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Current issues

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Articles this month:

Encouraging DC consolidation & investment in illiquid assets

The Department for Work and Pensions (DWP) has put forward for consultation measures intended to foster consolidation of under-performing defined contribution (DC) occupational pension schemes, and promote greater diversification of investment portfolios.[1] The plans include new disclosure obligations concerning investment returns and, for smaller schemes, expanded 'value for members' (VfM) assessments.

Background

In February 2019 the DWP published a consultation document that discussed the opportunities available from and obstacles in the way of investment in illiquid assets.[2] It also proposed a way to encourage the trustees of smaller schemes to consider whether consolidation into a larger scheme would serve their members' interests. The consultation period ended in April 2019.

Proposed legislation

Having considered the views expressed, the DWP has now circulated draft Regulations, which would make the following changes:

- *annual governance ('Chair's') statements—*
    - all 'relevant schemes' (broadly, DC schemes used for automatic enrolment compliance) would be required to provide information about the investment returns, net of charges and transaction costs, for their default arrangement and any member-selected funds;
    - schemes that have operated for three or more years and have assets of less than £100m would have to expand their assessments of the extent to which they provide good value for members so as to consider how their charges and transaction costs, and their net returns on investments, compare with those of at

[1] <www.gov.uk/government/consultations/improving-outcomes-for-members-of-defined-contribution-pension-schemes>.
[2] <assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/776181/consultation-investment-innovation-and-future-consolidation.pdf>.

    least three other schemes (either larger occupational schemes or personal pension schemes—not SIPPs—at least one of which would be a realistic potential transfer destination in the event of a wind-up), as well as how various administrative and governance criteria are being met;
  - charge and cost reporting would be extended to funds that were previously available for selection, provided some members are actually invested in them;
- *registrable information (gathered via scheme returns to the Pensions Regulator)*—
  - all schemes (defined benefit included, although it is unclear whether that is intentional) would have to report the value of their assets at the most recent scheme year-end;
  - schemes that have operated for three or more years and had assets of less than £100m at year-end would have to report the conclusions of their expanded VfM assessments (for the most recent scheme year and, if available, the previous one), and if the result of the latest assessment was negative they would have to state whether they propose to wind up and if not how they plan to improve their VfM;
- *investment*—
  - default investment arrangements subject to promise (e.g. with-profits) would need a statement of investment principles (SIP);
- *disclosure*—
  - the list of information to be extracted from the Chair's statement and published online would be expanded to cover the new requirements about net investment returns and VfM assessments for smaller schemes;
- *charges restrictions*—
  - the definition of 'charges' would be revised so that it does not include costs solely attributable to holding physical assets (this would cover things like the costs of management, maintenance, valuation, insurance, ground rents, rates and taxes on assets such as land, buildings, vehicles, and commodities);
  - where the charge cap associated with a single-charge structure requires to be pro-rated for part-year memberships, the trustees would be able to exclude any performance fees if they are assessed and deducted each time the member's investment value is calculated.

The intention is that the changes would come into force, broadly speaking, on 5 October 2021; the precise deadlines for compliance would vary from one change to the next depending on details such as the individual scheme's year-end date.

On the subject of accommodating performance fees within the charge cap, the consultation document also asks for respondents' thoughts on how best to construct a mechanism that will facilitate investment in assets for which performance is determined over multiple years. The use of a five-year rolling period has been suggested.

The DWP says that it has abandoned (for now) its proposals to require trustees to set out their policies on investment in illiquid assets in their SIPs, and to report on matter in their annual implementation statements.

Statutory guidance

The DWP is planning to revise its guidance on the production and presentation of illustrations of the compounding effects of costs and charges.[3] It would also provide additional statutory guidance covering the proposed new requirements for the disclosure of net returns and the expanded VfM assessment for smaller schemes. Draft versions of the guidance documents are included in the consultation package.

[3] *Reporting of Costs, Charges and Other Information: Guidance for Trustees and Managers of Relevant Occupational Schemes*.

Consultation arrangements

Formal responses to the latest set of proposals can be submitted until 30 October 2020.

The introduction of wider and more onerous 'value for members' obligations, backed by a 'comply or explain—or wind up' regulatory reporting requirement would make it much harder for many smaller schemes to continue as they are at present.

Mandatory climate-risk governance & reporting for large schemes

The Department for Work and Pensions (DWP) proposes that large occupational pension schemes be required to assess their exposure to climate-change risk, and publish their findings, in line with the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD).[4] It is planning to introduce the obligations gradually, so that schemes with £5bn or more in assets would be affected from 1 October 2021. It will consider extending the requirements to schemes with assets below £1bn at a later date.

Background

TCFD recommendations

The TCFD was established at the behest of the G20 international forum to develop a framework for climate-related financial risk disclosures that could be used by companies when providing information to the financial markets. It published recommendations in 2017.[5] They cover areas such as disclosure of governance activities and strategy, including how climate-related risks and opportunities are identified, assessed, measured and managed, as well as assessment of the actual and potential impacts if climate change on organizations. The TCFD said that asset owners like pension schemes should also implement the recommendations, providing climate-related financial information to their beneficiaries so that they could understand the performance of and risks associated with their investments and make more-informed choices; they should also engage with asset managers and organizations in which they invest to encourage them to adopt the recommendations.

Primary legislation

The *Pension Schemes Bill 2019/21*, which is set to be considered by the House of Commons after the summer recess, would allow the DWP to lay regulations aimed at ensuring effective governance of occupational pension schemes with respect to the effects of climate change, and to require their trustees or managers to publish related information. The current consultation exercise reveals what the Department intends to do with those powers. Draft regulations should follow in 2021.

Proposals

The DWP plans to oblige the trustees or managers of schemes with assets of £1bn or more, and all authorized master trusts and collective money purchase (CMP) schemes, to undertake various activities in accordance with the TCFD recommendations. For example, they would:

- need to embed processes for identifying and managing climate-related risks and opportunities within their risk-management activities, and satisfy themselves that those others involved in running the scheme are doing likewise;
- have to assess , in so far as they are able, the resilience of their investment and (in the case of DB schemes) funding strategies to the unfolding of at least two climate scenarios, one of which must assume that average warming is successfully limited to 2°C or less; and

[4] *Taking action on climate risk: improving governance and reporting by occupational pension schemes* (August 2020) <assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/911894/tcfd-taking-action-on-climate-risk.pdf>.
[5] <www.fsb-tcfd.org/publications>.

- be required to choose at least one measure based on greenhouse gas emissions and one non-emissions-based metric by which to assess their asset portfolios, use at least one of the measures to set targets, and calculate performance against those targets at least quarterly.

They would also be expected to publish details of their arrangements and findings in an annual TFCD report produced in conjunction with their annual report and accounts. The annual report and accounts would have to contain a link to the website on which the TFCD report is published, and members would be informed about its availability in annual benefit statements. The Pensions Regulator would be provided with the online address for the TFCD report (as well as the scheme's statement of investment principles and any required excerpts from Chair's statements) via scheme returns.

The proposed climate-risk regulations would be backed up with statutory guidance. Trustees would be obliged to take the guidance into account, but could deviate from it provided they can justify their actions.

Phased introduction

The DWP proposes to adopt a phased approach to implementation of the changes. They would apply initially to trustees of schemes that have (or had) net assets of at least £5bn on their first year-end falling on or after 1 June 2020, as well as to all authorized master trusts and collective money purchase schemes. Those trustees would have to comply with the governance requirements from 1 October 2021, and publish their first TCFD report within seven months of the end of the scheme year, or by 31 December 2022, if earlier.

The second phase would see the requirements extended to schemes that are found to have £1bn in net assets on their first year-end falling on or after 1 June 2021. The new governance rules would begin to apply to the trustees on 1 October 2022, and they would be expected to publish their initial TCFD report by the date seven months from the end of their scheme year, or by 31 December 2023 if earlier.

From 1 June 2022 onward the requirements would capture any scheme newly found to have net assets of £1bn or more at its year-end. The trustees would be given one year (i.e. the whole of the following scheme year) to prepare for the onset of the climate-governance obligations. They would then have to publish their first TCFD report within seven months of the end of the scheme year in which the obligations first applied. The governance requirements would cease to apply if net assets are found to have fallen below £500m at a subsequent year-end (although a TCFD report for that scheme year would still have to be published, with the usual seven-month deadline).

The DWP proposes to take stock of the changes in 2024, at which point it will consider the possibility of extending the obligations to smaller schemes.

Enforcement

Complete failure to produce a TCFD report by the statutory deadline would result in a mandatory fine of at least £2,500. Fines for less-serious failures would be at the discretion of the Pensions Regulator. In general, fines would be subject to a maximum of £5,000 for individuals and £50,000 for other entities.

Next steps

Those who wish to respond to the consultation proposals should do so by 7 October 2020.

The DWP has also signalled its intention to consult in the near future on mandatory public reporting on the extent of pension schemes' alignment with the Paris Agreement, in which countries committed to keeping the industrial-era increase in the global average temperature below 2°C, and to pursue efforts to limit it to 1.5°C. The DWP's focus is on the 'implied temperature rise' (ITR) of investment portfolios—also known as 'portfolio warming'—being the likely global average temperature rise, above pre-industrial levels, with which an asset owner's holdings are consistent. However, it recognizes that development of methods of measuring portfolio alignment is a work in progress.

As noted above, the Government plans to review the effectiveness of the changes, and their possible extension to all schemes, in 2024.

For more details of how the TCFD recommendations would be translated for occupational pension schemes, please see our recent Briefing Note on the consultation proposals.[6]

The Government's focus on climate risk is welcome. We are particularly encouraged that the consultation proposals would go further than mere disclosure to the underlying actions that trustees would be expected to take in developing their approaches. Looking beyond the risks associated with climate change to the potential opportunities to influence or create change must become a part of asset owners' mindset.

The proposals would mean that some trustees must report within relatively short time frames; they should therefore familiarize themselves with the likely new requirements as soon as possible and work closely with their advisers to ensure that they are ready for TCFD reporting.

Scheme Funding Analysis 2020

The Pensions Regulator has published an analysis of the funding positions of schemes with valuation dates between 22 September 2017 and 21 September 2018 (known as 'Tranche 13').[7] The main finding is that the increase in assets over the period exceeded the increase in liabilities, resulting in an improvement in the average funding level (37 per cent of schemes reported a surplus on the technical provisions basis[8]).

Other findings include:

- the average funding level on a technical provisions basis was 93.4 per cent;
- the mean recovery plan length was 6.1 years, with the median recovery plan length being 5.2 years; and
- the average deficit reduction contribution from Tranche 13 schemes was 2.2. per cent of technical provision liabilities (the same as for the valuations three years ago in Tranche 10).

It should be noted that the analysis does not take into account the effects that the COVID-19 pandemic will have had on scheme funding.

Call for Evidence on DB auto-enrolment standard

The Department for Work and Pensions (DWP) has issued its triennial call for evidence, as required by legislation, about the suitability of the alternative quality requirements for defined benefit (DB) and hybrid schemes that are used for automatic enrolment (AE).[9]

To be used for AE, a DB scheme must meet the '*test scheme standard*' or satisfy one of two alternative quality requirements: a 'cost of accruals' test or, for DB schemes that display money purchase characteristics, the money purchase quality requirements.

The DWP is, in particular, inviting respondents to provide examples of any issues that they have faced in satisfying the 'cost of accruals' test where some members have opted to make contributions below the qualifying rate. The potential problem was highlighted during the previous (2017) review of the alternative requirements: members who remain in the scheme but have chosen to pay lower contributions cannot be excluded from the cost-of-accruals assessment, creating the risk that the scheme could fail the test. The DWP decided not to address it in 2017, as it wanted to avoid adding

[6] *Climate risk: Taskforce on Climate-related Financial Disclosures reporting to become mandatory for larger pension schemes* (August 2020) <www.hymans.co.uk/media/uploads/Briefing_note_-_Taskforce_on_Climate-related_Financial_Disclosures_reporting_to_become_mandatory_for_larger_scheme.pdf>.
[7] <www.thepensionsregulator.gov.uk/en/document-library/research-and-analysis/scheme-funding-analysis-2020>.
[8] A scheme's technical provisions are the amounts, as calculated by the actuary, required to meet its accrued benefit liabilities.
[9] <www.gov.uk/government/consultations/automatic-enrolment-alternative-quality-requirements-for-defined-benefit-and-hybrid-schemes-being-used-as-a-workplace-pension/automatic-enrolment-alternative-quality-requirements-for-defined-benefit-and-hybrid-schemes-being-used-as-a-workplace-pension>.

complexity to requirements that seemed to be working well for most schemes; but it is interested in whether the problem remains.

The call for evidence ends on 21 October 2020.

Planned consultation on unified Code of Practice

The Pensions Regulator has updated its July statement about its intention to produce a streamlined, single of Code of Practice.[10] It now says that it is planning to consult formally '*in late 2020 or early 2021*', but will '*engage with stakeholders*' beforehand on the proposed design and content.

Viral news—September 2020

The Pensions Regulator has updated its COVID-19 guidance, signalling an end to the pandemic-related easements to schemes' reporting obligations.[11]

Trustees of defined contribution (DC) schemes are asked to resume reporting late contribution payments once they are 90 (not 150) days past their due dates, with effect from 1 January 2021. However, to allow them time to (re-)adjust, this return to the pre-coronavirus, 90-day reporting standard will not be made compulsory until 1 April 2021.

Enforcement of other requirements, such as those relating to audited accounts and SIP (statement of investment principles) reviews, returned to normal from 1 October 2020. The Regulator has also recommenced reviewing Chairs' statements submitted on and after that date (statements submitted before then were being returned unread).

The Regulator's emergency guidance for trustees of defined benefit schemes who are asked to consider sponsor requests for a reduction or suspension of deficit recovery contributions remains unchanged for now, but will continue to be reviewed in line with developments.

HMRC newsletters—September 2020

Pensions Schemes Newsletter 124 contains an update on some of the temporary process changes that were instituted due to the pandemic (in summary, HMRC is extending them until 31 March 2021), reminders for providers operating relief at source, and some notices related to the Managing Pension Schemes [online] service (including a reminder that HMRC will soon begin deleting log-in credentials once users of online tax services have been inactive for three years).[12]

[10] <www.thepensionsregulator.gov.uk/en/document-library/statements/single-code-of-practice-statement>.

[11] PN20-25, *TPR updates COVID-19 guidance* <www.thepensionsregulator.gov.uk/en/media-hub/press-releases/2020-press-releases/tpr-updates-covid-19-guidance>; *COVID-19: an update on reporting duties and enforcement activity* <https://www.thepensionsregulator.gov.uk/en/covid-19-coronavirus-what-you-need-to-consider/covid-19-an-update-on-reporting-duties-and-enforcement-activity>.

[12] <www.gov.uk/government/publications/pension-schemes-newsletter-124-september-2020/pension-schemes-newsletter-124-september-2020>.

And finally…

Sometimes a question just raises more questions. Take for instance this Freedom of Information Request in which the correspondent asks the Regulator for details of

> '*The number of times a pension administrator unknowingly employed a member of an organized crime group... broken down by year i.e. 2017, 2018, 2019, 2020.*'[13]

AF asked a couple of third-party administrators of our acquaintance, Dawn Corleone and Luke A. Brazzi, if that had ever been a problem that they'd encountered.

Dawn said she couldn't comment because of a '*code of silence*' (which *AF* took to be an idiosyncratic reference to the GDPR) and seemed mildly peeved that '*this is the first time you've come to me for counsel or for help*'. At least, we *think* that's what she said: she seemed to have balls of cotton wool stuffed into her cheeks and was consequently a bit difficult to understand. She also mentioned that *AF* had previously never even offered her so much as a cup of coffee even though her wife was godmother to our only child. Which struck us as an odd thing to say—not least because *AF* had *two* kids when last we checked. We did feel a bit guilty about the coffee, though, so bought her a venti caramel macchiato, which she eyed rather disdainfully.

Luke initially appeared more open to having a conversation on the subject, but sadly went AWOL almost immediately after our meeting, leaving behind only a cardigan wrapped round a Waitrose salmon fillet...

[13] <www.thepensionsregulator.gov.uk/en/about-us/freedom-of-information-(foi)/recently-released-information/unknowing-employment-of-members-of-an-organised-crime-group>.