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NAVIGATING THE CHARITY PENSIONS MAZE



Charity Finance Group

The purpose of Charity Finance Group (CFG) is to develop a financially-confident, dynamic and trustworthy charity sector.

Our 1,400 members are charity finance professionals, who between them manage £19bn of funds. We work with our members to: inspire and nurture leadership; drive up standards; create a better and fairer operating environment; identify best practice and share knowledge.

Ultimately, we strive to equip charities with the knowledge, skills and conditions they need to ensure that every pound works even harder, achieving a greater impact for even more beneficiaries.

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FOREWORD

Welcome to the latest edition of CFG's flagship pensions publication, Navigating the Charity Pensions Maze.

Pensions continue to be a priority for charities. Smaller charities are now implementing auto-enrolment whilst the largest ones are reviewing the arrangements they set up three or more years ago. As Defined Contribution schemes become the norm, charities need to review their pension investment strategies. Legacy defined benefit schemes continue to need close attention as do obligations to third party schemes such as the local government pension scheme.

Charity Finance Group is committed to supporting charities to be effective and responsible employers. Working with our partners we have set out the latest changes to the pensions landscape. We hope that this provides charities with the expertise they need to navigate a very complex world.

There will be something in here for every charity whether you have a DC or a DB scheme or both; whether you have already auto-enrolled, or if you are a small charity yet to auto-enrol; if you have employees in a local government pension scheme; or if you are thinking about your scheme's investment funds. And if you are new to the world of pensions in charities, this is the ideal place to start.

This publication will, I am sure, give charities the confidence to manage their pension challenges proactively and I would like to thank the corporate partners, experts and CFG team for making it happen.

John Tranter, CFG Trustee



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NAVIGATING THE CHARITY PENSIONS MAZE





INTRODUCING THE MAZE

Getting your pension provision right can be a challenge. This publication aims to help you navigate the pensions landscape so that your charity can find the right balance between equitable and fair pensions for staff while maintaining donor and beneficiary support.

This edition of the maze is split into three parts: the first takes you through the current Defined Benefit (DB) landscape, the second focuses on Defined Contribution (DC) schemes, and the third helps you navigate planning and reporting.

DEFINED BENEFIT (DB) SCHEMES

Historic liabilities of defined benefit pension schemes continue to pose a significant challenge to the charity sector. Liabilities can undermine a charity's financial sustainability as well as posing as a reputational risk.

If your charity has a DB scheme **sections 2 and 3** of this publication will be of particular interest.

For those charities who are facing the challenge of managing the costs and risks of their DB pensions arrangements, **Section 2**, produced by Punter Southall, will provide much needed insight into how your charity can pro-actively navigate the risks and costs associated with DB schemes.

Section 3, produced by the Cheviot Trust, will equip you with the knowledge you need to navigate the complex relationship between DB pension scheme trustees and the charity as an employer.

Section 4, by Spence & Partners, focuses on the ever persistent challenges caused by Section 75 in non-associated multi-employer DB schemes. For those charities with a handful of employees who are members of such schemes can be trapped with an impossible choice:

withdraw from a scheme that imposes unaffordable costs and unacceptable financial risks, or face huge costs if you attempt to exit the scheme.

The Department for Work and Pensions consulted on reforming Section 75 in May 2015. However, as of January 2017 the Government has not responded to the consultation. CFG continues to lobby for changes to Section 75.

In a new addition to this publication, **Section 5**, provided by Charles Russell Speechlys, takes you through the Local Government Pension Scheme, from entering as a third party employer, managing and monitoring the scheme and the challenges around exiting and how to mitigate these. If you are one of the thousands of charities with employees in the LGPS, this section will be of particular interest.

DEFINED CONTRIBUTION (DC)

Even before the introduction of auto-enrolment, employers across the economy, including charities, were increasingly opting for DC pension schemes. DC schemes are now the norm and it is critical that charities ensure that their employees' pension savings are invested in

well-designed and appropriately-governed schemes.

With this in mind, **Section 6** of this guide, written by Secondsight, will take you through the key issues that you need to consider, including the role of Master Trusts, the differences between Contract-based and Trust-based schemes, as well as the changes introduced by the Government's Freedom and Choice legislation.

Section 7, by the Cheviot Trust, turns its attention specifically to auto-enrolment legislation. For those readers who have already gone through the auto-enrolment process this section also looks towards re-enrolment.

Another new addition to *Navigating the Charity Pensions Maze* is an update from The Pensions Regulator (TPR). For small charities yet to auto-enrol TPR provides top tips on how to comply on time and what you can expect from the regulator.

PLANNING AND REPORTING

For those charities that have taken on contracts for employees who work for another employer, or are thinking of doing so, it is important that you consider the implications for your pension provision. In the

third and final part of *Navigating the Charity Pensions Maze*, **Section 8**, by Mills & Reeve, provides a comprehensive guide to these complexities, taking you through the regulations with which you need to be familiar, including TUPE and moral hazard.

Section 9, produced by MHA MacIntyre Hudson, closes the guide with details of how charities should include pensions in their accounts. This is particularly important amid intense media and public scrutiny of how charities use their money.

This section will guide you through the charities SORP, what information you need to include in your accounts for DC, DB and multi-employer schemes, how to disclose the pension costs of senior employees, and how your charity should report pension scheme deficits.



HISTORIC LIABILITIES OF
DEFINED BENEFIT PENSION
SCHEMES CONTINUE TO
POSE A SIGNIFICANT
CHALLENGE TO THE
CHARITY SECTOR



DEFINED BENEFIT PENSION SCHEMES



MEETING THE CHALLENGES OF DEFINED BENEFIT PENSION SCHEMES



Financial market turbulence, rising life expectancy, gilt yields at “all-time lows” and a shifting regulatory landscape means that charities face an enormous challenge in managing the costs and risks of their defined benefit (DB) pension arrangements.

The Pensions Regulator expects pension scheme trustees to approach covenant, investment and funding in an integrated manner. Engaging with trustees and aligning trustee and employer objectives is seen as a ‘21st century’ way for employers to manage pension risk and reduce the impact that the pension scheme has on the core objectives of the employer.

In July 2014, The Pensions Regulator released a new code of funding practice. Table 1 shows the key principles from this new code:

TABLE 1

OVERVIEW OF NEW CODE OF PRACTICE

Sustainable growth objective	Encouraging trustees to give full consideration to their employer’s affordability, growth and investment plans.
Integrated risk management	Ensuring that schemes understand and manage risks effectively through an integrated approach to risk management.
Employer covenant	Ensuring that trustees focus on understanding the employer’s covenant, its value and enforceability.
Collaboration	Encouraging trustees and employers to work collaboratively to balance the employer’s need to invest with the needs of the scheme.

TABLE 2

SUSTAINABLE GROWTH: CHARITIES

Sustainable vs sustainable growth	Sustainable growth can mean many things from the expansion of charitable operations, doing more with the same amount of resources, to the sustainability of the organisation’s existence.
Reliance on discretionary donation	The sustainability of the organisation is reliant upon discretionary donation income.
Donor perceptions	Trustees should be aware of donor perceptions with regard to the level of scheme contributions as a proportion of donation income.
Collaboration	Balance required to ensure that too high a proportion of donations will not reduce likelihood of future donor support Vs. too low a proportion leading to greater investment risk being required.

For the charity sector some of these areas are more difficult to put into context. In particular, The Pensions Regulator's new sustainable growth objective will mean something different when compared with a typical private sector employer. In this context, the objective may have more meaning when considering the points in Table 2.

In this section, we explore how charities can navigate the entire spectrum of pension risks and costs. We will cover how your charity can:

- Proactively position the covenant strength from the employer's perspective both now and into the future.
- Drive the investment strategy and put forward proposals that are more risk/cost efficient than the scheme trustees' strategy.
- In light of the covenant strength, position a future investment and funding strategy focusing on the "right level of risk" in the longer term rather than automatically assuming a de-risking path, helping to keep cash to use for the core objectives of the employer.
- Introduce additional member option flexibilities to help reduce the cost and risk of the scheme whilst at the same time giving members wider choice on how to shape their benefits.

Rather than focusing on the detail of each and every assumption within an actuarial valuation, this section looks at how to concentrate on what really matters i.e. an appropriate level of risk for the covenant strength (today and in the future), an efficient investment strategy and a tailored funding strategy. This can potentially then help to get the balance right between risk control from a pension scheme perspective versus the perspective of donor perceptions of pension scheme contributions.

POSITIONING THE EMPLOYER COVENANT

The employer sponsoring a DB pension scheme underwrites all the risk the scheme is exposed to. Therefore the employer covenant is a critical factor for pension scheme trustees to consider when deciding about the scheme's funding and investment strategy.

THE PENSIONS REGULATOR RECOGNISES THAT SUSTAINABLE GROWTH WILL MEAN DIFFERENT THINGS FOR EMPLOYERS IN DIFFERENT CIRCUMSTANCES

Covenant reviews are triggered by either employer or scheme related activities, the actuarial valuation being the most common example. The events when the covenant is a relevant consideration include the following:

- Employer events: merger and acquisition, divestment, refinancing and restructuring, deterioration of financial performance (in either commercial or non-commercial activities).
- Scheme events: actuarial valuation, investment strategy review, apportionment arrangements, withdrawal arrangement, transfer value calculations, scheme merger or scheme closure.

Given The Pensions Regulator's new statutory objective to minimise any adverse impact on the employer's sustainable growth, charities may wish to evaluate critically whether the pension scheme trustees' funding requests reflect a reasonable balance between the need of the scheme and the aims of the charity.

The Pensions Regulator recognises that sustainable growth will mean different things for employers in different circumstances. This is outlined in Annex B of the regulator's guidance on assessing and monitoring the employer covenant. For charities, sustainability may be less about sustainable growth and simply about remaining viable. When assessing the charity's position, pension scheme trustees should consider the organisation's ability to continue to serve its beneficiaries.

The Pensions Regulator's guidance states that scheme trustees should be cognisant of the impact that the level of scheme contributions as a proportion of donation income can have on donor perceptions and their willingness to support the charity as well as the impact on income from the charity's commercial operations.

The scheme trustees are expected to monitor the employer covenant between actuarial valuations and therefore charities will need to provide financial information to the scheme trustees on a regular basis under an agreed employer covenant monitoring framework. It is essential to make sure that this framework is fit for purpose and the requirements are proportionate, but in general sharing information with the scheme trustees can help maintain a good relationship and dialogue between the parties.

AN EMPLOYER DRIVEN INVESTMENT STRATEGY CAN RESULT IN PROPOSALS THAT ARE MORE EFFICIENT AND COST-EFFECTIVE

The employer proactively positioning their covenant strength means that they can:

- Lead the covenant discussion and present on the covenant to scheme trustees to pre-empt any issues and inappropriate anchoring of views.
- Ensure that the strength of the employer covenant is properly reflected in the actuarial assumption and that the level of prudence applied is not excessive.
- Discuss with trustees the appropriate level of contributions to be made by the employer expressed in terms of overall affordability and as a proportion of donor income.
- Present the employer's aims and financial projections, reflecting both its commercial and non-commercial activities.
- Explore the use of contingent assets and conditional funding arrangements as part of the funding strategy.
- Understand the scheme trustees' requirements and perspectives so the right information is released in a timely and helpful way.
- Encourage the scheme trustees to limit the importance given to short-term negative trends and fluctuations in donor income which can cause an overreaction to current events.

- Answer questions posed by scheme trustees and provide explanations appropriate to the relevant context and purpose of the covenant assessment.
- Explain the extent and nature of any restrictions on income, capital or reserves that may not be obvious to the scheme trustees or their advisers.
- Demonstrate the balance between the diversity of income sources and how these are expected to develop in the future alongside any other possible alternative sources.
- Negotiate with scheme trustees or their advisers on covenant-related issues, such as the pension scheme's recovery plan.

The end goal is to agree with the scheme trustees a more accurate level of prudence in the valuation that secures an appropriate level of contributions (e.g. expressed as a percentage of donor income) without stifling the main charitable aims of the employer.

DRIVING THE INVESTMENT STRATEGY

More employers, including those in the not-for-profit sector, are gearing up to position their views to the pension scheme trustees on risk, investment strategy and funding well in advance of the triennial valuation, rather than being consulted at the end of the funding or investment strategy process.

Seeking strategic investment advice enables the employer to play an active part in driving the investment strategy with the scheme trustees, rather than being "consulted" at the end of a trustee-led investment strategy review process.

It is particularly important for charities that have certain ethical considerations that their views are made known to the scheme trustees in advance. For example, cancer charities might be criticised for any investments their scheme holds in the tobacco industry. Indeed, we have seen an example of this when the Guardian reported that the Universities Superannuation Scheme was revealed to have £211 million of its £49 billion fund invested in British American Tobacco. These investments were used to fund the pension benefits of academics whose research is funded by Cancer Research UK. Avoiding such headlines in order to protect the charity's public image can be important for its future fundraising ability.

Further, some charities have significant asset bases of their own to manage and may be able to put that knowledge and experience to good use in constructing an optimal investment strategy for their pension scheme.

The employer's role in taking these matters forward is therefore to guide the scheme trustees into making changes to the investment strategy that enable risk to be taken in a more efficient way. It should be noted that the scheme trustees will need to go through a robust process and take advice, but the employer can guide them and take a more 'hands-on' role in the process.

For example, a Finance Director of a charity reviewed the investment strategy alongside their advisers with a view to increasing expected returns but retaining an acceptable risk exposure. The employer then proposed that the scheme trustees consider the following alternative approaches to investment strategy:

- **Increase growth assets:** The employer demonstrated to the trustees that the level of risk inherent in the current investment strategy is acceptable both now and in the future. Furthermore, the strength of the employer covenant would support an increase in the allocation to growth assets. The employer asked the scheme trustees to undertake an investment strategy review with an objective of making the strategy work harder to achieve the long-term funding aims of the trustees and employer.
- **Consider alternative Diversified Growth Funds (DGFs):** The employer stated to the scheme trustees that they would be open to discussing the introduction of alternative higher return-seeking DGFs within the growth assets. The employer demonstrated to the trustees that the increased return potential and diversification would be acceptable within the context of the employer covenant.
- **Investigate Liability-Driven Investment (LDI):** The employer also asked the trustees to investigate an approach to LDI that would be cost-effective for the size of the scheme. The employer stated that they did not want to decrease the allocation to growth assets to achieve this. As part of this, the employer indicated that they were comfortable with the principle of leveraging the LDI coverage based on a lower proportion of non-growth assets.

ETHICAL INVESTMENTS

Some charities and not-for-profit organisations take a highly principled approach when it comes to their investments and this can extend to the investment of the assets in their pension schemes. That usually rules out holding stocks in tobacco companies and businesses that sell arms. Oil and gas companies are another big no-no for many charities. With an increased focus on ethical investment, some charities are taking it to the next level. For example, we are aware of one organisation that will not invest in entities with offices in known tax havens.

Whilst such principled stances are admirable, from a practical perspective they can make pension scheme investment very tricky. The vast majority of pooled investment funds available to pension schemes will contain some exposure to one or more entities on the blacklist, which seriously restricts the number of options available. Diversified growth funds, LDI funds and fiduciary management offerings, all increasingly popular with pension schemes, rarely meet a typical set of ethical objectives.

There is however a growing market in ethical investments, with increasing numbers taking the view that ethical investments tend to be more sustainable and hence will provide a greater return over the long term as well as a clear conscience.

UNDERSTANDING THE 'RIGHT' LEVEL OF RISK

Over time most DB schemes will reduce materially in size. This will therefore reduce risk to the employer even with no changes to the current investment strategy. The graph in Figure 1 shows the projection of a typical closed scheme's liabilities over time. More members potentially taking DB to Defined Contribution (DC) transfers at the point of retirement will further accelerate this.

ETHICAL INVESTMENT FOR CHARITIES

The Charity Commission is clear that charities can make ethical investments. However, trustees have to be able to justify that this is in the best interests of their charity to do so. Reasons include:

- A)** A particular investment conflicts with the aims of the charity and is therefore unethical.
- B)** A charity might lose beneficiaries or supporters if it does not invest ethically and this would undermine the ability of the charity to carry out its work.
- C)** An ethical investment approach will not significantly financially impact the charity and therefore it has the flexibility to take this approach.

It is important that charities approach the issue of ethical investment not from a personal perspective, but from the perspective of what best serves the charity's purpose and the needs of beneficiaries. If trustees cannot provide a clear reasoning for how the charity's purpose will be supported through an ethical investment and there is a significant financial detriment to the charity, it should not be pursued.

Without a view to the contrary, many trustees will focus on de-risking the investment strategy over time even though the level of risk may well be projected to reduce anyway given a reducing scheme size – a default position from trustees of “double de-risking”. The employer view may be that the level of risk inherent in the scheme currently, and projected into the future, is acceptable, particularly if the employer expects to grow its revenue streams, which for charities may include committed income streams and future public donations. As a result, the employer could argue to the scheme trustees that they do not anticipate a need for de-risking the investment strategy as the scheme matures and view the current investment strategy as appropriate for the longer term.

The employer may be able to show that the investment risk is comfortably supported by the employer covenant to the scheme today and the impact of this risk is expected to reduce materially over time as the scheme reduces in size. The scheme would continue to be supported by the covenant over this same time horizon.

NEGOTIATING ON LONG TERM INVESTMENT AND FUNDING STRATEGY

Pension scheme trustees typically assume that the investment strategy will de-risk as the scheme matures when setting the scheme funding assumptions. This is known as the “dual discount rate approach”. In other words the scheme trustees have adopted an approach that assumes that as members retire, investments will be moved away from return seeking assets and into bonds.

Often this may or may not have been an explicit decision on the scheme trustees’ and the employer’s part.

If the scheme trustees and the employer agree that fundamentally they understand the current level of risk in the investment strategy and this level is acceptable to be maintained over the long term, they can reasonably remove this implied de-risking within the discount rate assumptions. In other words, if the scheme trustees and the employer agree that the long term objective is not to reduce investment risk over time, the liabilities could be lower to reflect this.

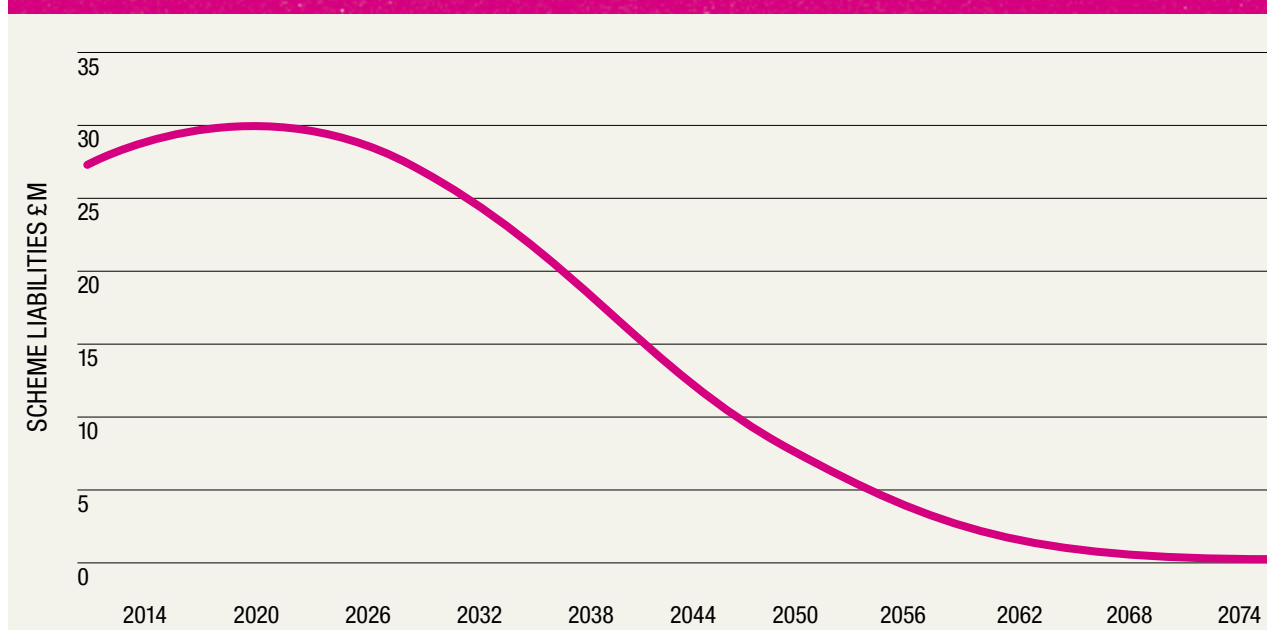
EMPLOYERS WHO UNDERSTAND AND CHALLENGE THE FUNDING ASSUMPTIONS MAY SEE LOWER LIABILITIES AND REDUCED CONTRIBUTIONS

Employers understanding the level of risk and presenting a view on this and the future investment strategy could lead to higher discount rates being used and could reduce any deficit.

Charities should consider whether any assets they hold could be used to support their pension schemes to help gain concessions from scheme trustees over the level of prudence in the funding assumption. For example, the provision of contingent security over an asset that gives the pension scheme a priority claim over that asset in the event of employer insolvency reduces the risk to members that their benefits will not be met in full.

Another option might be to use any of the charity’s committed income streams to guarantee some or all of the payments that the charity has agreed to make to the pension scheme to address the deficit. The scheme trustees may be prepared to afford the charity more time to address the deficit if they can be absolutely certain that the agreed amounts will flow to the scheme.

FIGURE 1. UNDERSTANDING THE ‘RIGHT’ LEVEL OF RISK



An important consequence of the scheme being in a more secure position and being funded over a longer time horizon is that more investment risk can be taken, with the expectation of generating a higher return over the long term. This gives a better chance of the funding gap being closed without the need for large contributions from the charity.

In order for the employer's view to be most effective, it is important that it is heard early in the valuation process. This is particularly important where The Pensions Trust are the trustees given that they have to look at the funding and investment strategy across multiple pensions schemes in the not-for-profit sector.

Working backwards from the effective date of the valuation, a typical timetable for an employer wanting to take the lead on investment and funding strategy is shown in Table 3. These dates should probably be even earlier for schemes with the Pensions Trust.

IMPACTS OF FREEDOM OF CHOICE AND MEMBER OPTIONS: REPUTATIONAL AND ETHICAL CONSIDERATIONS

Post April 2015, more DB members are showing interest in wanting to explore wider options at the point of retirement. This section looks at how retirees may genuinely value the additional flexibilities that employers could ask scheme trustees to introduce into the retirement process.

This is a major opportunity for employers to engage with scheme trustees and reduce the liabilities and risk in the scheme whilst helping members truly understand the wider options now available to them.

Employers can undertake a feasibility study of the proposed at-retirements options to ensure that objectives are clear, provide assistance with the implementation and deliver clear communication to members that meet the requirements set by The Pensions Regulator and the pensions industry voluntary code of good practice.

TABLE 3

TIME TO VALUATION DATE	ACTION
6 months	Employer training on new funding regime and implications for current funding and investment strategy approach
5 months	Consideration of level of risk in current funding and investment strategy both today and projected into the future
5 months	Explore risk projections for alternative investment strategy approaches (e.g. de-risk in the future or not)
4 months	Put risk projections into context of employer covenant projections
3 months	Look at how various investment strategy approaches will impact on the funding assumptions and hence the assessed value of the liabilities
2 months	Employer to agree on preferred approach for investment and funding strategy
1 month	Position the employer view with the trustees

TABLE 4. THE PENSIONS REGULATOR'S CODE OF PRACTICE

The July 2014 Code of Practice from The Pensions Regulator on funding defined benefits ("the Code") focuses on collaborative working and states that "trustees and employers should therefore work together in an open and transparent manner to reach funding solutions that strike the right balance between the needs of the scheme and those of the employer".

The Code also implies that the employer and the trustees should agree on a long-term investment and funding strategy for the scheme in the context of a proportionate approach to integrated risk management.

Employer contributions should now be "appropriate" balancing member security and needs of the employer to invest in the business. This is a big change from previous regulations that required contributions to be the maximum "reasonably affordable".

Employers who offer a clear and unambiguous ‘at-retirement’ options programme can reduce liabilities and risk whilst supporting members at retirement.

Within the charity and not-for-profit sector, reputation is key. With this in mind, some employers may be put off from the idea of introducing alternative options within the DB scheme for members. However, structured and communicated in the right way, these additional options are often appreciated by members as they approach retirement or indeed sometimes after they have retired. In addition to this, more employers are starting to pay for individual financial advice for their members to help them make the right choices where these wider options are introduced (even when not formally required under the code of good practice).

Typically, the sort of additional options being introduced into DB schemes are:

- **Pension Increase Exchange:**
Giving up future pension increases in exchange for a higher pension today. This can be applicable to current pensioners as well as future retirees.
- **Enhanced Transfer Value:**
Offering a higher than usual transfer value to a member that they can elect to take to an alternative pension arrangement (usually a DC scheme in which flexibility of member options will be much wider).
- **Flexible Retirement Offer:**
A transfer to an immediate annuity or drawdown arrangement. This will usually demonstrate the difference in the standard DB retirement terms versus those in a DC scenario where the member would have the option to remove increases, dependant’s pension, or obtain a higher annuity rate based on their own lifestyle factors.
- **Trivial Commutation:** For smaller pensions, this will be an offer to exchange the entire pension (in payment already or at the point of retirement) for a cash sum.

Often these exercises are combined together depending on the employer’s objective for the scheme and the membership profile.

A feasibility study will enable employers to:

- Understand the potential pattern of retirements over the short, medium and longer term.
- See the financial implications (funding, accounting and buy-out) of a potential increase in take-up of members taking DB to DC transfers.
- Work with trustees to design the communication programme for future retirees including decisions over partial transfers and how to accommodate the requirement for independent financial advice.
- Implement the design alongside the scheme trustees.

The clear advantages of high take-up of options as a result of a successful communication programme are:

- It reduces the potential future cash call on the employer.
- The buy-out deficit (the ultimate liability for the employer) can be significantly reduced.
- The liability is fully removed from the scheme and therefore the future investment.
- Inflation, interest rate, mortality and legislation risk is removed.
- It reduces exposure to the Pension Protection Fund levy.

CASE STUDY

BACKGROUND

In this case study, we see how the flexibilities that exist in the current scheme funding regime can be used to ensure that solutions can be found to fit the individual circumstances of a particular scheme.

For many years, trustees of DB pension schemes have derived the discount rates used in their actuarial valuations by reference to current gilt yields, usually with a fixed addition to reflect their scheme’s actual investment strategy, which typically will not be wholly gilts-based (the “gilts plus” approach to setting discount rates). As gilt yields have fallen over time, such an approach has produced ever lower discount rates leading to ever increasing liabilities and deficits.

Instead of using the “gilts plus” approach, it has often been forgotten that the scheme funding legislation also permits discount rates to be derived directly from expected returns on scheme assets. In some circumstances, this may represent a better approach and this case study is an example of this.

The sponsoring employer (“the Employer”) of the Scheme in question is a nationwide charitable organisation, offering a DB scheme to its current employees and also to new recruits. There is no expectation that this policy will change.

For many years, the membership of the Scheme has been in a “steady state”, with new joiners replacing those who leave or retire with the result that the membership profile has remained broadly unchanged. Over successive valuations, there had been repeated increases in the past service deficit, despite the Employer paying substantial deficit reduction contributions, as well as in the cost of providing future service benefits. In these valuations, discount rates had been derived on a “gilts plus” basis.

The next valuation was due as at 31 December 2012 and if the “gilts plus” approach had again been adopted, there would have been a further substantial increase in the Scheme’s deficit and in future service contributions. This worsening of the funding position was solely due to a further significant fall in gilt yields since the previous valuation.

COVENANT CONSIDERATIONS

The Employer fully accepts the need to fund the pension promises for its employees appropriately, but as with all charities it is concerned that this should not jeopardise its ability to undertake the activities for which it exists. Similarly, the Scheme Trustees are well aware of their responsibilities towards scheme members, but are also mindful that they should be supportive of the Employer where this does not contradict their other responsibilities. Members are generally best protected over the long term if the sponsoring employer thrives.

The covenant of the Employer was seen to be strong, with there being sufficient free assets on its balance sheet to cover the Scheme’s buy-out deficit. The Scheme also enjoyed a first charge over several properties owned by the Employer. The Scheme’s investment strategy reflected this long term covenant strength, being largely aimed at “on-risk” assets and, in particular, with only a small allocation to gilts. However, further increases in deficit contributions and future service costs would have had an adverse impact on the Employer’s cash flows to the detriment of its charitable activities.

The Scheme Trustees and the Employer viewed the increase in technical provisions brought about by the fall in gilt yields at this valuation as representing “artificial prudence”. There had been no weakening of the Employer covenant nor reduction in the security of members’ accrued benefits to justify such an increase in prudence.

THE RIGHT LEVEL OF RISK – LONG TERM INVESTMENT AND FUNDING STRATEGY

The Trustees could have chosen to reduce volatility in funding by making the investment strategy more conservative, but that would have been at the expense of future returns and would have locked in the current deficit. With a strong Employer covenant to support the Scheme, the Scheme Trustees felt it appropriate to maintain a significant exposure to “on-risk” assets both today and into the longer term with no explicit agreement to de-risk at any future stage.

Similarly, the Employer regards the Scheme as a fundamental part of its employees’ remuneration and did not want to reduce its risk by closing the Scheme, even just to new entrants.

Therefore, the Scheme Trustees and the Employer decided to adopt a revised approach to setting discount rates, basing these on the expected future returns on the Scheme assets and not on a fixed addition to the current gilt yield. In doing so, they took account of the current investment strategy and how that might change over time. The expected returns on each asset class were based on current market conditions, so consistency was maintained between the valuation of liabilities and assets; equity/property returns were built up from current dividend/rental yields; gilt and bond returns were based on current market yields.

The Scheme Trustees and the Employer believe that this revised approach represents a more appropriate basis for the Scheme, given the “steady state” nature of the membership, the strong Employer covenant and the actual investment strategy being pursued.

Having carried out some back-testing, the Scheme Trustees believed that this approach should produce more stable results over time, given the Scheme’s specific circumstances. For this particular valuation, the Scheme Trustees were able to agree lower technical provisions than would have been the case under a “gilts plus” approach, avoiding an increase in reserves and costs that were not linked to any need for additional prudence to be taken. Importantly, the back-testing also demonstrated that this approach retained an appropriate degree of prudence over the long term – there would have been occasions in the past when the technical provisions would have been higher than on a “gilts plus” basis, so it does not represent an “easy ride”.

THE OUTCOME

The Scheme Trustees are now part way through the 31 December 2015 actuarial valuation and the expected stability in results seems to have been borne out in practice, as it is likely that they will be able to maintain the current recovery plan and future service contribution rate. Naturally, they will keep their approach to funding under review, including how discount rates are set, to ensure that it remains appropriate to the current circumstances of their Scheme.

So, moving away from a “gilts plus” approach to setting discount rates may be appropriate for some schemes, in particular if there is a strong employer covenant, an investment strategy that largely avoids gilts and where there is no expectation that the scheme might be wound up even within a reasonably long timescale. Trustees and employers of schemes in a similar position should at least consider whether such an approach might be right for them.

GOVERNANCE OF DEFINED BENEFIT SCHEMES



INTRODUCTION

Good governance is about the processes for making and implementing decisions which serve to realise agreed goals. The problem of applying this in a pension scheme context is that the two parties involved, the trustees and the sponsor, come at it from completely different perspectives.

The trustees are focused on ensuring the security of members' benefits and managing those risks. The sponsor will be primarily focused on understanding and managing its financial exposure to the scheme. In addition, the trustee will hold many of the cards and, to be fair, much of the responsibility.

Finding and agreeing common goals is therefore both difficult and crucial to ensure that the scheme is well governed in the interests of both parties.

Governance for sponsors of defined benefit schemes is difficult because the trustees hold many of the cards. Understanding that and working collaboratively with trustees is the best route to achieving good governance. Agreement on the objectives for the scheme is a crucial step followed by an effective flow of accessible information showing progress against those objectives.

BALANCE OF POWERS/ CONFLICTS

Understanding the balance of powers between the trustees and sponsors is a key place to start. These will be set out in the scheme's governing documentation and can vary significantly from scheme to scheme. Table 5 sets out the key issues to look at:

Understanding the balance of responsibilities and powers informs the sponsor's relationship with the trustees and identifies where it has influence.

Involvement in appointment of trustees, or appointing one or more trustees, can be very helpful in terms of flow of information and influence. Conflicts have to be managed carefully (and usually by the trustee).

TABLE 5

Power to set contributions	The legislation provides for funding proposals to be agreed between the trustee and sponsor. Some schemes may have different provisions with the power to set contributions being vested in the trustees.
Appointment of trustees	Does this vest in you as sponsor? How can sponsors exercise this power to manage the scheme as effectively as possible?
Amendment power	Who controls amendments? How much is the sponsor involved?
Transfer value basis, early/late retirement, commutation	Usually with the trustee, but can have a significant financial impact.
Power to trigger a winding up	This is relevant because of the debt that could be triggered and so is a powerful tool for the trustees if it lies solely with them.

It would be normal for some trustee issues to be confidential to the trustees and not shared with the sponsor. It is preferable to be absolutely clear at outset for sponsor appointed trustees whether their primary obligation lies to the trustee or their employer and what the scope of their involvement is. Having an advocate from the sponsor can help the trustee understand the sponsor's position, but it is difficult, if not impossible, for that advocate to be involved subsequently in a key decision impacting on the sponsor (such as funding).

Don't appoint your financial director as chair of the trustees and then expect him or her to be able to act as advocate for the sponsor. Have a clear, written policy on conflicts and how they will be managed.

RELATIONSHIP BETWEEN TRUSTEE AND SPONSOR

The Pensions Regulator requires trustees "to seek an appropriate funding outcome that reflects a reasonable balance between the need to pay promised benefits and minimising any adverse impact on your sustainable growth". In a charity context, substitute ongoing viability or balance of priorities for sustainable growth.

In practice this means that trustees should not attempt to impose a funding or contribution regime on sponsors without appropriate and detailed discussions. From a sponsor's perspective it supports and encourages an open and frank discussion about the challenges faced by the charity, its balance of priorities for the future and therefore how much it can afford to pay. It is also helpful to explain the difficulties that the sponsor might face in the event of an unexpected increase in contributions.

The covenant review will play a key part in the trustees' analysis of the charity's financial position. It is in the sponsor's best interests to be open and transparent. You should be asked to check any factual statements for accuracy before any reports are issued.

Building a relationship with the covenant adviser can help ensure your key messages get through to the trustees.

If the relationship has been difficult in the past, the simple approach of changing the people involved from the sponsor or trustee, or indeed the advisers, can help remove barriers and allow a better relationship to develop.

GOVERNANCE FOR SPONSORS OF DEFINED BENEFIT SCHEMES IS DIFFICULT BECAUSE THE TRUSTEES HOLD MANY OF THE CARDS. UNDERSTANDING THAT AND WORKING COLLABORATIVELY WITH TRUSTEES IS THE BEST ROUTE TO ACHIEVING GOOD GOVERNANCE.

INVESTMENT STRATEGY

Investment strategy is a crucial element of the strategy for a defined benefit pension scheme. Usually a trustee decision, but the legislation provides for the sponsor to be consulted. The sponsor needs to be fully engaged in the investment strategy which has just as much, if not more, impact on the funding than contributions, depending on the maturity of the scheme.

Ask for clear explanations of the level and types of risk in the proposed strategy and how those risks are being managed. Expect regular information showing the progress of the investment strategy against investment targets and the more prudent funding targets. Some actuaries will express funding targets differently but they should reference them back to the expected return from the assets so that it is easier for you to monitor progress. See section 2 for more information on negotiating a long term investment and funding strategy.

COSTS

The costs of running a defined benefit scheme can be significant. Unfortunately many of the costs are relatively fixed and so for smaller schemes in particular, the costs can be very high per member.

Hold the trustees to account for the key costs they may be responsible for:

Actuarial costs: Are they appropriate and checked against the market regularly?

Administration costs: Are they appropriate and provide the right level of service to members? Are they fixed or time costed (as predictability of costs can be just as important as level)?

Investment costs: Are figures quoted net of fees or gross of fees? Are more expensive strategies (such as active management) justified? Remember some active strategies may be used for defensive purposes.

Legal costs: Are they used reasonably? Is the trust documentation up to date and easy to access?

SKILLS REQUIRED

As more defined benefit schemes become legacy schemes (i.e. not the current pension provision for staff in active service) and the key risks are financial, it makes sense for them to be managed by individuals with financial experience. To make the engagement with trustees productive, it is important that the sponsor has a thorough understanding of the way that scheme is managed, the investment strategy and the trustees' approach to funding. The Pensions Regulator's website, whilst mostly directed at trustees, can help sponsoring employers understand the trustees' approach which can sometimes appear counterintuitive.

EXAMPLE: ETHICAL INVESTMENT FOR CHARITIES

The covenant review confirms a strong covenant with no concerns about the sponsor's viability over the long term. The sponsor views this as illustrating that the trustees can properly agree a long recovery plan, allowing the sponsor to spread contributions to fund a deficit over a period of 10 years or more, as there is little risk that the sponsor will not be around to pay them. The covenant review comments on the affordability of contributions. The sponsor can clearly afford to pay a higher level of contributions and pay off the deficit in a shorter period. The trustees know the Regulator would expect them to adopt this approach.

Initial result: Sponsor feels aggrieved that a strong covenant is not being taken into account and that the trustees are just being difficult.

Trustees feel obliged to follow the guidance and impose a shorter recovery period.

Compromise: By understanding the trustees' constraints, the sponsor can support the proposal of a longer recovery period by illustrating different ways in which they would like to invest in the business, or other cash flow requirements, which could bring the parties to a compromise position.

TRAINING

Training and conferences are available for sponsors and trustees of defined benefit schemes, many of them free. Essential for trustees, they provide excellent insight for sponsors and enable them to understand the trustees' constraints and find ways of working with them. This can support a strong, collaborative relationship between sponsor and trustee who then work together to support the scheme in the most effective way possible.

Charities that sponsor defined benefit schemes should encourage trustees to get training on their role, ideally from charity specialists.

SELECTING ADVISERS

Depending on the impact of the scheme on the charity and internal skills, sponsors may decide to access advisers only during the triennial valuation process. Alternatively, the sponsor may appoint an adviser to monitor the progress of the scheme to avoid reliance on the trustees' information (although you should still encourage the trustee to provide regular information).

Leaving aside the obvious requirement to make sure they have the appropriate level of skill and knowledge, identifying what you need them to do is crucial. This goes further than the technical area and should be driven by the nature of the working relationship with the trustees and how you want that to develop. You need to ensure that the adviser will adjust their approach and tone to your requirements in terms of the relationship with the trustees. Not all advisers can resist the temptation to score points! You also need someone who can translate the jargon-ridden pensions technical speak into more accessible language and will provide clear and realistic advice about what outcomes are possible.

MULTI-EMPLOYER SCHEMES



A multi-employer scheme is a scheme where a number of employers participate under a single trust arrangement. Many charities chose to participate in schemes of this type as they presented an opportunity to share cost and pool risk.

Each multi-employer scheme needs a single set of trustees, deed and rules, and one administrative set up. The costs therefore could be spread amongst the participating employers. Certain multi-employer schemes also enabled the pooling of risk, by 'cross-guaranteeing' one another's liability. However, the extent to which the implications of this were fully understood by the charities involved at the time is debatable.

There are two types of multi-employer scheme: segmented and non-sectionalised.

- 1) Segmented multi-employer schemes operate in a very similar way to stand alone pension schemes where each participating organisation has a distinct ring fenced asset and liability share. In this instance, the main benefits of participating in a multi-employer scheme, is the sharing of costs.
- 2) A non-sectionalised multi-employer scheme (also known as a last man standing multi-employer scheme) operates in a different way from standalone arrangements. The assets and liabilities for all the employees of the participating employers in the scheme are pooled (although allocated on a 'notional' basis). This provides some risk sharing advantages as the longevity, salary and investment experience are shared between multiple organisations and, from a member perspective; benefits are effectively protected by all the participating employers and not just their employer.

As the funding position of DB schemes has deteriorated over recent years, these schemes have exposed participating employers to additional risk.

SECTION 75 DEBTS IN MULTI-EMPLOYER SCHEMES

Many charities that have their own DB schemes have sought to minimise future risk by closing them to future accrual. In the case of multi-employer schemes, this entails the triggering of a 'section 75 debt' unless all employers in the scheme agree closure to future accrual at the same time. In reality, this is difficult to achieve, particularly where the employers are not related.

Since 2006, legislation under section 75 Pensions Act 1995 has required that a non-sectionalised multi-employer scheme (an 'active multi-employer scheme') be treated differently from a non-sectionalised multi-employer scheme in which no employers employ active members (a 'frozen multi-employer scheme').

In an open multi-employer scheme, an employer who wishes to cease participation must depart the scheme after paying a debt based on:

- The cost of buying-out all pensions accrued by employees attributable to that employer with an insurer.
- The employer's share of any liabilities that are not attributed to any employer remaining in the scheme ('orphan liabilities'), calculated on that same basis.
- The costs associated with calculating and collecting the debt.

This total liability is the employer's 'section 75 debt'.

The assumptions underlying the calculation of the section 75 debt are stronger than those used for the ongoing and accounting funding assessments, a fact which is often not appreciated. As a result of the stronger assumptions, the section 75 debt is greater than the funding value of the liabilities associated with the employer at time of calculation. It is also critical to understand that the debt payment is triggered as soon as the employer exits the scheme. Although there have been cases where employers have negotiated repayment plans for the debt, scheme trustees are under no obligation to facilitate this payment in this way, and in most cases demand immediate payment. Generally, therefore, it risks a considerable cash demand on the charity wishing to exit the scheme.

Although the debt is based on the cost of providing annuities at then-current rates, no annuities are required to be actually purchased for any scheme members. Instead, any payments made towards the debt are usually added to the scheme's assets and spread to cover the on-going future liabilities of the scheme, including the liabilities attributable to other employers.

There is also a mechanism under legislation which allows an employer to trigger the debt in a frozen multi-employer scheme by the giving of notice to the trustees.

This is in contrast to the treatment of a frozen multi-employer scheme. Although no further accruals are being made in respect of any employer in such schemes, participating employers may continue to participate, making deficit contributions on an on-going basis. A section 75 debt will only arise if an employer applies to the pension trustees to trigger their debt; or if an employer winds up, becomes insolvent or decides to move its liabilities (and associated assets) to another pension scheme. A charity with their own pension scheme therefore has much more flexibility to manage and reduce its long-term risks arising from their pension obligations than one in a multi-employer scheme.

THE ASSUMPTIONS UNDERLYING THE CALCULATION OF THE SECTION 75 DEBT ARE STRONGER THAN THOSE USED FOR THE ONGOING AND ACCOUNTING FUNDING ASSESSMENTS, A FACT WHICH IS OFTEN NOT APPRECIATED

The fact that a much larger debt will be assessed on stopping future accrual than if an employer continues to accrue additional liabilities in an open multi-employer scheme presents a number of issues for individual participating employers, for the scheme and for remaining employers.

PROBLEMS ARISING FROM SECTION 75 DEBT FOR INDIVIDUAL EMPLOYERS

- Some employers otherwise capable of paying deficit reduction payments indefinitely into the future, cannot meet the cash demand of the section 75 debt and so must continue to accrue further debt by keeping active employees in the scheme.
- The fact that the section 75 debt increases as further liabilities accrue makes it more likely that, should the section 75 debt arise, it will lead to the insolvency of that employer.
- Even if the employer can manage to pay the section 75 debt, this does not secure the benefits for its employees, but rather to members of the scheme generally, making the employer more reluctant to incur the debt.
- Settling the debt provides certainty. However, the timing of the debt trigger may be at a point where market conditions are unfavourable. This for example could be when asset values are suppressed or when interest rates are low therefore placing a higher value on liabilities. Settling the debt also means that the ultimate payment will not reflect any future positive changes in membership, such as transfers out, or positive changes in market conditions.
- There is little incentive for individual employers within these schemes to fund the scheme over and above the rate which is affordable for the weakest employer, since this does not derive any individual benefit. Disincentivising employers in this way increases the challenge for ensuring the scheme is appropriately funded, and ultimately, increases the overall risk for the scheme.

- Where a scheme has been closed to new members, employers run the risk of accidentally triggering the debt if the last active member leaves their employment. With only deferred members and pensioners remaining, the scheme is likely to demand immediate payment of the debt in most cases. The cessation debt can be managed to some extent using the 'period of grace' provisions which allow members to be added to the Scheme within 12 months and therefore avoid a debt trigger. However, relatively short time constraints (usually within 2 months) mean that to utilise this option it has to be identified quickly after the last member has exited.

Within many schemes the ability to utilise a defined contribution option under the same trust can to some extent defer some of these issues.

PROBLEMS ARISING FOR THE SCHEME ITSELF

Whilst here we have concentrated on the 'catch-22' for employers, the schemes themselves are also placed in an increasingly painful vice due to increasing liabilities. The liability of the scheme continues to grow, while fewer employers are able to fund it.

In addition, the covenant of each employer needs to be considered when agreeing funding plans for meeting any deficit. The weaker the covenant, the shorter the likely Recovery Period leading to higher short term cost.

The Pensions Regulator has issued very helpful guidance on assessing an employer covenant with specific guidance for charities contained in the document Appendices.

PROBLEMS ARISING FOR EMPLOYERS REMAINING IN THE SCHEME

As the number of employers reduces, remaining employers in the scheme will be obliged to pick up the liabilities of employees employed by others.

This risks a 'domino' effect – insolvency leaves behind more orphan debt leading to increased funding cost which can push further scheme employers into insolvency, and so on. On the other hand, employers that remain in the scheme, while other employers leave, paying all or some of the section 75 debt, may see their on-going liabilities fall, although schemes are increasingly looking to address this anomaly by re-defining these exit liabilities.

CFG have made proposals to DWP to look to address some of these issues, by making amendments to secondary legislation, but at time of writing this has not been progressed.

RESTRUCTURES

Charities are increasingly looking to create partnership and mergers with other organisations in order to capitalise on their social impact and maximise effective use of resources.

Restructures through incorporation, mergers or take-overs are more problematic within multi-employer schemes. Should one employer cease to exist as a result of a change in organisation structure, a 'cessation debt' is triggered. Flexibility now exists through the use of apportionment and withdrawal arrangements, although these could be complex and costly to complete. There have been a number of instances in the last decade of merger or restructure negotiations coming to a standstill due to incompatibilities with pension arrangements. In particular, cases where charities with heavily aligned missions that wanted to merge to form a new entity were unable to take on the liabilities of the participating organisations, and cases where the creation of a new entity would have triggered a section 75 debt.

One trigger for the debt is known as an 'employment cessation event'. This occurs when a participating employer ceases to employ any active members within the scheme whilst at the time in question at least one other employer participates and employs active members.¹

This can happen in a variety of circumstances, such as a business transfer or share sale. A change in the legal identity of the employer, such as the incorporation of charity trustees into a company with a limited guarantee, may be sufficient to trigger an employer debt. Similarly, a merger or amalgamation could trigger a debt, even though the previous employers are still part of the corporate structure.

There does not even need to be a change of employment. The number of active members may simply reduce to zero through the passage of time for example where the last active member of the scheme leaves, retires or dies.

An employer wishing to end pension accrual in a multi-employer pension scheme will trigger an employment cessation event unless cessation could be coordinated to take place simultaneously with all other current employers.²

FOOTNOTES

¹ An example of this in action would be the Growth Plan section of the Pensions Trust, if you cease to employ active members (assuming all the other current employers do not cease to employ active members at the same time) you trigger an employment cessation event.

² The practicalities of this are difficult but not impossible. The author has done this in relation to a multi-employer pension scheme with around eight different (and non-associated) charity employers.

HOW TO STOP AN 'ACCIDENTAL TRIGGER'

Charities need to be wary that they do not accidentally trigger an employer debt, especially where those employing the members do not change.

To stop employers facing large liabilities as a result of relatively simple restructuring, there are now two easements where an employment cessation event will not be deemed to have occurred.

Both easements require a procedure to be strictly followed.

The first, the general easement, is designed for cases where a single employer is being replaced by another single employer (such as a legal identity change). The pension trustees need to follow a seven-stage decision making process. If, as a result, the trustees are satisfied that the receiving employer is at least as likely as the transferring employer to be able to meet the liabilities of the scheme, an employer cessation event will be deemed not to have occurred.

In situations where the liabilities involved are very small (the total annual amount of accrued benefits are less than £20,000/year), organisations may be able to rely on a de minimis easement. In both circumstances, trustees will need to follow a strictly defined procedure and act without delay.

STATUTORY EMPLOYERS (AND DEALING WITH SECTION 75 LIABILITIES)

Section 75 debts are the responsibility of 'statutory employers', i.e. those employers that meet the statutory definition and, as a result, are legally liable for debts arising. It can be more difficult than first appreciated to identify who the statutory employer is. For this reason, pension trustees are now required to identify the scheme's statutory employer in their Scheme Return to the Regulator.

A statutory employer for section 75 purposes is any entity which has employed an active member (or someone eligible to be so) since December 1996. This is subject to various exceptions. For example, an employer who has paid their section 75 debt upon leaving the scheme is no longer considered a statutory employer.

Another way for employers to be relieved of their status as statutory employer is through entering into a 'form of apportionment'. This is a legally enforceable agreement whereby another employer agrees to take over the old employer's scheme liabilities. In a similar way, an exiting employer could seek agreement to pay a lesser sum than the full exit debt in return for another entity guaranteeing the remainder.

CERTAINLY, WITHOUT LEGISLATIVE CHANGE, MANAGING CHARITIES' EXPOSURE TO THESE SCHEMES WILL BE DEMANDING.

Those who remain statutory employers will be left exposed to a scheme's hidden liabilities. For example, when it is not possible to match a liability for a member to a statutory employer, it is classified as an 'orphan liability'. The statutory employers in the scheme will assume responsibility for their own share of the overall deficit and a proportion of the orphan liabilities.

Employers need to ensure that when they 'leave' a pension scheme, they do so in a manner that results in their full discharge and they do not inadvertently retain residual liability towards the pension scheme.

THE PENSIONS TRUST GROWTH PLAN

The Pensions Trust is an organisation that provides pension schemes of various types, particularly to charities and not-for profits. They are probably the largest provider of multi-employer schemes to the charitable sector with their 'growth plans'. Consequently the running of their schemes has a significant bearing on the landscape of charity pensions.

The Pensions Trust is a 'master trust' type of arrangement whereby, under one overarching trust, there are a number of separate sub trusts. The Growth Plan is a large scheme used by many different employers who have no legal connection with one another and where liability is shared amongst all employers and arguably unlimited from a practical perspective.

As a multi-employer pension scheme, the risks of triggering exit liabilities include employers wishing to cease accrual, active members being extinguished through retirement, death or leaving service, and organisational change or restructure.

Any event that could have a material impact on the covenant of the employer may be of concern to the Pensions Trust.

Growth Plan has been running for decades and is made up of four series. The management of these four plans is related under the umbrella of the Growth Plan arrangements.

The four growth plan series are as follows:

Growth Plan Series 1 (GP1) –

The General Fund was established in April 1946 and closed to future benefits on 1 April 1997. Members purchased a defined amount of level pension at retirement with their contributions.

Growth Plan Series 2 (GP2) –

This was established as a replacement for GP1 on 1 April 1997 and closed to future accrual on 30 September 2001. Members purchased a defined amount of increasing pension at retirement with their contributions.

Growth Plan Series 3 (GP3) –

This was established on 1 October 2001, and was originally thought of as a self-contained DC scheme. Contributions are invested in a ‘pot’ for each individual; the pot is invested. The pension provided is not guaranteed but is based upon the contributions paid, the investment return achieved and the annuity rate available at retirement date. There is an underlying capital guarantee that the member’s value will never be less than the value at the start of the year plus contributions. The Scheme trustees have invested the funds in low risk asset classes to limit their exposure to this guarantee.

Growth Plan Series 4 (GP4) –

This was established on 1 October 2008. This is a DC scheme offering a choice of investment funds. There is no capital guarantee.

The Growth Plan was subject to some legislative uncertainty following the 2011 judgment in ‘Houldsworth and another v Bridge Trustees and the Secretary of State for Work & Pensions’ (the ‘Bridge’ case) was given. Following a legislative change in July 2015 the position is now much more clear cut. GP 1 and 2 will continue to be treated as DB arrangements and Growth Plan 4 (GP4) will continue as a DC (money purchase) arrangement. GP3 has been effectively re-classified as a DB scheme as a result of the underlying guarantee it contains. Prior to this reclassification, the assets and liabilities of Growth Plan 3 were broadly fully matched. However, because of the umbrella nature of the Growth Plan, the reclassification means that GP3 liabilities have been amalgamated with GP1 and GP2 liabilities. Consequently, many employers with only GP3 liabilities have been subject to a significant increase in their deficit. Those with only GP1 and GP2 liabilities have seen an equivalent reduction.

In an attempt to alleviate the impact of this, the Pensions Trust took the decision to close GP3 from the end of September 2013 and move future contributions to GP4 to prevent further accrual of GP3 liabilities.

Whilst this was seen as a relatively simple solution for many of the employers participating, there are a number of potentially negative implications, for example, preventing the flexibility for employers to move to an alternative DC provider.

News over recent months, for participants in the Plan, has been a little mixed. The good news is that the funding position of the Plan has improved to the end of December 2015 reflecting some improved asset returns, gilt yield changes and contributions paid. The Plan is very sensitive to interest rates so in all likelihood if interest rates / gilt yields begin to rise then the funding position could continue to improve, subject of course to what happens on the asset side.

The bad news however is that the orphan debt position has continued to deteriorate having increased to around 34% at 30 September 2015 up from around 21% at 30 September 2012. In addition the number of employers in the Plan has also fallen significantly, around 300 in the 4 years to September 2015 so this deficit must now be shared out across a smaller number of participants.

Importantly, for employers, the actuarial valuation also hinted at future changes to the contribution basis likely to reflect a move to funding on a cessation rather than on-going basis which is likely to result in higher contributions if implemented.

ADVICE FOR CHARITIES IN MULTI-EMPLOYER SCHEMES

Given the challenges outlined above to managing liabilities accrued from multi-employer schemes, charity trustees would be forgiven for feeling the odds are stacked against them. Certainly, without legislative change, managing charities, exposure to these schemes will be demanding.

As a first step a board of trustees needs to ensure they fully understand the pension arrangements their charity has in place.

This applies even when there are only a minority of staff and in some instances only one or two employees or ex-employees in a scheme. This is likely to involve pressing scheme trustees for a full understanding of future liabilities and valuations. You can find more on how to manage relationships with trustees to good effect in section 3.

Next, it is essential to monitor the membership of the schemes, to ensure that the section 75 debt either isn’t triggered, or that sufficient contingency plans are in place if it is. In certain circumstances, the best course of action may be to withdraw from a multi-employer scheme. It may be expensive and time-consuming, but the long-term benefits of being able to actively manage the charity’s specific liability and assets could enable the charity to have a better long-term impact.

We are aware of cases where the long-term liability can outweigh a reasonable probability that the charity will be able to fulfil its obligations. In these circumstances, it is vital that trustees seriously consider taking advice on the long-term solvency of the charity, and how the activities of the charity can be best maintained.



CFG is always listening to charities experiencing difficulties in order to ensure that charities are getting the support that they need. If you are experiencing problems with your Growth Plan scheme, or any pension scheme, please contact CFG (policy@cfg.org.uk) and let us know the challenges you are facing.

NAVIGATING THE LOCAL GOVERNMENT PENSION SCHEME



WHAT IS THE LGPS?

The Local Government Pension Scheme (LGPS) is a defined benefit pension scheme made up of a number of Funds. Each Fund is governed by an 'Administering Authority' (typically a county council or London Borough). The rules of the LGPS are set out in the Local Government Pensions Scheme Regulations 2013 (the Regulations) and associated legislation.

The LGPS covers employees in England and Wales (with devolved schemes for employees in Scotland and Northern Ireland) who are employed by eligible employers, such as local councils. So if a charity is thinking of taking on public sector contacts (see Section 8) from local councils, they will almost certainly have to join the LGPS.

ENTERING THE LGPS

WHEN WOULD YOU DO IT?

Local authorities are required by the Best Value Authorities Staff Transfers (Pensions) Direction 2007 to ensure that staff who have transferred to a charity retain a right to earn benefits in the LGPS or to earn benefits that are broadly comparable to the LGPS.

This means that any charity that wants to provide outsourced public services will have to participate in the LGPS or join or set up their own scheme that provides broadly comparable benefits to the LGPS.

There are a number of large multi-employer master trust arrangements that provide broadly comparable benefits but these will not give a charity any greater level of control over funding or investment than the LGPS, (see section 4). In addition, they are subject to the same legislative and regulatory conditions that apply to private defined benefit schemes.

The ability to provide a broadly comparable benefit may soon fall away as a result of the Government's consultation on the Regulations which seek to compel all new outsourcing employers to participate in the LGPS.

WHAT ARE THE BENEFITS/RISKS OF JOINING THE LGPS

The LGPS offers a familiar benefit structure to employees and avoids complications for the charity in communicating any new benefit provision to employees. The benefit for the employee is continuation of their existing pension with a provider they know.

CHARITIES MUST PAY THE ONGOING CONTRIBUTIONS SET BY THE FUND ACTUARY AND WILL HAVE NO ONGOING ABILITY TO NEGOTIATE SUCH AMOUNTS. THEREFORE, IF THE CHARITY WANTS MORE CERTAINTY AS TO ONGOING COSTS, IT NEEDS TO NEGOTIATE THESE PRE-CONTRACT.

The benefit for the charity is a pension arrangement that requires no set up costs or management time to run.

The risks for the charity of joining the LGPS all relate to costs.

Charities may participate for a fixed group of employees (closed contract) or for all employees related to a contract (open contract). They can be liable for only future accrual of those employees or pre-transfer accrual as well.

Charities must pay the ongoing contributions set by the Fund actuary and will have no ongoing ability to negotiate such amounts. Therefore, if the charity wants more certainty as to ongoing costs, it needs to negotiate these pre-contract.

Ways to address this are either via a fixed contractual contribution rate (for the full contract length), or an agreed capped higher and lower amount, whereby the charity pays the amounts due between the two rates but adjusts the contractual payments where the rates are above or below the agreed amounts. **If the charity agrees to simply pay the amounts due under the Regulations, it is taking a material risk if the initial rate rises which may make the delivery of the service uneconomic.**

It is common for charities to be liable to pay additional contributions if they offer an employee early retirement on preferential terms (e.g. no actuarial reduction for early payment) or an employee is made redundant with a right to enhanced pension benefits. The cost of this can be included in a smoothed contribution rate but it is commonly payable as a one-off payment. Redundancy is a matter over which charities do have some control and so this risk is capable of being managed to a degree.

Charities will also be required to assess the risk to the LGPS of premature termination of the contract due to insolvency, winding up or liquidation of the charity. In practice it is likely to be the Administering Authority who carries out this assessment.

Where the risk requires it, a charity must then provide a bond or indemnity to cover the risk of premature termination of the amount necessary to cover any possible funding shortfall on such termination.

Bonds will commonly be obtained from a bank, for a cost, and these can be relatively expensive. The Administering Authority may provide a draft Bond agreement which should be legally reviewed by both the charity and the bond provider.

WHAT QUESTIONS SHOULD CHARITIES BE ASKING?

In our experience, the following questions must be addressed pre-signing as they all relate to financial risk:

Contribution rates

- What is the profile of the employees, and will it be an open or closed contract?
- Is your charity able/willing to accept a variable contribution rate or should it seek a fixed rate contribution or cap and collar (albeit at a higher cost) to achieve certainty of cost?

Past accrual

- Is the charity required to take on the cost of future shortfalls in the funding of benefits earned before an employee transferred to the charity?
- Does the charity have a clear idea of the amount of the accrued liabilities i.e. numbers of staff, how long they've been in the LGPS, their levels of pay etc?

Is a bond or indemnity required?

- If yes, what elements of funding liability are included in the calculation of that bond and how might this change over the life of the contract – particularly at valuations and termination? What are the short term financial prospects for the charity – are there events in the near future that may have a negative impact on the covenant and could increase bond risk/cost?

Exit payments

- Will the charity be liable for exit payments for all benefits for transferred staff at the termination of participation in the LGPS? If so, does it have sufficient reserves to make provision for this? To what extent does the funding basis (on-going and cessation) change when an exit payment is triggered and will any other party share some or all of the risk for that cost?

MANAGING AND MONITORING

The crucial time for negotiation is at the point of participation in the LGPS. **Once a charity has agreed its terms, there is very limited scope for renegotiation.** The charity will be able to manage its salary increases and the redundancy of staff and should seek to have some input on the assessment of covenant (which affects contribution rates). However, outside of these issues, the Administering Authority will determine contribution requirements, investment risk and all other factors that are material to the contribution obligation.

Ceasing to employ active members can trigger an exit payment (in certain circumstances – legal advice should be sought in this event). Charities participating under a closed contract should put systems in place to ensure that they do not accidentally trigger such a payment. Charities with an open contract may be able to use existing flexibility in the Regulations which allows an Administering Authority to suspend an exit payment for up to 3 years where it is of the reasonable opinion that the charity is likely to have one or more active members contributing to the Fund within a specified period.

As stated above, for charities seeking more certainty, it is possible to negotiate a fixed rate contribution or a capped maximum/minimum contribution rate at the start of a contract. This would then be documented in the Admission Agreement. These types of arrangements have the advantage of allowing the charity to budget for fixed liabilities and so contract pricing becomes easier. However, the transfer of risk does mean that contribution rates are commonly higher than the standard contribution rate and the flipside is that if there is an improvement in funding levels, the charity would not benefit from this.

It may be possible to agree with an Administering Authority that a charity will not be liable for pre-transfer benefits. A fixed rate contribution rate for example could achieve this. Alternatively a charity could operate a standard variable contribution rate but seek agreement that the previously earned benefits will always be treated as 100% funded at each actuarial valuation.

EXITING THE LGPS

When a charity exits the LGPS it becomes an ‘exiting employer’ and liable to pay an exit payment if there is a deficit. Exit can happen if the contract ends, the charity ceases to employ active members or it breaches the terms of the admission agreement. The Regulations require the Fund actuary to obtain an actuarial valuation as at the exit date of the liabilities of the fund in respect of benefits for the exiting employer’s current and former employees. There is no legislation that determines the valuation basis for any deficit.

EXISTING FLEXIBILITY ON EXIT PAYMENTS

Different Administering Authorities take different approaches to the amount of any exit payment. Some will calculate an exit payment on a cessation basis, meaning that the charity has to fund a significant difference between the on-going basis (which determined the starting funding rate) and cessation basis. Exit payments in these circumstances can be material and disproportionate to the value of the public service contract. It is therefore essential to understand the potential liabilities at the point of entering into the Admission Agreement and seek to have these indemnified, or at least off-set to some degree by a contracting party.

It has long been argued by actuaries and lawyers that using the cessation basis on exit is inequitable. The reasoning being that, as the LGPS will never wind-up, contributing an amount in excess of the ongoing deficit only benefits the other participating employers by reducing the overall ongoing deficit.

The Regulations allow an Administering Authority to spread the payment of an exit payment over a period that it considers reasonable. While the standard position is for payment to be required on demand, there is therefore scope to negotiate payment over time. Clearly, if the reason behind the termination of participation is financial uncertainty within the charity, the Administering Authority is unlikely to accept any risk of default.

For more details on charities’ options for participation in the LGPS and managing exit payments you can download our briefing paper for free from the CFG website – <http://bit.ly/2g8Psev>

DEFINED CONTRIBUTION PENSION SCHEMES





DEFINED CONTRIBUTION

WHAT IS DEFINED CONTRIBUTION?

With a defined contribution (DC) an employee builds up a pension fund, by making regular contributions with the support of their employer and tax relief from HMRC. Their fund can be accessed from age 55. The generic name for a DC scheme is now a workplace pension.

With the introduction of automatic enrolment in 2012 (see section 7) DC schemes have become the norm across the UK and by October 2018 all employers will be required to operate a workplace pension for their staff. The vast majority of employers who have needed to establish a workplace pension to comply with automatic enrolment have selected a DC scheme of one type or other.

DC schemes have been radically impacted by legislation over the last couple of years with the following impacts:

- Pension Freedoms which came into force on the 1st April 2015, allow members of DC schemes far greater flexibility on how they draw their pension benefits. There is no longer a requirement to purchase an annuity.

- A charge cap has also been established limiting the maximum charge allowed to be applied to the individual fund of 0.75%. This legislation takes effect at either the 1st April 2015 or the employer's staging date if later.

PENSION FREEDOMS

April 2015 saw the biggest change in pension rules for over a decade with employees aged 55 and over able to choose how they access the money saved into DC pensions. Prior to this legislation most people retiring would have purchased an annuity, which provided a guaranteed level of income in retirement. However due to low interest rate and the fact that once purchased you could not change the benefits, meant that annuities were often seen as offering poor value and little flexibility.

Under the new legislation the following options are available currently from 55:

- Take the whole pension fund as cash.
- Take up to 25% tax free as a lump sum. If you take out more than 25% cash from the pension pot, potentially income tax will then be charged.

- Take regular smaller lump sums of cash.
- Opt to take regular lump sums of cash from the pension at times that suit. However, each withdrawal will only be tax free for the first 25%. If you withdraw more, income tax may be charged.
- Keep the money invested and draw a regular income.
- Take 25% tax free and then receive a regular income from the remaining amount. This could be through income drawdown, where income is taken directly from the pension fund, which remains invested, or you could receive a guaranteed income for life by buying an annuity.
- Or a combination of the above.

Providers are not legally required to offer all the pension freedom options, so this should be a consideration when reviewing existing arrangements and selecting a new scheme.

The increase in options available at retirement is excellent. However, with choice can come complexity.

WORKED EXAMPLE

The tax implications of pension freedoms could be significant, even for those on average incomes.

If you earn £33,288 in 2016/17 tax year (the average annual salary according to the ONS for a pre-retiree 2015/16), and you take a pension lump sum of £20,000, then the first 25% is tax-free (£5,000), and the remaining £15,000 is taxed as income. Earnings of £33,288 plus the £15,000 taxable portion of the pension lump sum make a total income of £48,288, taking the individual over the higher rate tax threshold of £43,001. The tax paid on the £15,000 pension payment is £4,200.60, or an effect rate of 27%.

In response to this growth in the DC market there have been a number of regulatory and legislative changes made to ensure schemes are adequately monitored and that scheme members benefit from increased protection and flexibility in retirement.

DC schemes can be set up in two ways:

- 1) Trust-based, or
- 2) Contract-based.

From the employer's position, deciding which of these two approaches is the most appropriate requires careful consideration. Each option has its own merits in respect of costs, charges, regulatory requirements and governance, depending on the context of the employer. Employers need to consider their wider business objectives, as well as the needs of employees, when selecting the right type of scheme.

CONTRACT-BASED VS TRUST-BASED

Ultimately both Contract-based and Trust-based schemes aim to achieve the same result – to build up a fund for scheme members to provide cash

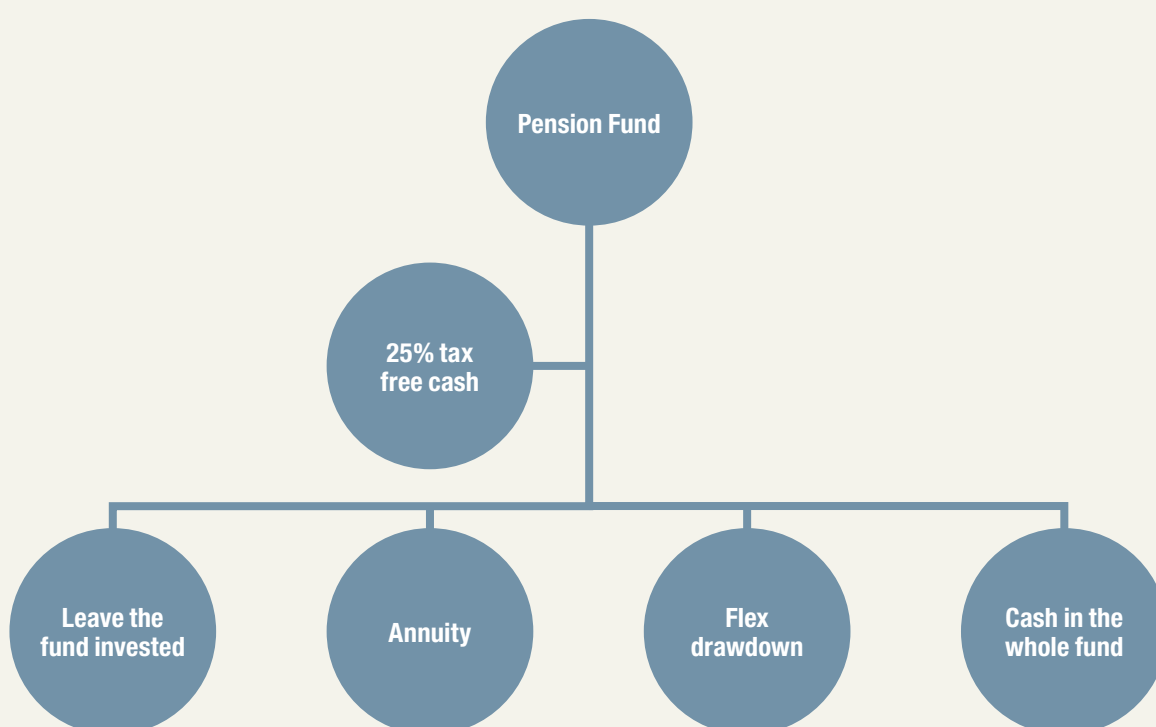
or retirement benefits. In the event of death before retirement, the funds can be used to provide a tax-free lump sum, subject to the limitations of the Lifetime Allowance.

Due to a combination of regulatory pressures (e.g. the recent introduction of a cap on Annual Management Charges, and a greater focus on governance), the growth of the Master Trust market and the similarity of services offered by providers for either option, means that the decision to go Contract-based or Trust-based is not clear cut.

Trust-based arrangements are where a board of trustees legally owns the pension funds on behalf of the members, and have a fiduciary duty to act in their interests. These can be split into:

- Self-administered arrangements, using a 'third party administrator' or an 'in-house pension team'.
- Insured arrangements, usually using an Insurance Company.
- Master Trusts, where multiple employers come together under one single trust and have all Investment decisions and regulatory requirements taken on their behalf by the Master Trust.

FIGURE 2. RETIREMENT OPTIONS UNDER PENSION FREEDOMS AT AGE 55



Contract-based arrangements

are governed by a contract between members and the provider and can be split into:

- Group Stakeholder Pension Plans, introduced in 2001 by the government as a way of ensuring that all employees had the option to save for their pension over and above the state pension. These schemes were typically offered by insurance companies with annual management charges of 1.5% p.a. for the first 10 years, followed thereafter by 1% p.a. These schemes can be used for automatic enrolment as long as the provider reduces the annual management charge within the charge cap of 0.75% pa and the scheme meets the other criteria. These plans tend to have a lower range of available investment funds compared to a personal pension plan.
- Group Personal Pension Plans, which have been around prior to 1990. These tend to be the main Contract-based DC scheme for employers wishing to provide an attractive benefit package to their employees, using a third party provider. Market pressures and legislation have greatly reduced charges and these plans tend to offer a wide range of investment funds and member education features.
- Group Self-invested Personal Pensions (SIPPs) have increased in numbers in recent years with some mainstream pension providers now offering group SIPP in place of a group personal pension at similar or lower charges for the default fund option. SIPPs offer greater flexibility to members in determining how their funds are managed. The default fund used for automatic enrolment would need to be within the charge cap, however these schemes can offer hundreds of different fund options through a variety of different fund managers and in some cases include direct equity investment. These more specialist funds would likely incur charges about the 0.75% charge cap.

Charities selecting a Contract-based scheme are effectively outsourcing pension provision and will therefore have little control over the running and governance of the scheme.

CHOOSING THE RIGHT SCHEME

There is no specific formula to follow and it would be prudent for employers to seek advice on which arrangement is best for them.

Where the decision can be seen as a strategic decision for the organisation, charity trustees ought to be engaged in the process.

Historically, larger DC schemes have tended to favour Trust-based arrangements as the overall costs tended to be lower. However the impact of the charge cap, automatic enrolment and improved technology means that Contract-based schemes now offer just as competitive charges.

Contract-based schemes were the favoured choice for small and medium sized employers prior to automatic enrolment. However since 2012 employers have had a huge choice of schemes including many new master trusts including NEST (National Employment Savings Trust)

Currently there is greater governance responsibility on Trust-based schemes, however with Contract-based schemes coming under increased scrutiny from The Pensions Regulator we can expect further regulation at some point.

THE MASTER TRUST

Over the last two to three years there has been a wave of enthusiasm in the pensions industry for 'Master Trust' products to satisfy employer's pension provision requirements. The running of a Trust-based pension, the burden of maintaining governance, providing various services to members and sourcing appropriate professional support for the scheme is costly. The 'unbundled' nature of these schemes means that separate costs are usually incurred for trusteeship, governance, administration, consulting services and investment management.

There are additional costs to take into consideration for staff attending trustee or governance meetings and managing the risk to the charity in running its own pension scheme.

A master trust provides the trusteeship, governance, administration, consulting and investment management on a bundled-together basis. This is similar to the multi-employer schemes outlined above but in this case provides DC benefits only. With each employer having their own sub-trust within the overarching master trust, economies of scale are achieved as a 'shared' delivery of services to each of the various employers is provided. Part of the fund management charge is used to cover trusteeship, governance, administration, and consulting and investment management.

These benefits need to be considered against the potential challenges of such a scheme.

These types of arrangements are still relatively new, however in just a few years over a hundred have been established. In this low charge pension environment, pension schemes need significant funds under investment to be viable, so additional care needs to be taken when considering this option.

Charities need to consider a range of factors before entering into them. The Pensions Regulator has stated in its principles, that 'the features necessary in a scheme to deliver good outcomes for members, include the provision of a suitable default fund, transparent costs and charges, protected assets, and sufficient protection for members against loss of their savings'. Whether therefore, the default fund provided by a master trust is appropriate for all members, given that the membership will likely consist of employees from a number of organisations, will need to be carefully considered. Master trusts may only be able to offer a limited potential for member engagement and consultation in running the fund; a Master trust tends to remove the employer from the burden of running the scheme. There is no requirement, therefore, for the employer to be actively involved in trusteeship or

TABLE 6

	CONTRACT-BASED	TRUST-BASED
Contractual Relationship	A contract between the Provider (insurance company) and Employee. There is no relationship between the Employer and the Provider.	Established under a Trust where the Employer and Trustees are party to the Trust. Scheme members are beneficiaries.
Trusteeship/ Governance	Not required. However best practice means that establishing a Governance Committee is advisable. Formal meeting is not required, but still advisable.	Trustees are required. At least one third of these should be member nominated, unless a specific exemption applies. Independent trustees can be appointed as an alternative option (but all of the trustees must be independent if there are to be no member-nominated trustees). Also required: <ul style="list-style-type: none"> • Formal minuted meetings • An internal dispute resolution procedure • A statement of investment principles • Suitable trustee knowledge and training
Scheme Accounts	Not required	These are required to be prepared and audited annually. NB a wholly insured scheme is exempt from this requirement.
Regulator	The Financial Conduct Authority and The Pensions Regulator.	The Pensions Regulator to which members pay a levy.
Administration	Usually undertaken by the Insurance Company.	Undertaken by a third party or handled by an in-house team.
Tax Relief Eligibility	Employer contributions receive corporation tax relief. Employee contributions receive tax relief at source if paid conventionally (i.e. net of basic rate tax, with higher rate relief claimed back from HMRC). Salary sacrifice ensures tax relief on “net pay” basis (i.e. at marginal rate).	Employer contributions receive corporation tax relief. Employee contributions receive tax relief at source where the employer takes contributions from pay before deducting tax (or tax relief can be claimed back from HMRC) Salary sacrifice ensures tax relief on “net pay” basis (i.e. at marginal rate).
Investment funds	Default fund is required for automatic enrolment schemes. Usually all provider funds are available – typically in excess of 60–200 funds.	Default fund is required for automatic enrolment schemes. The funds are chosen by the scheme trustees. Typically 10-20 funds are made available to members.
Expenses	Fund management charges are deducted by the fund. Other services are met by employer fees.	Fund management charges are deducted by the fund. Other services are met by employer fees.
Leavers	As the contract is between the provider and an individual, there is no ongoing employer responsibility.	Leaver benefits remain in the scheme and continue to be the responsibility of the Trustees.
Retirement Options	Tax free cash, full withdrawal, annuity, flexi drawdown, small fund and trivial pension rules as available.	Tax free cash, full withdrawal, annuity, flexi drawdown, small fund and trivial pension rules as available.

running governance committees. An employer needs to determine whether this low level of engagement is appropriate for their employees.

The employer of the charity will need to be satisfied that the potential conflict of interest between the providers providing the trust management alongside the provision of services to the scheme is adequately managed.

MASTER TRUST ASSURANCE

Providers of Master Trust schemes are expected to obtain independent master trust assurance. The master trust assurance framework has been developed by the ICAEW (Institute of Chartered Accountants in England and Wales) in partnership with The Pensions Regulator, and has been designed to help trustees assess whether their scheme has adopted standards of governance and administration that meet the DC code and DC regulatory guidance. The master trust assurance framework has been designed to help employers to find a pension scheme which can be used to comply with their automatic enrolment duties and which has been independently reviewed to show whether it has controls in place which meet the objectives set out in the master trust assurance framework.

So far only the following schemes have obtained the master trust assurance:

- AutoEnrolment.co.uk
- BCF Pension Trust
- National Employment Savings Trust (NEST)
- Now Pensions
- SEI Master Trust
- The BlueSky Pension Scheme (TBPS)
- The Pensions Trust
- The People's Pension
- Welplan

Generally, all types of schemes have their own merits and it is important that employers and trustees receive advice that covers all options, so that they can understand the pros and cons of each and make a very informed decision as to the right strategy going forward.

SCHEME DESIGN

CONTRIBUTION LEVELS

Contribution levels can be influenced by a number of factors and will also need to meet auto-enrolment requirements (laid out in the next section). These factors can include:

- A need to meet existing employee contractual requirements.
- To reflect contributions paid to a previous arrangement e.g. where a DB scheme has been closed to future accrual.
- Employer and employee affordability.
- Competing against other organisations.
- The need to attract and retain employees.

SALARY SACRIFICE

The use of salary sacrifice or salary exchange as it is sometimes known is increasingly the norm for many employers.

Salary sacrifice is a way of making pension contributions that could allow both employers and employees to save money. For example:

- An employee agrees to give up part of their salary or bonus in exchange for a pension payment paid by their employer.
- Employers pay lower NICs as a result of paying their employees a reduced salary.
- Employees also pay lower NICs and possibly less income tax.
- Employers are free to use their NIC saving how they wish. Some might use a portion of it to supplement their employees' pension plans.
- Employees can use their savings to boost their pension provision or increase their take home pay.

For those employers operating a Contract-based pension, it ensures employees are able to secure tax relief at their marginal rate (in addition to national insurance tax relief). This puts Contract-based pensions on a par with Trust-based pension plans and generates valuable national insurance savings for employers and employees.

For some employees, salary sacrifice is not appropriate (for example, if they are already paid a below market rate or by sacrificing income their earnings drop below the living wage). However, salary sacrifice is so commonplace that employers who have not thought about salary sacrifice are now in the minority.

There are strict rules laid down by HMRC on this which charities need to be alert to. The success of a salary sacrifice arrangement is likely to be dependent on providing quality communication and explanation of the scheme to staff. Where salary sacrifice is the default offer, the option for an employee to opt-out of the arrangement is required. Employees should seek advice on the best way to establish a salary sacrifice arrangement and to get assistance with staff contracts and communications.

INVESTMENT FUNDS

Investment funds within Trust-based and Contract-based pensions which are used for automatic enrolment must have a default fund option. The default fund should be suitable for the majority of employees and ensure members receive a good outcome from their pension. Selection of the default fund needs to take into account the needs and demographic profile of the membership. When employees are automatically enrolled into a workplace pension their contributions will be invested into the default fund, once in the scheme the members can select alternatives from the available funds. The default funds will have a 'lifestyle' approach (i.e. where investments are switched automatically and without cost, into less volatile funds as the member approaches retirement).

In recent years we have seen an increase in more specialist default funds, including blended options, target date funds and 'multi' default funds (i.e. giving the member an increased choice linked to their risk profile or appetite for socially responsible investment). This trend towards increased choice for the employee has knock on effects for the level of complexity that the employer needs to manage. However the vast majority of staff who have been automatically enrolled into their workplace pension have remained in the default fund.

The charges incurred using a default fund for any automatic enrolment schemes has been capped since the 1st April 2015 at a maximum of 0.75% per annum. Other fund options can have higher fund management charges.

For those members wishing to invest outside of the default investment fund, a group personal pension plan tends to have a greater selection of funds to choose from. A Trust-based pension may offer 10 to 20 alternative funds, all selected by the trustees. However a group personal pension can offer anything from 60 to 200+ funds, offered by a number of different investment managers, all selected by the insurance company's own internal governance team. While the move to increased choice in investments may on the face of it sound appealing, some employee groups may prefer simplicity and welcome straight-forward, accessible, investment guidance.

BUYING-IN ADVICE AND SUPPORT FOR YOUR EMPLOYEES

The amount of legislation impacting pensions over the last few years has been relentless with employers and employees getting lost in the complexity. It's no surprise that many employees just rely on the employer to be looking after their best interests. In reality many employees know very little about the impacts of recent legislation that include: automatic enrolment, charge cap, pension freedoms and now the flat rate pension which all effect the way we save and will draw our pensions eventually.

Many charities historically supported their employees with advice on their pension membership, paid for by provider commission to an advisory firm. However since the 1st April 2016 it is now illegal for pension providers to pay commission to advisers. The removal of commission is likely to further reduce the number of employers that offer pension advice to staff.

There are many ways that employers can support their employees, with the key areas listed below:

Benefits communication

portals: these can be low cost and underpin the communication of benefits using mobile friendly technology. This technology also cuts down the workload of HR in answering questions.

Financial Education: by providing financial education in groups and workshops a limited budget can go far further than providing individual advice. A good example of support that could be offered is a workshop explaining the new retirement options under Pension Freedoms

Individual pension advice: This is the ultimate support that you can provide your staff with and something that they are likely to put great value on. You could consider only providing advice to certain staff groups, for instance those approaching 55.

In selecting a financial advisory firm to work with you should be clear on your requirements so that they can give you an accurate cost for their services. Also consider who is best to provide the advice or education you require. Larger employers are likely to be better supported by specialist employee benefit firms, whereas smaller employers might be better suited a smaller local firm.

The term independent adviser has always been the term most people have understood as the best solution, however many independent advisers now operate on what is called a restricted basis. This means that the adviser will only be able to give advice on a limited number of providers and/or products. So given that you probably only offer one pension scheme to your staff the advice provided is going to be restricted to the provider you have chosen.

The adviser or firm that you chose will need to inform you in writing whether they provide independent or restricted advice. If you are unsure what service they offer you should ask them for more information.

The government now provides free and impartial guidance to individuals who are over the age of 50 who are in a defined contribution pension scheme. The guidance is provided by Pension Wise who offer 45 minute consultations either face-to-face or by phone: www.pensionwise.co.uk 0800 138 3944. The Pensions Advisory Service provide online and phone based support www.pensionsadvisoryservice.org.uk 0300 123 1047

GOVERNANCE OF DC SCHEMES

Trust-based pension plans benefit from having trustees monitoring the scheme and there is substantial guidance and regulation in place. However, Contract-based pension plans are not supervised by trustees. Instead some employers have established a Governance Committee to monitor the pension plan. To assist these employers, The Pensions Regulator first published a paper in July 2013 designed to provide guidance on how to effectively monitor a Contract-based pension plan. Following the legislative changes surrounding pensions in April 2015, The Pensions Regulator has issued some amends. The new governance standard requires that the governance committee / trustee board:

- Explain how you possess, or have access to, sufficient knowledge and understanding to run the pension scheme effectively.
- Ensure that core scheme financial transactions are processed promptly and accurately.
- Meet new requirements for the scheme's default investment arrangements.
- Consider whether the costs and charges borne by members represent good value.
- Meet additional standards if you run a relevant multi-employer scheme (eg master trusts).

And that they understand issues including:

- Early identification of administration problems.
- Better value for money.
- Improved employee engagement and awareness of employer contributions.
- Improved member understanding of their retirement savings.
- Fewer member complaints.

For the committee to be successful, it needs clear responsibilities, objectives, and authorities and to be measured against those.

In November 2013, The Pensions Regulator published their Code of Practice: Governance and administration of occupational Defined Contribution Trust-based pension schemes.

This code of practice sets out the legal requirements and standards of governance and administration that trustees of occupational DC Trust-based schemes need to attain. The Code introduced 6 'principles' and 31 'quality measures', which trustees have to demonstrate they are meeting.

Any organisation running a DC scheme should be familiar with The Pensions Regulator's papers of July and November 2013, and should also take note of the changes that were introduced in 2015.

Good governance of DC schemes needs to move beyond short-term tactical issues, such as changes in legislation.

Charities need to develop a strategy for DC schemes founded on clear objectives that support the overarching strategy of the organisation. It is therefore important for governance committees to be given absolute clarity on the purpose of providing a pension package and how this fits within the overall reward strategy. On an operational level, the committee needs to ensure that the people and processes support high quality service delivery to the employee and day-to-day risks are being proactively managed.

For details on accounting for your charity's DC scheme go to section 9.



AUTO-ENROLMENT

The Government introduced auto-enrolment in 2012 to tackle the problem of millions of people in the UK not saving enough, or at all, for their retirement. Auto-enrolment requires employers to provide a workplace pension for their employees and pay contributions into it. Contributions started at 1% of pay for both employers and employees but will increase to 8% in total by 2018 with the employer paying a minimum of 3%.

Eventually as many as 1.3 million employers will have auto-enrolled up to 10 million eligible workers into a workplace pension scheme. Many larger employers have already set up their auto-enrolment and only those with the smallest number of employees have yet to reach their "Staging Date". Those with 30 employees or less will have a latest Staging Date of April 2017.

Many smaller charities will find the auto-enrolment obligation daunting, and just another thing to increase the cost of employment and divert resources away from their day to day aims and objectives.

CHOOSING A WORKPLACE PENSION

Employers need to check whether their current scheme complies with the new requirements or introduce a new scheme. Even employers with an existing scheme which meets the minimum requirements will still need to auto-enrol any employees who have not joined and any new employees.

If you need a new provider, start the process early and select a provider at least six months before your Staging Date. The key requirements for a workplace pension are:

- Clear governance structure.
- Informed decision making.
- Fair outcomes for members.
- No requirement for an application form from the member.
- Default investment option so that the member does not have to make investment decisions.
- Minimum contributions as prescribed.

THINGS TO LOOK FOR

The best providers will support you through the process to ensure you meet your increased employer duties. An advantage of being an employer staging now is that pension providers now have more experience in this field and should be able to support you better.

Key issues include:

- Contacting your employees with relevant information or providing you with template letters.
- Checking that contributions are correct with the information provided about your members.
- Catering for all types of contributions to give you complete flexibility to comply in a way that suits your structure.
- Dealing directly with your members and providing them with support and information.
- Providing annual benefit statements directly to members.
- A high level of governance.
- An investment approach which is easy to understand and reviewed regularly.

- Preferably has adopted the assurance framework issued by the Audit and Assurance Faculty (AAF) of the Institute of Chartered Accountants which sets out control objectives and is reviewed regularly.

WORKING OUT WHOM TO AUTO-ENROL

THREE TYPES OF EMPLOYEES TO CONSIDER

Eligible
Jobholders

Non-eligible
Jobholders

Entitled
workers

The different categories are determined by age and earnings.

Eligible Jobholders must be auto-enrolled and Non-Eligible Jobholders and Entitled Workers may ask to join.

Your payroll provider is in the best position to help you with this by:

- Identifying which employees to enrol and when.
- Keeping records of any employees who opt out.
- Deducting the right level of contributions and calculating qualifying earnings on which contributions are based.

PAYROLL PROVIDER

Whilst there is a lot of focus on the pensions provider, your payroll provider is just as important in helping you comply with your auto-enrolment obligations. It is important you engage with them early in the process to check they can provide the relevant support, and also when choosing a pension provider.

Your payroll provider will hold all the information required to carry out the assessment of your jobholders. They also have the ability to use this information to issue the relevant communication, although your pension provider may also be able to do this for you.

Making sure that the roles between payroll provider and pension provider are clear is essential. You should establish early on who is responsible for which services to avoid duplicating tasks and potentially paying for a service already provided with your payroll software package. Many payroll packages now include an auto-enrolment “bolt on” or you may just need to upgrade your current package.

If possible, a straight through interface between your payroll provider and your pension provider will minimise your input. This means that you do not need to get involved in this element of the administration. But make sure you and the payroll provider:

- Agree the monthly timetable of events so that you can provide them with the payroll changes eg salary increases or new employees joining in plenty of time for their processing.
- Agree the contribution structure and agree the dates of increases in the contributions from the outset and diarise to ensure this happens.

LETTING YOUR EMPLOYEES KNOW ABOUT THE WORKPLACE PENSION

You need to make sure you give your employees all the information they need to make an informed decision within six weeks after the Staging Date.

You will need to decide whether to just tell employees the basic information or use auto-enrolment as an opportunity to remind employees of the importance of saving for their retirement and encourage them with their retirement planning. Either way, make sure they understand the commitment you, as employer, are now making towards their retirement saving.

You will need to supply information explaining:

- The new rules for pension saving.
- When employees will be affected.
- Details of the workplace pension selected including investment options.
- How the contributions will be structured.
- How they can opt-out.
- Opt-in notices for non-eligible jobholders.

Employers must communicate with employees in writing, either by providing a hard copy letter or sending an email to their email address. You are not allowed simply to refer employees to a website for information although directing them to a website for further information is permissible.

Employers can only give employees guidance and members would need to seek independent financial advice if they need advice about their own particular circumstances. Your pension provider or payroll provider should be able to assist you with your communications to members.

You will need to review your employment contracts and in particular the pension clause to check whether it is compliant with the new requirements or needs to be amended. If this is the first time you are offering pension benefits, you will need to consider adding a pension clause to your employment contracts and you may need legal advice.

HOW CAN I MAKE SURE AUTO-ENROLMENT RUNS SMOOTHLY?

Preparation is key. Use a checklist from a provider or the Regulator to ensure you have thought through all of the issues. The level of support from providers varies greatly so bear that in mind when selecting your provider.

There are plenty of resources to familiarise yourself with auto-enrolment, including The Pensions Regulator's website at www.thepensionsregulator.org.uk.

Start by analysing your workforce with help from your payroll provider. Then you need to think about the contributions you want to make, taking into account other pension schemes you may have in place. If most employees are already in a scheme and it is a qualifying scheme for auto-enrolment purposes, adding on any auto-enrolled members to the existing arrangement should be easy.

WHAT CAN GO WRONG?

Some key risk factors:

- Complicated contribution structure.
- Lack of support from pension provider.
- Lack of planning in advance of staging date.
- Lack of support from payroll.
- Mixture of pension provisions across different schemes.
- Lack of organised record keeping (particularly in respect of opting out as these members need to be re-enrolled after three years).

IF YOU ARE UNABLE TO COMPLY OR HAVEN'T UNDERSTOOD YOUR DUTIES THEN THE PENSIONS REGULATOR'S APPROACH IS TO WORK WITH YOU TOWARDS COMPLIANCE

MAKING SURE YOU TICK ALL THE BOXES

It is a legal requirement that all employers must complete a Declaration of Compliance to inform The Pensions Regulator that you have fulfilled your employer duties. The Declaration of Compliance must be completed within five calendar months of your staging date. More information can be found from your pension provider and on The Pensions Regulator's website at www.thepensionsregulator.org.uk.

If you fail to comply with your duties The Pensions Regulator may take enforcement action. Their overall approach is to educate and enable employers to comply with the legislation.

If you are unable to comply or haven't understood your duties then The Pensions Regulator's approach is to work with you towards compliance. But if employers choose to ignore their duties The Pensions Regulator will use their powers to ensure compliance. The range of actions includes statutory notices, penalty notices and court action if necessary. Clearly it is better to work with The Pensions Regulator and your pension and payroll provider to ensure you comply with your duties.

RE-ENROLMENT

Once you have auto-enrolled your employees you will have an additional duty every three years after your original staging date to automatically re-enrol any eligible employees who are not already members of your workplace pension. This will include employees who over a year ago opted out or left the workplace pension after joining. It also includes members of the workplace pension who have reduced their contributions below the minimum but are otherwise eligible.

You can choose a re-enrolment date within a six month window falling three months before and three months after the third anniversary of your original staging date. You will need to pay contributions on behalf of eligible employees and write to them six weeks before to tell them you will be automatically re-enrolling them. Employees can still opt out within one month of being automatically re-enrolled if they wish to do so.

You will also need to complete a re-declaration of compliance within five months of the third anniversary of your staging date. Good record keeping and assistance from your payroll provider will ensure that your re-enrolment process runs smoothly.

Visit The Pensions Regulator Website for more information – www.thepensionsregulator.gov.uk/reenrolment.aspx.

UPDATE FROM THE PENSIONS REGULATOR

SMALL AND MICRO EMPLOYERS ARE HEARING WORKIE'S MESSAGE – NOW WHAT SHOULD THEY DO?

By Charles Counsell, executive director of automatic enrolment at The Pensions Regulator

Many employers will have seen the large character Workie – calling on them not to ignore the workplace pension. They may now be wondering what to do next and what automatic enrolment will cost them.

The good news is that recent research by The Pensions Regulator shows most small and micro employers who have already met their workplace pension duties recognise the importance of workplace pensions and think that it is good for staff.

Our findings show automatic enrolment doesn't have to be costly and that it pays not to put your head in the sand. Starting plans early leaves employers with time to research and shop around and also helps them avoid the risk of a £400 fine.

Employers should first head to our website and follow the step by step Duties Checker which tells them what to do and by when.

The Duties Checker is designed for small employers without pensions experience and makes automatic enrolment as easy as possible. I'd also recommend that employers look at our information detailing the set up costs employers might incur which will help people avoid any unnecessary expense.

Employers who have already reached their staging date – the date the law applied to them – should ensure they complete their declaration of compliance and submit it to us. This must be done within five months of their staging date. Employers are at risk of being fined if despite putting staff into a pension, they fail to submit their Declaration of Compliance.

Already more than 100,000 employers have completed their workplace pensions duties and more than 6 million workers have been automatically enrolled since 2012. The Pensions Regulator is ready to help hundreds of thousands more small and micro employers join the pension revolution.

KEY CONSIDERATIONS TO BEAR IN MIND

Make sure you know what you need to do and by when – you will have duties even if you only employ one member of staff. TPR has an online duties checker which will help you with this – it takes 5 minutes to complete.

Work out the costs which may be involved in terms of time and money – it may be less than you think. TPR has information to help employers understand the one-off costs to set up automatic enrolment, as well as the ongoing cost of paying money into the scheme and managing the process.

Decide who will complete the tasks you need to undertake. While you can carry out the automatic enrolment tasks yourself, you may choose to ask your business adviser for extra support. Make sure you understand and agree which tasks you and they are doing so that nothing is missed.

Still to stage? Frequently asked questions from small employers

Can I use my existing scheme to automatically enrol my staff?

Maybe – but you first need to find out whether it meets certain conditions that will make it a 'qualifying scheme for automatic enrolment'. Contact your pension scheme provider to find out.

I need to find a pension scheme, but don't know where to start

Not all schemes offer the same level of services and some will charge more than others, so you should look at different schemes before you decide which is suitable for you and your staff. TPR has information on its website which can help you to choose a pension scheme, with a list of providers who can offer pensions to small employers.

I only have one staff member and their earnings fall under the threshold – do I still have to do anything?

Yes, you still have legal duties to meet. For example, you will need to tell your staff about automatic enrolment and complete and submit a declaration of compliance to TPR to let them know what you have done to meet your duties. Completing TPR's online duties checker will confirm what your duties are and when they need to be met.

I think my charity is exempt, what do I need to do?

You may be exempt from the automatic enrolment duties, but it's important to check. If you are exempt and receiving letters from The Pensions Regulator, then you will need to tell them you are exempt. Take 5 minutes to complete TPR's online duties checker, which will confirm what you need to do.

What will happen if I don't complete the Declaration of Compliance on time?

Don't leave your preparations to the last minute – if you don't submit your Declaration of Compliance on time, then you risk a fine. The date this needs to be submitted will be on all letters and emails sent to you by TPR; you can also find this out by completing TPR's online duties checker.

Useful links

Duties checker – www.tpr.gov.uk/en/employers/duties-checker

Step by step guide – www.tpr.gov.uk/en/employers

Nominate a contact – www.tpr.gov.uk/nominate

News by email: www.tpr.co.uk/news-by-email/subscribe

Choosing a pension scheme – www.tpr.gov.uk/scheme

WHAT TO EXPECT FROM THE PENSIONS REGULATOR

- TPR will send you letters 12 months, 6 months, and 1 month before your staging date – the date your duties start.
- It is important you nominate a contact. This is the person TPR will send communications to about what to do and when.
- Using the Duties Checker means employers will be sent specific information tailored for their circumstances.
- Information is available on TPR's online step by step guide to help you to complete every task.
- TPR produces a free, monthly 'News by Email' which will help you to keep up to date with news, information, tools and resources on automatic enrolment.



PLANNING AND REPORTING



CONTRACTING, OUTSOURCING AND RESTRUCTURING



When a charity takes on contracts for any employees who work for another employer, there are a number of significant risks and challenges that must be addressed in the context of pensions. These include:

Clarity of employment rights:

For example, will the Transfer of Undertakings Protection of Employment ("TUPE") legislation apply?

The application of public sector requirements: If employees are transferring out of the public sector the charity must have clarity on what requirements will apply to their pension arrangements at the beginning and termination of the contract.

Undertaking pensions due diligence at an early stage:

Charities must ensure that they have details to price bids and contracts appropriately.

Negotiation: An early assessment will be needed to determine the scope to negotiate and mitigate risk for the duration of the contract.

Monitoring the performance of the contract against agreed terms:

For example, if there might be redundancies during the contract a full understanding of these restructuring risks will be needed.

Moral hazard: Charities must be aware of any operational risks which could cause them to fall foul of The Pensions Regulator's regime for protecting schemes and their members.

TUPE

Where employees are transferred from one employer to another it is likely that TUPE will apply. Charities must understand how the law applies and what consequences may follow on for the pension arrangements of transferring employees. TUPE protects employees' employment when the business in which they work, or the services they are providing, are transferred from one entity to another. It can apply where there is a transfer of an undertaking, business, or part of an undertaking or business, or where there is a service provision change. It also applies where an entity engaging a contractor to do work on its behalf reassigns such a contract or brings the work in-house.

As a general rule, TUPE prohibits rights relating to an occupational pension scheme from transferring.

However, following the cases of Beckmann and Martin (in 2003 and 2004 respectively) it is accepted that, where an employee has pension rights relating to their employment (e.g. those rights to early retirement, or enhancements, which are contingent on dismissal), such rights do follow with the transfer of employment and may have also followed from a previous TUPE transfer of their employment. This means that the employer to whom the employees with such rights are transferred may be required to fund the additional pension liabilities arising. It is generally accepted that an offset will apply against these rights on any normal pension benefits payable in respect of the same periods of employment (although this interpretation of the law is in itself subject to debate and charities would be wise to take specialist advice on the point). An example of a Beckmann right frequently found in some defined benefit or public sector schemes is one which provides a member with enhanced pension rights on redundancy (which was the issue in the Beckmann case). The amounts involved could be substantial which is why it is essential that there is clarity of contractual terms where redundancies are contemplated during the contract.

Where employers do not need to consider so called Beckmann liabilities they must still address the minimum requirements of pensions legislation which stipulates the level of benefits to be provided on a TUPE transfer. Outside of the public sector, there is no obligation to mirror the existing occupational pension scheme to which transferring employees belong. The level of provision varies according to the transferring employer's pension arrangements available to transferring employees (which includes those employees who are eligible for but who have not yet joined the transferring employer's scheme). There are various options available; generally referred to as the employer's obligation to match up to 6% (of the employee's basic pay). It is acceptable for a defined contribution scheme to be utilised to satisfy this requirement.

Running in parallel to the requirements of TUPE, are the obligations in relation to the need for an employer to auto-enrol its employees into a workplace pension scheme that satisfies certain criteria so charities must be aware of this at the same time as dealing with the operation of TUPE.

CONTRACTING WITH THE PUBLIC SECTOR

The limited scope of TUPE to pension arrangements means that, in the public sector, there is a separate non-statutory regime of guidance dealing with protection of public sector employees. This guidance, known as 'Fair Deal' has been significantly amended in recent years so that the "new Fair Deal" guidance applies to all contracts tendered or renewed from October 2013. As the policy currently stands, Fair Deal guidance applies to:

- Central government departments.
- Agencies.
- The NHS.
- Maintained schools (including academies).
- Other parts of the public sector under the control of government ministers where staff are eligible to be members of a public service pension scheme.

The guidance does not generally apply to local authorities although its principles are set to be replicated (see below).

Under the new Fair Deal employers can bid for contracts without the need to put in place a broadly comparable pension scheme (which was the default position under 'old' Fair Deal). Instead the employer will participate directly in the public sector scheme. There are, however, some significant considerations to be addressed in pricing, operating, administering and terminating the contract. These are touched on in the due diligence section below.

In the world of local authority contracting, a different regime of "Best Value" currently applies. This means employees are provided with rights to acquire pension benefits that are the same as, broadly comparable to, or better than those they had before the transfer. In practice, this means that employers will either join the Local Government Pensions Scheme (LGPS) as 'admission bodies', or use their own scheme to provide benefits certified as being broadly comparable to the LGPS. Charities joining the LGPS as admission bodies will take on significant investment and funding risks on pensions unless they are able to mitigate these risks within the commercial contract. However, a watching brief for charities is that the Department for Communities and Local Government is currently consulting on proposals to replicate certain key features of the new Fair Deal guidance through amendments to the LGPS regulations.

DUE DILIGENCE: THE KEY TO CONTROLLING RISK

With more charities looking for partnering and outsourcing opportunities as a way to maximise income, charities must undertake due diligence to ensure an 'eyes wide open' approach to dealing with pension risks and liabilities. In the context of public sector contracts, the team with responsibility for bidding must get to grips with the structure of the proposed employee transfer including understanding how exactly the pension rights of any transferring employees are proposed to be protected, whether the employees are transferring straight from the public sector or from an incumbent contractor. If employees are transferring from an incumbent contractor who has been using a broadly comparable scheme, clarity is required on any bulk transfer terms that may apply in respect of employees' past service benefits. Charities must also understand whether they are being asked to contribute towards meeting any shortfall liabilities on transfer back into the public sector scheme which the charity is required to join.

Charities should also negotiate for pricing issues that may arise during the contract period and how any pension liabilities arising upon contract termination should be funded. This will include securing contractual protection to guard against increases in employer contributions during the contract term, costs required to be paid at the end of the contract (such as LGPS 'exit payments') and unexpected 'strain costs' which can be triggered (for example on redundancy).

MORAL HAZARD: ORGANISATIONAL AND STRUCTURAL CHANGE

Putting aside the operational risks charities face when contracting with the public sector, it is also necessary to consider what operational risks might present where transferred employees have been offered membership of the charity's own defined benefit scheme. Where a charity has a multi-employer scheme it is possible that risks may arise at the end of a contract where there is an employment cessation event which leads to a debt on the employer. The issues on this have been covered in section 4.

Charities must also be aware of The Pensions Regulator's (TPR) moral hazard powers which may come into play in any operational or strategic change the charity may embark upon. TPR's powers are extremely wide and have been put in place to protect members, schemes and the Pension Protection Fund from employers avoiding liabilities to their defined benefit schemes by implementing changes which have the effect of weakening or reducing the employer's ability and willingness to fund its pension liabilities.

In the context of charities, examples could include changes to business plans which reduce reserves or the sale of charity assets at an undervalue. Although TPR is aware of the operational challenges charities face and there are defences employers can use, advice should be sought on any significant structural change or reorganisations which may impact on the charity's ability to fund its pension liabilities.



ACCOUNTING FOR PENSIONS

SETTING THE SCENE

In 2002, FRS 17 introduced the accounting requirement to include the pension liability in the balance sheet. This was reflected in the disclosures required for Charity SORP 2005, so charity trustees and finance professionals have now had over ten years to get to grips with the accounting and disclosure problems arising from the inclusion of this pension liability and the deficits created on reserves. The introduction of the new accounting standards has now brought in further changes to accounting for pensions and charity financial statements.

CHARITIES SORP 2015

All charities are now required to use SORP FRS 102 based on FRS 102, the Financial Reporting Standard applicable in the UK and Republic of Ireland. These were issued on 16 July 2014, with an update in February 2016, and apply to charities for accounting periods commencing on or after 1 January 2015.

Despite the more onerous reporting requirements of SORP FRS 102, the option to use FRSSE SORP has been difficult to justify, as it is being withdrawn after a very short life. It will cease to be used for periods commencing on or after 1 January 2016. Those smaller charities electing to adopt FRSSE SORP will therefore face changes in accounting for pensions for two years in succession; firstly with small changes for FRSSE 2015 and then further changes as they move to FRS 102 the following year.

The FRS 102 definitions of pension schemes and the mandatory accounts disclosures are reflected in Module 17 of the Charity SORP FRS 102. The disclosures required in the accounts are very similar to those previously used under FRS 17, other than the disclosures in respect of multi-employer pension schemes and group plans.

FRS 17 did not distinguish between multi-employer schemes and group pension plans. However, FRS 102 differentiates between the two in the accounting requirements. For entities participating in group plans, with contractual agreements in place between the charities in the plan, each charity will recognise its share of the costs, assets and liabilities of the group scheme. If there is no contractual agreement, and the expenditure cannot be separately identified by each charity, then the one member of the group plan which is responsible for the operation of the plan will recognise all of the costs, assets and liabilities of the group plan. Other members of the plan will reflect in the Statement of Financial Activities (SOFA) only the contributions made by their charity to the plan during the period and disclose in the notes the details of the arrangement.

DEFINED CONTRIBUTION SCHEMES

Employers' pension contributions to defined contribution schemes under FRS 102 continue to be recognised as an expense in the SOFA, using the accruals basis of accounting. The accounts of the charity will include all employer contributions payable to defined benefit schemes within the relevant categories of expenses in the SOFA. The total pension costs are disclosed in a separate line in the wages and salaries note to the accounts.

Under FRS 102 the charity must disclose the following information within the financial statements on defined benefit schemes:

- The nature of the scheme as being a defined contribution scheme.
- The total pension costs for the year charged as an expense in the SOFA.
- Any pre-paid and outstanding pension contributions at the balance sheet date included in debtors or creditors.

Under FRS 102, any overpayment or prepayment of contributions to a defined contribution scheme can only be recognised in the financial statements as an asset of the charity if the overpayment/prepayment will lead to a reduction in future payments to the scheme or in situations where a cash refund can be obtained.

Where there are underpaid or outstanding contributions to the scheme at the year end, under FRS 102 the outstanding liability must be included in creditors. They should be discounted to net present value unless it is expected that the outstanding contributions will be paid within 12 months.

DEFINED BENEFIT SCHEMES

FRS 102 requires very detailed disclosures in the financial statements in respect of defined benefit pension schemes, often running to a significant number of pages of the accounts. The notes to the accounts must reflect all of the costs of providing retirement benefits for staff, including all pension expenses within salaries and costs of employment. The actuarial movement on the scheme reflecting the gains or losses on the defined benefit pension scheme are reflected as movements in the year.

In 2013, the Charity Commission produced guidance on pension scheme reporting and the impact of pension scheme deficits on charity reserves in the publication 'Charity reserves and Defined Benefit pension schemes'. (www.gov.uk/government/publications/defined-benefit-pension-schemes-questions-and-answers). This guidance related to pensions reporting under SORP 2005. Although it has not been updated for SORP 2015 (FRS 102), it is still applicable. The guidance is helpful in focusing attention on the liquidity and cash flow issues when considering a charity's going concern status, rather than the net assets, or net liabilities of the charity.

The FRS 102 valuation for a defined benefit scheme is undertaken by a professionally qualified actuary, appointed by the charity. FRS 102 does not require the appointment of an independent actuary to calculate the defined benefit obligation, but it is unlikely that many charities will have the necessary expertise within the charity to undertake an actuarial valuation other than through the services of a paid professional. So, although there is the possibility that a valuation could be undertaken by an actuary who is not independent of the charity, this is really only an option if there is an actuary on the charity's board of trustees who is willing to undertake this task.

An annual valuation of the assets and liabilities of the scheme is not required if the basis of the valuation is not significantly changed and FRS 102 does not specify the frequency against which a full valuation is required to be undertaken. However, as most charities are required to reflect the ever changing conditions and asset values in their accounts, the valuation is usually undertaken on an annual basis.

There are differences in the requirements of FRS 17 and FRS 102 in the valuation of the pension scheme liabilities. These apply to the first year under FRS 102 and to the comparative year disclosures. The FRS 102 valuation methodology has led to significant volatility in charities' net asset values, with considerable flexing of valuations due to minor changes in assumptions. There may be significant movements in the SOFA as the deficit values of the scheme are re-assessed at each actuarial valuation.

There is also a difference in the recognition of the interest expense in the SOFA. Previously, actuarial gains and losses were recognised in the Statement of total recognised gains and losses while the interest charge in the SOFA reflected the expected return on plan assets and the interest cost on pension liabilities. Under FRS 102, the impact of the actuarial remeasurement of the assets and liabilities of the scheme are reflected in 'other comprehensive income', while the SOFA reflects the employee costs in the pension liability. These include the total obligation to the employees, including all costs and a 'net interest charge'. This change means that the comparatives will be adjusted. This will be reflected in changes to the net interest charge and actuarial gains and losses figures.

As with defined contribution schemes, the requirements of FRS 102 accounts disclosures broadly follow the same principles as FRS 17 when accounting for defined benefit Schemes. It is essential that trustees consider at an early stage both the frequency of the actuarial valuations and whether the charity is able to dispense with a professional actuarial valuation for accounting purposes.

For those charities with trading subsidiaries that are liable to taxation, with a deferred tax asset or liability on their balance sheet due to capital allowances or losses, there is a significant impact on financial reporting due to the impact of FRS 102 relating to pension liabilities.

With defined benefit schemes, any deferred tax arising on the pension scheme liability or asset is not set off against other deferred tax. Under FRS 17, there was netting off in deferred tax in the company, resulting in lower assets and lower liabilities. However, this grossing up does not have any impact on the amount that can be distributed/gift aided by the subsidiary to its charitable parent.

The conditions to recognise a pension scheme asset remain the same under FRS 102 valuations as they were with FRS 17. The pension scheme asset must be reflected as a separate asset on the balance sheet.

ACCOUNTING FOR PENSION SCHEME DEFICITS

If the defined benefit pension scheme is in deficit, the full liability is reflected in the balance sheet of the charity as a pension scheme liability. The full details of the make-up of the pension scheme deficit liability are included in a note to the accounts. Details of the deficit recovery plan must be disclosed in the Trustees' Annual Report.

The Charity Commission guidance on pension scheme deficits and the impact on going concern, notes that where the pension scheme liability, calculated under current UK GAAP, exceeds the amount of the unrestricted funds of the charity, this does not of itself automatically create a state of insolvency in the charity and going concern implications. However, a shortfall will indicate a need for a detailed review of the charity's cash flow, with a sharp focus required as this may signal major problems that could ultimately lead to the closure of the charity.

A number of charities have adopted the practice of showing their reserves both before and after the pension liability in the accounts, or referring to these 'before' figures in the Trustees' Report. This remains the best method of informing the users of the accounts of the short term asset position of the charity, prior to inclusion of the pension scheme liabilities.

There are specific requirements in SORP FRS 102 for disclosures of the deficit in the Trustees' Report. Under SORP FRS 102, where there is a pension scheme deficit in the charity, this must be disclosed in full in the Trustees' Report, together with an explanation of the financial implications of the deficit and its impact on the overall reserves. Details of how the trustees have planned to deal with the deficit in future years are also required. Where the deficit is significant, it is therefore essential that the trustees address the issue and highlight for potential donors and beneficiaries how the deficit problem is being appropriately monitored and why it will not have an impact on the future of the charity.

The Charity Commission Accounts Monitoring Review on pension scheme deficits reported in August 2014 on the results of 97 charities that it had surveyed.

(www.gov.uk/government/uploads/system/uploads/attachment_data/file/459149/amr_pension_scheme_deficits.pdf)

All 97 charities surveyed by the Charity Commission had disclosed the deficits in their pension schemes in their financial statements, with the required information on the actuarial figures. However, only 31 of the 97 charities had provided in the Trustees' Report the required disclosure of the financial implications of the deficit on the reserves. The Charity Commission has highlighted that this means that those charities had missed the opportunity to demonstrate to donors and beneficiaries that they were appropriately tackling the pension deficit problem.

The majority of the Trustees' Report of charity accounts which have recorded their consideration of the issue have disclosed three options in their reports:

- The trustees' plan for repayment of the deficit over a specified timescale alongside increased contributions.
- Details of the planned closure of the scheme to existing members and future accrual of benefits.
- Closure of the scheme to new members, usually alongside reduced terms for existing members.

MULTI-EMPLOYER SCHEMES

For those multi-employer schemes (see section 4) where the charity is unable to identify their share of the assets and liabilities of the scheme, the charity will continue to account for the scheme as a defined contribution scheme. However, in a key departure from FRS 17, if the charity in a multi-employer defined benefit scheme has entered into an agreement that sets out a schedule of contributions to fund any deficit, the charity must include the net present value of the total deficit contributions payable and the resulting expense in the SOFA. This will have a significant impact on the balance sheets of many charities in the first year under SORP FRS 102 (see section 9).

DISCLOSURE OF PENSION COSTS OF SENIOR EMPLOYEES OF THE CHARITY

The charity SORP requires disclosure in the notes to the financial statements of details of staff earning more than £60,000, being disclosed in bands of £10,000. The disclosed remuneration includes all emoluments, although pension contributions by the charity in respect of such individuals are not disclosed as a part of this figure of aggregate remuneration. SORP FRS 102 requires this disclosure for all charities.

Where employees are covered by a defined contribution scheme, the disclosure of individual contributions to defined contribution schemes gives an indication to readers of the financial statements of the benefit to that charity employee. In contrast, any disclosure of the individual contributions to a Defined Benefit scheme for higher paid charity employees does not necessarily provide an indication of the pension benefits accruing to any one individual. The ongoing level of funding is dependent on whether the scheme is in deficit or surplus. Pension costs are disclosed for higher paid employees within the total number of employees for whom the defined benefits accrue.

DISCLOSURES ON TRANSITION TO FRS 102

In the year of transition to FRS 102, disclosures are required in the financial statements reflecting the adjustments to the pension figures previously presented under FRS 17. Where there is a multi-employer scheme, there may be significant impact on the charity results in the year of transition.

SORP FRS 102 requires recognition of the liability on the balance sheet of the contractual liability of the charity to make future pension payments to cover the deficit, recognising the contractual future amount as the pension scheme deficit at the year end. This contractual liability is shown on the balance sheet, split between a creditor due within one year and a creditor due after more than one year as appropriate. The impact of the ongoing expense of the pension scheme for the year is shown as an expense for the year within total wages and salaries expenses.

In the year of transition to FRS 102, the charity will reflect the change in accounting policy to reflect the deficit which is recognised for the first time as an adjustment to the opening balances at transition. The contractual liability is included as the pension scheme deficit at that date. The opening balances at the date of transition are adjusted to reflect the cumulative future pension liability. This is discounted at the agreed corporate bond rate.

MODEL DISCLOSURES – MULTI EMPLOYER SCHEMES:

Charities will need to discuss their specific disclosures with their professional advisers. However, model disclosures in respect of multi-employer schemes would include:

Accounting policies:

The charity participates in a multi-employer defined benefit pension scheme. This provides defined benefits to employees which are based on final pensionable pay. The assets of the pension scheme are held separately from those of the charity.

Pensions note to the accounts:

The charity has participated in the ABC defined benefit multi-employer pension plan for employees from (date). The multi-employer plan was closed by the charity to new members and to any accrual on (date).

The actuaries, ABC, have advised in their actuarial valuation of (date) that it is not possible to separately identify the assets and liabilities of the pension scheme relating to the charity. The liabilities in relation to the scheme are therefore accounted for as a defined contribution scheme.

The charity has a contractual obligation under the multi-employer scheme to contribute annually (x) equal deficit repayments of £000 over the period to (date) in order to extinguish this deficit. This total liability, discounted at (x %), is reflected in these accounts as a creditor.

The charity is also required to contribute annual payments to the scheme in respect of ongoing operating expenses of the scheme. These expenses of operating the scheme are charged to the SOFA as they are incurred.

SPONSORS AND CONTRIBUTORS



THE CHEVIOT TRUST

The Cheviot Trust, an award winning not-for-profit mastertrust established in 1930, provides high quality pension management services for around 500 employers including a growing number of charities. We have been shortlisted for five industry awards in 2016.

Cheviot can help navigate through the pensions maze by providing simple pension solutions to CFG members and the Charity sector. Our trust structure allows employers to focus on their business, whilst providing peace of mind that employees' retirement savings are well managed. In addition, our structure which includes employer and member representatives on the board, means that the interests of members and employers are always at the forefront of any decision making process.

Cheviot's mastertrust framework looks after a number of pension schemes for different employers. Each has its own rules and is funded separately. All schemes benefit from Cheviot's robust governance, efficient administration, dynamic investment strategy tailored to each scheme, together with clear employer and member communications.

Cheviot offers a total management service for final salary schemes, auto-enrolment services for workplace pensions, and a leading edge, Trust-based approach to providing flexible retirement options for members. There is no minimum size requirement to join our scheme.

For more information please visit www.cheviottrust.com.



JLT

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Punter Southall Group is an independently owned actuarial, pensions administration, investment and financial advisory organisation. We have over 840 staff in 15 offices across the UK. Our clients are pension scheme trustees and employers from spectrum of businesses, charities and institutions. We currently work with over 100 clients in the charity and not-for-profit sector. We provide support on wide ranging pensions matters from funding and investment of DB schemes to Auto Enrolment and Freedom of Choice for employees under the new pensions regime.

For more information or to discuss how we may be of assistance to your organisation, please visit www.puntersouthall.com



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SecondSight is a multi-award winning employee benefits specialist advising the corporate and charity sectors. We are the dedicated employee benefits division of Foster Denovo. An established part of Foster Denovo for over 10 years, SecondSight work with over 400 charity and corporate clients.

We understand the financial challenges that charities may face, which is why we provide engaging employee benefit solutions, financial advice and support that help you to meet your organisation's needs. Where we can help: pensions, financial education, group risk and healthcare, benefits communication and advice.

We are proud of our long standing relationships with both ACEVO and Charity Finance Group.

Visit www.second-sight.com.



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Director and company owner of leading actuarial adviser **Spence**, David Davison, heads a specialist practice in the firm advising charities on the pensions issues they face and with access to the modelling tools and communications skills necessary to guide boards through a variety of solutions.

David helps boards understand their options to address issues such as 'last man standing' and 'multi-employer' pension schemes, pension accounting, auto-enrolment, Local Government pension scheme participation and pension schemes limiting merger and reconstruction.

For charities operating their own pension schemes we can provide a full range of award winning actuarial, administration, data, consultancy and communication services for employers, charity trustees and scheme trustees.

An active member of the third sector finance community, and a regular commentator, David has worked alongside the Charity Finance Group, PLSA and ICAS in lobbying to find sustainable solutions to the pension and finance problems often experienced by organisations in the sector.

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MILLS & REEVE

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