement to early engagement before seeking new debt in future.

Why is the framework not proportionate to the risk?

Engagement under the framework would be considered on a case-by-case basis, and the actions taken (if any) would be specific to the institution's circumstances. Any actions would be formulated so as to protect the Scheme's covenant overall taking into account the impact on the employer's own operations.

Example mitigating actions include seeking:

- Bespoke monitoring of an employer
- An agreement that an employer's gross debt will not increase at a faster rate than the growth in net assets or income for a period of time
- The granting of security over assets in favour of the Scheme

Unilateral action would only be required in the event that no mutually acceptable arrangement can be reached or in the event of an employer not working within the framework or breaching an arrangement made under it.

In such circumstances, we would consider accelerated payment of existing contributions due for the institution and, if appropriate, notifying The Pensions Regulator.

Institutions generally have robust internal control processes and formal governance arrangements. Will the Trustee try to usurp these arrangements?

We do not wish to intervene in the running of institutions nor to undermine decision-making. This would not act to maintain and strengthen the covenant, which is our concern.

Increased borrowing *is* a concern, particularly where secured.

Where the metrics were triggered, we would consider the individual circumstances and proceed collaboratively with the employer. We are particularly open to early engagement and discussion with employers. Where helpful, we will review proposals in advance and confirm to governing bodies that the impacts on the metrics have been considered and either that no further action will be required in the future or what further information might be needed.

And what about Metric E?

If Metric E is exceeded in one financial year (or the Trustee has been notified of a floating charge proposal or quasi-security arrangement), we would look to discuss with the employer what mitigation measures (if any) might be appropriate.

In the majority of cases where mitigation measures were needed, these would be granting of *pari passu* security as/before the employer takes on new or additional secured debt, and/or granting security for existing unsecured debt.

In principle, a debt would usually be exempt if it is funding a new asset which is expected to grow revenue and enhance covenant (rather than funding a replacement asset) and if it is only secured against the new asset (as opposed to any existing assets).

The framework refers to carve-outs from the requirement for *pari passu*. What are they?

In addition to the exemption for covenant-enhancing borrowing, we would not expect *pari passu* security to be granted to the Scheme in the following circumstances[1]:

1. Where secured debt is below the following thresholds: i) consolidated total secured borrowings are less than 10% of consolidated net assets (pension provisions added back); AND ii) consolidated total secured borrowings are secured on assets the value of which are less than 10% of the employer's consolidated gross assets.
2. Irrespective of whether an employer exceeds the thresholds given above, total aggregate security over specific assets is exempt if the total aggregate value of such assets is less than the higher of: i) 2% of net assets excluding pension provisions; and ii) £0.5m.
3. Secured debt that refinances secured debt already in place if there is no material change in total secured debt, the assets secured and security terms (i.e., a like-for-like replacement or substantially the same).

What does the Trustee mean by covenant-enhancing debt?

Outside of the above carve-outs, we would not seek *pari passu* if we were content that the outcome clearly enhances the covenant. Cases would be considered individually and our review would consider the institution's business case and financial metrics including, for example, the payback period. As above, secured borrowing would usually be exempt if it is funding a new asset that is expected to grow revenue and enhance the covenant. This principle would apply also to investment opportunities within endowment funds or where security is required in order to secure non-repayable grant funding. Again, this would be considered on a case-by-case basis but would normally be expected to be exempt.

The approach would always be to consider the impact on covenant, and therefore expenditure which an institution may reasonably undertake would not always be considered covenant-enhancing where financed by secured debt. For example, the refurbishment of existing facilities in order to enhance the attractiveness of the institution to new students might, depending on the circumstances, not fall within our definition and *pari passu* might be required.

Metrics and triggers are on a more prudent basis than borrowing covenants in the sector. Won't this bring too many employers into individual covenant discussions given the impact of COVID-19?

Analysis of the FY19 data indicates that – of the 122 HEI employers (i.e., excluding Oxbridge colleges and other non-HEIs) – 13 would have triggered further engagement based on exceeding metrics A-D.

We recognise that COVID-19 might have impacted the size of this population, but an employer would need to exceed all four metrics A-D in one year, or three in two consecutive years, to trigger further engagement. We believe this makes the proposals more proportionate.

If COVID-19 was a factor in leading an institution to trigger further engagement, we would take this into account in our follow-up review. We have not adjusted the principles or thresholds for COVID-19 because it is important for the debt monitoring framework to be suitable for all economic circumstances. The best support for the Scheme is to have strong and sustainable sponsoring employers and the rationale for incurring debt would be considered if any further engagement is triggered.

[1] All figures relate to Scenario 3, as detailed in the supporting document circulated as part of UUK's consultation

How can we be confident that the Trustee won't move the goal posts, becoming more intrusive over time?

The framework will defeat its purpose if it excessively constrains institutions. We believe the framework we have proposed is proportionate and strikes an appropriate balance between managing the risks to the Scheme (and hence its sponsoring employers) and not being unduly intrusive.

All parties will gain experience as the processes work in practice and amendments to the practical implementation can be made to avoid unnecessary impacts. There will be an opportunity in subsequent valuations to review the extent to which these aims have been met and what amendments might be required.

These measures would appear to make it difficult for institutions to secure necessary financing to continue their operations. Shouldn't the Trustee be seeking to prevent employers from falling into financial distress?

We are not seeking to prevent institutions taking out appropriate levels of debt, but instead are seeking to ensure the Scheme's position is maintained.

Secured debt is a concern for us as it would rank ahead of the Scheme in a distressed scenario.

Sustainable sponsoring employers provide the best support for the Scheme. As such, if an institution needs to raise secured debt in a distressed scenario but does not have sufficient assets available to provide USS with *pari passu* security, we would be willing to discuss what alternatives may be available.

Does the Trustee have the expertise and resources available to respond if an institution is required to refinance quickly?

We hope that in most cases employers would notify us when the metrics are likely to be triggered so that we can work together to achieve the most appropriate outcome. We are reviewing our resourcing requirements and will have access to external advice where required. It is our strong belief that we have the capacity to act swiftly when circumstances dictate.