CFG INSPIRING FINANCIAL LEADERSHIP

Submission to The Pensions Regulator

Consultation on draft defined benefit (DB) funding code of practice and regulatory approach

24 March 2023

About Charity Finance Group

Charity Finance Group (CFG) is the charity that works to improve the financial leadership of charitable organisations, promote best practice, inspire change and help organisations to make the most of their funds so they can deliver the biggest possible impact for the communities and beneficiaries they serve. CFG has over 1450 members and collectively they manage over £21 billion in charitable funds – around a third of the entire charity sector's income.

Understanding the diversity of charity business models

In a previous submission to The Pensions Regulator, Charity Finance Group provided a more detailed overview of the sector and its legal and regulatory context. This included some of the specific challenges facing charitable organisations and the ways in which they are to an extent financially constrained in their use of funds, depending on the source of those funds. There are certain points which we wish to re-emphasise in the context of the proposed new funding code.

Charities are different to corporate entities; not only are they not for profit but their governance, legal and regulatory environment differs in significant ways. It is important that revised regulation avoids any unintended consequences which would run counter to the need for pension schemes to be fully funded. The revised code must take account of the implications of these differences.

This brief summary is not intended to give an exhaustive account of the differences between the charity (not-for-profit) sector and for-profit sector, but instead is meant to highlight certain challenges which we believe are specific to charities.

Charities operate for the public benefit and are governed by unpaid Trustees who must ensure their organisation meets its obligations under its governance documents, as well as charity law and regulation, whilst achieving the charity's purpose. Whilst a charity is a legally defined entity, the 'charity sector' encompasses as many varied entities as the 'corporate sector'. Charities operate in the areas of health, care, heritage, education, employability support and training, overseas relief, development, social, and arts, to name but a few. The economics and business models of their activities will vary as much as the differences seen in the corporate sector. Even if possible, segmenting the charity sector to provide straightforward definitions would add a layer of interpretive complexity on top of an already complex regulatory process.[1]

It is also worth noting that the sector is highly regulated. The legal framework for charities is underpinned by the Charities Act 2011 which is supplemented by regulations and guidance issued by the charity commission. This regulation is comprehensive, it covers what activities charities my undertake, how they are managed, how they should be run and manage their financial affairs, including the need to manage their financial reserves The management (financial and otherwise) and responsibilities of charity trustees is the main focus of the charity commission regulation and oversight.

Ultimately, charity decisions will be based around what is the most balanced outcome for the charity to deliver the charity's purpose for present and future beneficiaries and stakeholders (including current and former employees), rather than focussing on maximising shareholder value.

It is important that the guidance takes into account the nuances of charity finance, so that pension scheme trustees do not feel obliged to follow guidance which ultimately undermines the charities' purpose.

Tailoring the code for charities

It is positive that, following CFG's previous submission, the second iteration of the code recognises to a greater extent the challenges of not-for-profits in covenant assessment, and explicitly references them. For instance, TPR has included a section on assessing prospects which asks not-for-profits to consider "the reputation and public profile of the employer and the impact of any changes to that on future donations".

However, we do not feel this fully expresses the concerns that charities have in this regard.

The primary concern is that there is a potential conflict between charities fulfilling their duty to dedicate resources to their beneficiaries, and spending increasing amounts to contribute to pension schemes, particularly in cases where there is a strong covenant. During a time when charity finances are already under significant strain:

> "… a substantial proportion of charitable organisations have experienced a deterioration in their financial positions over the past three months, with many more anticipating further deterioration to come. This financial stress is of such a scale that a majority of charities

[1] Further detail on the differences between the corporate sector and charity sector has been provided previously by CFG in our June 2021 Submission to The Pensions Regulator ahead of the second DB Funding Code consultation under the heading 'Charity Business Model Scenarios and Risks'.

> and community groups are now using their reserves in order to meet their operating costs.” [2]

This is deeply concerning for charities themselves and will be equally concerning for the beneficiaries they exist to serve.

We would recommend there is explicit reference to concerns around donor/stakeholder perception in the funding code. The issue of perception goes beyond the general public as donors to include grant-making bodies and also contract issuers, where charities may be seeking to include an element of their core costs in funding bids and this could include a contribution towards a DB pension deficit. Specifically, we would like more explanation on understanding the potential risk to charitable organisations, in that increasing the level of scheme contributions to pensions could have a detrimental impact on donor/stakeholder perception, which in turn could reduce the willingness of donor’s to provide financial support to the charity. The unintended consequence could be a weakening of the charity’s financial position and a corresponding weakening of the covenant.

We have further concerns that as things stand, there are parts of the guidance that do not apply well to charities. These include:

- We do not believe that covenant leakage as a principle applies well in a charity context. Given that charities’ legal purpose is to act for public benefit, the challenge is to understand the balance of the charity spending a pound on its charitable purpose rather than its pension fund. The concept of leakage carries assumptions from the economic environment in the corporate sector which are not helpful in identifying the choices available and decisions required in respect of funding charity pension schemes.
- There is no clarity on what ‘investing for sustainable growth’ would mean for a not-for-profit.

Concerns with the new ‘reasonably affordable’ requirement

It is positive that there is greater flexibility with the twin-track approach so that fast track is a regulatory filter rather than a universal benchmark. Nonetheless, while there is some flexibility with the bespoke approach, concerns remain about the new regulations being too restrictive in requiring progress to a low risk position.

Large healthcare charity – statement

Having reviewed the newly proposed DB Funding code that has been published by The Pension Regulator (TPR), the concept that ‘trustees must follow the principle that funding deficits be recovered “as soon at the employer can reasonably afford”’ could

[2] Pro Bono Economics and Nottingham Trent University, Dec 2022, Breaching the Dam (An analysis of the VCSE Sector Barometer, in partnership with Nottingham Trent University’s National VCSE Data and Insights Observatory)

present some challenges for the diverse charity sector that has to follow regulations set by The Charity Commission and a different business model to that of the private sector.

Whilst there is an understanding of the need for TPR to want pensions to be protected and reduce risk, the guidance could present difficulties; for example, the inflexibly of the new regime driving the need for charities to pay down their DB pension scheme quicker. Concerns for charities could range from what this might mean for the finances of the charity as a whole and the concerns about funds which were meant for the charity's beneficiaries having to go towards paying DB pensions more quickly than is necessary. Another concern could be about the perception from donors if they feel that their contribution is being used to fund a DB pension scheme rather than the beneficiaries of the charity. This could result in a reduction in donors and could make the financial situation of the charity worse, in turn affecting the charity's ability to pay into the pension.

An observation would be that it would be beneficial for the Charities Commission to engage proactively with the charity sector and The Pensions Regulator to establish the feasibility of the newly proposed code, the impact it could have on the charity sector, their business models and donors.

The ability of the employer to sustain pension contributions may not be easily assessed on the basis of headline figures for cash balances or reserves. Charity finances are complex and charities may face considerable restrictions on the use of certain funds which means those funds are not available to be used for the pension scheme. Charities have duties to consider holding certain balances as reserves, to manage the financial risks they face, including risks associated with the pension scheme. Reserves held for managing risk in accordance with the Charity Commission's guidelines will not 'available' to the pension scheme but they do contribute to the long term resilience and sustainability of the charity, enabling it to continue to generate unrestricted funding that can be allocated to the scheme. Any assessment of affordability needs to be based on a detailed understanding of the constraints which the individual charity may face, including the need to balance pension contributions with other commitments consistent with the organisation's charitable purpose.

There are also important differences with regard to the visibility of income streams from the charity and corporate world.

A large veterinary charity has observed:

The work we did to attract legacy donors a number of years ago has meant that we have income streams which we expect to be received beyond the 5-6 year time horizon typical of many corporate entities. So we believe we have better visibility over many of our income streams than you would typically see in the corporate world.

This longer timeframe should provide additional assurance that in many instances additional flexibility for the charity sector is warranted, and the code should be updated accordingly.

Inflexibility of the new regime

Concerns remain about the inflexibility of the new regime. At a point of significant maturity, it requires very low risk investments even when the overall financial position of the charity is strong. We believe greater flexibility should be available to charities which can demonstrate a strong long term covenant.

Depending on the sources of its income, a charity may have more or less flexibility on how to deploy that income. In turn, what is "reasonably affordable" to put in to pension schemes will vary.

A 2001 FOI request from TPR showed that the mean and median recovery plan lengths for not-for-profit sponsors was just under nine years.[3] If the current flexibility available for not-for-profits is reduced to the average length of recovery plans for for-profit organisations of six years, this would mean an increase in contributions by not-for-profits of 30-40%.

As already demonstrated, increasing contributions by this amount would likely have a large impact on donor perceptions and could therefore weaken the financial position of the charity and therefore weaken the covenant.

The newly proposed 'reasonably affordable' legal requirement combined with the faster pace of funding will make it harder for charities to determine what is an acceptable outcome in the new regime.

We would recommend TPR tightens the code so it is clear that the requirement for pension schemes to be funded at a reasonable level does not unduly impact on charitable purpose.

[3] The Pensions Regulator, June 2021, Recovery plan lengths