Assessing the covenant strength of a charitable employer

With the third code of practice *"Funding defined benefits"* released in Summer 2014, there has been an increased focus by the Pensions Regulator on employer covenant recently. There has also been recognition of the challenges faced by the not-for-profit sector in assessing this area.

Making an objective assessment of an employer's ability to support their scheme is a critical part of the scheme funding process and many of our clients have asked for greater clarity on how best to do this. This briefing note has been produced to cover some of the key considerations.

The table below summarises the areas of employer covenant and the covenant factors that would typically be considered within each. The level of detail adopted should be proportionate to the situation.

Covenant area	Factors to consider
Group structure and legal powers *Considers the legal/structural position of the participating charity in its group, and the support accessible from the group on an ongoing basis*	• **Who** are the employers, and what is their **role/importance** to the group? • What is the balance of **legal powers** between the scheme and employer? • What is the **constitution** of the charity and other entities in its group – for example, 'old-style' charitable trust, industrial and provident society, company limited by guarantee? This can have wide ranging implications, including affecting: - the distribution of assets in a failure or wind-up scenario; - its ability to control other group entities; and - whether surpluses can be extracted from a subsidiary.
Recent trading and cash flows *Considers the recent trading and cash flows of the charity to assess its ability to fund the scheme on an ongoing basis*	• Understanding the **key risks and attributes** of the charity's **sources of income**: - Public sector funding - Foundation income - Trading - Fundraising - Legacies - Committed giving - Major donors - Membership - Corporate giving - Investment • Are income streams **diversified?** This is usually beneficial, but can bring increased risk. • Consistency/volatility of results and cash flows. • Understanding the level of **flexibility in the cost base**, and consequent resilience to withstand future shocks. • What are the major discretionary uses of cash? • What amount of cash is used for pension funding compared to other uses? Does this change over time?
Forecast trading and cash flows *Considers the forecast trading and cash generation of the charity*	• Are forecasts prepared on a break-even basis? Bottom-up or top down? Are assumptions reasonable, and is there a suitable level of detail supporting the forecasts? • **Historical forecasting accuracy** – prudent or over-optimistic/achievable or aspirational? • Consideration of the forecast surpluses and cash flows compared to liquidity, and impact on the reserve policy. • **Certainty of income -** balance of risks and opportunities incorporated into the forecasts. Is a sensitised case appropriate? • Consideration of **life of pension scheme vs. life of charity.** Are charitable objectives ongoing or could they be achieved and the charity wound up?

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Affordability *To assess the ability to fund the scheme on an ongoing basis*	***The affordability considerations set out below should be considered in relation to the analysis in the recent and forecast trading and cash flow sections.*** • Charities are not-for-profit by nature, leading to **difficulty in establishing the amount of 'free cash'** available for deficit contributions each year. • Understanding the level of expenditure that is discretionary is critical. • Is it reasonable to curtail certain charitable activities, such as campaigning for example? Is it reasonable to divert additional funds to a pension scheme? • If a higher proportion of income were diverted to the pension scheme, would this damage the charity's brand? The impact of **public perception** on the employer **needs to be considered.** • Balance between making deficit contributions and reinvestment in the business to enable the sustainable growth of the employer.
Balance sheet – ongoing *Considers the current balance sheet to assess the financial risk profile of the charity*	• Adequacy of available liquidity, including consideration of debt maturity and working capital swings. • Financial covenants, where applicable, and credit metrics such as interest cover and leverage, compared to peers. • Not all balance sheet funds may be accessible to a scheme. The impact of **restricted, designated and endowed funds** needs to be considered. • **Brand value** can be crucial, potentially representing the ability to raise donations in the future - but this is not typically recognised on the balance sheet and can be difficult to value. Care should be taken to ensure it is not double-counted with the strength of forecast earnings. • The impact of the **reserves policy.** Does it give the charity sufficient flexibility and resilience to withstand unforeseen events?
Balance sheet – Exit *Considers the potential return to the scheme in wind up or insolvency scenarios*	• The insolvency of charitable employers is a niche area. Applying standard insolvency assumptions used for commercial entities could miss critical structural factors. • Treatment of restricted/endowed/designated funds and legacies received can be complex and may depend on the individual bequests. • Potential to use shortcuts in calculations e.g. 'restricted funds assumed to not be available to creditors' – likely to be prudent, if not necessarily accurate.
Wider group *Considers the financial position of the wider group and its ability to support the participating charity and hence the scheme*	• What **access and support** is provided by the wider group, demonstrated by either: 1. **willingness** to support employer/scheme e.g. through making additional payments, providing funding and capital to employer; and 2. **legal agreements** in place, for example: ◦ group guarantees to scheme or employers; ◦ operating agreements allowing cost recharges; and ◦ the nature of employers e.g. entities with unlimited liability.
Market *Considers the market position of the charity, and the long term outlook for the markets and their characteristics*	• The sectors in which charities operate vary enormously from education and housing through to the provision of quasi public-sector services. • Link back to nature of funding. This can drive the sectors the charity is exposed to. • Impact of **oversight from sector regulator** such as the Charity Commission or Homes and Communities Agency, for example. • Market size and employer's share of it. • Are there **barriers to entry?** What is the **competitive environment** like? There is increasing competition between charities for grants and available funding. • Take into account the impact of UK and global long term trends on the long term covenant.

PwC people and experience

We have extensive experience working with Trustees and DB schemes in the charitable sector...

How we can help...

- We simplify what is a complex and heavily regulated area, making it understandable and able to be put into practise.
- We can identify key covenant risks for trustees and employers, and provide solutions that work for both parties.
- Our team comprises a mix of covenant and charity specialists working closely together to offer insight and add real value to our clients.
- Our advice and assistance can be in varying forms to suit you, from a half day workshop (cost effective) to reporting in more detail where covenant risk is particularly high and a creative solution is required.

Case studies

Religious charity

How we helped: We provided a covenant assessment reporting on a complex set of factors

Key factors:

1. Forecasts were for a limited term and showed substantial deficits;
2. Structural issues due to the recent move from an old style charitable trust to a company limited by guarantee;
3. Difficulty in striking a balance between the charity pursuing its charitable objectives and paying deficit contributions to the scheme; and
4. Complexities in establishing what assets were genuinely unrestricted in nature, and the ability to access value in other group entities

***Outcome**: A new security arrangement under a bespoke structure which ensured no escape of value, and a recovery plan designed to suit that particular charity*

Service-providing charity

How we helped: We assisted a charity in agreeing a managed exit from a multi-employer pension scheme

Key factors:

1. The legacy scheme liabilities had grown to be disproportionate to the size of the employer;
2. The scheme was a multi-employer last-man-standing arrangement; the charity could not cease accrual without triggering a substantial exit debt;
3. Strategic capital investment was planned in the short term, which was expected to enhance the covenant; and
4. The charity faced increasing competition from commercial service providers who did not have legacy pension issues

***Outcome**: a managed exit from the multi-employer arrangement including a suitable recovery plan which allowed the employer's capital investment to go ahead*

If you need any assistance in assessing employer covenant for your scheme, we would be happy to meet with you, at no cost, to discuss your circumstances and how we may be able to help

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