HYMANS ROBERTSON

DB pension funding in the charitable sector

May 2020

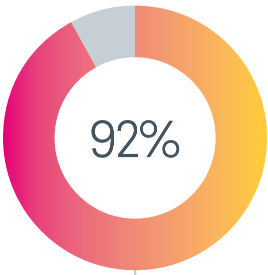
Summary

The COVID-19 pandemic has placed charities under significant financial strain in the last few months, with fundraising and retail income particularly badly hit. Charities therefore need to conserve cash, but in many cases DB pension deficits have also increased.

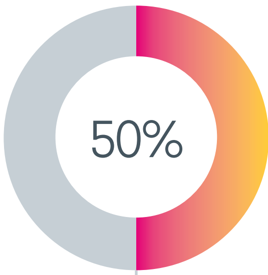
On top of this, forthcoming regulatory changes are putting pressure on charities to pay off pension deficits quicker. A delicate balancing act is required between ensuring the sustainability of charities and funding higher pension deficits.

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 £42bn of reserves and £13bn of annual income and support aggregate DB liabilities of £9bn.

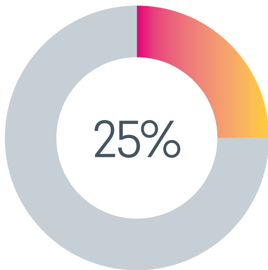
Key findings



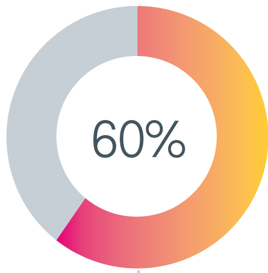
Average DB scheme funding level



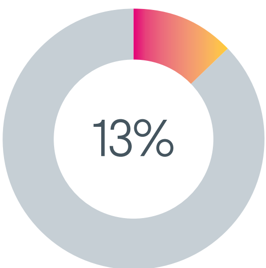
Average allocation to growth assets



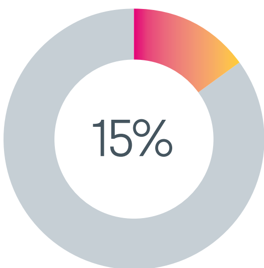
25% of charities have a pension surplus



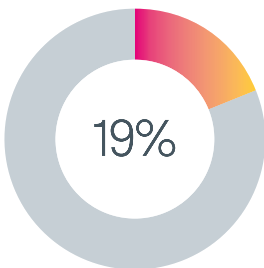
60% of charities have closed their DB scheme to future accrual



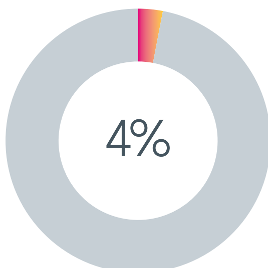
13% of charities have granted security to their DB scheme



The average pension deficit is 15% of unrestricted reserves



The average pension deficit is 19% of annual net unrestricted income



The average charity pays 4% of net unrestricted income into its pension scheme

How should charities respond?

1 Consider accessing COVID-19 flexibilities to defer pension contributions.

March 2020 guidance from The Pensions Regulator (TPR) acknowledges that suspending contributions may be appropriate in some situations at the moment. The key requirements are a strong business need for a deferral, that the deferral is for no longer than 3 months initially, and that other stakeholders are sharing the pain with the pension scheme.

2 Prepare for a new DB funding regime in 2021.

This new regime will introduce "Fast Track" and "Bespoke" options for DB funding. "Fast Track" ensures no regulatory intervention if minimum standards are met but may mean too big an increase in deficit contributions for some charities. In which case "Bespoke" options are available, but this will mean regulatory scrutiny. Providing security to the pension scheme (e.g. a charge over charity property or investments) could help support the "Bespoke" funding options.

3 Consider DB consolidation options.

As the DB market runs-off, new solutions are emerging that reduce running costs by aggregating pension schemes. Consider a DB Master Trust to reduce running costs by around 30%, or commercial consolidators to give a clean break at a cost expected to be lower than full insurance buy-out.

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Charity analysis

Introduction

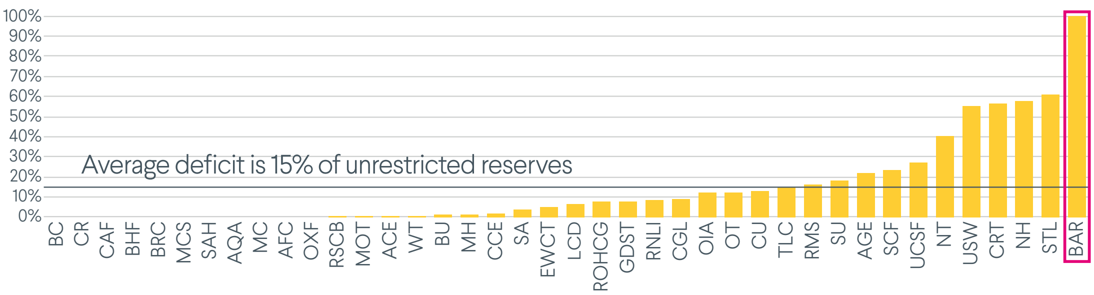
The ability of a charity to support its DB obligations is more important than the size of the liabilities or deficit in isolation. Our analysis focuses primarily on the size of the pension scheme relative to the size of the charity, by considering the following measures:

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

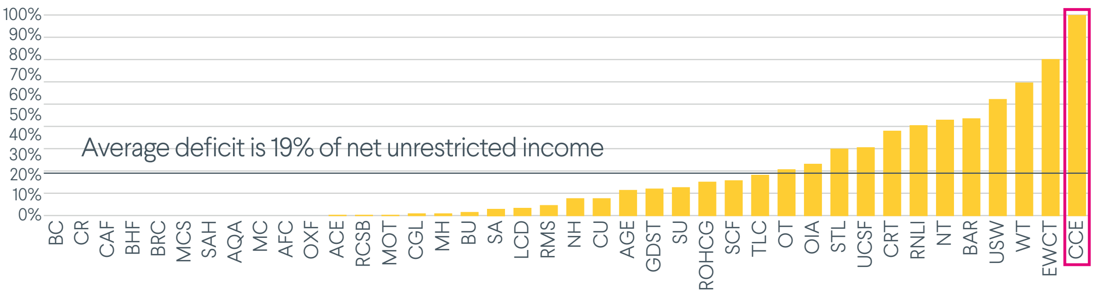
The charts below show the distribution of results on each of these measures.

Deficit/unrestricted reserves



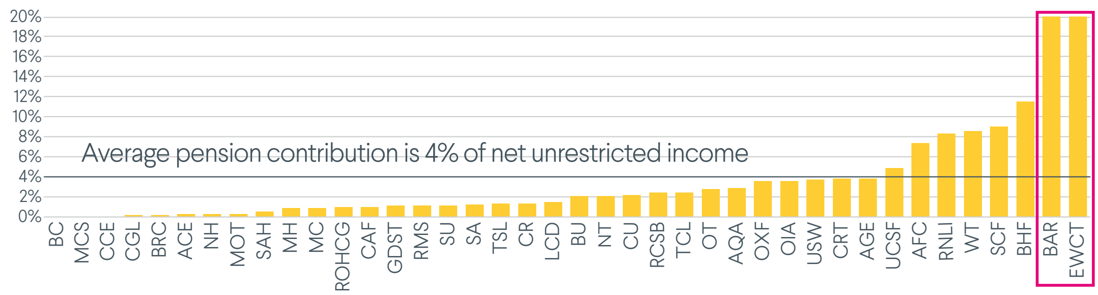
1 charity has a deficit that exceeds their unrestricted reserves

Deficit/net unrestricted income



1 charity has a deficit that exceeds their unrestricted income

DB contributions/net unrestricted income

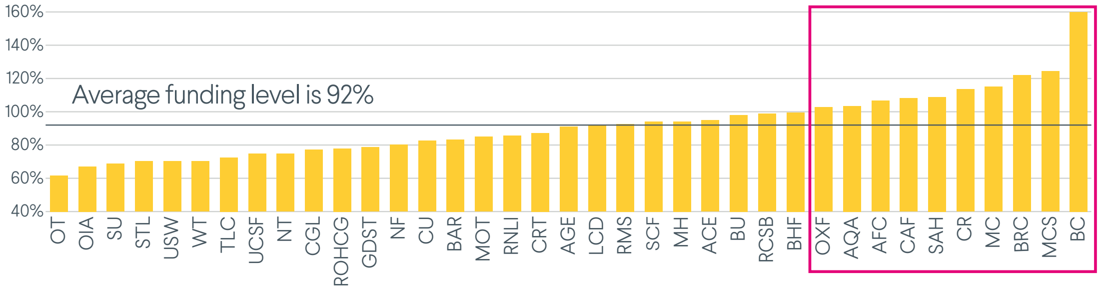


2 charities paid contributions in excess of 20% of their net unrestricted income

Pension scheme analysis

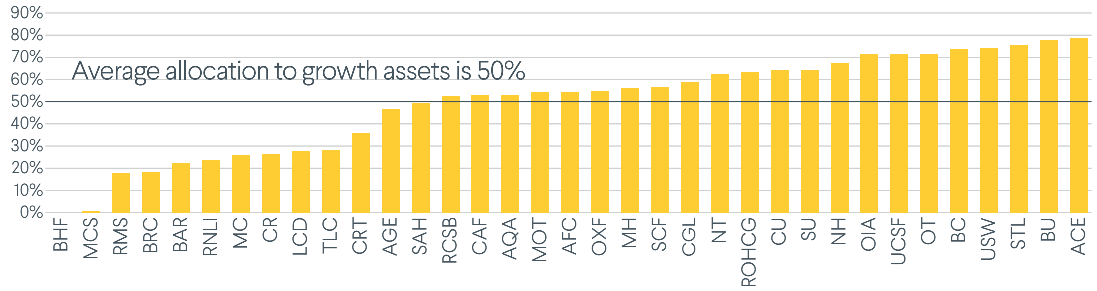
The wellbeing of the pension scheme also provides valuable insights. The charts below show the distributions of funding level and allocations to growth assets.

Funding level



10 charities have a surplus.

Growth asset proportion



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

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
AT	Anchor Trust
BAR	Barnardo's
BC	The British Council
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
CGLI	The City & Guilds of London Institute
CR	Cancer Research UK
CRT	Canal & River Trust
CU	Cardiff University
EWCT	The Eric Wright Charitable Trust
GDST	The Girls' Day School Trust
LCD	Leonard Cheshire Disability
MC	Marie Curie Cancer Care
MCS	MacMillan Cancer Support
MH	Methodist Homes
MOT	Motability
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
RMS	Royal Mencap Society
RNLI	The Royal National Lifeboat Institution
ROHCG	Royal Opera House Covent Gardens Foundation
SA	The Salvation Army
SAH	St Andrew's Healthcare
SCF	The Save the Children Fund
STL	The Shaw Trust Limited
SU	Swansea University
TLC	Trustees of the London Clinic Limited
UCSF	United Church Schools Foundation Ltd
USW	University of South Wales/ Prifysgol de Cymru
WC	The Woodard Corporation
WT	Wellcome Trust

The average allocation to growth assets has reduced from 60% to 52% over the past 3 years. We expect that this is as 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.

How should charities respond?

1) Consider accessing COVID-19 flexibilities to defer pension contributions

The speed and scale of the COVID-19 crisis has had a severe financial impact on many charities. Retail income has stopped, and fundraising income is down significantly. Income from running contracts seems to be holding up, but often the associated expenses have increased from the cost of managing the COVID-19 impact on the contract. Cash conservation is therefore crucial, and understandably, this means some charities are looking to defer pension contributions.

March 2020 guidance from The Pensions Regulator (TPR) acknowledges that suspending contributions may be appropriate in some situations. It is clear that initial requests to defer contributions should be for no longer than three months, especially if longer term covenant visibility is not clear.

Charities need to be aware that while deferring pension contributions provides short term respite, the contributions will ultimately still need to be paid. In addition, pension scheme trustees need to ensure they are being treated equitably and sharing the pain with other stakeholders. A clear case for the deferral therefore needs to be set out, and evidence of other cost saving measures being introduced at the same time is helpful.

2) Prepare for a new DB funding regime

In March 2020 The Pensions Regulator (TPR) launched a consultation on a new funding regime for DB pensions, which is expected to commence in 2021. Under this regime, schemes will need to decide whether to adopt a "Fast Track" funding approach or a "Bespoke" funding approach.

Adopting "Fast Track" involves complying with a set of minimum funding standards set by TPR, which then ensures no regulatory intervention. Alternatively, a "Bespoke" approach, which falls short of these minimum standards, is possible but will be subject to scrutiny from TPR.

The "Fast Track" parameters cover the following areas: a long-term funding objective, technical provisions, recovery plan (length and shape) and investment risk. All of the parameters need to be met to comply with "Fast Track."

Two key aspects of the proposed "Fast Track" regime are:

- Recovery periods for deficit contributions should be no longer than 6 years for strong employers and 12 years for weak employers; and
- Schemes should be on track to be fully funded on a long-term basis of between gilts + 0.25% pa and gilts + 0.5% pa (an uplift of 10-15% to a typical current Technical Provisions funding target) within 15-20 years.

Our expectation is that some charities will be unable to meet the "Fast Track" standards because the required level of cash contributions will be too high. In these cases, charities need to have robust funding strategies in place that will stand up to TPR's scrutiny. Options to support funding plans include:

- Provision of security to the pension scheme (such as a charge over charity property or investments) to support a lower funding target or longer recovery period. 13% of charities in our survey have already done this, and we expect this proportion to rise.
- Use of contingent funding plans, whereby core cash contributions are kept low, but additional contingent contributions are payable if funding falls too far behind plan (for example if anticipated investment returns do not materialise).

3) Consider DB consolidation solutions

As DB schemes run-off, new consolidation solutions are emerging which reduce costs through economies of scale. Options to consider include:

DB Master Trusts

These aggregate pension schemes under one trust umbrella, enabling reduced running costs and access to a wider range of investment options than might be available to a stand-alone smaller scheme.

They maintain the link to the sponsoring employer, and as there is no change in benefits, funding level or covenant, they are straightforward for pension scheme trustees to agree to.

We have seen reductions in running costs of around 30% in recent transfers to DB Master Trusts.

Commercial consolidators

Commercial consolidators are like DB Master Trusts, but they also sever the link with the employer covenant. The employer covenant is instead replaced with a capital buffer that sits outside the pension scheme and is tipped into the pension scheme if it is required. This means a significant cash injection is still needed from the charity, but it should be less than a full insurance buy-out cost. It also means it is a far more complex decision for the pension scheme trustees than moving to a DB Master Trust.

This solution could be particularly relevant for charities participating in last-man-standing multi-employer schemes, as it should enable a clean break at a lower cost than the Section 75 debt. It could also lead to the transferring members reaching the insurance regime far more quickly than if those members were to stay in the scheme.

We expect to see initial transactions into commercial consolidators in 2020.

Are you investing responsibly?

There is a growing body of evidence to support the importance of Responsible Investment principles in developing investment strategies. This is relevant to both charities' pension schemes and their charitable funds, to ensure their investment principles are aligned to their charitable goals and objectives.

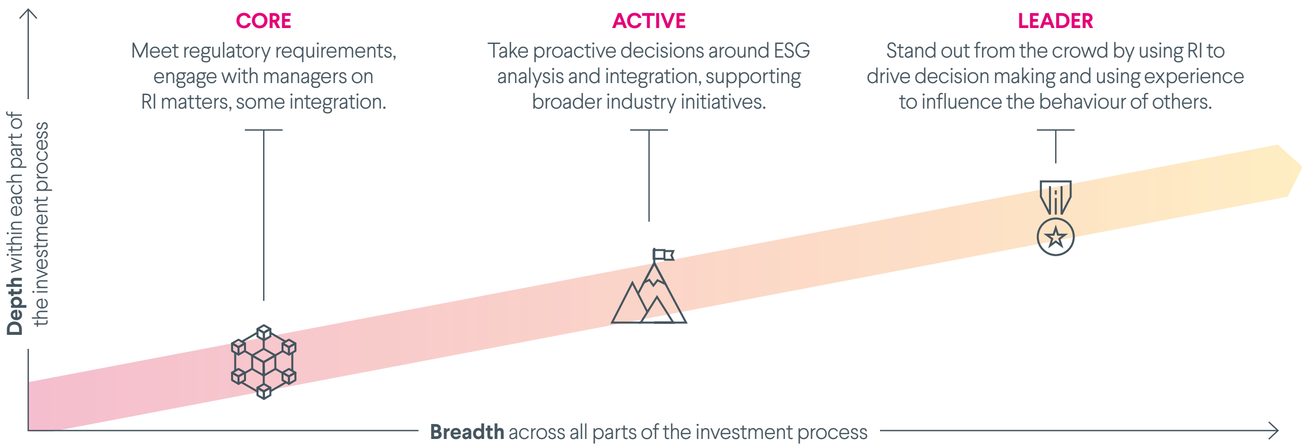
Alongside our pensions advice to charitable organisations, we also advise a broad range of charities on the investment approach for their own assets.

Delivering the 'social contract' has clearly been critical to charities for a long time, an example that other investors have been following in their wake, either through a desire to do the right thing, the mounting evidence supporting superior returns for responsible investors or, in some cases, social pressure on less responsible investors.

Our 'Core – Active – Leader' Responsible Investment framework enables clients to define the type of investor they want to be and then how to deliver it. The approach is summarised below.

Our approach to advising charities focusses on...

- **Delivering promises – this has two aspects:**
  - Delivering the income required today to support key projects with more certainty; and
  - Investing in a way that does not 'damage future generations' by either taking too much risk in volatile markets or failing the 'social contract'.
- **Understanding the landscape:**
  - What are the investments available to you and which best deliver the characteristics required to deliver your promises?
- **Achieving success:**
  - Bringing the first two points together to provide a coherent and robust solution.



Our experience is that charities want to be active in all areas, and a leader where this is in line with their charitable goals (both within the charitable funds and the pension scheme). Some will wish to be leaders in all aspects and recognise that setting an example of good practice has little to do with fund size and far more to do with drive and determination to demonstrate best practice.

If you want to discuss your investment strategy for your charity or pension scheme, please get in touch with Matt Woodman, who leads our investment advice to charities.

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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 January 2020 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 2020.

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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