BRIEFING

TRAVERS SMITH

What's Happening in Pensions

Issue 102 – May 2023

In this issue:

TPR Corporate Plan: The Pensions Regulator has published its 2023/24 Corporate Plan. This confirmed the latest delay to the new funding and investment regime and includes updates on various other workstreams.

TPR annual funding statement: The Pensions Regulator has published its Annual Funding Statement 2023, setting out expectations and matters for DB schemes to consider in various circumstances - especially in light of generally improved funding positions.

LDI – TPR and FCA guidance: The Pensions Regulator has published liability-driven investment guidance for trustees to replace its 2022 statements. The FCA has published guidance and recommendations for LDI managers.

Lifetime allowance – HMRC guidance: HMRC has published the first in a planned series of Lifetime allowance guidance newsletters to explain to administrators some of the more technical aspects of the changes to the lifetime allowance regime from 6 April 2023 and beyond. This included a section on a new procedure for taxing death benefits in excess of available lifetime allowance that was quickly withdrawn.

TPR EDI guidance: The Pensions Regulator has published equality, diversity and inclusion (EDI) guidance for pension scheme governing bodies and for employers.

DC illiquid investment etc. regulations: The Occupational Pension Schemes (Administration, Investment, Charges and Governance) and Pensions Dashboards (Amendment) Regulations 2023 have been made. These generally concern DC schemes' investment in illiquid assets.

TPR VFM initiative: The Pensions Regulator has launched a new initiative to check that small DC schemes are complying with legislation on assessing value for members.

TPR ESG blog post: Nicola Parish of the Pensions Regulator has written a blog post "Great expectations: why trustees must be ready to step up on ESG and climate reporting". This follows last month's press release about the Regulator's initial review of schemes' TCFD reports.

Government green finance strategy / FCA delay: The Government has published its 2023 Green Finance Strategy, which sets out its proposals for mobilising green finance and investment in the UK. The FCA has announced a delay to its SDR rules and investment labels regime.

PLSA stewardship and voting guidelines: The PLSA has published its 2023 Stewardship & Voting Guidelines. Particular areas of focus are the cost of living crisis and executive pay; climate change and the environment; and the workforce and impact of operations on society.

State pension age review: The Government's latest state pension age review has confirmed that state pension age increases will not be accelerated but that the increase from 67 to 68 will be reviewed again after the next general election.

UK EMIR clearing exemption: Regulations have extended the exemption for certain pension fund derivative transactions from the UK EMIR clearing obligation until 18 June 2025.

PENSIONS RADAR: You may also be interested in the latest edition of Pensions Radar, our quarterly listing of expected future changes in the UK law affecting work-based pension schemes.

SUSTAINABILITY MATERIALS: Our Sustainable Business Hub includes a section on ESG and sustainable finance issues for pension schemes and their sponsors. See also our latest ESG Newsletter.

TPR Corporate Plan

The Pensions Regulator has published its 2023/24 Corporate Plan. This is the third year of the Regulator's latest three-year planning cycle. The Plan included the following updates and new points of interest:

- A further delay to the Regulator's DB funding code of practice (see WHiP Issue 99) is confirmed. It is now due to take effect for valuations with effective dates from April 2024, rather than October 2023. There was no mention in the Plan of whether the associated regulations will start to apply at the same time but the Regulator's later-published annual funding statement (see below) mentions that they will.
- The Regulator expects the outcome of the joint consultation on proposals for extending DC value for money assessment and reporting requirements (see WHiP Issue 100) to be published this summer. Legislation is likely to be needed to progress this. The Regulator will work with the Government and the FCA to explore how the value for money framework may be broadened "over the coming years".
- The Regulator's general code of practice (formerly known as the single code) is due to be launched by the end of June 2023. Schemes are expected to be given time to comply with the new requirements for 'own-risk assessments'.
- The Regulator will be working with the Government to explore options for better protecting value at decumulation for members of DC schemes. In the meantime, it will "reinforce the importance of acting in savers' best interests when facilitating their transition into decumulation".
- The Regulator will "establish a baseline of the diversity of schemes' governing bodies and drive more diverse and inclusive decision-making". Following the recent publication of guidance (see below), the Regulator will now engage with schemes through supervisory work to understand the progress they are making, the challenges they face and to re-affirm expectations. It says: "This will enable us to share and reinforce best practice.".
- The Regulator will assess options for driving up standards of governance and trusteeship, including the feasibility of mandating (via legislation) that a professional trustee sits on each board or accrediting or authorising professional trustees. Option analysis is expected to be published by the end of March 2024.
- The Regulator intends to review its 'superfunds' (DB consolidator schemes) guidance and publish guidance on 'alternative DB models' during its 2023/24 financial year.
- The Regulator will further develop the Pension Scams Action Group (formerly known as Project Bloom) to bolster the sharing of intelligence between partners and better co-ordinate disruption and enforcement activity.

TPR annual funding statement

The Pensions Regulator has published its Annual Funding Statement 2023. The Statement is particularly relevant to schemes with valuation dates between 22 September 2022 and 21 September 2023 (Tranche 18) but also to schemes undergoing significant changes that require a review of their funding and risk strategies. It includes content for schemes that may be receiving requests for reduced contributions, amendments to contingent asset arrangements, and proposals for other uses of surplus. It is also, of course, of general interest as an indicator of current Regulator thinking.

Naturally, the content is consistent with the Regulator's existing approach and its draft funding code of practice. The Statement applies this approach to scheme circumstances in the current economic environment. With reference to generally improved funding levels, with most schemes currently being ahead of their own expectations, the Regulator says the following:

- Favourable market conditions mean that around a quarter of schemes could (ignoring market capacity limitations) currently buy out benefits. It says that trustees of such schemes should consider whether their long-term target is still the same. If that was buy-out, for example, should they now execute that plan or perhaps consider run-off to give members (and employers, for example where the scheme has an open DC section to which surplus could be applied in lieu of contributions) the potential to benefit from future surpluses, whilst using some of the surplus to mitigate investment risks?
- The many other schemes in surplus on a technical provisions but not on a buy-out basis should consider whether their existing strategy and level of risk are in the best interests of members. Alternatively, should they apply some of the funding gains towards a less risky funding and investment strategy designed for a smoother and more predictable transition to their long-term target?
- Schemes with funding levels below technical provisions, potentially including the minority of schemes where funding has deteriorated due to collateral call difficulties during last autumn's LDI turmoil, will need to reset their funding and investment strategies to reach their long-term target and should review their operational governance processes to ensure future resilience.

Other points of interest include the following:

- Trustees should be mindful and realistic about the implications for their **employer covenant** in the current economic circumstances. When considering covenant, they should be sure to assess "refinancing risk", i.e. the risk of materially different terms and conditions insisted upon by lenders when existing debt facilities are refinanced.
- The Regulator's new **covenant guidance** is expected later this year. Regarding this, the Statement says: "We intend to provide more detail on covenant visibility, reliability and longevity, how to treat guarantees for scheme funding purposes and more information regarding ESG risks and how these can be factored into the covenant. We will also outline various examples to support trustees in understanding how to apply any updated guidance.".
- The Regulator expects that many trustees will be revising their **mortality assumptions**, after taking advice from their scheme actuary, in light of the latest reported trends. The Regulator says that the suggestion that there may be lower future life expectancies should be treated with a degree of caution and that it will take time to see the new trends develop. It says, as usual, that trustees should ensure that any changes are appropriate and justifiable.
- There are sections with unsurprising content on dealing with **employer requests** to revise recovery plans and amend contingent asset arrangements.
- Again this year, several pages of **tables** set out the Regulator's expectations regarding covenant, investment and funding in various combinations of scheme and employer specific circumstances. The revised tables set out the key risks on which the Regulator expects trustees to focus and features of the funding plans it expects to be developed, in both cases depending on scheme and employer characteristics. Whilst noting that the new funding law and code of practice are not yet in force, the Regulator urges trustees who have not already done so to set a long-term objective and formulate their journey plan.

LDI – TPR and FCA guidance

TPR guidance for trustees

The Pensions Regulator has published LDI guidance to replace its 2022 initial statement and subsequent guidance statement (see WHiP Issues 98 and 99). The new guidance, *"Using leveraged liability-driven investment"*, sets out practical steps for trustees to take and is intended to apply whether trustees used a pooled or segregated LDI arrangement. This of course follows the gilts market turmoil in autumn 2022 when schemes' LDI arrangements resulted in the widespread selling of gilts and a downward spiral in their value, which led to the Bank of England intervening in the market.

The guidance sets out specific issues for trustees to consider, including:

- *"where LDI fits within your investment strategy*
- *setting, operating and maintaining a collateral buffer*
- *testing for resilience*

- *making sure you have the right governance in place*
- *monitoring LDI"*

Points of particular interest in sections on these different topics include the following:

- The Regulator expects trustees to invest only in LDI arrangements that maintain a minimum buffer of 250 basis points so as to provide resilience in times of market stress (this was recently recommended by the Bank of England's Financial Policy Committee). This is in addition to a scheme-specific operational buffer to manage day-to-day changes. The figure assumes that collateral can be provided to replenish the buffer, where required, within five days. A different market stress buffer may be appropriate in certain circumstances (for example, a larger buffer may be appropriate where the assets held within the buffer are more volatile). Trustees are also urged to consider in advance what assets should be sold when the buffer needs to be replenished and the process for doing that.
- Resilience testing should be done regularly (for example on an annual or triennial basis, alongside wider investment strategy testing) but also when there are significant changes to the scheme's funding or investment position, or significant changes in market conditions.
- Governance expectations include trustees having in place ways of working with advisers and managers so that they can act quickly and effectively. The Regulator says: "This is particularly true if you have high levels of leverage, meet infrequently as a trustee board or have more infrequent contact with advisers.". All parties involved should understand their respective roles.

FCA guidance and recommendations for asset managers

In the same context, the FCA has published guidance and recommendations for LDI managers, whether operating a pooled fund or under a single mandate. This sets out what the FCA expects in terms of risk management, stress testing and client communication.

Lifetime allowance – HMRC guidance

We have recently added a new briefing to our website: Pensions lifetime allowance and annual allowance changes – considerations for employers

HMRC has published the first in a planned series of Lifetime allowance guidance newsletters to explain to administrators some of the more technical aspects of the changes to the lifetime allowance regime from 6 April 2023 and beyond. (See WHiP Issue 101 for background.)

HMRC's Pensions Tax Manual does not yet reflect the Budget changes but some separate items of HMRC guidance have been updated and there are two new guidance web pages:

- Taking higher tax-free lump sums with lifetime allowance protection
- Losing your lifetime allowance protection

Lifetime allowance checks and reporting

The newsletter explains to administrators that when paying benefits they will still need to operate lifetime allowance checks and issue benefit crystallisation statements. But since no lifetime allowance charges will arise from 6 April 2023, there is no need to report charges that would have arisen on or after that date.

Enhanced and fixed protection

A section on enhanced protection and fixed protection explains, with the use of ten examples, how these protections will (or will not) apply to pension commencement lump sums in various circumstances. It confirms that protection will still be lost where enhanced or fixed protection is applied for late on or after 15 March 2023 and the individual accrues new benefits, joins an arrangement or transfers on or after 6 April 2023. (Applications for fixed protection 2016 are still open to all, so it would not be a late application in that case, but the same analysis would seem to apply.) As previously announced, those who applied before 15 March 2023 and have been granted protection do not now lose the protection in those circumstances.

On lump sum protections for individuals with enhanced protection, it adds:

> *"Members who have enhanced protection with lump sum protection will still be entitled to a higher pension commencement lump sum, but the value of the lump sum will be limited based on the value of their pension pot on 5 April 2023. This means that you will need to be able to provide members with a valuation as at 5 April 2023. Any contributions made on or after 6 April 2023 will not be included for the purposes of calculating their pension commencement lump sum."*

Taxation of lump sums

Another section of the newsletter discusses how administrators should account for tax on lump sum benefits.

- For benefits payable to members (i.e. lifetime allowance excess lump sums and serious ill-health lump sums), PAYE should be operated on the lifetime allowance excess but in some circumstances an emergency tax code will need to be used and a P45 will need to be issued. This could result in the individual paying too much tax (apparently in a similar way to the tax treatment of UFPLS payments). In such cases, the individual will need to contact HMRC to ask for an in-year refund. In the absence of that, the position will be assessed following the end of the tax year.
- For death benefits (i.e. an uncrystallised funds lump sum death benefit or defined benefit lump sum death benefit), the newsletter said that administrators would have to ask the deceased member's legal personal representatives about the member's unused annual allowance and then apply an emergency income tax code (as above) to the lifetime allowance excess payment. HMRC, however, quickly U-turned on this after it was pointed out that this would inevitably lead to confusion for personal representatives and delays in paying out death benefits. It emailed various industry parties, including the ACA, and asked them to issue an update which was followed later by a formal HMRC update in Pension schemes newsletter 149.

  Administrators have now been told to ignore the above information concerning death benefits and instead continue to apply the existing process rather than deducting any tax themselves. In other words, the scheme administrators must give information about the payment(s) to the deceased member's legal personal representatives, who must make a report to HMRC if the payments exceed the individual's available lifetime allowance. HMRC then asks the scheme for details of the beneficiary/ies and levies a tax charge on the beneficiary/ies after the end of the tax year (now on a marginal rate basis rather than a lifetime allowance charge).

  HMRC state that this process will continue until they develop a longer-term procedure for when the lifetime allowance is abolished completely from 6 April 2024.

TPR EDI guidance

The Pensions Regulator has published equality, diversity and inclusion (EDI) guidance for pension scheme governing bodies and for employers. This was developed with the assistance of an industry working group, in which Travers Smith was involved.

The Regulator's press release highlights the following content:

> *"**The role of the chair***
>
> *The guidance provides pointers for chairs – explaining that the chair should play a key role in making boards more diverse and inclusive.*
>
> *It also includes advice on some of the EDI-related considerations an employer will wish to consider when appointing a chair.*
>
> ***EDI policy and performance assessments***
>
> *TPR's guidance suggests pension schemes have an EDI policy, which covered an agreed definition of EDI, the EDI aims of the governing body and an EDI training plan.*
>
> *Assessments of the governing body's performance should include how well EDI has been, and continues to be, embedded into processes, according to scheme objectives.*
>
> *The guidance suggests that EDI goals and objectives, including ways to achieve a diverse and inclusive governing body, should be agreed at the start of the scheme year.*

Enhancing board diversity

Governing bodies should also regularly review and assess their body's diversity of life experiences, expertise and skills, TPR said.

The guidance also encourages sponsoring employers to consider widening the pool of candidates for governing bodies beyond senior management positions.

It also highlights the value being a trustee can have on an employee's personal and career development.

Fixed-term appointments

The guidance suggests governing bodies may wish to consider fixed terms, usually between three to five years, for member-nominated trustee positions to encourage a scheduled change to the trustee board bringing new perspectives to the group's decision making.

Where there is a professional trustee, the guidance reminds it is possible for governing bodies to change the individual representative from the firm over time to support their board's diversity.

The guidance also adds that governing bodies finding it challenging to address diversity gaps through member-nominated and employer-nominated trustee positions could consider an independent or professional trustee position.

TPR also says it encourages any employer or governing body considering replacing the governing body with a sole trustee, to make sure that EDI is considered as part of that decision-making process.

Reasonable adjustments

TPR highlight the existing legal duties of Governing bodies under the Equality Act 2020, to make reasonable adjustments for candidates and existing trustees with disabilities for example, to premises, equipment and technology or the role itself.

Reasonable adjustments may also need to be considered as part of the trustee selection process, for example, access to interviews remotely or providing braille or large-print documents in advance, TPR's guidance said.

Inclusive communications

TPR has added a section on inclusive communications to its guidance on communicating and reporting for defined contribution schemes.

The updates aim to help ensure scheme communications consider the diverse range of backgrounds, needs and vulnerabilities of their savers.

All communications, the update advises, should be checked for bias and to ensure they avoid inclusion of stereotypes.

Governing bodies and trustees are reminded they have legal duties to ensure their communications are accessible for disabled people."

DC illiquid investment regulations

The Occupational Pension Schemes (Administration, Investment, Charges and Governance) and Pensions Dashboards (Amendment) Regulations 2023, which had already been published in final form, have been made. They provide broadly as follows.

- "Well-designed" performance fees are excluded from the DC automatic enrolment scheme default fund charges cap from 6 April 2023. To qualify, the fees must meet specific criteria. Trustees are required to have regard to statutory guidance when considering whether fees meet the criteria but the guidance has not yet been issued.

  Requirements to include disclosures in the chair's statement and for publication on a publicly accessible website apply where such fees are excluded, in respect of scheme years ending after 6 April 2023.

  The existing legislative provisions allowing the smoothing or pro-rating of performance fees for the purposes of the charges cap are repealed (on the basis that these are no longer required following the above exclusion) but with transitional provisions for those who have been taking advantage of them.

- Relevant schemes (i.e. schemes providing money purchase benefits other than just from AVCs) will have to disclose and explain their policy on investment in illiquid assets in their default fund(s) statement of investment principles. This must be done from the first date on which the statement is revised after 1 October 2023 and by 1 October 2024 at the latest.
- Such schemes will also have to disclose in their chair's statement the percentage of assets in their default funds allocated to eight prescribed asset classes. This disclosure must be included in the annual report and displayed on a publicly accessible website for scheme years ending after 1 October 2023. Trustees will be required to have regard to the statutory guidance (when published) when making the calculations.
- An error in the provisions on staging dates for connecting to the pensions dashboards ecosystem has been corrected (but this has been superseded by the programme being paused).

See WHiP Issue 100 for more detail.

TPR VFM initiative

The Pensions Regulator has launched a new initiative to check that small DC schemes are complying with the legislation applicable to them on assessing value for members. A survey of DC schemes carried out by the Regulator last year found that just 17% of schemes required to complete the new value for members assessment had done so.

The value for member rules have been in force since October 2021 (see WHiP Issue 92). Particular rules apply to trustees of DC schemes with assets under management of less than £100 million. The Regulator says:

> *"TPR will take a data-led approach in order to contact selected schemes about their value for members assessment, including those that have indicated they have failed the assessment. The initiative will then check that trustees have plans in place to improve their assessments.*
>
> *Where improvements in compliance cannot be evidenced, TPR will ultimately expect trustees to wind up and consolidate into a better run scheme."*

TPR ESG blog post

Nicola Parish of the Pensions Regulator has written a blog post *"Great expectations: why trustees must be ready to step up on ESG and climate reporting"*. This follows last month's press release about its initial review of schemes' TCFD reports (see WHiP Issue 101). Ms Parish explains the steps that the Regulator is taking to check compliance by schemes with 100 or more members with the requirements regarding content in statements of investment principles and implementation statements, and for publication on a website.

Regarding TCFD reports (and their publication on a website), the Regulator expects reporting to evolve and improve as industry gains experience and data and analytical techniques develop. It also believes that the review and scrutiny of disclosures by external stakeholders and interested parties will drive change.

On scenario analysis, the Regulator recognises that climate change impacts are difficult to model effectively in practice but encourages trustees and advisers to think carefully about the narratives they apply to the scenarios they chose and the outcomes those scenarios produce. Ms Parish adds:

> *"More focus on outcomes is crucial. Early indications are some reports are light on actions. There are some who appear to regard these reports as merely a tick-box exercise. Reports lacking clarity over actions that have been taken or are being considered will only reinforce that view.".*

Finally, she says that trustees might consider developing a climate action plan setting out what actions (if any) they expect to take and when. She points to guidance available from the Transition Plan Taskforce. She adds:

> *"The regulations require that trustees set at least one scheme-specific target, which is not legally binding. Some targets in the reports we have seen lacked ambition. That needs to change."*

Government green finance strategy / FCA delay

The Government has published a revised Green Finance Strategy, setting out its proposals for mobilising green finance and investment in the UK. This is intended to support the UK commitment at COP26 to become the world's first Net Zero-aligned Financial Centre.

The Strategy seeks to deliver five key objectives: UK financial services growth and competitiveness; enhancing investment in the green economy; ensuring financial stability to manage risks from climate change and nature loss; incorporation of nature and climate adaptation; and aligning global financial flows with climate and nature objectives.

The Strategy includes a number of proposals and future actions. This will all be subject to further consultation and implementing measures to set out the finer detail and to bring the relevant requirements into force. The Strategy only gives an indication of the UK Government's direction of travel.

In a joint statement, the FCA, FRC, Bank of England and the Pensions Regulator welcomed the updated strategy.

This came the day after the FCA announced a delay to the publication of its policy statement and final rules on its Sustainability Disclosure Requirements (SDR) and investment labels regime. Originally expected at the end of Q2, it will now be published in Q3. All the proposed effective dates will be adjusted accordingly. The postponement is due to the "significant response" that the FCA received in response to its consultation.

For more detail, see our Financial Services and Markets department's briefing.

PLSA stewardship and voting guidelines

The PLSA has published its 2023 Stewardship & Voting Guidelines. Particular areas of focus in the 2023 Guidelines are the cost of living crisis and executive pay; climate change and the environment; and the workforce and impact of operations on society.

Changes to the 2022 guidelines include the following:

- **Virtual AGMs:** The PLSA has clarified its position on virtual meetings post-COVID. It acknowledges the case for the use of virtual meetings in exceptional circumstances such as when a government restricts people's movements but otherwise believes AGMs should allow for in-person attendance. The PLSA would therefore not support permanent virtual AGMs, as it believes that such meetings "fundamentally erode the ability of shareholders to hold boards to account".
- **Chair appointment:** Board diversity has been added to the list of factors which shareholders must consider when assessing the suitability of a new Chair.
- **Board composition and diversity:**
  - The sections on diversity have been expanded to reflect the new Listing Rules requirements and other recent developments.
  - Investors should consider voting against the re-election of the Chair and Nomination Committee Chair if: the board consistently fails to move towards the PLSA recommendations of good company behaviour regarding board diversity or shows a lack of effort to do so; or the board fails to move towards the latest FCA diversity and requirements or satisfactorily explain such non-compliance.
  - Investors should vote against the re-election of a director if there is no clear evidence that diversity is being sufficiently considered by the board, or where previously committed timescales are not being met, in the senior board positions.
- **Remuneration:** The PLSA calls on companies to exercise restraint in executive pay given the current economic situation.
- **Climate change:** The PLSA has expanded its list of questions investors should ask when deciding whether to support a particular climate-related resolution.

- **Workforce:** There is a new section setting out the PLSA's expectations in relation to matters such as workplace health (including mental health), wellbeing, modern slavery issues and DEI, specifying the situations where investors should consider voting against the approval of the annual report and accounts or the re-election of a relevant director such as where companies identified as highly exposed to modern slavery risks fail to demonstrate adequate risk management and a willingness to change their approach.

State pension age review

The Government's latest State Pension age review has confirmed that state pension age increases will not be accelerated but that the increase from 67 to 68 will be reviewed again after the next general election.

The state pension age is currently 66. Under existing legislation it will increase to 67 between 2026 and 2028 and to 68 between 2044 and 2046. Statute requires reviews at least every five years.

The Government has confirmed that the legislation under which the state pension age will increase to 67 by 2028 will not be amended. The Government had previously been minded to bring forward the increase to age 68, subject to a further review, but that will not be done at this stage. There will, however, be another review within two years of the beginning of the next Parliament (i.e. following the next general election). The Government still intends to give ten years' notice of any change to those who are affected.

UK EMIR clearing extension

Regulations extend the exemption for certain pension fund derivative transactions from the clearing obligation in UK EMIR. The exemption has been extended by two years, so that it now ends on 18 June 2025.

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