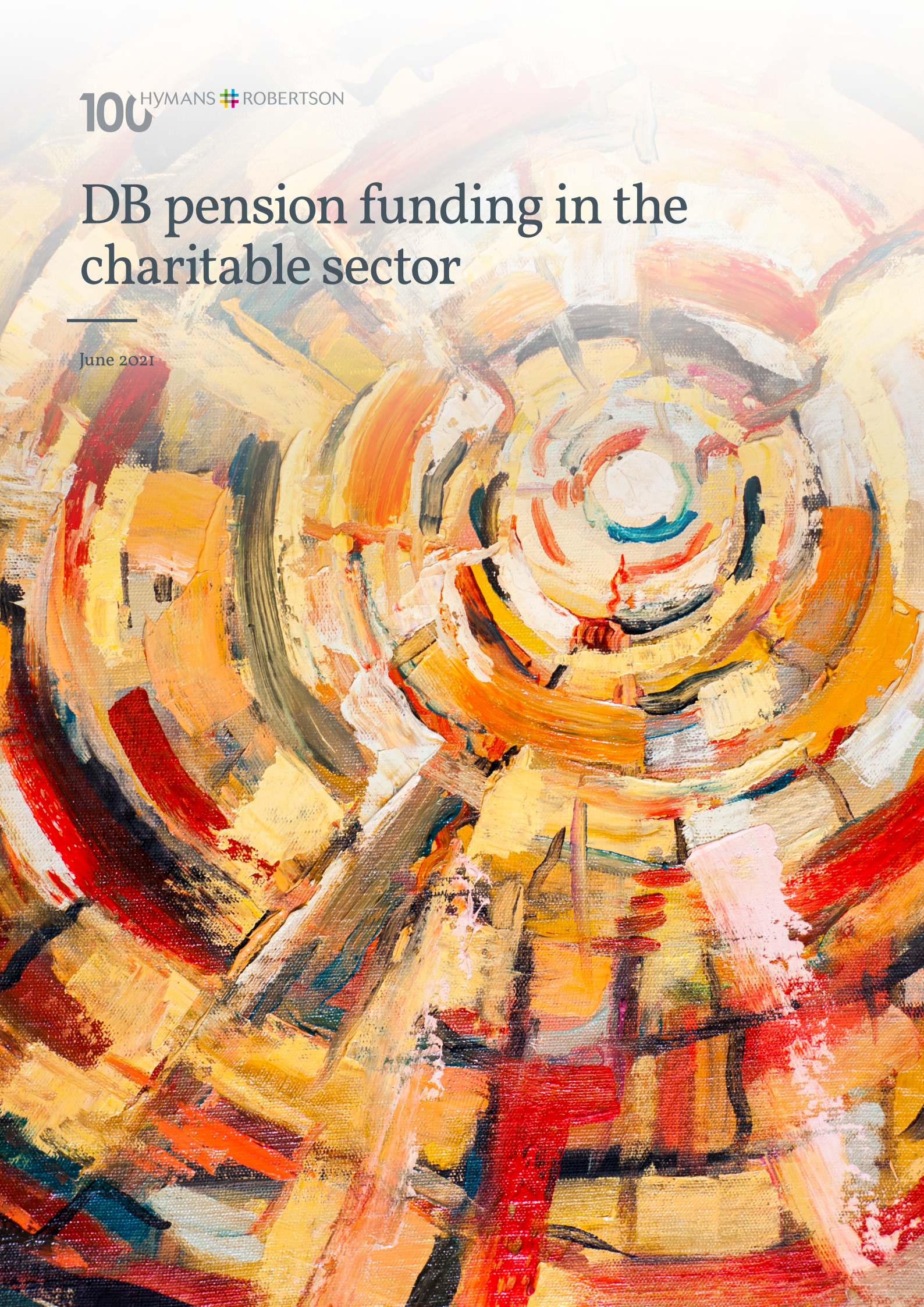


DB pension funding in the charitable sector

June 2021



Summary

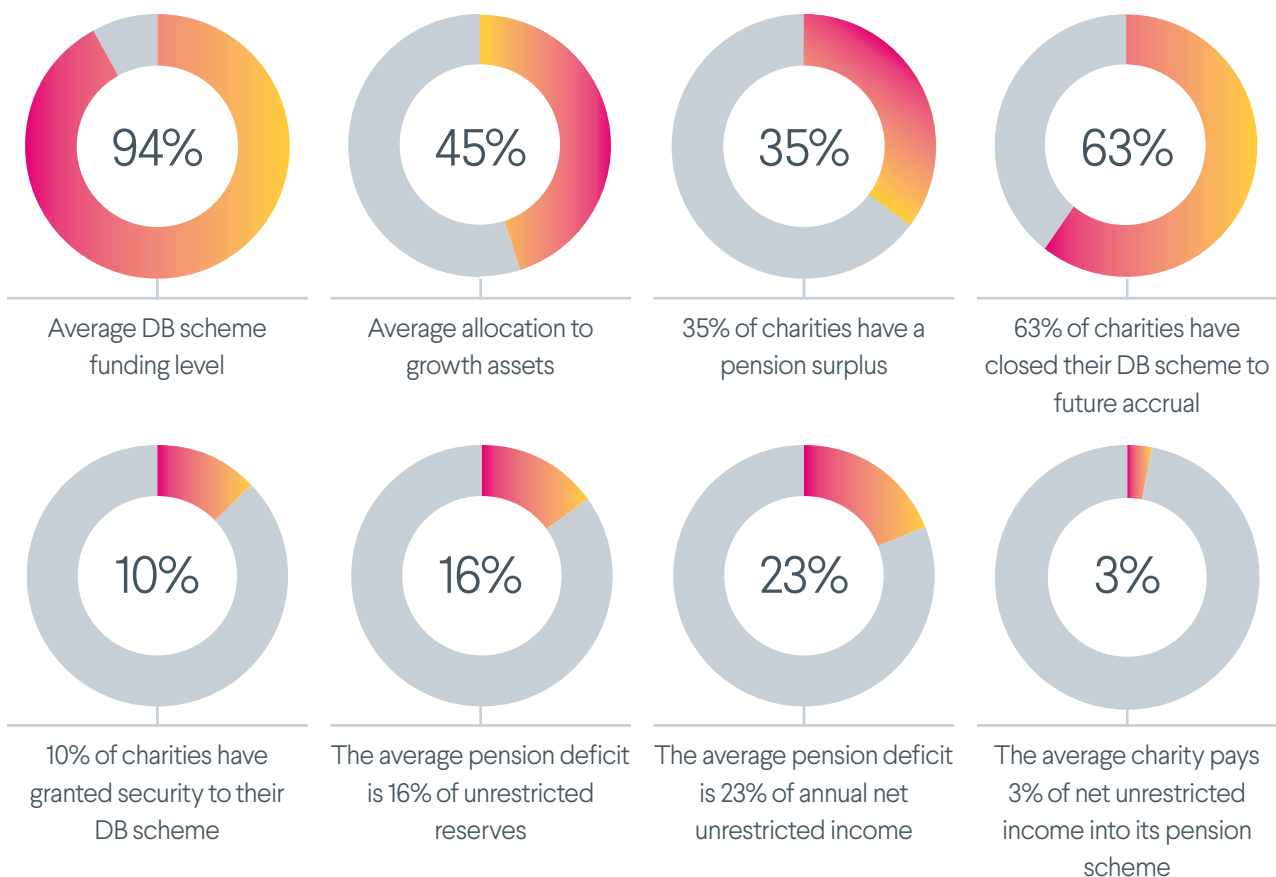
The COVID-19 pandemic has placed charities under significant financial strain over the past year, with fundraising and retail income particularly badly hit. While charities are preserving cash, their DB pension schemes continue to require substantial funding.

On top of this, charities need to start planning for a new DB funding regime, which requires more prudent funding targets and quicker repayment of deficits. There is a delicate balancing act between ensuring the sustainability of charities and funding 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 £46bn of reserves and £13bn of annual income and support aggregate DB liabilities of £9.5bn.

In our analysis we already see income being hit for charities. However, it's worth noting that for many of these charities, the full impact of the tough past 12 months won't yet be fully recognised in these figures, as they are based on publicly available charity accounts, typically as at 31 March 2020. We anticipate that the 2021 accounts published for these charities could paint a much gloomier picture.

Key findings (all liability measures are on FRS102 as disclosed in charity accounts)



How should charities respond?

1 Plan triennial actuarial valuations in the aftermath of COVID-19.

Charities with triennial actuarial valuations over the coming year will need to consider the implications of COVID-19. In the short term, the pandemic may have resulted in higher levels of mortality within the pension scheme, although the long-term effect on life expectancy remains unclear. COVID-19 may have also weakened the covenant support that some charities provide to their pension scheme. Early engagement on triennial valuations is therefore important to give time to develop the right balance between affordability and member security.

2 Adapt funding plans for the new forthcoming DB funding regime.

A new DB funding regime is coming into force in 2022/23. The funding position of pension schemes in the 'not for profit' sector is, on average, worse than other sectors in the UK. Charities are therefore more exposed to increased cash requirements under the new funding regime. However, providing security to the pension scheme (e.g. a charge over charity property or investments) can support a lower funding target or longer recovery plan, thereby reducing the cash requirement down to more affordable levels.

3 Managing multi-employer scheme exposures.

Many charities participate in a range of multi-employer schemes, which come with their own challenges. Often charities want to exit these schemes or shrink their exposure but are unable to for fear of triggering unaffordable Section 75 debts or cessation debts. However, developments in recent years mean there are now some options available for managing cost and risk in most multi-employer schemes. Charities participating in these schemes should therefore reconsider their position and assess some of the options explored in this report.



Heather Allingham

Head of Pensions Consulting for Charities
heather.allingham@hymans.co.uk
0141 566 7779



Craig Ritchie

Actuary
craig.ritchie@hymans.co.uk
0131 656 5172



Alistair Russell-Smith

Partner and Charity Pensions Adviser
alistair.russell-smith@hymans.co.uk
020 7082 6222

Charity analysis

Introduction

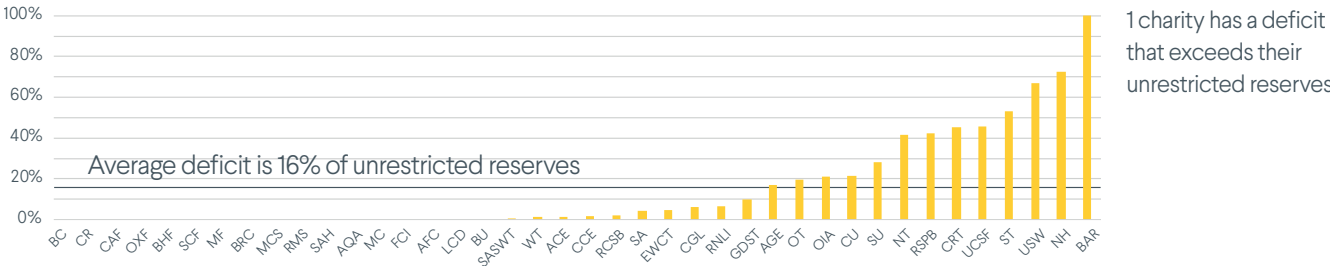
The ability of a charity to support its DB obligations is more important than the size of the liabilities or deficit in isolation. Our analysis therefore focuses primarily on the size of the pension scheme relative to the size of the charity by considering the following measures:

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 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

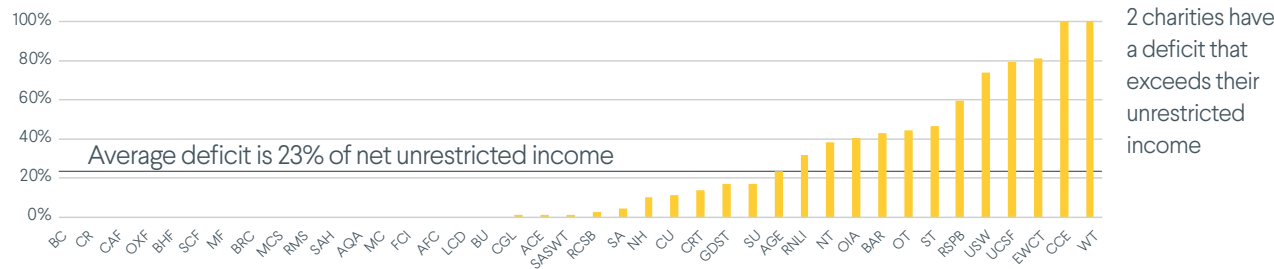
Results

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

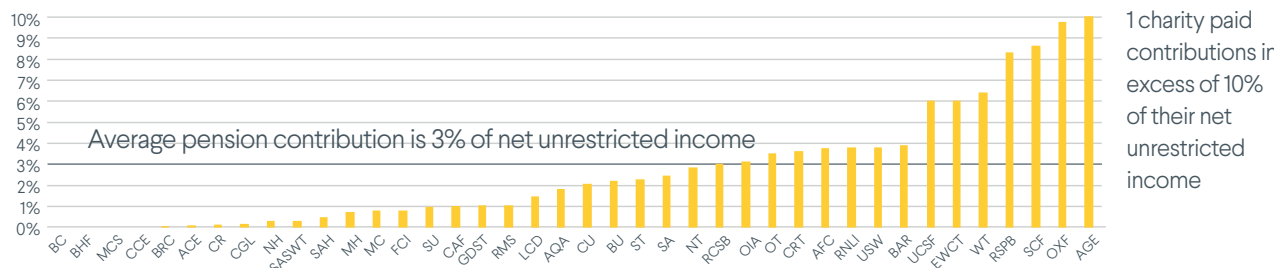
Deficit/unrestricted reserves



Deficit/net unrestricted income



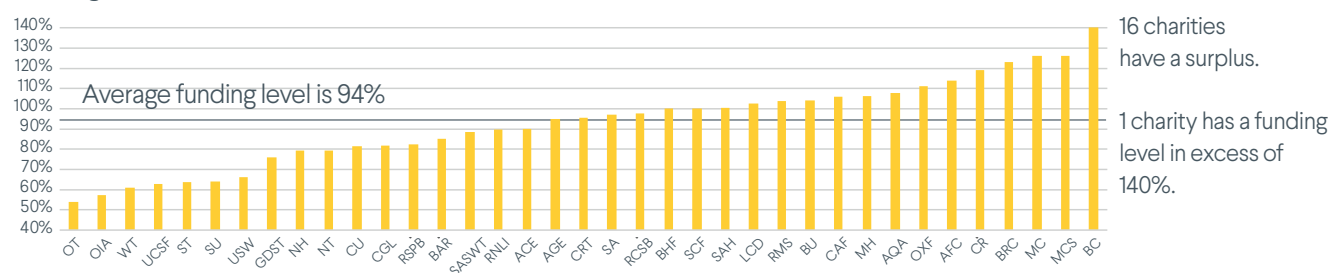
DB contributions/net unrestricted income



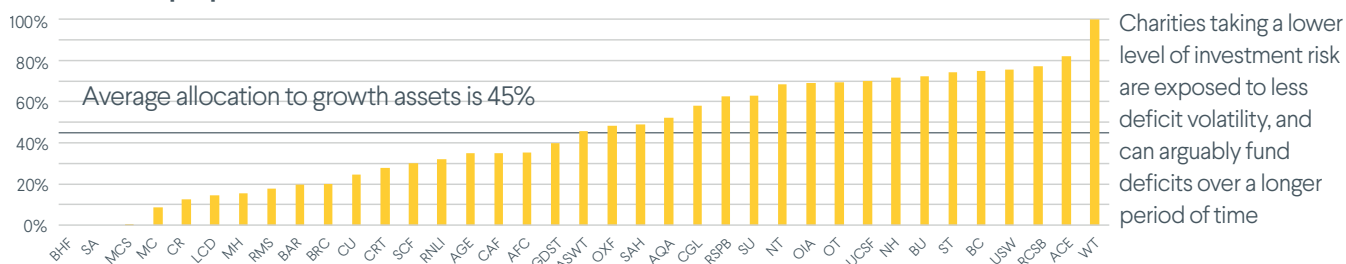
Pension scheme analysis

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



Growth asset proportion



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

Code	Charity	Code	Charity	Code	Charity
ACE	The Arts Council of England	LCD	Leonard Cheshire Disability	SASWT	The Salvation Army Social Work Trust
AFC	Action for Children	MC	Marie Curie Cancer Care	SCF	The Save the Children Fund
AGE	Age UK	MCS	MacMillan Cancer Support	STL	The Shaw Trust Limited
AQA	AQA Education	MH	Methodist Homes	SU	Swansea University
BAR	Barnardo's	NH	Nuffield Health	UCSF	United Church Schools Foundation Ltd
BC	The British Council	NT	The National Trust for Places of Historic Interest or Natural Beauty	USW	University of South Wales/ Prifysgol de Cymru
BHF	British Heart Foundation	OIA	Oasis International Association	WT	Wellcome Trust
BRC	The British Red Cross Society	OT	Ormiston Trust		
BU	Bangor University	OXF	Oxfam		
CAF	The Charities Aid Foundation	RCSB	Royal Commonwealth Society for the Blind		
CCE	Church Commissioners for England	RMS	Royal Mencap Society		
CGL	Change Grow Live	RNLI	The Royal National Lifeboat Institution		
CR	Cancer Research UK	RSPB	RSPB		
CRT	Canal & River Trust	SA	The Salvation Army		
CU	Cardiff University	SAH	St Andrew's Healthcare		
EWCT	The Eric Wright Charitable Trust				
GDST	The Girls' Day School Trust				

The average allocation to growth assets has reduced from 60% to 45% over the past 5 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.

How should charities respond?

1) Actuarial valuations in the aftermath of COVID-19

Charities with actuarial valuations over the coming year will need to consider the implications of COVID-19 on their funding plans. Two major considerations are the impact on life expectancy and the impact on a charity's covenant support for the scheme.

Slowdown in life expectancy

In the short term, the pandemic may have resulted in higher levels of mortality within the pension scheme. The mortality rate in 2020 was around 13.5% higher than we would have expected at the start of the year. Even if we go back to the 1960s, 2020 is by far the biggest outlier in terms of excess deaths. This has had an immediate impact on scheme liabilities and may result in funding improvements for schemes. The longer-term impact remains uncertain.

- At one extreme, COVID-19 may have a short and isolated effect and, after a marked increase in deaths due to the pandemic in 2020 and 2021, trends return to the pre-pandemic rate, although with a couple of "lost years" of longevity improvement that will never be recovered, and scheme liabilities might be expected to drop by c1%.
- At the other extreme, the effectiveness of vaccine programmes may be limited by emerging mutations and adverse publicity limiting the uptake. The second and subsequent waves may prove more deadly than the first and mortality rates remain elevated for much of the 2020s, creating a prolonged economic recession. Healthcare enters a downward spiral as our systems struggle to provide regular care during the ongoing pandemic, and scheme liabilities might be expected to drop by upwards of 5%.

Funding gains should therefore come through at forthcoming valuations, both from using a more recent cut of the membership data, and from adopting a lower life expectancy assumption.

Employer covenant

While the pandemic may have reduced scheme liabilities, it has also severely hit charitable income, particularly from fundraising and retail, meaning the covenant support provided to the scheme may now be weaker. Charities should engage with their pension scheme trustees on

covenant assessment, and ensure that deficit contributions do not rise to unaffordable levels (perhaps driven by a weaker employer covenant leading to a more prudent assessment of the deficit), at the very time when the charity finances might be under strain. We explore some options for keeping cash contributions lower in the next section.

2) Adapt funding plans for the new forthcoming DB funding regime

A new DB funding regime is coming into force in 2022/23. While the new regime is still in development (with a second consultation and draft code of practice expected in the second half of 2021), the direction of travel is clear with the primary legislation (the Pensions Scheme Act 2021) now in place and a first consultation now completed.

Under the new regime, there will be a choice between:

- a "Fast Track" funding approach; or
- a "Bespoke" funding approach.

Fast Track

Adopting "Fast Track" involves complying with a set of minimum funding standards set by TPR, which then ensures no regulatory intervention. This involves setting a Long-Term Objective ("LTO") to be fully funded on a basis of "gilts + 0.5% pa" or stronger within 15-20 years, and having cash recovery plans of no more than 6 years for stronger employers. The funding position of pension schemes in the 'not for profit' sector is, on average, worse than other sectors in the UK. As such, we expect the "Fast Track" funding standards will lead to substantial increases in contribution requirements for charities.

Bespoke

However, the alternative "Bespoke" funding approach gives some much-needed flexibility, albeit potentially subject to additional scrutiny from TPR. One option under Bespoke that could work well for charities is using assets of the charity to enhance the covenant support for the scheme, and therefore support a lower LTO or longer recovery plan, thereby reducing the annual cash requirement. The new funding regime does now clearly quantify a value for providing security to the pension scheme for the first time, which directly flows through to lower cash contributions.

Case study

The case study below compares Fast Track and Bespoke funding strategies for an illustrative £100m DB scheme. It shows that using the Bespoke route could reduce annual cash contributions by 35% to 65% depending on the level of security provided to the pension scheme.

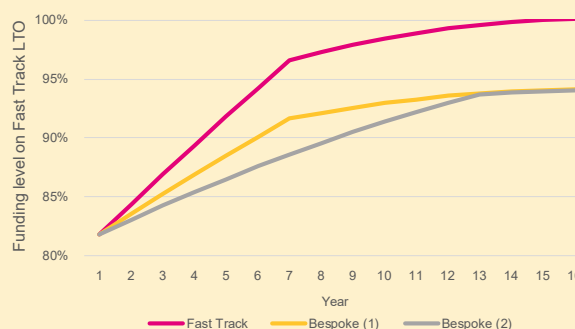
This charity has a £100m DB scheme that is 90% funded on Technical Provisions (the average funding level for UK DB schemes). Fast Track requires a plan for this charity to be fully funded on a gilts + 0.5% LTO within 15 years, with a cash recovery plan of no more than 6 years. However, using the Bespoke approach enables adoption of a lower gilts + 0.8% LTO, with £16m of security bridging the gap between this and the equivalent Fast Track LTO. Pledging further security can then also support a longer cash recovery plan than 6 years.

The table below sets out the funding position of the scheme on these different bases.

Funding basis	Technical Provisions	Fast Track LTO	Bespoke LTO
Discount rate	Gilts + 1% pa	Gilts + 0.5% pa	Gilts + 0.8% pa
Assets	£90m	£90m	£90m
(Liabilities)	(£100m)	(£110m)	(£104m)
(Deficit)	(£10m)	(£20m)	(£14m)
Funding level	90%	82%	87%

This table and chart then set out possible funding strategies under Fast Track and two Bespoke options. Bespoke (1) pledges £16m of security to support the lower LTO. Bespoke (2) pledges a further £3m of security to also cover a cash recovery plan extension of 6 years. All three options are based on the same initial investment strategy, but as can be seen the Bespoke options lead to very significant reductions in the annual cash contribution requirement.

Strategy	Fast Track	Bespoke (1)	Bespoke (2)
Security	-	£16m	£19m
Recovery plan	£1.75m pa for 6 years	£1.1m pa for 6 years	£0.6m pa for 12 years



On aggregate we estimate that the deficit on the Pension Regulator's Fast Track long-term funding basis of gilts + 0.5% pa is £3.5bn across the charities within our analysis. Charities should therefore begin planning now to ensure that they are not hit with unaffordable cash requirements under the new funding regime.

3) Managing multi-employer scheme exposures

Many charities participate in multi-employer pension schemes, which present their own challenges. The table below summarises the main types of multi-employer pension scheme exposures in the sector, and their key issues.

Type of multi-employer scheme	Funded private sector schemes	Funded public sector schemes	Unfunded public sector schemes
Examples	Sector specific schemes, e.g. universities, social housing, faith based.	Local Government Pension Schemes (LGPS)	Teachers Pension Scheme, NHS Pension Scheme
Issues	Lack of control, managing section 75 debts, "last man standing" risk, hardening of exit terms.	Lack of control, managing cessation debts, participation in multiple funds.	Increasing contribution rates, fear of exit penalties being introduced.

In our experience, charities would usually prefer to exit or manage down their exposure to these schemes. However, this has historically been seen as unaffordable because it requires payment of the Section 75 debt in funded occupational schemes or the cessation debt in the LGPS. Furthermore, continued participation in some of these schemes (if they do not have a separate DC section) means the build-up of further DB liability and risk that cannot be afforded. But there have been significant developments in recent years, which mean that there are now a range of ways to manage cost and risk in these schemes, including the options set out in the table below.

Solution	Description	Applicable to:
Shrink DB accrual	Reduce the number of employees with DB accrual to minimise the build-up of additional DB cost and risk, without triggering the section 75 debt. Some schemes offer DC sections, which enables employers to cease DB accrual without the Section 75 debt triggering. Other mechanisms include facilitating voluntary opt-outs of the DB scheme or setting up service companies that do not participate in the DB scheme.	Funded private sector schemes, LGPS, Unfunded public sector schemes.
Bulk transfer	Transfer your share of the DB assets and liabilities to your own arrangement and fund the deficit over time rather than paying the section 75 debt upfront. Viable if funding or covenant improvements can be offered to maintain member security post transfer.	Funded private sector schemes
Apportion liability	Apportion your liability to another participating employer in the scheme, in exchange for cash or assets outside of the scheme. This is viable in cases where the receiving employer expects to stay in the scheme for the long-term, meaning the liability they take on is not expected to crystallise at current section 75 levels.	Funded private sector schemes
Deferred Debt Arrangement	Cease future accrual, but carry on paying ongoing deficit contributions, triggering an eventual section 75 or cessation debt in the future when it should be for a lower amount. A concern here is an ability for the scheme to call in the debt if they are concerned about a deterioration in employer covenant in the future.	Funded private sector schemes, LGPS
Deferred Spreading Arrangement	Cease participation in LGPS but pay the cessation debt over time rather than upfront, backed by security to cover the outstanding debt.	LGPS
Merge exposures	Usually seen in LGPS, some charities participate in multiple funds, giving governance complexity and higher administration costs. Merging all the assets and liabilities into one fund reduces cost and complexity, as well as enabling more control over funding and investment strategy and pushing back the triggering of cessation debts.	LGPS
Hard exit	Some charities participate in unfunded public sector schemes voluntarily for recruitment and retention purposes. However, increasing contribution rates are leading some to exit if they do not have to be in the scheme. Independent schools exiting the Teachers' Pension Scheme is a recent example. There is currently no requirement to pay an exit debt from these types of schemes as they are unfunded.	Teachers' Pension Scheme
Phased withdrawal	The Teachers' Pension Scheme is allowing independent schools to put new hires into a different scheme from the next academic year, allowing a phased withdrawal, whereas previously a school had to be fully in or out of the scheme.	Teachers' Pension Scheme

Appendix – methodology

1. The charities analysed are the largest 40 by income in England & Wales (as listed by the Charity Commission website) at January 2021 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 2021.
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.