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PULSE
Quarterly Newsletter of Deloitte's Charities and Not for Profit Group

Welcome to the Winter 2016 edition of Pulse.

Amongst hot topics being discussed at charities is cyber security. It is important that charities have plans in place to ensure security of data; not only their own but more importantly the data they hold on their supporters. It is important that charity donors can continue to support their charity with the knowledge that their own personal data is secure. I urge you to read the article on cyber security in this edition.

Please note that the views expressed in this publication are those of the authors and not of Deloitte. In the complicated environment in which we all operate, always seek professional advice specifically and don't rely on contents of articles that have been written for general guidance only.

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Fundraising – developments in 2016

Charitable fundraising was in the headlines throughout 2015, from the sad death of Olive Cooke to Sir Stuart Etherington's review and the promise of a new regulator. Media interest in fundraising scandals attracted politicians and other high profile critics and towards the end of the year the Charity Commission had written to a significant number of charities about their fundraising activities.

What do I need to know?

A new regulator of fundraising is being set up with the hope that it will succeed where the various current regulators are perceived to have failed. It is due to start work in the Spring, but as yet no date has been confirmed. It is unclear at this stage whether the regulator will be able to avoid the difficulties that beset previous regulators, including the lack of sustainable long term funding, the influence of fundraising organisations over the board and the effectiveness of its engagement with (and sanctions against) non-charitable fundraisers.

Fundraising will remain self-regulated. However, the new regulator is stated to be the last chance for self-regulation. Powers in the Charities (Protection and Social Investment) Bill will empower the government to impose a statutory regulator in the future if required. There is little political appetite to take this step but it is intended that the existence of the reserve power will give the new regulator additional influence.

The Charity Commission's consultation on its new fundraising guidance, CC20, will remain open until 11 February. The final draft is likely to reflect developments in setting up the new regulator during and after the consultation period. It is expected to be significantly different from the current guidance and in particular is likely to emphasise the need to consider legislation which is not specific to fundraising but which applies to many fundraising activities, such as data protection laws.

Avoiding the fate of the class of 2015

In 2015, much of the legitimate criticism that charities received in relation to fundraising focused on their apparent breaches of Data Protection law. This non-compliance provided a way in for adverse stories in the media to cover wider dissatisfactions with a charity's fundraising activities. It can be onerous to comply with all of the different legislation that concerns fundraising activities, but the message from 2015 was that charities must conduct their activities lawfully for reputational as well as legal reasons. This is particularly difficult at a time when funding is scarce but regulation is ever-increasing, for example the imminent disclosure requirements of persons of significant control over companies, or the Modern Slavery Act which will apply to its first charities from March this year.

Charities have been slow at times to defend their legitimate fundraising activities from media criticism. The Charity Commission wrote in 2015 to charities whose accounts disclosed low returns from their fundraising costs, asking them to justify their fundraising activities. The lessons are clear: even if acting properly and lawfully, a charity must also be prepared to justify its actions and demonstrate its compliance, often at short notice.

Actions to take – legal

To be able to justify your activities in the current media environment, compliance with the law is an essential first step. Every board of trustees should be confident that their charity's fundraising function is compliant with fundraising requirements and other legislation. It is not just a box-ticking compliance issue but a pragmatic step to maintaining supporters' goodwill and being prepared in case the charity does find itself the subject of adverse media attention.

Actions to take – good practice

There is extensive and ongoing debate in the sector about what constitutes fundraising good practice, but there are certain "low-hanging fruit" that can easily be achieved by even small fundraising operations and which, for large charities, are likely to be imposed as part of their new audit requirements after the Charities (Protection and Social Investment) Bill is enacted. Adopting a vulnerable person's policy should be the first step, and it is notable that media stories tend to focus on vulnerable people. It is not enough for fundraisers to act sensitively and with common sense towards those who are vulnerable: proper standards of behaviour by the charity's fundraisers should be set out in an up to date policy, which may be produced in response to Charity Commission or media interest. The trustees should also be able to demonstrate how they ensure compliance with the policy.

Similarly it is advisable to have a strategy which limits the frequency of contact with supporters or potential donors, and requires records to be kept to enable the charity to demonstrate compliance with this strategy. When assessing whether to submit to the regulation of the new regulator, it is worth considering that one advantage is the ability to point to your membership and your compliance with its rules when facing critical press or regulator attention which could otherwise damage the charity's reputation. Charities have long had a reputation for leading the way in good practice and they can take the events of 2015 as an opportunity to lead the way in their fundraising practices.

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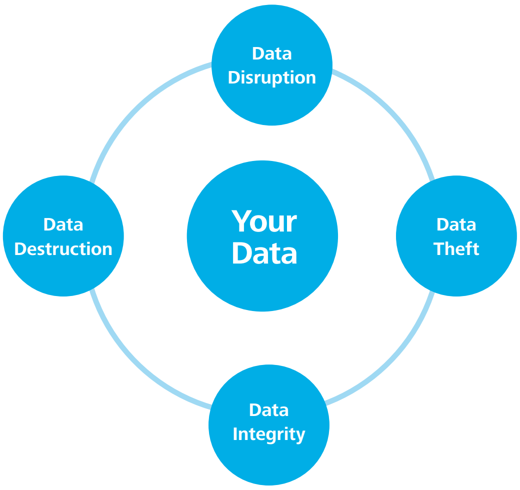
How secure is your data?

We recently held a charity lunch discussion on cyber fraud and attacks, where a Deloitte expert, Andrew France, who once worked for GCHQ, shared some insights. The event was held under Chatham House rules, so I won't disclose or quote anything that was discussed specifically, but I wanted to give you a flavour of the discussion and its focus.

Over the past few years there have been considerable attacks on major media organisations: the attacks on Sony, TalkTalk and others. It is clear that all organisations are starting to need to take consumer trust seriously on data security.

We talked about the types of risks and Andrew highlighted the four main risks that would stop access to your data:



Digital risk encompasses threats to confidentiality, integrity and availability either by disrupting access to data, stealing it, changing it or deleting (or destroying) data.

Some of the biggest threats are assumed to face finance organisations, however, the random nature of some cyber attacks means that any organisation, including charities could be vulnerable.

But what should and can be protected? Can we simply throw a firewall around all data? Of course not; to do so would be incredibly costly and not focus the right resources on the key data.

The advice was simple and could be boiled down into five key questions:

1. Do you know the value of your data?
Understanding what data is held and what value that data has is the first step to effectively managing data protection in a targeted and cost effective way.

2. Do you know who has access to the data?
Can anyone in your organisation access all your data, or are there divisions and hierarchical access levels established? Understanding and managing access to key data is part of the protection plan.

3. Do you know where it is (or at least the important bits)?
How is data backed-up and managed, cloud or database? How well is it secured? Has the disaster recovery plan been tested? The security of data is not just about managing cyber threats but also key to business continuity.

4. Do you know who is looking after it for you?
And do you know how well they are managing it and what their contingency plans are? Have you walked through what would happen if there was an incident? Understanding your key contacts should something happen, be they technical or PR related, are an essential part of preparing your defences.

5. Do you have an incident response plan?
The depressing fact is that attacks are sometimes inevitable, so the preparation of a reaction and contingency plan will assist in surviving the cyber world threat.

All in all it was an interesting seminar developing our understanding of the threats faced and the steps that may be taken by organisations to defend themselves. Our leaving thought was the realisation that one key tool in the cyber armoury is a thorough risk assessment: understanding and matching the value of the data with commensurate protection and mitigation of risks.

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Total return investing for charities

The risks and rewards for charities of investing in financial assets have changed over recent years as monetary authorities have intervened in the financial markets with highly unorthodox policies.

By pushing down interest rates and implementing successive rounds of quantitative easing, policymakers have hoped to stimulate growth in the global economy and avoid a painful correction to asset prices and living standards.[1] This, we believe, has had the unintended consequence of distorting the cost of capital, the rate of return above the risk-free rate which is required to persuade an investor to make an investment.[2] In turn, this could have a considerable impact on how charities may seek to meet their investment objectives.

The hunt for yield in a distorted world

Distortion is seen most acutely in fixed-interest markets, given that central banks in the US, Europe and Japan have reduced interest rates to near-zero levels.[3] In some cases, rates have slipped below zero; for example, savers with the European Central Bank must now pay for the pleasure of depositing their assets in euros, following the implementation of negative deposit rates earlier this year.

In addition, central bankers are creating money to purchase longer-dated fixed-interest securities, otherwise known as 'quantitative easing'. A result of this is that investors looking for the security of a government guarantee on the repayment of their capital receive scant reward from their investment, with nominal yields of just 2-3%[4] available on 30-year bonds issued by the major developed countries.[5]

As a result, charity investors hoping for more than a low single-digit return on their assets are being forced to take more risk with their capital, for example by moving into higher-yielding (and higher-risk) fixed-income securities, into property, or into equities in the hope of receiving a higher level of income from dividends with the potential for capital growth.

Volatility ahead

At Newton, we believe that there are a number of structural forces at work in the global economy, such as ageing populations, high debt levels (which bring forward consumption) and the distorted cost of capital (which has created overcapacity in some industries), which lead us to believe that over the medium term global economic growth levels are likely to be subdued, but not necessarily linear over time or between geographies.

Changes in political power will ensure that fiscal and monetary policy objectives change over time, and we expect that all policy tools available will be used as each country attempts to grab a share of economic growth. Technological advances will continue to provide growth for some companies and industries, but leave others with redundant products or assets. All these factors lead us to believe that volatility is likely to be a feature of financial markets for the foreseeable future.

Reconsidering returns

It is important that investors have some expectation of the potential returns which their assets may be able to achieve. The starting point, or the level at which an investment is made, is an important determinant of future returns. If we take the cyclically adjusted price-to-earnings ratio of the S&P 500 index (the total current price of the S&P 500 divided by the inflation-adjusted total earnings of its constituents over the last decade) as a measure of valuation, we can see that over the last few decades valuations have risen somewhat; at the end of 1981 the average company in the S&P 500 was trading at a price which was around seven times its earnings. Fast forward to the present day, and this figure is now consistently well over 20 times (Source: Newton, 2015). Meanwhile, the aggregate dividend yield of the MSCI USA index has fallen from just under 6% at the end of 1981, (Source: Newton, MSCI) to around 2% today (Source: MSCI, as at 30 June 2015).[6] It could be argued, therefore, that current asset valuations are less conducive to producing the same level of returns as those assets have generated over the last three decades.

A challenging time for income investing

The current environment in financial markets is certainly challenging for charities attempting to adopt an investment policy for their assets which will provide a reasonable level of return with an acceptable level of risk to their capital. This challenging backdrop only serves to highlight the importance of a much-debated issue for charities; what constitutes a sustainable withdrawal rate from their portfolios.

In a low growth environment, the income received from an investment often forms a large part of the total return. However, in adopting an income-focused strategy, it is important to have transparency about how that income is being generated, the underlying holdings behind it, and how sustainable it is. Adopting a strategy that employs some form of derivative instrument to enhance income may add further complexity to the mix and reduce capital returns.

In the UK equity market in 2014, the top five dividend-paying companies accounted for 45% of the total dividends paid over that year, with the top 15 firms paying out 63%. Just three sectors (telecommunications, oil and gas and financials) generated slightly over 54% of the total dividends paid over the same period.[7]

Having a strategy focused on income alone is therefore susceptible to being concentrated in just a few areas, concentrating the risk to capital should a change occur in one of those sectors, for example the oil price fall last year. It also means that areas of the market that may have better prospects could be under-represented in a portfolio.

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1 Quantitative easing: An unconventional monetary policy where a central bank creates new money to buy financial assets

2 The risk-free rate: The interest an investor would expect from an absolutely risk-free investment

3 Bloomberg, November 2015

4 Past performance is not a guide to future performance. The value of investments and the income from them can fall as well as rise and investors may not get back the original amount invested. Past or current yields are not indicative of future yields

5 Bloomberg, November 2015

6 Past or current yields are not indicative of future yields

7 Source: Capita UK Dividend Monitor, January 2015.http://www.capitaassetservices.com/assets/media/SS14420_Dividend_Monitor_Q1_2015-r3.PP.pdf

The sustainability and growth potential of high-yielding companies is an important factor to consider too. Higher-yielding companies tend to pay out the majority of their earnings as dividends, leaving little to reinvest, unless borrowings increase or indeed the income is paid out in the form of a 'scrip' (through which dividends are paid by issuing more shares, thereby diluting the holdings of those who opt to receive cash dividends).

The benefits of a total return approach for charities

To take advantage of the potentially more volatile and low-growth environment, charities, in particular those with permanent endowments which have recently been afforded more freedom in creating their policies with a change in legislation, could consider a total return approach. An investment policy without the constraints of producing a predetermined level of income allows greater flexibility as to where assets are employed.

That is not to say that such a policy would avoid income-producing stocks where it is thought that the income stream is sustainable, but it would allow the charity the freedom to invest in those select companies which are likely to grow. This does not have to mean taking more risk with capital, as many companies strike a balance between shareholder returns and reinvestment in the growing parts of their businesses.

Conclusion

To conclude, we, at Newton's, believe that a total return approach, which may increase a charity's investment universe and frees it from the constraints of a pre-determined income target, could help to mitigate risk and capture select growth opportunities in today's volatile, low growth environment.

Covenant guidance and the impact on trustees of defined benefit pension schemes

In late 2015, the Pensions Regulator issued a comprehensive guidance paper on the way in which trustees should assess the key risk for their pension scheme – the ability of the employer to fund the scheme.

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This guidance comes on the back of the Code of Practice for Funding Defined Benefit Pension Schemes issued in late 2014 and will be a major consideration for non-profit organisations and trustees when they embark on their next actuarial valuation. The Code rightly put the employer covenant at the heart of all investment and funding decisions that trustees make. Trustees will, therefore, welcome what is a clear and useable guidance document, setting out the way in which the Regulator expects them to assess and monitor the covenant of their employer(s).

What's new?

Not very much at all. The Regulator has been consistent in communicating the principles that it wants trustees to follow when examining the strength or otherwise of the organisation which sits behind the pension promises made to members. This document is not about reinventing the wheel or 'tweaking' the message. In the guidance, the Regulator seeks to set out best practice and provide worked examples to ensure that trustees are clear on what is expected from them and how to achieve this.

There are, however, some key points which are emphasised:

Term: the guidance urges focus on long term cash generation, in line with the duration of scheme liabilities. This could be difficult in practice, particularly in the case of non profit organisations, given the potential uncertainty around revenue from year to year. Few forecasts extend longer than 3 years and the duration of the scheme liabilities would normally be closer to 20 years. In addition to looking at short term cashflow forecasts, it will therefore be important for trustees to explicitly assess and overlay longer term market challenges and opportunities affecting their employer(s).

Monitoring: the Regulator once again stresses the importance of ongoing monitoring with appropriate triggers and contingency plans in place to deal with circumstances where experience is out of line with expectations. Assessing the covenant at a single point in time is not sufficient – a proper framework for ongoing monitoring is key.

Contingent Assets: where anything other than cash is being used to fund the Scheme, the Regulator urges caution and consideration of the likely situation when the contingent asset would be required. This links in with the Pension Protection Fund's guidance on contingent assets for levy reduction.

DIY Reviews: conflicts of interest are highlighted and the Regulator makes clear that the trustee board as a whole (rather than one or two well informed individuals) should have a clear understanding of the strength of the employer and the factors which might cause that to change.

Context: the guidance explains that covenant reviews should be undertaken against the background of the pension scheme, the employer and the wider group, including key external indicators and off-balance sheet issues, for example cross-company guarantees and cash-pooling facilities.

Further considerations for Not for Profit Organisations

A separate section is included in the guidance for trustees of pension schemes backed by NFP organisations, setting out the following key considerations:

- The Regulator acknowledges that scheme trustees will need to carefully balance their need for contributions to the pension scheme against the fact that donations may fall if donors perceive that too high a proportion of donations is being used to fund the pension scheme.
- Trustees are urged to recognise that NFP sponsors may have both commercial income and donations, these should be analysed as distinct operations.
- Restricted funds may impact on the assessment of current financial resources and legal advice may be needed to determine the extent to which these can be used to back the pension scheme.
- Trustees should understand the prospective financial performance of their employer, by considering:
  - The diversity of income sources available
  - The future outlook for those income sources
  - Alternative means of raising funds
  - Current reserves and the policy of the NFP for retaining reserves
  - The availability of income from permanent endowment funds
  - The extent to which the sponsor has discretion over the level of costs incurred each year
  - Key risks (e.g. reputational risks) which might impact on future income streams.

What is the effect likely to be?

Trustees looking to assess the strength of their sponsor in line with the guidance, and then use the findings to shape their investment and funding decisions will require **a change in approach from their advisors across the board**. Advisors will be expected to collaborate more and to explicitly allow for each other's advice when providing their own recommendations, so that their clients are able to develop properly integrated strategies and straightforward monitoring frameworks.

The guidance suggests that, where data from the employer is not available, trustees make very prudent assumptions. It is likely, therefore, that employers will want to provide as much as possible in order to avoid overly cautious assessments being made. Trustees, for their part, should ensure that their requirements are made clear to employers and issued in plenty of time. **It will be important for trustees and employers to work together to determine the best format for information sharing** and how key metrics should be provided without involving employers in a great deal of additional work.

The way in which trustees use their covenant advisors may well change. We expect trustees will increasingly seek advisors that can explicitly link covenant advice with the relevant investment and funding implications. This will require clear communication and a specific, tailored scope of work up front to ensure effort and advice is focused on the key risks to the employer and the scheme.

A sound and regularly updated view of the employer covenant will form an invaluable input into any funding and investment scenario analysis, stress testing and contingency planning. Covenant reviews carried out in line with the guidance will make it **much easier for trustees and their other advisors to set sensible strategies**, to determine when action is needed to correct any element of their funding plan and to make sure that their actions are appropriate and timely.

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