Summary
• Like other DB schemes, charities' schemes have seen funding improvements in recent years.
• However, charities' schemes may be more susceptible to rising interest rates and regulatory changes.
• They are facing challenges due to affordability constraints and dependency on donations.
• Many still have strong surpluses and endgame is on their horizon.

Charitable differences

Paige Perrin surveys the charity DB scheme funding landscape amid sustainability and endgame challenges

Charity DB pension schemes have seen funding levels rise to 104 per cent on an FRS102 basis and 83 per cent on an insurance buyout basis between 30 April 2022 to 31 July 2023, according to research from Spence & Partners.

The research highlights significant improvements in the funding position of DB schemes, in the charity sector, over the past couple of years.

Barnett Waddingham partner, Steve Hitchiner, credits a "significant increase in long-term interest rate expectations over 2022 and 2023" for this improvement.

Hitchiner explains: "At the beginning of 2022, the 15-year gilt yield was around 1 per cent per annum. Towards the end of May 2024, the same gilt yield was approaching 5 per cent per annum."

This significant rise in gilt yields has had substantial financial implications, particularly for charities.

Further research conducted by Spence & Partners this year highlights this impact, revealing that buyout deficits averaged 21 per cent of unrestricted charity reserves. In contrast, for FTSE 350 companies, pension deficits represented less than 1 per cent of market capitalisation.

This comparison underscores the vulnerability of charities to rising interest rates and the severe challenges they face in managing their pension obligations relative to their corporate counterparts.

So, what is currently happening in the charity DB pension space, and how similar is this to the broader DB pension world?

Regulation

Charity DB schemes adhere to regulations set by The Pensions Regulator (TPR), like corporate DB schemes, and are subject to upcoming changes such as the new DB Funding Code, pension dashboards, and considerations regarding longevity. However, these regulations have some unique challenges for charity schemes.

Specifically, Hymans Robertson senior actuarial consultant, Heather Allingham, highlights that, regarding the new funding code, "charities will be keen to ensure they understand these new requirements with a particular focus on how to assess their sponsoring charity's covenant".

"Charity pension scheme trustees have to ensure that they have a good understanding of employer covenant and affordability," she adds.

Spence & Partners head of charity and not-for-profit practice, Alistair Russell-Smith, says: "The new DB funding regime will not have a significant impact on most corporates because their schemes are already funded to the required levels but charities with poorly funded, mature schemes will see an increase in deficit contributions if the scheme is to be fully funded on a low dependency basis by the time of significant maturity."

Hitchner echoes this, but suggests for those "without good risk management plans, the funding regime may require more substantial changes, potentially leading to an increase in cash contributions for the charity".

"The funding regime can be tricky to apply to a charity, as many of the metrics for defining the support provided by the sponsoring employer have been designed with corporate entities in mind," he adds.

Hitchiner also urges charities to "check that their administrators are on track to meet the requirements" in complying with new governance requirements set out in the General Code and "ensure that they can connect with the pensions dashboards".

In addition, BDO pension advisory team associate director, Ruth Bromley, explains that recent changes grant TPR new enforcement powers and emphasise a long-term funding objective, potentially increasing the prudence of funding assumptions and contributions.

"These evolving regulations may significantly impact charity pension schemes, necessitating careful management and professional advice to maintain compliance and manage a potential pensions shock," she says.

LCP partner, Edward Symes, notes: "In addition to the formal regulations, many charities have particular policies for environmental, sustainability and governance, which can restrict their pension scheme's investment strategy or supply chain."

Challenges

Alongside the evolving regulations, Russell-Smith says: "On average, charity schemes are more poorly funded than corporate pension schemes, and the scheme size is larger, relative to the sponsoring employer.

"This is likely driven by affordability constraints in the sector necessitating a lower level of deficit contributions, and schemes staying open to accrual for longer than in the corporate sector."

A significant challenge facing charity schemes is how donor and fundraising efforts affect their sustainability.

"Unlike businesses with more stable revenue from sales, charities often depend on donations, legacies and grants, which can fluctuate greatly in terms of timing and amounts, and therefore can present difficulties in long-term planning for pensions funding," Bromley remarks.

However, Russell-Smith explains: "Donor contributions and fundraising are only an issue for the pension scheme if employer contributions are still required, and in an increasing number of situations, this is no longer the case."

Spence & Partners research found that 26 per cent of charities have already stopped paying deficit contributions and Russell-Smith expects this proportion to increase as more triennial valuations get signed off, reflecting higher interest rates and the improved funding positions of the past two years.

However, he warns that care is required, as fundraising levels can be affected if large proportions are diverted to the pension scheme rather than to charitable causes.

Furthermore, Bromley emphasises the importance of charity law and that the "need to maintain donor trust" and "protect their reputation" further complicates the funding of pension schemes.

"Donors generally expect their contributions to go directly towards the charitable cause, not to cover pension shortfalls," she says. "Balancing these factors is crucial for charities to meet pension obligations."

To address this, Bromley argues "trustees and charities need to collaborate on strategies that support both the scheme and the charity's financial health. This may include restructuring pension benefits, securing additional funding, or creating sensitive deficit recovery plans".

"Charities are rightly concerned that if these costs are too high, it may put off donors leading to a vicious cycle resulting in a further reduction in charitable donations. That is not good for the charity or the support it can offer the pension scheme," Symes says.

"On average charity schemes are more poorly funded than corporate pension schemes, and the scheme size is larger, relative to the sponsoring employer"

However, he warns it needs to be balanced with the regulatory requirements for charities to fund their pension schemes adequately, "getting this trade-off right is the unique funding challenge for charities".

"Ensuring a clear understanding of affordability for the charity when considering the recovery plan is key and utilising a covenant adviser with the right skillset is helpful," Allingham says.

Bromley also notes that longevity "can increase the total cost of pensions benefits as people live longer, which can result in higher deficits when factored into actuarial assumptions, this in turn may increase demands on the charity's cash".

Sustaining charity DB schemes

However, Hitchiner argues: "Overall, the position for DB schemes looks healthy, with many reporting significant surpluses. For many, the strategic focus is now on securing the liabilities, typically through an insurance company buyout, although we are seeing alternative solutions coming to the market."

He says that it will be "interesting" to see how the market for alternative transactions develops and says that "prior to the general election the government were consulting on the possibility of a public consolidator for DB schemes where an insurance company buyout is not viable. This has the potential to significantly change the DB pensions landscape".

In terms of steps being taken to ensure the long-term sustainability of charity schemes, Allingham explains that, due to the "improvement in funding levels in charity pension schemes over the past few years, alongside a reduction in allocation to growth assets, many charity pensions schemes will be starting to plan for buyout over coming years".

"I expect risk transfer will remain the preferred endgame for charities because they remain scarred from years of DB costs and risk, and so their priority is to get the scheme off balance sheet rather than run it on to access surplus," Russell-Smith adds.

Bromley adds that charities may consider a consolidator that offers cost savings and potentially better risk management, "albeit with some loss of control and initial expenses, and possibly an upfront cash contribution".

She concludes: "Over the next decade, charity pension schemes are expected to face continued regulation, requiring charities to be adaptable and informed to continue to balance charity beneficiary needs with pension obligations."

Written by Paige Perrin