Pensions law group

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Pensions law trustee update

Speed read

Defined benefit (**DB**) and defined contribution (**DC**) considerations

- **New reporting and governance requirements for large occupational schemes?** – The DWP has issued a consultation suggesting climate-related governance and disclosure requirements will be imposed on certain pension schemes. This would require trustees to, amongst other things, identify and assess climate related risks and opportunities on the scheme's investments. *SH comment: The proposed changes will initially affect schemes with assets of £5 billion or more, authorised master trusts and authorised collective money purchase schemes from 1 October 2021. From 1 October 2022, the intention is to include schemes with assets of at least £1 billion. The requirements could be extended more widely to other schemes from 2024. Trustees should therefore have environmental, social and governance (**ESG**) considerations on the radar as this area becomes increasingly more important.*

- **The Pension Regulator's (TPR) scam pledge –** TPR is asking trustees to take steps to protect scheme members from scams by taking the 'scam pledge' and self-certifying that they have done so. *SH comment: In today's economic climate it is likely that TPR will be expecting trustees to address pension scam concerns. Self-certification is a way for trustees to show compliance with TPR's expected standards.*

DB considerations

- **RPI to be aligned with CPIH from February 2030 –** The Retail Prices Index (**RPI**) values will be calculated using the same methods and data sources that are used to calculate the CPIH (the Consumer Prices Index including owner occupiers' housing costs) from February 2030. *SH comment: The extent each scheme is impacted will depend upon the proportion of scheme assets held in index-linked gilts (RPI linked) and whether scheme liabilities are calculated based on RPI or CPI.*

- **TPR guidance on employers in distress** – TPR has issued guidance on the steps it expects DB trustees to take in order to protect members and minimise potential scheme losses that could arise as a result of sponsor distress. *SH comment: There are a number of steps TPR expects trustees to take both before and during times of employer distress.*

- **Guaranteed minimum pensions (GMP) and transfers-out** – The High Court has ruled that where an individual member has taken a statutory transfer of his benefits on an unequalised basis, that member is entitled to a top-up of that payment. *SH comment: The steps trustees need to take depend upon whether their scheme was the receiving or transferring scheme and whether the transfer was a statutory or a non-statutory transfer.*

- **TPR guidance on superfunds** – TPR has set out guidance governing transfers to superfunds. *SH comment: Trustees should be aware of the requirements of the guidance if they are asked to consider a transfer to a superfund.*

DC considerations

- **When does temporary closure of funds create a default arrangement? –** Redirecting scheme contributions from self-selected funds into alternative funds where the original arrangement has been suspended could lead to these alternative funds becoming default arrangements and subject to additional requirements. *SH comment: Trustees should seek advice if they believe this situation has occurred as non-compliance with the requirements may result in TPR imposing fines.*

DB and DC Issues

New reporting and governance requirements for large occupational schemes?

The draft Pension Schemes Bill is currently making its way through Parliament. This Bill contains powers for regulations to be made:

- imposing requirements on scheme trustees with a view to securing effective governance of the scheme with respect to the effects of climate change;
- requiring information relating to the effect of climate change on the scheme to be published; and
- imposing penalties to ensure compliance with the above.

Over the summer the DWP issued a consultation suggesting one use of this regulation making power would be to enable recommendations set out by the Task Force on Climate-related Financial Disclosures (**TCFD**) to be mandated for larger occupational pension schemes, including master trusts and collective money purchase schemes. It will place into pensions law governance and disclosure obligations in line with the recommendations made by TCFD.

Which schemes would the new requirements apply to?

Scheme type	Deadline for governance requirements	Deadline for disclosure requirements
Schemes with £5 billion or more in assets	From 1 October 2021	Earliest of (i) within 7 months of first scheme year to end after 1 October 2021 and (ii) 31 December 2022
Authorised master trusts		
Collective money purchase schemes		
Schemes with £1 billion or more in assets	From 1 October 2022	Earliest of (i) within 7 months of first scheme year to end after 1 October 2022 and (ii) 31 December 2023
Schemes with less than £1 billion in assets	The government will look to review the position in 2024 and consult again before extending the requirements to other schemes	

What will the new governance and disclosure requirements be?

The governance and disclosure obligations largely focus upon trustees assessing and understanding climate-related risks and opportunities to pension scheme assets, liabilities, investments and, where appropriate, funding strategies.

It is proposed that statutory guidance will be produced by the DWP to set out detailed assistance to trustees in meeting the proposed new obligations. In addition to the proposed statutory guidance, trustees are also signposted to the non-statutory draft guidance by the Pensions Climate Risk Industry Group on aligning pension scheme disclosures with the TCFD.

The DWP recognises trustees' concerns that these requirements may lead to increased pressure for divestment of pension schemes from high carbon sectors. It also recognises that the ultimate decision-making on climate change risk and opportunities are matters for trustees alone. The consultation makes clear that it is not for the government to direct trustees to sell or buy certain assets and the proposals do not create any expectation that schemes must divest or invest in a given way.

Full details of the proposed new obligations can be found in the consultation document and also in our ESG brochure, which can be obtained from your usual Stephenson Harwood pensions law group contact.

What are the proposed reporting obligations?

The consultation proposes that the trustees' TCFD report must either be published or signposted in certain places. Discretionary penalties can be imposed by TPR for any failure.

Proposed audience	Reporting obligation
General	The consultation proposes that schemes will have to publish their TCFD report on their website, or the scheme sponsor's website. A link to the report will also have to be provided in the Annual Report and Accounts.
The scheme members	Members must be told in their annual benefit statement where they can locate the TCFD report.
The Pensions Regulator	The web address of where the report is published must be included in the annual scheme return form (as well as the link to their SIP implementation statement and published excerpts of the Chair's statements).

Enforcement

A new penalty regime will be set out in the Pension Schemes Bill 2019 to deal with a failure to comply with the new requirements. This will allow TPR to issue penalty notices to both trustees and third parties. Penalties will be discretionary, unless there has been wholesale non-compliance where no TCFD report has been published at all. This would attract a mandatory penalty of at least £2,500. TPR has discretion to determine the amount of a fine in the case of a discretionary penalty. The maximum penalty for any breach of the requirements would not exceed £5,000 for an individual or £50,000 for a corporate trustee.

ICO guidance on subject access requests

The ICO published detailed guidance on SARs on 21 October 2020. A SAR is a request from an individual for a copy of their personal data. For employers and trustees, SARs can become a time-consuming and expensive exercise; and are often a pre-curser to litigation or complaints.

Under the General Data Protection Regulations, data controllers are required to respond to a SAR "without undue delay and in any event within one month of receipt of the request." Previously, there was no provision to extend that timeframe. Now the clock can be stopped where a data controller (for example the trustee) asks for the data subject (for example the member) to clarify their request. The guidance makes clear that clarification should only be sought if it is genuinely required in order to respond and if large amounts of data are processed about the requesting individual.

The new guidance has also broadened the definition of what constitutes a "manifestly excessive" request. A data controller may refuse to respond to certain requests from individuals if it can demonstrate that they are manifestly unfounded or excessive. Data controllers should base their assessment of a SAR on the proportionality of the request when considering the burden or costs involved against the rights of the requester. Organisations will need to consider whether a request is "clearly or obviously" unreasonable. This will mean taking into account all the circumstances of the request to include the nature of the requested information, the relationship with the requester, available resources, the potential impact of not providing the information and whether the request duplicates a previous request or overlaps with other requests.

The ICO places weight on the word "manifestly" and advises that organisations must have strong justifications for concluding that a request is excessive. This will present a high bar in practice and each case should be decided on its own facts.

The guidance has also been updated to provide what organisations can take into account when charging an administrative fee for a SARs. This will include administrative costs of accessing, locating, retrieving, extracting and copying the information, as well as time taken to communicate the response.

Whilst the new guidance does not change the underlying law, it does provide some useful direction for trustees which should serve to simplify and clarify how to respond to SARs.

TPR scam pledge

TPR is asking trustees, providers and administrators to 'make the pledge' to take steps to protect scheme members from scams.

The requirements for taking the pledge are to commit to:

- regularly warn members about pension scams;
- encourage members asking for cash drawdown to get impartial guidance from The Pensions Advisory Service;
- complete the scams module in the Trustee Toolkit and use resources on the Financial Conduct Authority's ScamSmart website, TPRs scams information and the Pension Scams Industry Group Code of Good Practice in order to understand the warning signs of a scam and best practice for transfers;
- carry out appropriate due diligence on pension transfers by undertaking checks and documenting pension transfer procedures;
- warn members if they insist on high risk transfers being paid; and
- report concerns about a scam to the authorities and communicate this to the member.

Once steps have been taken to implement these principles, trustees can self-certify they have met the pledge. By doing so it will demonstrate to members and the pensions industry that the pledge principles are being followed. TPR will then send the trustees resources that can be used to demonstrate that the trustees are using best practice. In communications with members and the public trustees should, however, make clear that the process is one of self-certification and not certification by TPR.

Given the tough economic climate caused by COVID-19, it is no surprise that TPR is taking a closer look at pension scams. Members may also increasingly be expecting trustees to address this concern. Self-certification is one way trustees can show that they are seeking to comply with the standards expected by TPR.

DB issues

RPI to be aligned with CPIH from February 2030

In March 2020, a consultation was published seeking views on whether the change to the composition of RPI to be aligned with CPIH (the Consumer Prices Index including owner occupiers' housing costs) should be made earlier than 2030 (when the last relevant index-linked gilts mature) and if so, when. The response to the consultation was published on 25 November 2020.

For more information on the background to this change, please ask your usual Stephenson Harwood pensions law team member for a copy of our briefing on this topic.

What will change?

From the implementation date (please see below), RPI index values will be calculated using the same methods and data sources that are used to calculate the CPIH. The consultation document provides that, based on recent experience, RPI is likely to be lower by an average of 1% per annum, although depending on the economic climate this will not always be the case; the change could be positive or negative from time to time. The RPI and CPIH will continue to be calculated and published as separate indices.

When will it change?

In order to minimise the impact of the proposals on the holders if index-linked gilts, the Chancellor has stated that he will not consent to the composition of RPI being aligned with CPIH until the final index linked gilt has matured in 2030. After this time, the Chancellor's consent will no longer be required. The UK Statistics Authority has therefore confirmed it will align RPI with CPIH with in **February 2030.**

Impact for pension schemes

Defined benefit pension schemes will be the main pension schemes affected by this change. The extent each scheme is impacted will depend upon the proportion of scheme assets held in index-linked gilts (RPI linked) and whether scheme liabilities are calculated based on RPI or CPI (for example for revaluations and indexation).

"... the extent to which a DB pensions scheme will be impacted by reform will depend on the extent to which it is hedged and the nature of its liabilities " A Response to the Consultation on the Reform to Retail Prices Index Methodology 25 November 2020

Schemes that are perfectly hedged may not be impacted as the total value of the RPI linked liabilities may fall in line with the reduction in the value of the scheme assets. However, a large number of responses to the consultation were from pension schemes that had CPI linked liabilities but RPI linked assets. For these schemes, their funding position will be negatively affected as the value of their assets will fall while the level of their liabilities will not change. The Government has confirmed that it will not be providing compensation to the holders of index-linked gilts (including pension schemes).

It will also be interesting to see if this change leads to a reduction of court cases where employers whose pension scheme rules seemingly hard-code RPI as the measure of inflation for revaluation and indexation have sought to use CPI instead. If from 2030 RPI will generally produce a lower level of inflation than it has in the past, employers may consider that it is not worth the time and cost of attempting to change the newly reformed RPI to CPI.

TPR guidance on employers in distress

In response to the impact of COVID-19 on the UK economy, TPR has issued guidance designed to help trustees of DB schemes protect their schemes from sponsoring employer distress. TPR observes that when a sponsor experiences financial distress, the resulting actions taken by the sponsor can lead to significant pension scheme losses. TPR therefore expects DB trustees to protect savers and minimise potential scheme losses by adopting risk-based principles on an ongoing basis in order to identify risks earlier and act sooner.

The guidance can be broken down into three key areas:

1. Preventing – a best practice integrated risk management (**IRM**) approach

The guidance highlights that taking action before a sponsor shows signs of distress increases the chances of mitigating downside risk in the future. In particular, it can help secure a positive scheme outcome before other stakeholders compete for value alongside the scheme, at which point options may be significantly reduced. To this end, trustees should already be taking a number of preventative actions as part of a robust IRM plan designed to reduce the risk of potential scheme losses due to an employer restructuring, refinancing or insolvency. For example:

- understand the sponsor's legal obligations to the scheme and possible outcomes for the scheme in a hypothetical insolvency scenario;
- ensure effective risk management processes are in place with legally enforceable and workable contingency plans;
- monitor the covenant on an ongoing basis, providing an opportunity to regularly engage with management and understand key covenant risks; and
- seek appropriate advice which can highlight options or problems that may not be obvious and, in doing so, save money in the longer run.

2. Identifying – spotting signs of sponsor distress

The guidance states:

> *"As a trustee, you are the first line of defence for savers and their pension schemes, and it is vital that you remain alert, prepare, plan and are ready to act as the economic impact of global events develop."*

It is therefore incumbent on trustees to spot the warning signs of sponsor distress. These signs may vary according to the nature of the sponsor's business and the industry in which it operates. Nevertheless, key warning signs may include:

- cash flow constraints;
- credit downgrades;
- removal of trade credit insurance;
- disposal of profitable business units; and
- loss of a key customer contract.

3. Responding – options for protecting members' benefits from sponsor distress

The guidance sets out a number of actions trustees can take if they spot the warning signs, including:

- increase the frequency of covenant monitoring – don't wait for formal confirmation of a covenant downgrade at the next valuation before taking action;
- review the scheme's position in distress scenarios – understand the potential returns to the scheme and the position/role of other creditors in an insolvency situation;
- review the scheme's investment strategy – sponsor insolvency can crystallise short-term investment losses, but various mitigating actions can be taken;
- carefully consider sponsor requests for scheme easements – these may include deferring deficit repair contributions or releasing scheme security;
- obtain sponsor information – information requests to the sponsor should, if possible, be aligned with the information that management is producing in response to the distress;
- monitor transaction activity – corporate transactions triggered by distress could cause material detriment to the scheme, e.g. injection of additional debt into sponsor; and
- communicate with members – the distress could be in the public domain and so it is important to make members aware of the protections in place and steps being taken by the trustees.

This guidance highlights that there are a multitude of issues for DB scheme trustees to consider where the scheme sponsor is facing financial difficulties. However, trustees are unlikely to possess all the skills and know-how needed to give each of these issues due consideration. This means they will almost certainly need to seek specialist professional advice in order to effectively deal with potential or actual sponsor distress in line with TPR's expectations.

GMP equalisation and transfers-out

The long-awaited conclusion to the GMP equalisation litigation, concerning the Lloyds Banking Group's DB scheme, was handed down on Friday, 20 November 2020. It comes two years after Morgan J's first judgement in this case, which determined that DB schemes were obliged to equalise scheme members' GMPs (***Lloyds I***). In the *Lloyds I* judgment, Morgan J left the question of whether historically transferred-out members were entitled, under the cash equivalent transfer value (**CETV**) regulations, to have their transfer payments topped up where those payments had not been equalised at the point of transfer.

The High Court ruled that where an individual member has transferred out of a scheme with an unequalised CETV, that member is entitled to a top-up of that payment. In other words, transferring scheme trustees are legally responsible for equalising the GMPs of members who took a statutory transfer out of their DB pension scheme.

This ruling affects all GMPs accrued between 17 May 1990 and 5 April 1997 and, unlike in *Lloyds I*, there is no time limit. This means that trustees will not be able to rely on any scheme forfeiture rules or the terms of the Limitation Act 1980 and there is no time limit for transferred out members to seek a top up of their CETVs.

What must trustees do now?

The implication of the judgment for trustees will depend upon whether the pension scheme was a transferring or a receiving scheme and whether the transfer was a statutory transfer under the CETV legislation, or a non-statutory transfer. Where trustees do have an obligation to top up a member's payment, our view is that whilst trustees have an obligation to pay benefits in full, their actions do not need to be disproportionate in cases where the uplift is minor in comparison to the effort and costs involved. What will be disproportionate for these purposes will depend upon the circumstances of each case.

<u>Trustees of transferring schemes involving a statutory transfer out</u>

Trustees of DB schemes with GMP components should already be working to equalise GMPs between male and female scheme members. However, following this judgment, trustees and their advisers must now look further to equalise CETVs that have been previously been paid from their scheme.

<u>Trustees of schemes involving a bulk-transfer</u>

Morgan J found that, in circumstances where a scheme received a bulk transfer, the transferring scheme trustees are discharged because the obligation to equalise (by topping up scheme benefits) rests with the receiving scheme. As a result, trustees of receiving schemes may need to undertake a wider GMP equalisation effort than first thought under the *Lloyds I* ruling.

<u>Non-statutory transfers out</u>

In the case of individual transfers made under relevant scheme rules (as opposed to under the CETV legislation) and where those rules provide for a discharge (assuming that the discharge would be otherwise effective), a transferring member no longer has rights under the transferring scheme. This is the case unless the court sets aside the exercise of the transfer power and the transferring member can require the trustees to exercise the power again. In order to do this, the member would need a court to find that the trustees were in breach of duty when they exercised their power. A breach of duty may be found, for example, if the trustees failed to "adequately deliberate". This will be a fact-specific exercise, dictated by specific scheme rules and based upon the circumstances at the time the scheme trustees made their decision.

Further detail on the judgment can be found in our briefing on the case.

TPR guidance on superfunds

Superfunds are coming and TPR has issued its own guidance to regulate this area whilst we await a formal legislative regime.

Transferring to a defined benefit superfund is one of a number of ways of de-risking a defined benefit pension scheme. It allows an employer, with the consent of the trustees, to transfer their defined benefit pension scheme to a third-party superfund provider.

Which schemes can transfer to a superfund?

Before any transfer can occur, the employer of the transferring scheme will have to receive clearance from TPR. Clearance will not be forthcoming unless the following 'gateway' principles are satisfied:

1. <u>The existing pension scheme cannot afford to buy out now</u>

   TPR's guidance provides that this should be based on the scheme actuary's estimated buy-out funding level at a date no more than one month before the date of the clearance application.

2. <u>The existing pension scheme has no realistic prospect of buy-out in the foreseeable future given potential employer cash contributions and the insolvency risk of the employer</u>

   TPR states that this would usually mean that the scheme has no realistic prospect of buying-out within 5 years.

3. <u>A transfer to the chosen superfund must improve the likelihood of members receiving full benefits.</u>

Trustees will need to compare the likelihood of members receiving full benefits in the superfund with the likelihood of members receiving full benefits if the scheme remains with the employer.

These gateway principles make clear that a transfer to a superfund will not be available to all schemes; in particular those for who a buy-out is within reach.

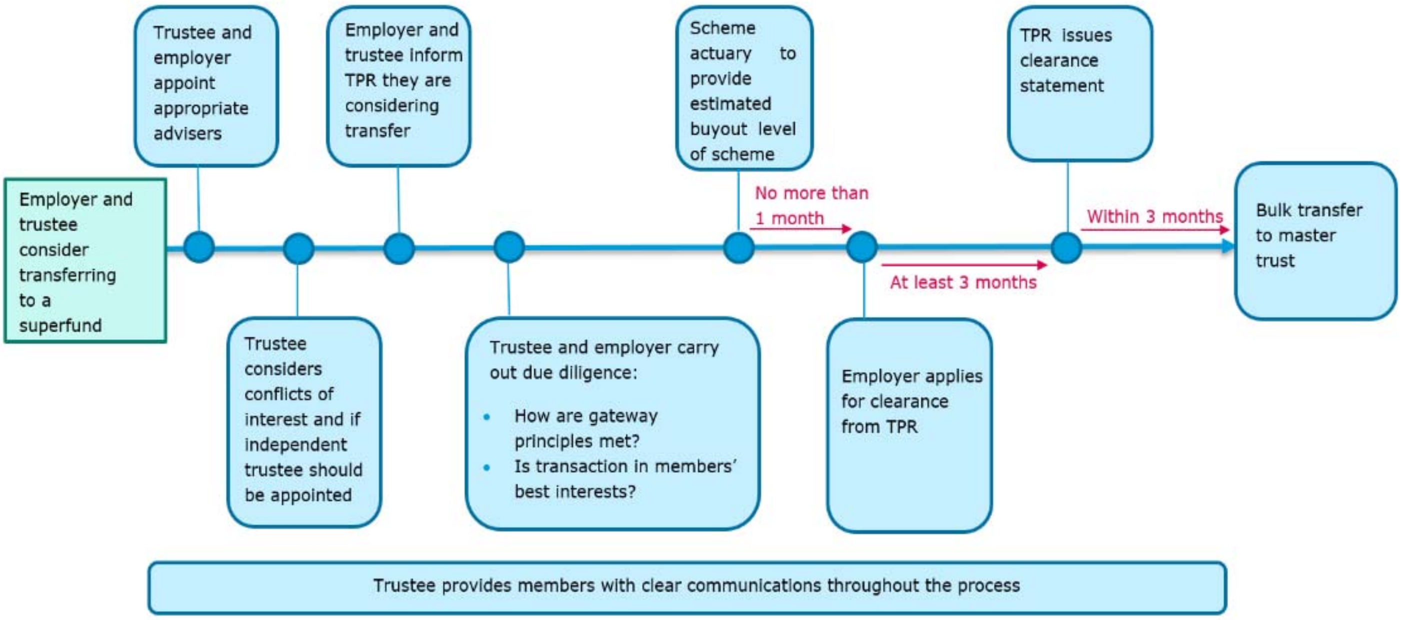
The role of the trustee

In its guidance TPR sets out the steps it expects trustees and employers to take in reaching the decision of whether the gateway principles have been met. A transfer should only occur if it would be in the best interests of the members.

Further details of these and the process more generally can be found in our superfund brochure which can be obtained from your usual Stephenson Harwood pensions law group contact.

Moving to a superfund – an overview of the process

TPR's guidance sets out the process for a transfer to a superfund which are summarised in the diagram below.



DC issues

When does temporary closure of funds create a default arrangement?

As part of its guidance for trustees of DC schemes to follow during the Covid-19 crisis, TPR has considered the situation where DC scheme trustees are redirecting scheme contributions from self-selected funds into alternative funds where the original arrangement has been temporarily frozen. This could lead to these alternative funds actually becoming default arrangements and therefore subject to the additional requirements applying to a default fund. The TPR guidance notes that the only circumstances where a default arrangement would **not** be created are as follows:

- members were made aware, before they selected the original fund, that contributions could be diverted to another fund in certain situations and agreed to this when choosing the original fund; and

- the trustees contacted the members before diverting contributions and obtained their consent.

Where contributions are to be re-directed back to the original fund, consideration needs to be given to whether a pre-existing expression of choice still applies. Where contributions are directed back to the original fund without the consent of the member, the original fund will become the default fund. TPR would expect a member's consent form to still apply where the members have either:

- consented to the redirection of the contributions on a temporary basis, until the original fund ceases to be gated; or

- been informed by the trustees that their contributions are being diverted into a default fund but that this will be corrected as soon as the original fund reopens

Care should be taken that a default arrangement is not created inadvertently particularly as, whilst TPR notes it will take a pragmatic approach in deciding whether to take action in certain circumstances, in the case of chair's statements it has no discretion in using its powers and will continue to impose fines for non-compliance.

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