Research on Charities in UK LGPS

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INTRODUCTION

For nearly 2 decades Spence & Partners Limited have advised charities participating in multi-employer pension schemes including the Local Government Pension Scheme ('LGPS'/'the Scheme'). Participating in these schemes can be very challenging for third sector organisations. It is also very challenging to obtain definitive figures showing the impact this has on the sector as there is no public record of the financial position or any surveys carried out to provide comparative information.

In this report we have collated information from publicly available charity accounts to seek to provide some insight for the sector and the charities involved.

DATA COLLECTION PROCESS

We started by analysing the actuarial valuation reports for the 99 Schemes across the UK (87 in England and Wales, 11 in Scotland and 1 in Northern Ireland) to identify which charities participated. We had to assess which organisations were specifically charities rather than other 3rd sector organisations such as housing associations, leisure centres, schools/colleges or indeed private entities participating to provide membership for public sector outsourcing work they were providing.

From this research we identified 676 organisations although there were a number of these with multiple entries for a single organisation which reduced the pool to 608. However, that was filtered down to 208 where full FRS102 pension disclosures were included in the charity accounts. Many organisation were participating but did not chose to disclose presumably using an exemption under FRS102. The reduction also reflects a number of charities who have left LGPS since the valuation information was compiled, either on a solvent or insolvent basis.

It was also interesting that in around 30 cases disclosures were provided but they were incomplete providing limited information on the assumptions used, on the service cost applicable or on the level of employer contributions payable which meant unfortunately we were forced to exclude them from our analysis.

Of the 676 set of accounts these were compiled by well over 100 different audit firms. What was also striking is the huge array of accounting design and terminology used within the disclosures. I'm sure we would all welcome some increased level of consistency of approach to make these important figures more accessible for users.

Whilst clearly we would have preferred to have access to a greater number of complete records we believe the population identified is large enough to provide a good indication of trends and to allow us to draw some conclusions.

KEY VALUATION METHODOLOGIES

There are a number of possible valuation bases which can be used however, there are three main approaches which are relevant for LGPS Employers:-

- **'On-going' basis** – this is the basis used by the scheme in the triennial actuarial valuation to calculate the future pension contributions assuming continuing participation in the scheme. This basis will assume a long term expected rate of return on assets over the medium to long-term in most cases adjusted depending upon whether the admission is open or closed.
- **FRS 102 basis** – this is the basis used each year to assess the pension liabilities for accounting purposes and is calculated using a prescribed basis set by the accountancy profession. This will use an assumed return based upon good quality ('AA') corporate bonds of an equivalent duration to the scheme liabilities. As this valuation is undertaken every year the results can be very volatile.
- **Cessation basis** - this is the basis used by the scheme to calculate the liabilities assuming an exit from the scheme (i.e. no actively participating members). In most cases the basis removes any (or most) allowance in the discount rate for asset outperformance over gilts. This result will therefore be likely to result in liabilities / deficit much larger than either of the two bases above.

The results on each of these bases will be very different primarily because of the assumptions used and also any valuation timing.

FINANCIAL ANALYSIS METHODOLOGY

The information was available at accounting dates between 31 March 2021 to 30 September 2021. We used the FRS results at each organisations FRS date and approximately switched those results to the on-going and cessation bases as at that date. Having access to the FRS102 disclosures and assumptions for the 208 we were able to verify the assumptions against an average to ensure accuracy and consistency to identify the funding rate.

Where assumptions were missing in the disclosures or a range of assumptions were provided we reverted to the median figures.

The table below shows the range of assumptions used and the mean and median assumptions adopted.

Table 1 – FRS Assumptions identified

	High Assumption	Low Assumption	Average Assumption
Salary Increase	4.4%	1.0%	3.38%
Pension Increase	3.72%	1.99%	2.77%
Discount rate	2.7%	1.50%	2.01%

These figures are broadly within the range of acceptable assumptions we would have expected to see with only a very small number of outliers.

Having satisfied ourselves about the consistency of the results we then converted the FRS results to both an on-going funding basis and a cessation basis at the same date using the assumptions in the table below.

Table 2 – Conversion assumptions used

	On-going basis	Cessation basis
Average Discount rate	3.27%	1.27%

The cessation discount rates used for our analysis were derived with reference to the >15 year UK gilt redemption yield at the relevant date of each organisation's accounts.

The ongoing discount rate was assumed to be equal to the Organisation's estimated cessation discount rate (derived as above) plus 2% p.a.

The salary inflation assumptions and demographic assumptions were assumed to be in line with those used for the Organisation's FRS 102.

KEY RESULTS ANALYSIS – PAST SERVICE

The pension funding information for the 208 charities is as summarised below.

Table 3 – Estimated Overall Funding Positions

£'millions	FRS102	Estimated On-going	Estimated Cessation
Assets*	£3,987	£3,987	£3,987
Liabilities	£5,031	£3,930	£5,813
(Deficit)/Surplus	(£1,044)	£56	(£1,826)
Funding rate	79%	101%	69%

*Asset values used in the ongoing and cessation estimates have been set equal to the asset value quoted in the Organisation's FRS102 results.

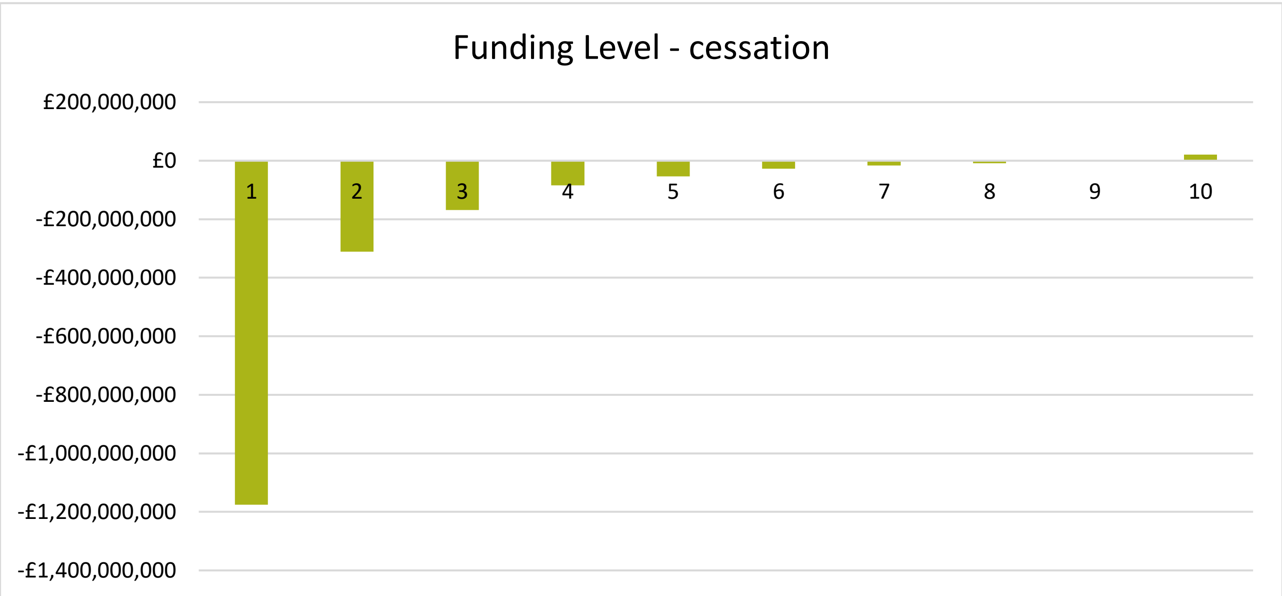
The distribution of results is largely as expected with the deficit increasing materially from the on-going basis to the FRS basis to the cessation basis. For the 208 employers the total estimated deficit on the cessation basis was c£1.83Bn. Given that over 65% of the employers are estimated to be fully funded on an on-going basis it's all too easy to come to a conclusion that no funding issue exists however, when you assess the cessation position around 90% of employers have a funding deficit on this basis. As a very material number of these employers will be closed to new entrants, clearly the funding position which is relevant is the cessation position, as these employers are moving inexorably towards it. This is particularly high risk for employers where they have fewer than five active members which suggests a cessation could be imminent.

What is also interesting is the distribution of the deficit with the estimated cessation funding position varying between funding levels of around 20% up to around 150%.

Clearly the table represents a pool of 208 employers out of a potential pool of around 608 so the total figures in the table across the sector could potentially be three times higher with total liabilities potentially in excess of £15Bn and a cessation deficit potentially in excess of £5Bn.

The table on the next page shows the cessation position split by deciles.

Table 4 – Breakdown of Funding position by decile



This table clearly shows that there is a wide distribution of risk levels across the charities participating. It suggests that some employers will have a much more material deficit which they are having to manage.

What we therefore need to do is put this information in context with the financial position of the charities participating by comparing the deficit levels with underlying financial assets. The table below identifies some key metrics.

Table 5 – Charity Underlying financial position

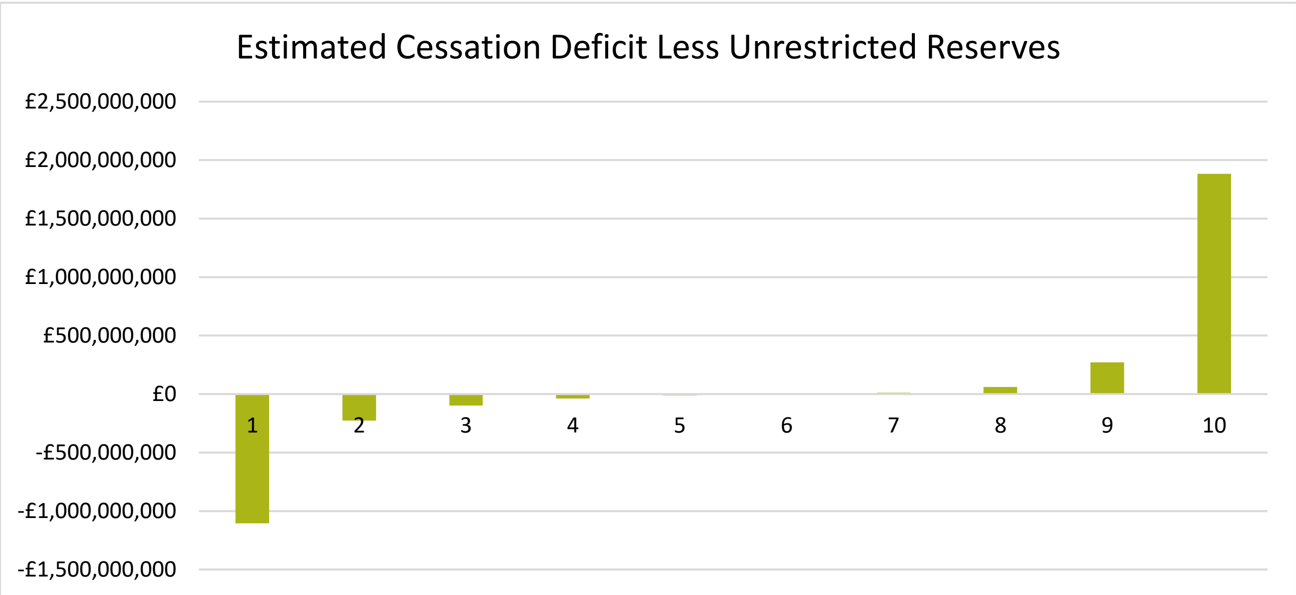
£'millions	Core results	Adjusted results to 208 (Approx)
Total Reserves	£7,670 (190)	£8,400
Unrestricted reserves	£2,580 (186)	£2,885
Total Income	£4,600 (203)	£4,710

As the figures in these table were not available for all the 208 employers, we have identified how many employers provided the relevant information and also provided estimated adjusted results.

The cessation deficit of £1.83Bn represents only around 22% of adjusted total reserves but 63% of unrestricted reserves and around 39% of total income.

Again as is shown in the table below there is a huge distribution of risk across different employers.

Table 6 – Estimated Cessation Deficit less unrestricted reserves by decile



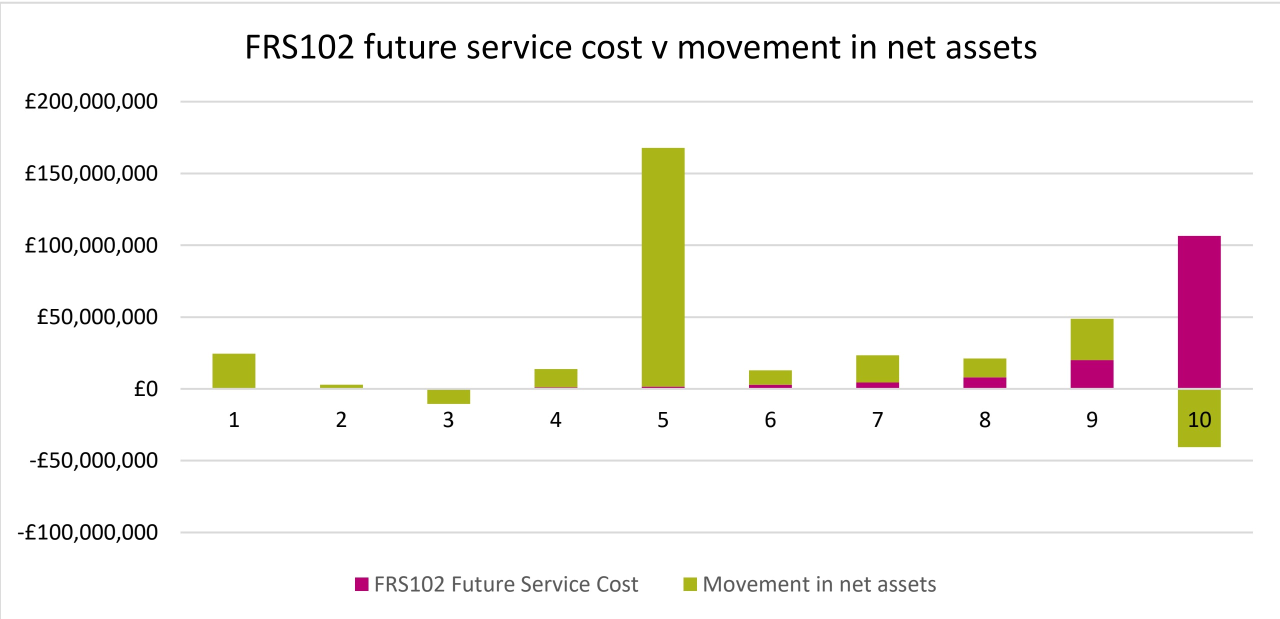
FUTURE ACCRUAL

Not wholly surprisingly the focus on managing risk tends to be on the accrued liabilities however, this tends to miss the significance of the future funding risk. As benefits build risk increases, particularly as contributions will be set on or close to an on-going funding basis whilst the ultimate liabilities will be accruing on a cessation basis.

The total service cost on an FRS basis was £145m with employer contributions totalling around £110m. However, estimating the accruing annual cessation liability this will be much higher than this probably somewhere in the region of £200m-£250m. The total surplus on charitable funds, excluding pension payments, would be around £570m and net movement in funds around £330m. So the employer contributions represent around 33% of movement in net funds but the accruing cessation liability would represent around 60% to 75%.

Again there is a wide distribution of risk across employers here as shown in the table below.

Table 7 – FRS102 future service cost vs movement in net assets.

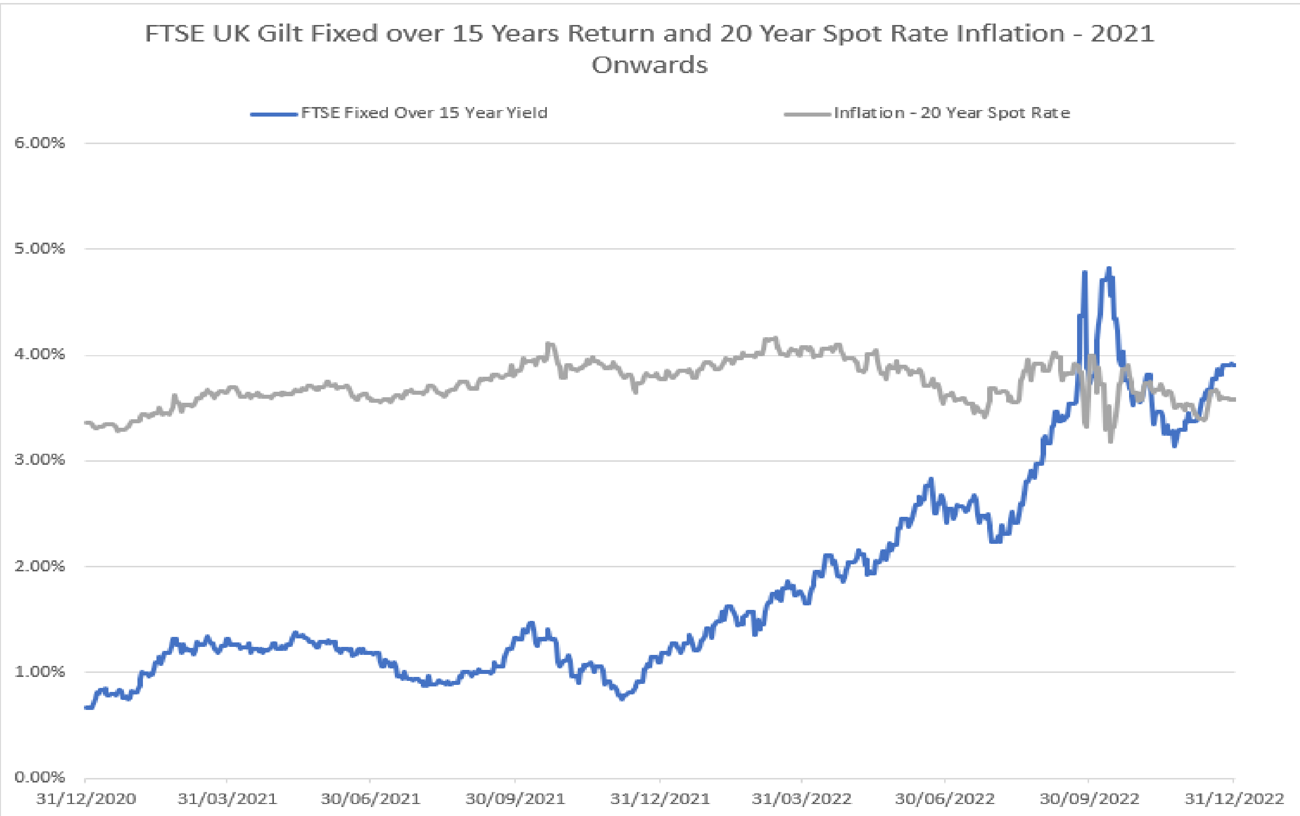


CURRENT OUTLOOK

Clearly this snapshot of the position is by default around 18 months out of date. Charities will undoubtedly be dealing with financial issues post Covid and it is likely that income and total reserves will have been negatively impacted for some.

The economic environment has also changed dramatically.

The graph below shows the movement of gilt yields and inflation since January 2021.



As gilt yields increase the value of liabilities fall and vice versa. As inflation rises the value of liabilities increase and vice versa. 20 year inflation has shown a modest increase however gilt yields have increased substantially. Based upon this we would expect that cessation liability values will have reduced very materially in the period to 30 November 2022, probably somewhere in the region of 35%. What is unclear however is how asset values may have been impacted although from experience we have seen falls of around 5%-10% between April 2022 and the end of November 2022 although with variations between schemes. We also don't have information on future accrual over the period and pension increases will have been material given the short-term inflation level.

In the table below we have updated the estimated cessation debt from that shown in Table 3 earlier in this paper to reflect the likely estimated change in liabilities given recent market movements and assuming a) a neutral asset position and b) a reduction in asset values of 10%.

Table 8 – Updated Estimated Cessation Position

£'millions	Estimated Cessation Deficit Table 3	(a) Estimated Cessation Deficit (Neutral Asset Value)	(b) Estimated Cessation Deficit (& 10% reduction in Asset value)
(Deficit)/Surplus	(£1,826)	£200	(£200)

Given the improvement in cessation funding charities may wish to consider their future participation options, especially given the wider range of exit flexibilities introduced in England & Wales in 2020 and in Scotland in 2022.

Cessation Valuation Methodology

The figures above are estimated using a gilts-based (i.e. nil risk) actuarial cessation methodology. It is however interesting that some funds are moving away from this model and are instead adopting a probability model assuming an 80% or 90% probability that the deficit will be funded over an agreed funding period. This approach tends to reduce the cessation liabilities by 10%-30%, depending upon the duration of the liabilities, and therefore materially reduce the cessation debt payable.

The probability method appears to be more frequently adopted by two of the four leading actuarial firms who provide advice to Funds. However, what is additionally interesting is that the method is not universally adopted within these actuarial advisers often with a divergence of approach between actuaries within the same firm.

In my view this direction of travel away from a pure gilts-based methodology is more equitable and hopefully over time will become the default cessation approach for Funds.

SUMMARY

Not surprisingly there is a wide divergence between individual employers and the level of exposure they face.

The changes in market conditions between April 2022 and the end of 2022 have been dramatic and will have changed the deficit position for all charities in LGPS very significantly reducing cessation / exit deficits. Particularly for charities that are closed to new entrants and therefore who are inevitably working towards a cessation they need to actively consider if they should be taking actions now to bring that cessation timescale forward.

Indeed all charities should be considering their position and seeking to understand if current conditions are likely to persist for the medium to long term or if they should be taking steps to secure their position in the short-term.

About

Spence & Partners Limited

Spence & Partners is a specialist actuarial practice primarily focusing on providing advisory services to DB scheme trustees and employers. Our business employs over 200 staff, with a turnover in excess of £25m and has offices in Glasgow, London, Manchester, Bristol, Birmingham, Leeds and Belfast. Spence have been providing focussed actuarial and pensions advice in the charitable sector for over 18 years and have worked with in excess of 500 charities and not-for-profit organisations throughout the UK.

The Authors

David Davison

Head of the Charity Practice David Davison has built up very considerable experience working with charities and other not-for-profit bodies participating in the LGPS and other multi-employer schemes.

David is a regular contributor on pension issues for charitable publications. David is a member of the Institute of Chartered Accountants of Scotland Pensions Group, provides specialist pensions support to Charity Finance Group co-authoring their 'Pensions Maze' publication, is a co-author of PLSA's local government pension scheme guides and provides the Pension Helpline for CFG.

David worked with ICAS and the Scottish Public Pension Agency to assist with the revisions to the Scottish LGPS Regulations in 2018 and 2022.

Rachel Graham

Rachel is a Fellow of the Institute & Faculty of Actuaries. She has worked in the not-for-profit practice for the last six years and has built considerable experience working with admitted bodies in LGPS as well as charities in other multi-employer pension schemes.

Rachel has carried out bespoke modelling and analysis as well as building a specific member illustration tool to allow individuals to see the impact of any changes to their scheme.

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