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Defined Benefit pension funding in the charitable sector

September 2022

Summary

The last few years have been tough for charities. The Covid-19 pandemic put fundraising and retail income under a significant financial strain, and increased demand for some charitable services.

2022 hasn't been easier with the Ukraine-Russia war and huge increases in the cost of living resulting in new calls for support in many areas, as well as continued strains on fundraising.

Alongside this challenging environment, defined benefit (DB) pension schemes sponsored by charities continue to require substantial funding.

This tough combination of challenges means that charities need to continually refine the delicate balance between ensuring the stability of charitable support and funding pension deficits.

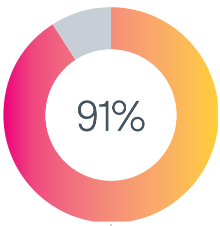
Further, all DB schemes are facing an increased focus on governance from The Pensions Regulator (TPR) and a significant expense in the form of the equalisation of Guaranteed Minimum Pensions (GMP). Funding the cost of these projects is a particular challenge for charity DB schemes and a focus on value and efficiency is key.

We've analysed the DB pension exposures of the largest 40 charities in England & Wales by income to assess the issues and how charities should respond. These charities have a combined reserves of £39.5bn. This has fallen from £46bn last year, perhaps suggesting that some charities have had to dip into reserves to fund their causes.

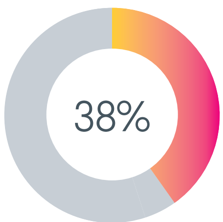
This year's income is £14bn, which is up slightly from last year. However, a significant portion of this is Covid-19 relief funding. Underlying income from fundraising and charitable activities generally fell.

Aggregate DB liabilities remain around £9.5bn with a fall in average funding level, driven by a drop in scheme assets. A lack of movement in liabilities, coupled with a challenging income situation and a fall in reserves, paints a difficult picture for charities.

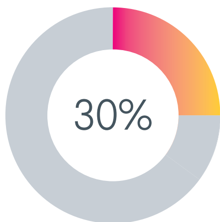
Key findings - 8 figures



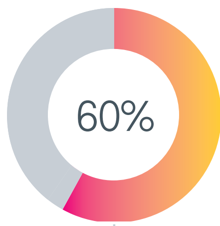
Average FRS102 funding level



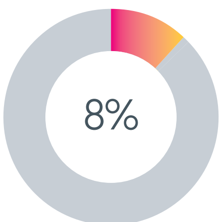
Average allocation to growth assets



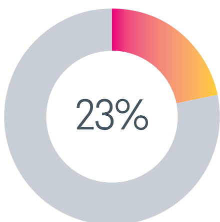
30% of charities have a FRS102 pension surplus



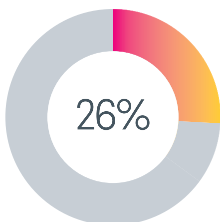
60% of charities have closed their DB scheme to accrual



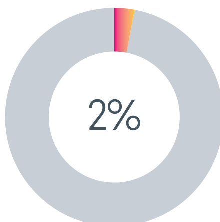
8% of charities have granted security to their DB scheme



The average FRS102 pension deficit is 23% of unrestricted reserves



The average FRS102 pension deficit is 26% of annual net unrestricted income



The average charity pays 2% of net unrestricted income into its pension scheme

How should charities respond?

1 Review the covenant interaction with your funding plan

In its Annual Funding Statement 2022, TPR acknowledges that upcoming valuations are taking place in a period of significant economic uncertainty. They encourage trustees of DB pension schemes to engage in an open dialogue with their sponsors about immediate challenges and longer-term risks. Regular dialogue between the charity and pension scheme trustees can help build an understanding of the challenges to both income and reserves and the potential implications for covenant ratings and available cash.

TPR also advises pension trustees to keep an eye on covenant leakage. This is less of an issue for charities than for corporates, with charities not paying dividends and often having little or no debt. However, it does come into play when ensuring equitable treatment of the pension scheme with other stakeholders. It's important that any financial pain is spread equitably across stakeholders, for example, not all taken by the pension scheme.

Where there are short-term affordability constraints, any temporary contribution easements should be carefully considered – ideally higher contributions should be paid upon resumption to limit the extension of recovery plans. Another option in this area is the use of a contingent contribution structure which can allow the charity to invest now, benefitting the pension scheme later.

Charities can also consider alternative funding packages to give pension scheme trustees greater security – potentially to back a higher returning asset strategy and lower cash contributions. Granting the pension scheme security over a charity asset is one way to do this.

Case Study – contingent contributions

We work with a charity DB pension scheme who have implemented an upside-sharing contingent contribution structure that reflects both covenant and funding. An annual check takes place, which covers the progress of the funding level vs the recovery plan and the level of charitable reserves. If charitable reserves increase above a defined threshold, then some of that excess is paid into the pension scheme.

If, at the same time, funding is also behind plan the cash paid into the pension scheme goes up. On the flip side, if pension scheme funding remains sufficiently ahead of plan, the additional cash contributions cease.

This structure can be a win-win for the charity and the scheme, allowing the scheme to benefit when the charitable reserves are strong and equally giving the charity a bit of space on contributions when funding remains ahead of plan.

2 Consider the impact of Covid-19 on your scheme

Pension scheme trustees are now starting to consider how the impact of the pandemic should be built into longevity assumptions for funding valuations.

Some trustees are concluding that the pandemic represents a previously unanticipated headwind in relation to mortality improvements, both in terms of mortality directly related to Covid-19 and the knock-on effects on healthcare systems and the wider economy. Therefore, an adjustment can be made to future improvements to allow for potential future changes in longevity as a direct and indirect result of the pandemic.

In their annual funding statement, the TPR has also indicated that reducing liabilities by up to 2% for a Covid slowdown in longevity can also be a reasonable course of action.

Charities should engage with their pension scheme trustees to understand the rationale for their longevity assumption and ensure the possible pandemic impact has been duly considered.

3 Consider the impact of high inflation

Inflation over the year to March 2022 was 7% for Consumer Price Index (CPI) and 9% for Retail Price Index (RPI). This cost of living crisis is putting a strain on charitable expenditure as well as causing upward pressure on salaries across the industry.

From a pension scheme perspective, high inflation pushing up a scheme's liabilities feels like bad news. However, pension increases, whether RPI or CPI-linked, are usually capped at 5% or 2.5% on a year-on-year basis. If your scheme is well-hedged against uncapped RPI, then it is possible that current high rates of inflation could even be having a beneficial impact on the funding position. Charities should engage with the pensions scheme trustees to understand the impact of inflation on your scheme and review your approach to hedging inflation risk going forwards.

Some trustee boards may seek the charity's agreement to pay discretionary pension increases over and above the capped RPI or CPI increases specified in the scheme rules. Given the current economic uncertainties, we would anticipate that most charities will not want to contemplate agreeing to anything other than guaranteed pension increases.

4 Review your approach to GMP equalisation

Most pension scheme trustees of DB schemes are moving forward with the implementation of equalisation of GMP following the 2019 ruling. For most schemes, this is likely to be fairly immaterial in terms of additional scheme liabilities, and therefore we expect most funding plans to be broadly unaffected.

However, the cost to undertake the necessary calculations and implement the updated pensions could be the largest one-off project costs schemes have had to take on for many years. Carefully considering the approach your approach to GMP equalisation and how it might interact with future strategy decisions, including risk transfer or member options project, is vital.

Charities and pensions scheme trustees must also challenge their advisors to ensure the most efficient approach is taken by the administrators and actuaries, including considering maximising value from data cleanse projects and combining GMP rectification with equalisation where appropriate.

Charity analysis

Introduction

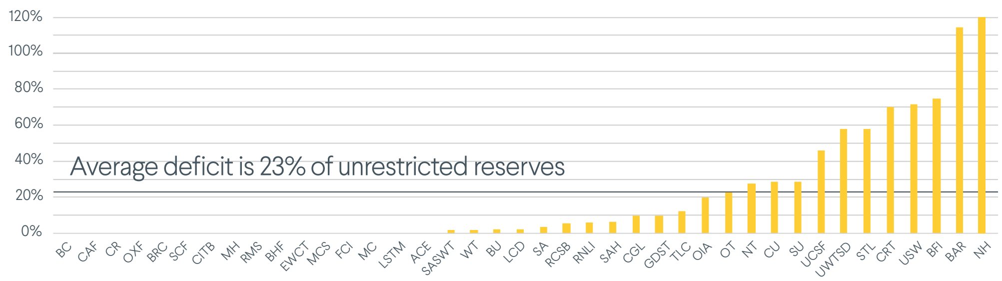
The ability of a charity to support its DB obligations is more important than the size of the liabilities or deficit in isolation. Our analysis therefore focuses primarily on the size of the pension scheme relative to the size of the charity by considering the following measures. The pension deficit in these measures is the FRS102 deficit as reported in charity accounts.

Measure	What it shows
Deficit / unrestricted reserves	The level of charity assets available to potentially support the pension scheme (restricted assets and endowments are excluded as they are typically not accessible by the pension scheme).
Deficit / net unrestricted income	The level of charity income available to potentially fund the pension scheme (restricted income is excluded, and the cost of generating the unrestricted income has been removed to leave a net amount of income that could be spent on charitable activities or to fund the pension scheme).
DB pension contributions / net unrestricted income	The proportion of net unrestricted income that is paid into the pension scheme.

Results

The charts below show the distribution of results on each of these measures.

Deficit/unrestricted reserves

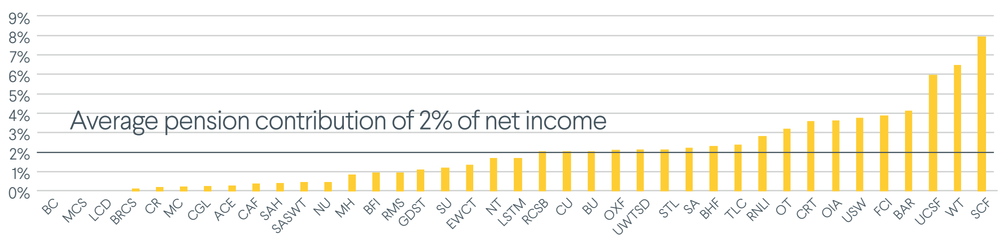


2 charities have deficits that exceed their unrestricted reserves.

Deficit/net unrestricted income

2 charities have a deficit that exceeds unrestricted income.

DB contributions/net unrestricted income

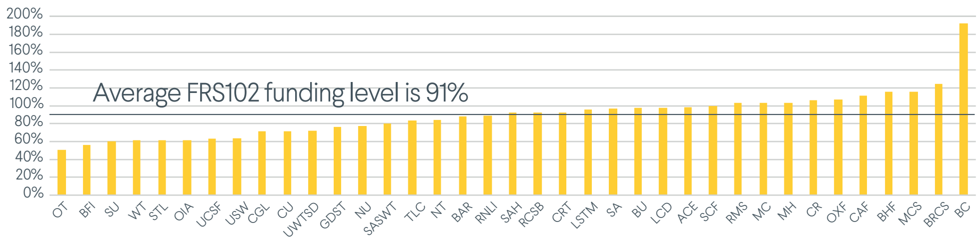


1 charity paid contributions of 8% of their net unrestricted income.

Pension scheme

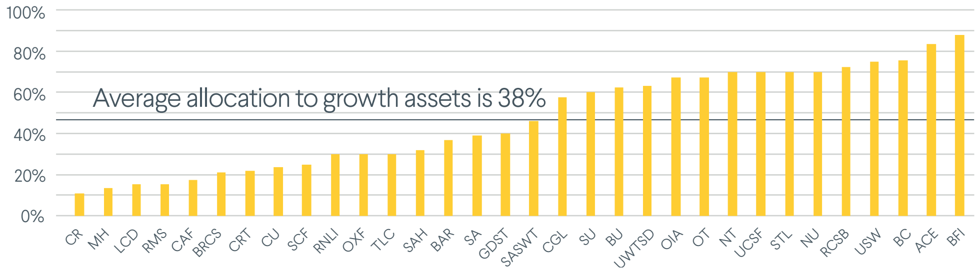
The wellbeing of the pension scheme also provides valuable insights. The charts below show the distributions of funding level and allocations to growth assets.

Funding level



12 charities have a funding level over 100%.

Growth asset production



Charities taking a lower level of investment risk are exposed to less deficit volatility and can arguably fund deficits over a longer period of time.

The average allocation to growth assets has reduced from 60% to 38% over the past six years. We expect this is a result of investment risk being taken off as funding levels improve. Importantly this starts to reduce the risk of pension funding falling behind plan, and means the scheme is more resilient to market shocks like we have seen recently with Covid-19 and the Russia-Ukraine war.

A number of charities have not disclosed an asset allocation; resulting in fewer charities being represented in the above chart.

Code	Charity
ACE	The Arts Council of England
AFC	Action for Children
AGE	Age UK
AQA	AQA Education
BAR	Barnardo's
BC	The British Council
BC	The British Film Institute
BHF	British Heart Foundation
BRC	The British Red Cross Society
BU	Bangor University
CAF	The Charities Aid Foundation
CCE	Church Commissioners for England
CGL	Change Grow Live
CR	Cancer Research UK
CRT	Canal & River Trust

Code	Charity
CU	Cardiff University
EWCT	The Eric Wright Charitable Trust
GDST	The Girls' Day School Trust
LCD	Leonard Cheshire Disability
LSTM	Liverpool School of Tropical Medicine
MC	Marie Curie Cancer Care
MCS	MacMillan Cancer Support
MH	Methodist Homes
NH	Nuffield Health
NT	The National Trust for Places of Historic Interest or Natural Beauty
OIA	Oasis International Association
OT	Ormiston Trust
OXF	Oxfam
RCSB	Royal Commonwealth Society for the Blind

Code	Charity
RMS	Royal Mencap Society
RNLI	The Royal National Lifeboat Institution
SA	The Salvation Army
SAH	St Andrew's Healthcare
SASWT	The Salvation Army Social Work Trust
SCF	The Save the Children Fund
STL	The Shaw Trust Limited
TLC	Trustees of the London Clinic
SU	Swansea University
UCSF	United Church Schools Foundation Ltd
USW	University of South Wales/ Prifysgol de Cymru
UWTSD	University of Wales Trinity Saint David
WT	Wellcome Trust

Please get in touch with us to find out more:

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Appendix – methodology

1. The charities analysed are the largest 40 by income in England & Wales (as listed by the Charity Commission website) at March 2022 that have DB liabilities disclosed in their accounts. Charities that have no DB exposure (or only account on a cash basis for DB schemes) are excluded. Lloyd's Register Foundation is also excluded as the charity is the parent of a large trading company.

2. All information has been sourced from the most recently available annual reports and financial statements as published on 1 March 2022.

3. Group / consolidated accounts have been used rather than charity accounts where relevant.

4. Unrestricted reserves and income are considered on the basis that these are potentially available to support or fund the pension scheme. Restricted reserves and income and any endowment funds are excluded on the basis that a pension scheme would not have access to them, other than where the relevant charity accounts explicitly suggest otherwise.

5. Unrestricted reserves are prior to the deduction of any pension deficit.

6. Net unrestricted income has been considered because this is the amount of income that could be spent on charitable activities or could be used to fund the pension scheme. This therefore excludes any restricted income or endowments and is net of the costs of generating that unrestricted income. This measure will be crude in some cases, in particular for charities whose charitable activities include running contracts, as the expense to deliver these contracts must be incurred to generate the associated income in the first place.

7. For charities with a DB surplus, the surplus is shown prior to any balance sheet restriction that is sometimes put in place if the charity does not have a unilateral right to a refund of surplus in their pension scheme rules.

8. DB contributions do include future service contributions (where applicable) as well as deficit contributions.

9. Some charities have significant scheme assets categorised as 'other.' In these cases, we have tried to allocate these to growth or matching as appropriate using other information in the accounts, but this has required some judgement and may not always be correct.

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