USS: The Need for a 2021 Valuation

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In finalising the 2018 valuation the USS committed to a further out of cycle valuation as at the 31st March 2020. This allows consideration of the recommendations of second report of the Joint Expert Panel (JEP) and the incorporation of new information in a highly volatile environment. The next in cycle valuation would be in 2023. Currently as far as is known the USS is not considering a further valuation in 2021. However, there is a need for this to capture important new information in this uncertain time and manage some of the uncertainties unresolved by the 2020 valuation. A 2021 valuation would give a clearer picture of the long-term health of the scheme by generating a more up to date picture of the deficit and of future service costs.

The USS often says that a valuation is based on a 'snapshot' of the scheme's funding at a specific time, that is its health. At the current time such snapshot is like taking a photograph of someone suffering a major acute illness as indicating their continuing health even though the person is underlyingly well.

A photo snapshot freezes everything at a given time whereas the USS's snapshot extends to the whole life of the scheme with the initial conditions at the start date influencing the parameters used over the scheme's whole lifetime.

Current Environmental Conditions

The current highly adverse conditions are likely to generate a disastrous valuation if undertaken as at 31ST March 2020, that is now. The Coronavirus (Covid-19) is only a few months old but its physical and economic effects and those of the Government's substantial mitigating actions are all far reaching. The finance market is trying to price in these effects in a setting of great uncertainty including a current lack of antivirals and of a vaccine. This market has been described as disorderly (displaying excessive volatility). Since mid-February 2020 the FTSE 100 index has featured some of the largest daily price changes even seen and has declined by around 30 percent with some reversal recently. Other share indices show similar falls. Rushes to security by buying gilts and the reinstitution of quantitative easing have reduced the yields on 30-year UK gilts to around 0.8 percent at the current time after shooting up to 1.5 percent earlier in March reflecting the rush to cash.

These market problems are of great signification to defined benefit pension schemes because they are reflected in the rates of returns expected from investments. As they are in calculating the deficit on accrued benefits where the present value of the liabilities is compared with the value of the scheme's investment portfolio priced using the current market prices where possible. A deficit requires a recovery plan extending over several years.

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[2] I am grateful for comments by Kevin Wesbroom and Con Keating.

Market prices reflect the views of the market based on public information at a given time. In a disorderly market these views can change radically with new information as can returns. Some allowance for these alterations can be made by post valuation adjustments to the valuation in the 15 months period before a valuation has to submitted to the pensions regulator.

Possible Effects on the 2020 Valuation

What this means for the USS 2020 valuation can be calculated only by USS. Some feeling for how the current environment might affect the 2020 deficit can be suggested by taking the assets at the 31st December 2019 as calculated by USS in their methodology discussion document which uses the 2018 methodology but in the financial setting of December 2019 [3]. The assets valued at their market prices amounted to £73 billion. Assume that the 65 percent investment in risky assets were affected by say a 30 percent fall in prices from December 2019 to late March 2020. This approximates to the experience of the FTSE 100 over the period from the end of December 2019 to 23 March 2020. This generates a £13 billion fall in the value of the USS's return seeking assets which would be offset by increases in the value of non-risky debt. Based on 20-year UK gilts prices this approximates to £4 billion in March 2020. Aon (the actuarial advisors of Universities UK (UUK)) in a recent paper estimated the possible deficit at £13 billion.

The same forces increase the cost of meeting future service costs at least in the short run. Little return will be generated by investments in gilts. The return on the benchmark 10-year UK government debt had fallen to 0.24 percent in March 2020. Companies are already are cutting dividends though not (yet?) the major oil companies. The income from companies will be severely reduced by the lack of activity and the shutting down of many operations even with the government's rescue packages. Crude calculations suggest that if USS investment income declines similarly to GDP it could fall by around £0.5 billion per year.

Uncertainty about the Virus's Effects

There is great uncertainty surrounding the effects of the coronavirus and its effects on the UK economy. Models of the numbers who might die in the UK generate very differing predictions: a maximum of 250 thousand and the consensus of between 50 thousand and 20 thousand. Currently it looks as if the lock-down may work but only further lockdown-time will tell. Neither antivirals nor other remedies are yet available. It could be a year or eighteen months before a reliable vaccine is ready. Given the planned programme of testing it will a substantial time before the numbers who have or have had the virus in the UK are known and before the "self-isolating" can be advised that it is unnecessary and the lockdown can be relaxed.

Medical commentators are clear that normal activity will return. The latest official view is that this return could take six months but others suggest up to a year or more. Economic

[3] *Methodology and risk appetite for 2020 valuation*, USS 9 March 2020.

commentators also expect an economic recovery in the relative short term. This is different to the financial crisis of 2008, some of the consequences of which are still being felt. There are differences between economists however, on whether the economic recovery will be either a quick return to normality or a slow recovery with some possible long-term damage to the economy.

Forecasts are very time sensitive. Capital Economics' latest forecast (4 April 2020) is a 15 percent fall in GDP in the second quarter of 2020 relative to the first, and a seven percent fall in the year relative to the previous year but very modest positive net growth in the year 2021. In what they describe as a reference scenario not a forecast, the Office of Budget Responsibility estimated (14 April 2020) that the decrease in GDP from the first to the second quarter of 2020 would be 35 percent but would recover in the third and fourth quarters so that the annual change from the 2019 would be minus 13 percent reverting to normal growth in 2021. IMF in its latest Economic Outlook (April 2020) predicted that the UK's GDP in 2020 would fall relative to the previous year by minus 6.5 percent and grow by 4.3 percent in 2021.

A substantial and quick 'bounce-back' is a common feature of many forecasts. This amounts to 17 percent increase in the third quarter of 2020 in the Office of Budget Responsibility's scenario. Some commentators expect a slower reversal and some persistent economic damage. This makes it more difficult to model these effects on pensions.

Share prices may behave differently. Public share price forecasts for the FTSE 100, for what they are worth, are for something like a 10 percent fall in the first quarter of 2021 from today's prices which themselves reflect a fall of around 30 percent in 2020. Such changes in prices are not necessarily correlated with returns.

These uncertainties will need to be resolved as far as possible prior to any valuation and a number of these may be clarified with a 2021 valuation.

The Financial State of Universities

So far 2020 has been a bad year for university finances. There have been strikes by lecturers over pay, conditions and pensions with some on-going industrial action and because of the lockdown a recent movement to virtual teaching. There are predictions that the next teaching year will be worse because surveys predict that a very large number of students mainly potential international students will either not come or will delay their attendance until the following year generating a loss of income from fees and accommodation provision. Conference revenue is also expected to fall. There may also be a long-term reputation effect. UUK have said that there is a top-end risk to income of £7 billion, some 10 percent of income in the next academic year. They have asked the government for a bailout of £2 billion to cover the loss of the contribution of overseas student fees to research.

These factors cause a weakening of the universities' currently strong covenant which indicates the sector's ability to fund pensions. For some time the pensions regulator has cast doubt on the strength of the covenant. USS's methodology document hints that even under December 2019 assumptions there are doubts about its strength going forward. Currently the covenant is ranked by USS as strong but on negative watch until some measures to protect the covenant are put in place. Several tables in the methodology document displayed together the results with a tending to strong covenant and those for a strong covenant.

Possible Approaches to the 2020 Valuation

There is no doubt that the usual approach to determining valuations will generate some highly adverse figures leading to cries to alter future benefits, to restructure the scheme and to switch completely to a DC scheme. The USS have always said that they take a long-term view. This is true of the methodology document which has been subject to a major review and includes the main recommendations of the second report of the Joint Expert Panel. The major structural features of this methodology are like those used in previous valuations especially the need to be able to switch to a low return but safe investment portfolio if necessary. As the orientation is long term the document says nothing about the current uncertain environment and about how USS intends to cope.

There is general agreement that the current situation will reverse and USS could seek to build this reversal into its calculations. It is part of pensions 'lore' that the long life of open schemes allows relaxation over both one or two bad years and any seeming need for precipitative action.

There are three problems with this approach. One is that in the presence of unresolved uncertainties may force USS to use their ideas about the future as the they see it especially with regard to expected investment returns and the covenant. They did this in previous valuations with the reversal of gilts yields. Two is that the pensions regulator needs to see that this approach is sufficiently prudent and that the stakeholders may have different views.

The major problem is the great uncertainty referred to above. In the valuation, what amounts should be taken as current at the 31st March 2020 and to what degree will these amounts be reversed later and when? With the current state of knowledge it is difficult to answer these questions. Indeed, they would seem difficult to answer even in June of 2021 when the final valuation 2020 must be submitted. A least some of these questions should be answerable in a 2021 valuation.

The 2020 valuation is being carried out a time of great uncertainty whilst the world is still learning about new type of virus known about publicly for only four months This valuation is not legally required. The next in cycle valuation after the 2018 exercise would be due at 31 March 2021 with submission in June 2022. Continuing with this valuation would have advantages. Currently most commentators expect that the virus would be defeated by then and much of today's uncertainty would be resolved. This should be the case even if there were a second bout of the virus in the Autumn of 2020 or early in 2021 which should be less disruptive given the experience gained in dealing with the first attack. Markets may not be in equilibrium in 2021 but they should be much better informed allowing a better founded and more precise valuation.

The 2020 valuation allowed the recommendations of the second report of the Joint Expert Panel to be considered in the valuation. The 2020 valuation was required by USS as the economic conditions around the 2018 valuation were seen as so challenging and volatile that a further valuation was required in case major adjustments were needed to protect the scheme and USS. These problems are redoubled in 2020.

In the light of Covid-19 the USS has said that:" As we have committed to a 2020 valuation, we will continue the process for the time being. However, we will review conditions and act as appropriate, which may include applying post-valuation experience that allows us to adjust the picture based on significant changes to conditions at the late stages of the valuation. The regulator allows post-valuation adjustments reflecting changing conditions during the 15-month period allowed for the valuation. There seems to be no information about these on the relevant current websites and the only explanation found with the advice of an actuary was a 10-year-old document issued by the regulator after the global financial crisis.

This document does allow the incorporation of changes in asset values, in returns and in liabilities experienced during the valuation period in the recovery plan. The pension provider can select another date for the certification of the recovery plan and contributions within the 15-month period. This requires a revised valuation. Any change must reflect known past events and is subject to the usual constraints of prudence, the strength of the covenant, respecting the employer's risk attitude and the best interest of members. Reasons must be given for this change of date and it should be used in the future. The regulator makes it clear that such an alteration is not a right but depends on its merits. The window for post valuation adjustments is really about a year (ending in say January 2021 for the USS 2020 valuation) to allow the final valuation decision to be made in a timely manner.

The scope for post- valuation adjustments in the 2020 valuation by say January 2021 would seem limited. It would capture the end of the (first) lock down, a test for the virus should be widely available as may be an antibodies test and some treatments but not a mass-produced vaccine.

Such adjustments could not reflect all the information/data of the then economic forecasts because they do not reflect known past events. Some of these could influence the valuation prior to August 2020 the time when the valuation needs to be sent to the Joint Negotiating Committee for it to consider changing benefits and the character of the scheme.

Capital Economics' latest forecast (4 April 2020) is a 15 percent fall in GDP in the second quarter of 2020 relative to the first, and a seven percent fall in the year relative to the previous year but very modest positive net growth in the year 2021. In what they describe as a reference scenario not a forecast the Office of Budget Responsibility estimated (14 August 2020) that the decrease in GDP from the first to the second quarter of 2020 would fall by 35 percent but would recover in the third and fourth quarters so that the annual change from the 2019 would be minus 13 percent. IMF in its latest Economic Outlook (14 August 2020) predicted that the UK's GDP in 2020 would fall relative to the previous year by minus 6.5 percent and grow by 4.3 percent in 2021.

The pensions regulator has recognised the stress on pension schemes imposed by Covid-19 and has allowed trustees to delay or reduce deficit recovery contributions and future service contributions for an initial period of three months in the first instance. These concessions mirror the government's policy of reducing financial pressure and are likely to be extended for further time periods. Such relaxations are unlikely to be enough to overcome the difficulties encountered with a 2020 valuation. The regulator will issue further guidance shortly. Such guidance needs to allow for the long lives of open pension schemes.

USS also say that they will not take immediate short-term action and make it clear that they will maintain their long- term strategy. The short-term actions they have in mind are more of the same: accelerated valuation, higher contributions and speedier de-risking. Only the first these seems to encompass the short term and none are entirely appropriate in these unsettled times.

2021 Valuation and Conclusions

There is currently a very uncertain environment mainly associated with the Covid-19 virus worldwide and the UK's policy for dealing with the virus. The likely effects of these factors on UK universities and on the results of a 2020 valuation are profound including a possibly weaker covenant, a large increased deficit because of the fall in asset prices, a substantial number of universities showing accounting deficits in the short run and doubts about when the effects of the virus on economic activity and on higher education will be reversed. An additional 2021 valuation would allow for the possible reversal of many of these factors and additional information which would make for a more a well-founded and precise valuation.

In the current setting this may appeal to the pensions regulator. Of course a 2021 valuation may portray a worse situation than that of the 2020 if there is a further incidence(s), neither a vaccine nor remedies are discovered and the virus's effects are not reversed as quickly as expected and have some long-term effects. In this setting a 2021 valuation becomes imperative. However, the probabilities of all three events happening together are very low. Some seventy groups worldwide are working on finding a vaccine and a few are starting human trials though some minority expert opinion is that a vaccine may not be found or will take a long time. The situation with remedies is similar but with less adverse opinions. The likelihood of a further emergence of the virus is subject to much speculation but current new breakouts seem related to the first wave.

Assuming a reversal of the virus a snapshot of the 2021 valuation may still be tainted by the virus but it should provide a relatively clearer and more precise view of the scheme's overall health for good or ill than that of the 2020 valuation.