Debt monitoring framework

1. The proposed debt monitoring metric definitions and triggers are proposed on a considerably more prudent basis than borrowing covenants to the sector. We appreciate that they are a means to highlight to USS and its advisors those employers where there may be a risk to the overall scheme covenant and where a further dialogue to understand any potential risk would be in everyone’s interest. However, we are concerned that they will bring too many employers into individual covenant discussions with USS each year, particularly given the impact of coronavirus on the sector. We are also concerned that the proposed debt monitoring framework is moving away from the collective covenant established through the cross guarantee that exists between all employers for USS’ liabilities. It is the collective covenant that is fairly unique to USS and is a fundamental plank of the ‘strong’ covenant assessment. Restrictions on employer exits are arguably much more fundamental to the scheme covenant strength than borrowing levels, which are almost universally required to develop and enhance UK higher education institutions as a consequence of a material reduction in financial support from Government over the last couple of decades.

2. We are supportive of the debt monitoring framework in principle, but ask that the thresholds and definitions reflect a more pragmatic approach in the current environment to set them at levels that should trigger a covenant discussion due to the risk that an institution is using debt to fund their operating expenditure, as opposed to investing in a covenant enhancing activity. More appropriate trigger levels could include interest cover being less than 2, operating leverage greater than 8 and debt measured on a net debt basis. We are very concerned that measuring debt on a gross basis, as opposed to a net basis (net of cash and cash equivalents), may deter institutions from acting in a prudent manner in response to the current crisis by increasing their short term borrowings to enhance their cash position. A disincentive to manage liquidity may ultimately put USS’ beneficiaries at greater risk. Net debt is also a better indicator of an organisation’s true indebtedness.

3. A more efficient and effective approach to operating a debt monitoring framework may be to set two threshold levels. One that it is ‘amber’ where the thresholds are established approximately in accordance with the current proposal and would require an employer to provide an explanation to USS to explain why the amber level has been triggered and what their future plans are. The second that is ‘red’, where the triggers are set much closer to debt covenant levels within the sector and a breach of which would trigger the proposed dialogue and potential sanctions. Whilst the scenario examples provided in the consultation document are helpful, they are likely to be harmful to both current and potential lenders and investors given that they suggest very significant action could be taken by USS to institutions that by many other financial and
non-financial measures have a strong credit profile. Making it clearer (enhanced contributions etc.) that they would only be implemented in a ‘red’ scenario would help to reduce the risk of the proposed debt framework negatively impacting on the creditworthiness of the sector and consequently its success and the strength of the covenant into the future.

4. The proposal does not currently include any safeguards for employers, many of which are charitable, against USS not operating the proposals on a reasonable basis in the future. We would like a form of appeals mechanism to be added before the USS / TPR imposes a change on an employer.

Pari passu

5. We are very concerned that there is no mention of either USS and/or UUK holding a consultation with lenders. It would be usual for such a consultation to be held given lenders’ existing commitment to the sector and the critical future role that they play to funding institutions into the future in the absence of material Government funding. Private sector lending and investment will be critical to USS employers developing their institutions to enable them to continue to be world leading. This needs to be done in a responsible manner. However, the introduction of measures by USS that potentially fetter future lending to the sector may ultimately be to the detriment of USS and its beneficiaries. We strongly urge that the pari passu element of the proposal is not introduced until a meaningful structured engagement has been undertaken by USS and/or UUK with lenders to the sector.

6. The 5% threshold for secured borrowing is too restrictive. We appreciate the carve outs for specific secured assets under the framework. However, USS are proposing to implement a disproportionate level of control over the sector, which may ultimately inhibit its ability to strengthen the covenant as a consequence of the decisions that its implementation may lead Boards to make. We ask the USS Trustee to reconsider the employer proposal of 15% being the trigger level, but to require the employer to notify USS if the 5% threshold is exceeded.

7. Unsecured lenders to the sector permit secured borrowing between members of the same group on the basis that it does not ultimately pose a risk to their creditor position on the basis that the parent company is likely to provide the resources required to its subsidiary to continue trading and meeting its obligations. University subsidiary companies may be USS employers in their own right. Universities often use subsidiary companies to assist them achieving their overall objectives where for tax and/or employment reasons it is beneficial for an activity to be undertaken by a subsidiary company. Subsidiary companies often require intra group lending. This is typically made from the University, which is usually a charitable organisation. HMRC require any loans made by charitable organisations to meet the criteria of a qualifying charitable investment. These are that the loan is documented, on arms length terms and secured. We ask that USS provides a specific carve out from the pari passu proposal for any secured intra group borrowing other than security granted by a higher education institution to another member of the group.
Implementation date

8. We suggest that a two phased approach should be adopted to the implementation of the proposals. A proportionate debt monitoring framework should be introduced from 1 August 2020. However, a robust consultation with all USS employers and lenders and investors in the sector must be undertaken before the pari passu proposals are finalised and implemented. We do not consider that an implementation date of 1 August 2020 for a matter so material and irreversible as the pari passu proposals can be implemented responsibly following a consultation launched with all USS employers on the 8th July 2020. This approach could ultimately be detrimental to USS’ beneficiaries for the reasons outlined in 5 above.