HYMANS ROBERTSON

DB pension funding in the charitable sector

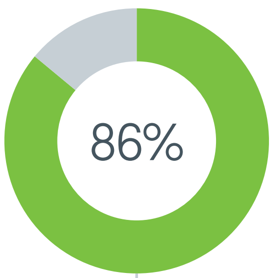
May 2017

Summary

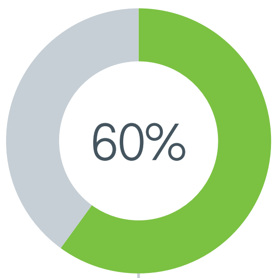
Charities continue to face financial challenges at the moment with fundraising under pressure from public and regulatory scrutiny, and contracts being run on ever tighter margins.

Layered on top of this are increased pension costs with continuing falls in yields. We've therefore analysed the DB pension exposures of the largest 40 charities by income in England & Wales to assess the issues and how charities should respond. These charities have a combined £38bn of reserves and £12bn of annual income, and disclose £7bn of DB liabilities.

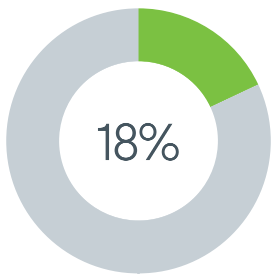
Key findings



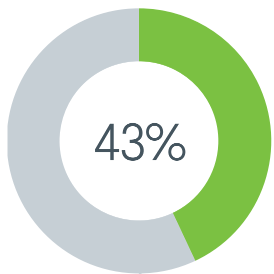
Average FRS102 funding level



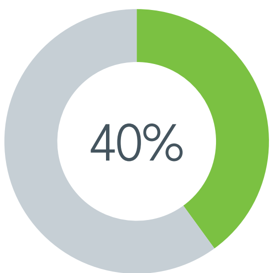
Average allocation to growth assets



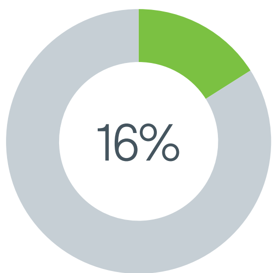
18% of charities have a FRS102 pension surplus



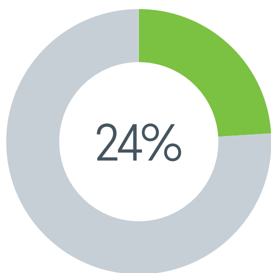
43% of charities have closed their DB scheme to future accrual



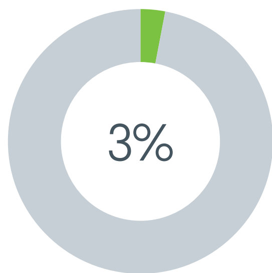
40% of charities have new DB exposures that have come on balance-sheet with FRS102 (through participation in multi-employer schemes)



The average FRS102 pension deficit is 16% of unrestricted reserves



The average FRS102 pension deficit is 24% of annual net unrestricted income



The average charity pays 3% of net unrestricted income into its pension scheme

How should charities respond?

1. **Take less investment risk and hold it on for longer** - whilst charities often want to work scheme assets hard to free up more charity resources for charitable works, in many cases this means taking more investment risk than is necessary. Consider taking a lower level of investment risk and holding that on for a longer period of time. This reduces deficit volatility and stabilises cash costs. By holding the remaining risk on for longer, overall returns and hence deficits are not impacted.

2. **Design funding and investment strategies to pay the projected cashflows** - change your focus from paying off deficits (which have ballooned with low gilt yields) to funding the future pension benefits over time. Many schemes only need to generate around 3% pa to pay their future benefits over time. This can often be achieved with modest levels of investment risk.

3. **Keep up with emerging developments** - two sector specific issues on the horizon are rising PPF levies and an expected easement in paying Section 75 debts in multi-employer schemes. The Green Paper on the future of DB may also ultimately lead to some cost savings, such as scheme consolidation, and changing indexation or suspending pension increases for distressed schemes. Engage early with these issues to understand the impact on your charity and the potential opportunities.

This is our third report assessing the ability of charities to support their DB pension schemes. I hope you find the report interesting and informative. Please contact me if there are any aspects of the report you would like to discuss.

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Charity analysis

Introduction

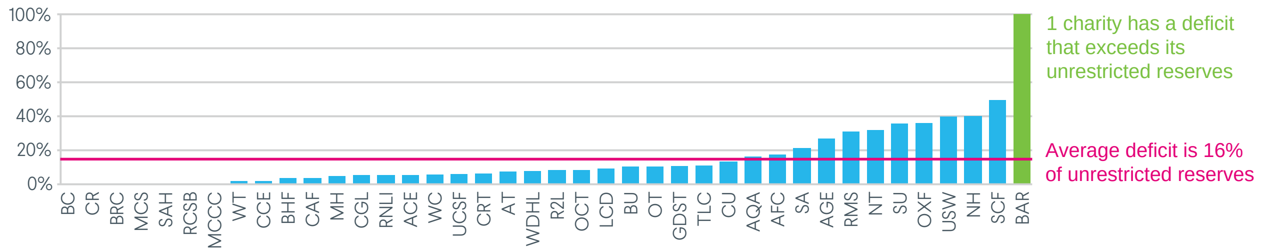
The ability of a charity to support its DB obligations is more important than the size of the liabilities or deficit in isolation. Our analysis therefore focuses primarily on the size of the pension scheme relative to the size of the charity, by considering the following measures:

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 unless restricted funds are used to fund the deficit)
Deficit / net unrestricted income	The level of charity income available to potentially fund the pension scheme (restricted income is excluded unless restricted funds are used to fund the deficit)
DB pension contributions / net unrestricted income	The proportion of net unrestricted income that is paid into the pension scheme

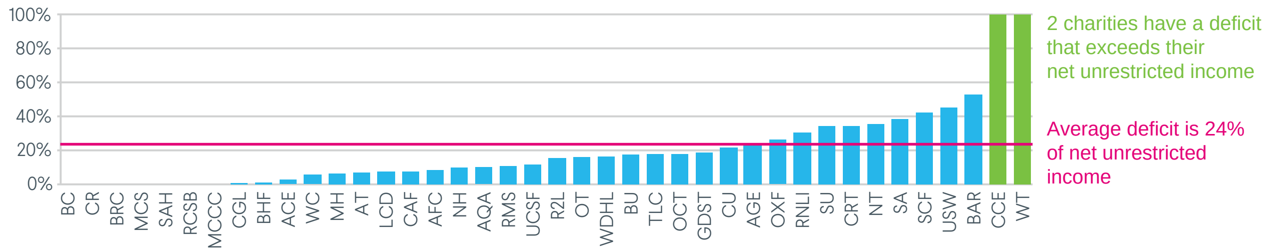
Results

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

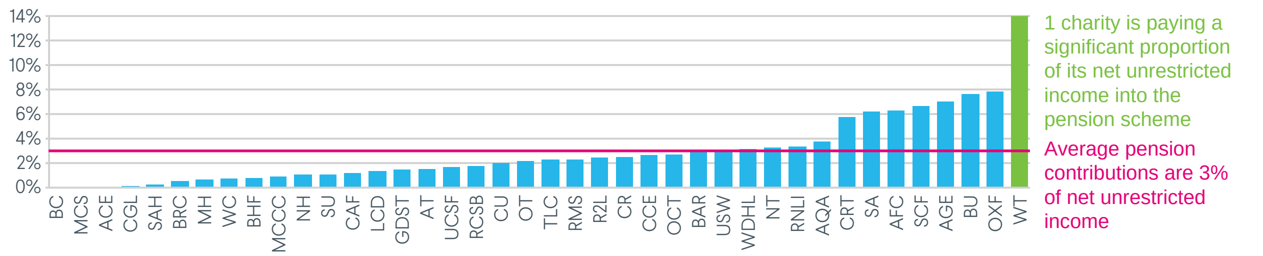
FRS102 deficit/unrestricted reserves



FRS102 deficit/net unrestricted income



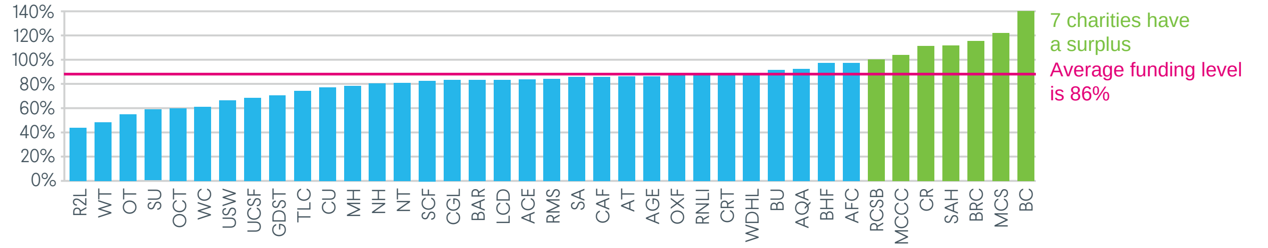
DB contributions/net unrestricted income



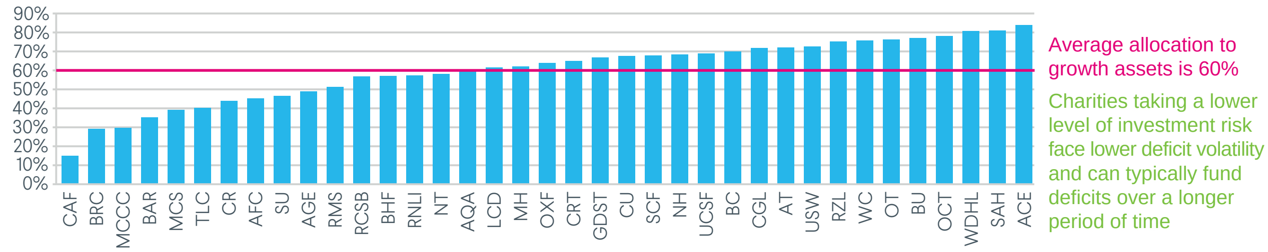
Pension scheme analysis

The charts below focus on scheme metrics and show the distributions of funding level and allocations to growth assets.

FRS102 funding level



Growth asset proportion



Code	Charity	Code	Charity
ACE	The Arts Council of England	MH	Methodist Homes
AFC	Action for Children	NH	Nuffield Health
AGE	Age UK	NT	The National Trust for Places of Historic Interest or Natural Beauty
AQA	AQA Education	OCT	Oasis Charitable Trust
AT	Anchor Trust	OT	The Ormiston Trust
BAR	Barnardo's	OXF	Oxfam
BU	Bangor University	R2L	Reach2 Limited
BC	The British Council	RCSB	Royal Commonwealth Society for the Blind
BHF	British Heart Foundation	RMS	Royal Mencap Society
BRC	The British Red Cross Society	RNLI	The Royal National Lifeboat Institution
CAF	The Charities Aid Foundation	SA	The Salvation Army
CR	Cancer Research UK	SAH	St Andrew's Healthcare
CRT	Canal & River Trust	SCF	The Save the Children Fund
CU	Cardiff University	SU	Swansea University
CGL	Change Grow Live	TLC	Trustees of the London Clinic Limited
CCE	Church Commissioners for England	UCSF	United Church Schools Foundation Ltd
GDST	The Girls' Day School Trust	USW	University of South Wales/Prifysgol de Cymru
LCD	Leonard Cheshire Disability	WDHL	Wakefield and District Housing Limited
MCCC	Marie Curie Cancer Care	WC	The Woodard Corporation
MCS	MacMillan Cancer Support	WT	Wellcome Trust

Not included in this benchmarking?

Contact Alistair Russell-Smith and we'll run the same analysis for your charity and send you details. You can contact Alistair on 020 7082 6222 or email alistair.russell-smith@hymans.co.uk

How should charities respond?

In our view, the key actions that charities and their pension schemes should be taking are:

1) Take less investment risk and hold it on for longer

The average allocation to growth assets across the assessed charities is 60%, which is higher than the 50% allocation across all UK schemes. Whilst charities often want to work their scheme assets hard to enable more of their resources to be spent on charitable works, in many cases this is likely to be taking more risk than is necessary. When the emphasis switches to paying the cashflows over time rather than paying off a deficit, the required returns can often be relatively modest at around 3% pa.

Taking less investment risk and holding the remaining risk on for longer reduces deficit volatility. This controls the likelihood of further cash calls on charities at the very time when income is under pressure. By holding the remaining risk on for longer, overall returns and hence deficits are not impacted. This lower risk approach can also enable longer recovery periods, which can help with affordability constraints.

2) Design funding and investment strategies to pay the projected cashflows

Much has been made of falling gilt yields and the subsequent rise in pension liabilities. However, the projected cashflows are not linked to gilt yields, and schemes should focus on designing funding and investment strategies to meet these cashflows over time rather than paying off a deficit. As mentioned above, this means a lower risk investment approach can be taken, with required returns often falling to around 3% pa.

With this approach it becomes important to get the projected cashflows right. Consider using our Club Vita longevity analysis, as this provides the clearest possible picture on longevity by ascribing a 12 year range on life expectancy depending on individual member characteristics. And our On Demand Valuations automatically refresh the cashflows quarterly for new membership data.

3) Keep up with emerging developments

There are two sector specific developments on the horizon which you need to keep on top of:

- Rising PPF levies - a new levy methodology comes in from 2018/19 and the PPF and Experian are using a new scorecard for not-for-profits which is expected to increase levies as actual insolvency rates in the sector have been higher than predicted by the current model. Check your score under the new model to understand the impact.

- Section 75 debt consultation - the current DWP consultation should provide some much needed relief to charities participating in multi-employer schemes by enabling their exit debt to be deferred. This will enable struggling charities to at least turn off DB accrual, and give more flexibility to those stuck in DC schemes with little ability to move for fear of triggering associated DB Section 75 debts.

The Green Paper on the future of DB could also ultimately lead to some changes to DB schemes for charities, including scheme consolidation, and the possibility of reducing indexation or suspending pension increases for distressed schemes. Charities that remain open to future accrual need to plan for very significant increases in future accrual coming through at their next triennial valuations. Many multi-employer schemes including the local government pension schemes, the Universities Superannuation Scheme and the Social Housing Pension Scheme have either implemented new contribution schedules recently or will be imminently after forthcoming triennial valuations.

Appendix – methodology

1. The charities analysed are the largest 40 by income in England & Wales (as listed by the Charities Aid Foundation's Charity Trends website) at February 2017 that have DB liabilities disclosed in their accounts. Those charities that have no DB exposure (or only participate in public sector schemes and account on a cash basis for DB liabilities) 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 28 February 2017.

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 generally excluded on the basis that a pension scheme would not have access to them. However, they are included if the deficit is funded out of restricted funds which is the case for Canal & River Trust, The Church Commissioners, Oasis Charitable Trust, The Ormiston Trust, Reach2 Limited and United Church Schools Foundation.

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 unrestricted income in the first place.

7. For charities with a DB surplus, the surplus is shown prior to any balance sheet restriction. The introduction of FRS102 means that surpluses can often be recognised on balance sheet when this was not possible under FRS17.

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

9. Some charities have significant assets allocated to '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.

10. FRS102 means that the present value of future deficit contributions is now on balance sheet for multi-employer schemes that were previously accounted for on a cash basis (like the USS). This liability is included within the pension deficit and pension contributions in this analysis.

11. DB pension liabilities relating to unfunded schemes (like the Teachers Pension Scheme and Principal Civil Service Pension Scheme) are excluded from this analysis as they are accounted for on a cash basis.

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