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Pulse – Deloitte's Charities and Not for Profit Group Newsletter

Welcome to the new edition of PULSE

As we all look forward to the 'new normal' and the lifting of restrictions, we have included here some food for thought on what the future may bring.

Our Deloitte Chief UK Economist Ian Stewart considers 'levelling up' and the post pandemic impact on the economy. Bhavin Shah of Newton's Sustainable Growth and Income Fund for Charities explores the impact of the climate agenda on investments, and Sarah Rowley and Cara Fung of Charles Russell Speechlys consider the impact of the Kids Company verdict on trustees.

We would like to thank all our contributors for their thoughts and wish you a good Spring break.

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 do not rely on contents of articles that have been written for general guidance only.

Kids Company verdict – a good result for the sector?

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The Kids Company was set up in 1996 by a passionate founder and Chief Executive, Camila Batmanghelidjh, to help young ex-offenders and vulnerable children.

It was very successful at raising money from government and blue chip companies and enjoyed enviable celebrity support. The charity's support provided to children included counselling, hot meals, assistance with healthcare, and housing.

The reader will no doubt be aware of the media attention following the collapse of the charity. Details emerged suggesting that it was completely dependent on government support to survive and it lived a so hand to mouth existence. Its business model was not sustainable and it operated on low inadequate reserves with poor governance and minimal oversight by its trustees.

Concerns were initially raised by the Cabinet Office in June 2015 about the charity's request for a £3 million government grant, but Ministers approved the funding. Soon after, in July 2015, Batmanghelidjh stepped down, denying that the charity was mismanaged. In the same month, the Met Police launched an investigation into allegations of physical and sexual abuse linked with the charity. In August 2015, the charity closed down. In January 2016, the Met Police completed its investigation, concluding there was no evidence of criminality.

Commons Public Administration Committee

In late 2015, Batmanghelidjh and the charity's Chair Alan Yentob appeared before the Commons Public Administration Committee, which produced a report critical of the charity's mismanagement. There were many allegations of inappropriate 'therapies', lavish spending and abuse of power within the organisation. The report also revealed that between 2013 and 2015, the government released almost £17 million through direct, non-competitive grants. The Committee expressed concern that the charity's board of trustees lacked the experience of youth services or psychotherapy necessary to interrogate the decisions of Batmanghelidjh. The report made clear that even without the police investigation that triggered the charity's collapse, it was unlikely to survive due to the trustees' financial negligence and Batmanghelidjh's reluctance to restructure the organisation. The report noted that the charity had significant cash flow issues and struggled to meet its HMRC obligations on several occasions. As early as 2002, HMRC wrote off tax debts of £590,000.

Official Receiver

At the end of last year, the Official Receiver brought a case seeking bans of up to 6 years against Batmanghelidjh and 7 trustees of the charity. The Official Receiver claimed Batmanghelidjh and the trustees ran an unsustainable business model and should have foreseen the charity was heading for financial meltdown. Although Batmanghelidjh was not formally a director of the charity, if she was considered to have had a sufficient degree of control of the organisation, she still could be treated as a director under the Insolvency Act 1986. Batmanghelidjh rejected the claim that she was a de facto director, and the trustees stated they had acted in good faith.

Good news for trustees

Justice Falk recently dismissed all disqualification proceedings. It was concluded that Batmanghelidjh was not a de facto director, so it was not necessary to decide whether she was unfit. However, Justice Falk noted that if it had been necessary to decide whether she was unfit, a disqualification order would not have been made against her. The decision was based on the court's findings that while aspects of the charity's operating model were high risk, it was not unsustainable in principle. In fact, had there not been the unfounded abuse allegations, it is more likely than not that the restructure would have succeeded and the charity would have survived. Justice Falk emphasised that charitable volunteers should not be discouraged from volunteering in fear of litigation. It is important to ensure that able and experienced individuals with the range of skills required by charities are not deterred from becoming charity trustees.

Charity Commission's Inquiry

The Charity Commission's inquiry was opened on 20 August 2015, but its work was put on hold and delayed by the investigation and action taken by the Official Receiver. The Charity Commission has now resumed its inquiry but has already stated it does not intend to take any regulatory action against the trustees. The Commission intends to publish its concluding report as soon as possible, and to remove the charity from the register on the grounds that it is no longer operating.

The outcome is undoubtedly a good one in the greater interests of charity trusteeship. Trustees are of course volunteers, often with busy professional and private / family lives and if the decision had gone the other way, we may not have seen mass resignations, but the stance taken would have made many trustees uncomfortable in their role and it would be harder to recruit trustees, particularly those in the prime of their careers. This would set back any progress made to diversify boards to include younger, professionally active trustees. The ripples caused by the Kids Company's downfall have already affected the charity sector as a whole, as it has certainly led funders of charity projects to look much more closely at the charities they are supporting and specifically their financial and governance practices before agreeing support. This is of course a positive development and helps encourage best practice in the sector.

Energy investment: a changing climate

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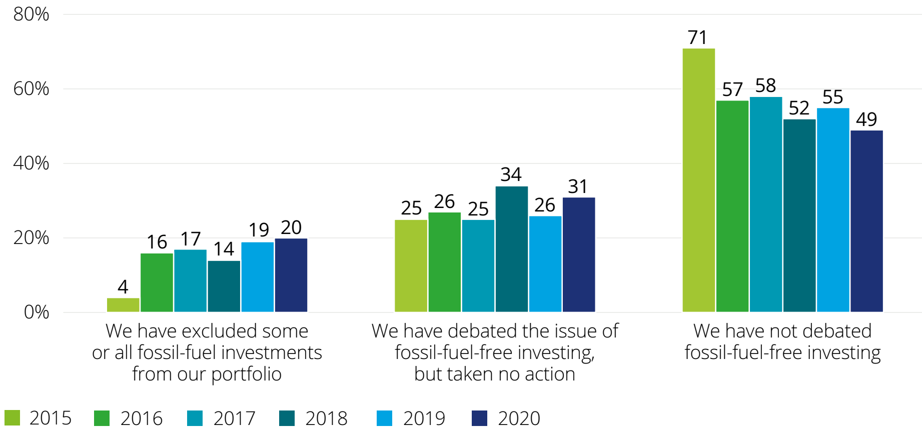
As climate change looms large over society, an increasing number of charities are being scrutinised for investments in fossil fuels, with the proportion of charities excluding fossil-fuel investments, or considering doing so, growing steadily.

According to Newton's annual Charity Investment Survey, conducted among leaders and decision-makers in the UK charity sector, the proportion of charities excluding some or all fossil-fuel investments has risen from just 4% in 2015 to 20% in 2020.[1] In April 2020, the University of Oxford's endowment fund joined a growing list of institutions that have announced plans to exclude all fossil-fuel investments.[2]

Fossil-fuel companies vulnerable to change

At the same time, the fossil-fuel sector in its current guise now looks increasingly vulnerable to becoming irrelevant to future investors. In 2019, the MSCI World Index was up almost 24% in US-dollar terms, while the MSCI World Energy Index returned just over 12% and has underperformed its wider global equity equivalent in four of the last five years.[3] Despite a recovery in the oil price from record lows as global lockdowns have eased, falling returns on capital, volatile energy prices and the rise of renewables had increasingly made fossil-fuel investments an unappealing choice for investors. The primary salvation was high dividend yields for those in need of income in an income-starved world.

Charity trustees' position on fossil-fuel-free investing



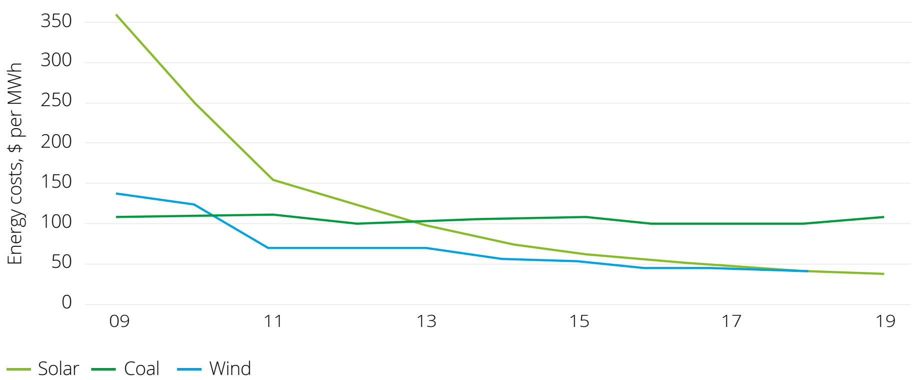
Source: Newton Charity Investment Survey. Data set: No. of respondents: 2015: 93; 2016: 77; 2017: 93; 2018: 97; 2019: 102; 2020: 114.

In 2020, as severe restrictions were imposed on the global economy as a result of the efforts to curb the coronavirus, the International Energy Association (IEA) predicted that demand for oil & gas could fall by over 5%, while growth in output from solar and wind was expected to rise by about 5%.[4] In the UK, 37% of electricity production came from renewables in 2019,[5] and their increased use is a trend which is being replicated across the globe.

As the cost of renewable energy falls further, grid systems adapt, and material science evolves, the abundance of green energy is likely to progressively undermine the economics of fossil fuels.

While COVID-19 lockdowns are expected to have a negative immediate impact on the commissioning and construction of some renewables projects, investors actually gave the green light to US$35bn worth of offshore wind projects worldwide in the first half of 2020, more than quadrupling the figure from the previous year in this area, and the long-term forecast for other renewables appears bright.[6]

Energy costs - US$ per MWh



Source: Lazard/The Economist, 4 July 2019.

[1] Source: 2020 Newton Charity Investment Survey
[2] Source: University of Oxford, 27 April 2020 (https://www.ox.ac.uk/news/2020-04-27-oxford-announces-historic-commitment-fossil-fuel-divestment)
[3] Source: Bloomberg, September 2020
[4] Source: Global Energy Review, International Energy Association, April 2020 (https://www.iea.org/reports/global-energy-review-2020)
[5] Source: UK Energy Statistics, 2019 & Q4 2019, 26 March 2020 (https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/877047/Press_Notice_March_2020.pdf)
[6] Source: Offshore wind energy investment quadruples despite Covid-19 slump, The Guardian, 13 July 2020

Not only have investors in the oil & gas sector seen unsustainable dividend yields cut, they have also experienced painful losses in high-yield and private-debt holdings linked to fossil-fuel investments. For those investors not persuaded by concerns over climate change and the rapidly increasing competition from renewables, losses from oil & gas holdings in their portfolios are bringing home the reality of investing in assets where the tide of history is against them.

Demand for oil & gas is likely to bounce back, and the oil price may well recover further from present levels too, but does this matter? Prices are set by marginal demand, and if the future rate of change is negative, in our view, even the high yields on offer could provide insufficient compensation for the risk of asset impairment and redundancy.

Changing client preferences

But there is another influence that is diminishing the demand for fossil-fuel investments: client preferences. While investment managers are increasingly being asked to divest from fossil-fuel investments by pension funds, private clients, charities and foundations, this is not the only issue. We are also seeing more and more lobbying of banks and insurance companies to cease funding fossil-fuel businesses. One leading UK bank has already announced that it will no longer fund fossil-fuel investments, and other commercial banks are under pressure to follow suit. And it is not only the production of fossil fuels that is in focus: the use of petrochemical products, such as single-use plastics, is a topic for active engagement by investors who are putting pressure on major food companies to limit their use.

Many major oil companies are pledging that they will be running zero-carbon strategies by 2050, reflecting the demand from many in civil society for a more rapid energy transition, and the pressure for increased disclosure and reporting of their carbon footprints. The hidden message in these announcements is the calling out of governments to put in place the incentives (and disincentives) to accelerate that transition. Betting on continuous support from governments for fossil fuels as a central plank of an investment thesis could be a proposition based on shaky ground.

Against this backdrop, charities may be seeking investment solutions that can enable them to integrate climate-change concerns, the energy transition and other important considerations into their portfolios. Investment strategies with sustainability at their core can encourage a better allocation of capital with the aim of improved long-term global outcomes for society and the environment, alongside generating resilient risk-adjusted returns.

Many active investment strategies with a sustainable remit view engagement as a critical part of the stewardship role. A growing number of charities also see the merits of engaging with companies to seek to change their behaviour, recognising that such an approach does not have to come at the cost of investment returns and can, in fact, improve them. In 2020, 63% of the charities that we surveyed felt that ESG (environmental, social and governance) engagement had an impact on investment performance, with 69% of those charities believing that the impact was positive.[7]

Engaging for the future

Active, engaged investment managers can push for corporate change, working with companies to increase the sustainability of their businesses over time. For example, in 2019, under the Climate Action 100+ initiative, a group of international investors co-filed a special climate-change shareholder resolution, asking BP to explain its thinking on climate change and how its business is aligned with the goal of the Paris Agreement to keep global warming to well below 2°C. This initiative took place after more than six months of engagement. The Board positively supported the proposal, and at BP's AGM the resolution received huge support, gaining 99.14% global investor approval, the highest ever investor support for an ESG resolution.[8] This demonstrates what can happen when investors engage constructively with companies on important issues.

A well-managed sustainable investment strategy can also seek to identify and invest in the 'winners' – companies with exposure to trends such as clean energy provision, or the transition to the electric vehicle – which should be well positioned to benefit from structural demand in such areas. For example, many renewable-energy assets benefit from steady government subsidies that can help to underpin the value of investments in the sector and offer investors important diversification benefits. Furthermore, while the coronavirus crisis has resulted in many dividend cuts in wider equity markets, renewables have continued to pay stable dividends throughout this turbulent period. This can help to compound returns over the longer term and is also particularly relevant to charities that require a regular income from their investments.

Climate change is a multi-faceted issue for the investment community, and there are many complexities associated with the energy transition. However, we believe an active investment approach which integrates ESG considerations and prioritises engagement could be a compelling option for charities that wish to achieve their long-term investment goals in a responsible and sustainable manner.

Important information

[7] Source: 2020 Newton Charity Investment Survey
[8] Source: Financial Times, 'BP shareholders vote in favour of greater climate disclosure', 21 May 2019 (https://www.ft.com/content/fcb14d66-7bcd-11e9-81d2-f785092ab560)

Time to take levelling up seriously

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When he became prime minister in July 2019, Boris Johnson brought with him a new priority in the form of 'levelling up'. It's an old idea and an enduring political concern, one that, for getting on for a hundred years, has gone by the name of regional policy.

A growing focus on inequalities of income, health and opportunity across Britain has brought regional policy back to the fore. The Conservative's 2019 general election success in Labour 'red wall' seats in the North, the Midlands, Yorkshire and Wales, has lent political weight to the cause. And in the last year the pandemic has added a new dimension to regional inequalities. Levelling up's time has arrived.

With the pandemic in retreat, levelling up will need to develop into a set of policies and objectives. The government is likely to outline how it plans to make a reality of levelling up within the next few weeks. We have been discussing the nature of the challenges in a series of events with private and public organisations across the UK. Here are eight conclusions we have drawn from those discussions and our research.

First, differences in economic performance between the regions of the UK are large, in absolute terms and by international standards. According to the Institute for Fiscal Studies (IFS), the UK is one of the most regionally unequal countries, ranking near the top on most measures of inequality in a universe of 26 industrialised countries. The regional divide is longstanding. Differences in regional GDP per head today are similar to those of over a hundred years ago. Regional income inequality narrowed in the first half of the last century, then widened between the 1970s and the 1990s. While the income and earnings gap has narrowed somewhat since, it remains large and its effects have been intensified by a wider stagnation of incomes since the global financial crisis.

Second, this isn't just a North-South divide. The towns and cities of the former industrial regions have particular and longstanding problems, but so do many coastal and remote rural areas. An index of the most 'left-behind' areas, created by the IFS, includes many English-seaside areas including Great Yarmouth, North Norfolk, Thanet, Portsmouth and the Isle of Wight. Moreover, the income difference between local authority areas within regions is greater than the difference between the regions themselves. In the jargon, intra-regional differences are greater than inter-regional ones. The claimant count unemployment rate in Lancashire, for instance, varies from a low of 3.1% in Ribble Valley to a high of 8.9% in Burnley, a distance of just ten miles. Life expectancy within local areas in counties, including Essex, Kent, Cumbria and Greater Manchester, varies by as much as five years.

Third, regional disparities are complex in nature and understanding them calls for a set of measures that go beyond GDP per head or productivity. Housing costs clearly have a major impact on actual standards of living. High London house prices mean that most of the London salary premium is swallowed up by higher housing costs. After-housing income for the median London worker is just 1.0% above the national average and, partly because of housing costs, London has the highest poverty rate in the UK. Wellbeing is a function of a host of factors including education, health, local services and job opportunities. Some areas, of the UK, including South Derbyshire, West Devon and Northern Ireland, report high levels of wellbeing despite being relatively low down the GDP per head league. Broad measures of welfare are needed to capture the quality of life.

Fourth, the varied and specific nature of the challenges calls for local solutions and a partnership between central and local government. Active, heavyweight political sponsorship from the centre, as was provided by Michael Heseltine in the 1980s, helps. Deloitte's "State of the State" report found that what people want levelled up varies. Londoners are most concerned about housing, crime and the local environment while people in the North East worry most about jobs, schools, transport, adult skills training and local amenities. Devolving authority to regions can allow policy to be more closely tailored to local needs. Research by the OECD has found that tax and revenue decentralisation tend to reduce regional disparities. Since the turn of this century government has sought to encourage direct mayoral elections. Local referendums have rejected the approach in some areas, but elected mayors have become more prominent and influential locally and nationally.

Fifth, levelling up, though often construed as such, is not just about the public sector. The private sector accounts for the great majority of jobs and GDP across the regions. The lesson from the regeneration of urban areas, including Liverpool and the London docklands, is that success comes from a close partnership of the public and private sectors, repurposing industrial sites as business parks and attracting investment with government support and tax incentives. Strong collaboration between the private sector, local authorities, national government and universities is essential.

Sixth, policy needs to operate at a local, regional and national level. Major infrastructure projects, such as HS2, 5G and broadband, loom large in regional policy, though their scale and complexity can mean they take years to come to fruition. A recent Oxford university research paper argues that rapid improvements can be achieved through small, tailored projects. Examples of standardised modular projects include wind farms and battery storage, electrifying public and private transport, retrofitting buildings to improve energy efficiency and construction of schools, hospitals and care homes. Spending needs to go beyond traditional capital projects, into skills and current spending more generally, such as on policing, schools and social services, where funding has fallen in recent years. Spending per student in real terms in further education and sixth-form colleges has fallen by 12% in the last ten years and by 23% in school sixth forms, more than in the secondary school or university sector. Local government revenues, from council tax, business rates and central grants, have fallen 18%.

Seventh, the complex and deep-rooted nature of regional disparities mean that policies need to be set for the long term. Changes in structure and funding are disruptive. As with major infrastructure projects, success in regional policy calls for consistency over time.

Eighth, and finally, progress is possible. Rates of unemployment between UK regions have narrowed significantly since the 1980s, while employment rates have risen across the country. By the end of 2019 unemployment rates across the UK were at the lowest levels since the 1970s. Meanwhile the fortunes of a number of cities have revived, including those of Edinburgh, Derby, Dundee, Bristol Southampton and Leamington Spa. Regional performance and inequalities are not immutable.

The UK economy will be shaped in coming years by Brexit, the aftermath of the pandemic and the transition to net zero. The shifting balance between office and home working creates new opportunities and risks for all parts of the country. Levelling up should be seen not as a standalone policy, but as the vehicle for spreading opportunity across the UK underpinning and expanding on the work and principles already embedded in the charity sector.

For the latest charts and data on health and economics, visit our COVID-19 Economics Monitor:

https://www2.deloitte.com/uk/en/pages/finance/articles/covid-19-economics-monitor.html

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