The Office for Students

The Secretary of State's guarantee against the Office for Students' obligations to the scheme, due under the Trust Deed & Rules and legislation, does not release participating employers from their responsibilities to USS. It has no material impact on the strength of the covenant, on the relevance to USS of regulations covering pensions, or to the funding decisions made for the 2020 valuation.

Doesn't the Secretary of State's guarantee make the covenant stronger than you've assumed for the 2020 valuation?

We already rate the covenant as 'strong' – the strongest of The Pensions Regulator's (TPR) four rating bands. TPR is of the view that the covenant is "at (the upper end of) 'Tending to Strong'".

As an open, immature scheme, our primary covenant measure is the ability of employers to fund the scheme on an ongoing basis through regular payroll contributions. That is, the contributions required are affordable, sustainable, and do not have a significant impact on their core functions.

We call this the *affordable* risk capacity. It is measured consistent with the long-term funding objective[1] suggested by UCU and UUK's Joint Expert Panel on page 58 of its second report.

Running the scheme on this basis requires us to take account of the ability of **all** participating employers to fund the scheme on an ongoing basis – not just the ability of the wealthiest. Consistent with this, the covenant assessment considers a range of factors including **all** employers' affordability, balance sheet strength and financing arrangements, profitability, cash generation, market position and outlook.

The Office for Students' participation in the scheme has no material impact on the strength of these factors.

We also assess and monitor the ultimate, collective ability of employers to underwrite the scheme. This is called *available* risk capacity. It is the most that employers could pay to secure all the benefits already promised to members in an extreme downside scenario.

This is the ultimate safety net, and some employers do contribute more *on paper* in this sense, than they do in terms of both regular contributions and their proportionate share of the scheme's liabilities. But it is not the basis on which we fund the scheme or set the contributions required.

That's because having to call on the available risk capacity implies institutional failures across a substantial portion of the HE sector. Such an extreme downside scenario is likely to require remaining employers to significantly change their business models and engage in substantial restructuring.

We must recognise that taking too much risk could weaken the very financial support we are actively relying on. That is, the size of the potential payments required in future could be beyond the means of employers to fund without a significant impact on their core functions.

[1] *"USS aims to be fully funded on a Technical Provisions basis where Technical Provisions are valued on a low-risk self-sufficiency basis for post-retirement years and on a prudent on-going basis for the pre-retirement years. The Scheme will also ensure that, at all times, the proximity to full self-sufficiency assessed on a low-risk basis can be supported by employers over an appropriate time frame if the Scheme were to be closed to future accruals."*

So, it would be reckless to fund the scheme in a way that puts individual employers at risk of insolvency or of having to pick up the potentially substantial liabilities on insolvency of other employers.

That is why *affordable* risk capacity is our primary covenant measure.

In any event, the Secretary of State's guarantee to the Office for Students' obligations to the scheme – due under the Trust Deed & Rules and legislation – does not guarantee for the obligations of other employers in the scheme. Nor does it amount to a general obligation to meet the liabilities of the scheme as a whole and in all circumstances.

Put another way: it does not release participating employers from their responsibilities to USS.

What about the 'last man standing' nature of the scheme?

Any form of 'backstop' covenant support is given limited weight by the Trustee and its covenant advisors, as it would ultimately only ever apply in the extremely unlikely event of wholesale insolvency across participating employers.

- We note that Department for Education's recent comment to The Times in response to speculation surrounding the potential implications of the Secretary of State's guarantee: *"The hypothetical scenario described would require every UK university and other contributing employer in our world-leading universities sector to go bust – this is not something the Government expects or intends to let happen."*

This is particularly the case given the moratorium on employers leaving the scheme without the Trustee's consent. As long as that is in place, there is unlikely to ever be a 'last *man* standing' scenario, as it actively minimises the risk of the scheme's liabilities falling disproportionately on a smaller group of employers.

As stated above, the Secretary of State's guarantee to the Office for Students' obligations to the scheme does not release participating employers from their responsibilities to USS.

It is worth noting that 122 university employers and 65 Oxbridge colleges collectively support around 98% of the scheme's liabilities. In contrast, OFS has four employees in the scheme – that's 0.002% of the scheme's c.200,000 active membership.

So why did Trinity College's exit put the strength of the covenant on 'negative watch'?

The following is taken from our briefing note 'Rationale for a long-term rule change', first published in April 2020.

> *It is understood that a number of small employers with a small deficit share have withdrawn from the scheme by giving notice to cease participation.*
>
> *However, to our knowledge, no employer offering a 'strong' covenant that was material to the scheme had sought to leave the scheme prior to Trinity College, Cambridge (Trinity).*
>
> *As such, it was assumed that reliance, particularly on strong employers, could continue indefinitely.*

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

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

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

…A key concern is that the minority of sponsoring employers who could afford to pay their section 75 debt and exit the scheme account for over 20% of the free cash flow calculation made as part of the covenant analysis.

In other words, Trinity College's exit raised the prospect of other strong (i.e., wealthy) employers paying to leave the scheme, which would have reduced the *available* risk capacity and made the 'safety net' weaker and weaker. A moratorium on employers leaving the scheme without the Trustee's written consent has since been put in place.

As noted above, the moratorium also effectively prevents the so-called 'last man standing' scenario from coming to pass. It ensures the Trustee has recourse to the resources of the strongest employers (plural) to make good any shortfall in the event of an extreme downside event that results in the scheme having to be wound up. Under the terms of the moratorium, the Trustee now has this right whether or not the employers in question have already paid their Section 75 debt.

The final outstanding balance in this hypothetical scenario would therefore not fall to any *single* employer but would instead be shared amongst the remaining employers. Examples of how this would work in principle have been provided – see Section D of our associated consultation document. Again, it is worth noting here that 122 university employers and 65 Oxbridge colleges collectively support around 98% of the scheme's liabilities. In contrast, the Office for Students has four employees in the scheme – that's 0.002% of the scheme's c.200,000 active membership.

What about the relevance of the regulations surrounding private funded pension schemes?

The existence of the Secretary of State's guarantee makes no difference to the relevance of the regulatory framework to USS: for a 'Crown guarantee' to exempt schemes from compliance with funding legislation, it needs (among other things) to be provided in legislation. TPR is of the view that USS's covenant is *"at (the upper end of) 'Tending to Strong'"* even with the moratorium on employer exits in place. It has also said the contribution rate of 31.2% set by the Trustee in respect of the benefit changes proposed by the Joint Negotiating Committee in September 2021 *"…should be at least 1% to 2% of salaries higher".*