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REVIEW

What does the DB funding code mean for charities?

In partnership with Barnett Waddingham and BDO, Charity Times hosted a roundtable discussing the implications of the new defined benefit (DB) funding regime.

WRITTEN BY MELISSA MOODY

High profile corporate failures in recent years have prompted an increase in conversations relating to defined benefit (DB) pension schemes, leading up to an overhaul of pension scheme funding legislation and a new DB funding code. The regime will come into force no earlier than October 2023 and will only affect funding valuations after the effective date, although this timescale would be optimistic, and a later implementation date seems likely. As a result, charity finance and HR managers are having to wrap their heads around these new regulations in addition to their usual workload. .

The new legislation applies to all employers with DB pension schemes, including charities, and focuses on these schemes achieving a low risk position with reduced reliance on the sponsor by the time they are mature, and also on establishing a journey plan for how to get there.

The new draft funding code requires schemes to only run an appropriate level of investment risk based on the sponsor's cashflow through their journey plan and reduce reliance on their sponsor once the trustees have less certainty/ visibility on these cashflows.

The draft funding code consists of over 200 pages' of much-awaited detail on the proposed new regime and will be an overwhelming amount of material for charity finance managers to sift through.

Against this backdrop, Charity Times, in partnership with Barnett Waddingham and BDO, brought together leaders from across the sector to help break down the detail and to provide a clearer overview of what the changes mean to charities.

The roundtable discussion kicked off with a presentation from Barnett Waddingham partners, Steve Hitchiner and Neil Davies, who provided an outline of what the funding code means and what the key changes are.

The code has been a while in the making, they explained, beginning in 2016 when there were several high-profile insolvencies with underfunded pension schemes. This caused concern within government, leading to a Department of Work and Pensions (DWP) green and then white papers.

"The 2018 White Paper can probably be best summed up with the very first paragraph in the introduction, which is that the funding regime was working very well for most, but there were a few that were abusing the flexibilities within that funding regime, and therefore changes were needed," they said. "It's really important to bear in mind that the original intention of all of this was for the few and not the many."

This then led to a consultation by the Pensions Regulator (TPR) in 2020 about how the new funding regime should work. The Pensions Schemes Act 2021 then followed, with draft regulations released in July 2022 and finally another consultation and draft funding code from TPR in December 2022.

The discussion moved on to address funding valuations, which are a cause of confusion for many charities. "It's basically cash flows," Barnett Waddingham explained. "The pension scheme liabilities are just a series of expected cash flows based on assumptions about future experience."

These assumptions consider issues such as inflation before a member's retirement, how much they'll take as a cash lump sum at retirement, and then how their pension is going to increase during retirement until they die.

"The purpose of the funding valuation is then to calculate the present value of these cashflows. In other words, 'how much cash do we need to put aside now to meet these obligations?'" That answer depends on the investment return we expect to earn between now and when the payment is made, allowing for expected changes to the investment strategy over time.

"You can't assume that the current investment strategy is going to apply forever, and, in a nutshell, that's what

the code of practice is all about. It's about the allowance that we make for the investment strategy to change in the future because that's what the regulator is fundamentally concerned about."

The code of practice

The new code of practice is the regulator's guidance on how schemes should comply with the regulations. As a "really lengthy document" it would be impossible to cover the details in one session, but the roundtable honed in on some of the most important elements to understand. Perhaps the most fundamental requirement, is that all schemes need to target low dependency no later than the point at which they reach significant maturity.

Low dependency means that schemes need to have a "very high" degree of resilience towards market movements and matching of cash flows. Essentially, "you've got to be investing in things that look and feel very much like those cash flows."

In the new code, schemes will need to set out exactly how they will de-risk towards that target. With that logic, what is the maximum amount of risk able to be taken? That depends on two things: maturity and covenant – essentially the employer's financial ability to fund the scheme.

"The whole point here is you need to de-risk over time down to the point of significant maturity, so the further away you are, the more investment risk you can take," Barnett Waddingham's experts said. "But that doesn't mean to say you will necessarily take that maximum amount of risk".

Significant maturity is defined when a scheme's 'duration' is 12 years or less, and is a measure of the average time until benefits are paid.

"Previously we would have said that 12-year duration would correspond to when you're about 85% or 90% pension liabilities, but it's now going to be quite a lot less than that because of increases in interest rates during 2022."

However, the regulator is consulting on ways to address this, the speakers added.

The regulator is also consulting on a fast-track regime, set out in a separate regulatory approach document, consisting of pass or fail tests on the liabilities, the investments, and the recovery plan. "If you pass these tests, then you can expect very little challenge from the regulator because they're satisfied that the funding and investment strategy is low risk."

However, charity finance managers were reminded that the fast-track approach is just a measure of tolerable risk from the regulator's perspective. "Just because you're on the fast track doesn't mean you don't need to understand the requirements."

The final section of the first part of the discussion provided insight into

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the statement of strategy, which all schemes must prepare. The first part of the statement sets out the fundamental strategy – the target date for low-dependency, how the plan is being implemented and what to do with a divergence of the plan.

Part two sets out matters that must be consulted on with the employer. "So, you don't need to agree with the employer on these matters as a trustee, but you do need to consult the employer and take their views into account," Barnett Waddingham said. Both parts of the statement must be prepared as part of each valuation and reviewed as part of each subsequent evaluation.

One of the main concerns highlighted by Barnett Waddingham was the level detail required for the statement of strategy, which could place a big compliance burden on all schemes, even those that are already well funded on a low risk basis.

Employer covenant aspects of the draft Code

The second half of the roundtable heard from BDO pension covenant advisory's Associate Director, Ruth Bromley and Charities Audit Partner, Fiona Condron, on what the wider implications of the changes are for the sector. One of the first challenges, they said, is simply a function of how diverse the sector is, looking at everything from number of different income streams up to the issues they're facing.

Comments from chair of the Charity Commission, Orlando Fraser, were highlighted, in which he spoke about the need for trustees to act "prudently." These comments surrounded wider funding conversations, including the forecast of a recession, which could affect donations, legacy income and problems with the administration of the probate system, as well as dealing with increasing cases of cyber fraud and inflation.

The discussion then moved onto the covenant, and changes the code will bring to that. Every pension trustee should have figured out where their legal obligation sits, which hasn't changed, but the new draft funding code does bring with it a change in emphasis, it was explained.

"The strength of the employer's covenant under the new code will be determined by the employer's financial ability to fund the scheme and then any support from contingent assets," BDO's Ruth Bromley explained.

The code goes into some detail about making sure any contingent asset will be legally enforceable and sufficient to provide the level of support when required. "The assessment has a real focus on the future," Bromley added. BDO highlighted how the quality of forecast information along with the duration of those forecasts will be

crucial factors in assessing what is going to be known as ‘covenant reliability’. This is the period over which the pension trustees will have reasonable certainty over the charity’s cash flows available to fund the pension scheme. In practice, the Pensions Regulator expects this period to be maximum around 6 years without further extensive justification. Longer term forecasts can be difficult to create for charities dependent on voluntary income, and this could have an impact on their covenant assessment and result in requests for higher contributions from pension scheme trustees. However, the covenant guidance isn’t out yet, so there’s still speculation on what some of the detailed charity-specific guidance might look like, but “bad governance is going to cause you a problem”. Little is made of ESG (environmental, social and governance) considerations in the draft code, but “our expectation is that [the guidance] will want any companies or charities where the environment will materially change the shape of that business in, say, the next ten years, to be flagged in some way.”

The code also lists a set of additional considerations specifically for not-for-profit employers, which includes charities.

Reputation is a consideration here, as any impact to income through reputational damage could create a more challenging financial environment for charities and could make it difficult for charities to provide evidence for a longer period of reliability. If anything, this simply emphasises the need for charities to ensure all activities always remain compliant and in-line with the organisation’s mission, although negative media coverage can sometimes cause unexpected issues.

The code mentions a few important notes about how deficits should be repaired. As BDO’s experts said: “The underpinning mantra now is that funding deficits will have to be recovered as soon as the employer can reasonably afford.” This could involve some interesting discussions between charities and their pension scheme trustees as to what ‘reasonable affordability‘ might look like in entities that by nature do not seek to run surpluses, but to use resources for charitable expenditure. In the shorter term, however, surpluses can contribute to increased resilience by rebuilding reserves. Public perception of large contributions to a pension scheme from donated funds could itself be a reputational risk, impacting the Employer’s ‘longevity’ i.e. the period it can reasonably be anticipated to remain in existence.

Charities may need to be prepared to explain how some of their expenditure represents a ‘reasonable alternative use’ of cash as opposed to increasing contributions to the pension scheme. This could include what the regulator calls ‘investment in sustainable growth’. It’s worth remembering, however, that in the regulator’s current covenant guidance, they acknowledge that sustainable growth for charities could just mean remaining viable.

Another concern for charities with large unrestricted investment portfolios is that pension schemes will have to consider the charity’s ‘available cash’ to see what is reasonably affordable. Available cash would include both cash balances and investment balances as well as forecast cash flows, so any significant portfolio could potentially provide pension trustees with an argument for a shorter recovery period.

As the discussion wound down, it was again made clear that “this is not straightforward”, and that the code sometimes contradicts itself. But it’s still in draft, and things may change – much of the code is aimed towards for-profit organisations, so there’s hope that more consideration will be made for charities. However, cash flow will remain key, and charities should bear this in mind when considering risk because there will certainly be more scrutiny.

Overall, the session provided a huge amount of food-for-thought, which allowed delegates to raise their questions to a team of experts and highlighted the key issues charities need to look out for with the new DB pension funding code. It was clear that whilst many rules could still change, preparing for all possibilities will be a fast-track route to success further down the line. ■