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Current issues

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Articles this month:

Improving DC outcomes

The Department for Work and Pensions (DWP) announced the outcomes of two consultation exercises: *Improving outcomes for members of defined contribution pension schemes* (which ran from September to October 2020), and *Incorporating performance fees within the charge cap* (which ran from March to April 2021).[1] The necessary legislation was laid before Parliament for its approval, and guidance on the changes has been published.

Changes to legislation

The draft *Occupational Pension Schemes (Administration, Investment, Charges and Governance) (Amendment) Regulations 2021*[2] will (assuming they obtain Parliament's approval)—

- require the trustees of defined contribution (DC) schemes to report net returns on investments in their annual governance ('Chairs'') statements;
- as part of their value-for-members (VfM) assessments (also a feature of Chairs' statements), require trustees of schemes with assets of less than £100m to compare their charges and transaction costs and the return on investments with those of three other schemes, and assess how they are meeting certain administration and governance criteria;
- extend the list of registrable information provided to the Regulator via annual scheme returns so as to require trustees of all schemes to report the value of scheme assets, and trustees of small (<£100m) DC schemes to disclose the outcome of their enhanced VfM assessments (as summarized in the preceding bullet point)—where their assessment was negative they will need to say whether they propose to transfer members out and wind up, and if not, why not;
- require that transaction costs are taken into account as well as charges when trustees' review the return on their default arrangement(s), as is required under the investment legislation;
- require the preparation of statements of investment principles (SIPs) in respect of default arrangements that carry a third-party benefit promise (this might be the case where a scheme offers a with-profits fund as a default arrangement);
- extend the exemptions from the SIP requirements that apply to wholly-insured schemes so that the trustees do not have to detail their policies on arrangements with asset managers;

[1] <assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/995066/response-improving-outcomes-for-members-of-dc-pension-schemes.pdf>.
[2] <www.legislation.gov.uk/ukdsi/2021/9780348224788>.

- exclude costs solely attributable to holding physical assets from the charges that are subject to the default arrangement charge cap;
- require trustees to ignore, when pro-rating a charge under a single-charge structure for the purposes of the cap (for example when a member joined or left the scheme part-way through the charges year) any performance fee that falls to be calculated and deducted from the investment value whenever units are bought or sold; and
- allow trustees to smooth performance fees over a multi-year period (up to five years) when assessing compliance with the charge cap.

The changes are set to come into force on 1 October 2021, but there are specific timing provisions in some cases. For example, the first enhanced VfM assessment for small schemes will be required for the first scheme year ending after 31 December 2021. The inclusion of net-return information in Chair's statements and reporting of asset values via scheme returns will apply in respect of the first year-end falling after 1 October 2021. The requirement for default SIPs in respect of funds with a benefit promise will apply from the later of (i) 1 April 2022, and (ii) three months after the first year-end falling after 1 October 2021.

The consultation outcome document confirms that hybrid schemes with total (i.e. DB + DC) assets below £100m will be within the scope of the enhanced value-for-members assessment, but that only the DC section will be subject to the assessment.

Guidance

The DWP has revised its guidance on *Reporting of Costs, Charges and Other Information*[3] in light of the changes, and published new guidance on *Completing the Annual Value for Members Assessment and Reporting of Net Investment* Returns[4]. Both documents are 'statutory' in the sense that trustees must take the applicable guidance into account when seeking to satisfy the relevant legal obligation. They are effective from 1 October 2021.

Call for evidence on the merits of wider consolidation

The DWP has also issued a call for evidence about the barriers to further consolidation of occupational trust-based DC schemes.[5] It asks for views on how the Government might extend the nudge toward consolidation to cover schemes with up to £5 billion in assets. The call for evidence remains open until 29 July 2021 (or perhaps 30 July 2021: at the time of writing the closing date given at the top of the webpage for the call for evidence was at odds with the date specified in the linked documents).

Activating the Regulator's new powers

The Department for Work and Pensions (DWP) has laid two sets of Regulations before Parliament under new powers contained in the *Pension Schemes Act 2021*. They are concerned, respectively, with a new test for the imposition of contribution notices, and with beefing up the Pensions Regulator's information-gathering powers. Both statutory instruments have been re-titled since they were published for consultation purposes.

Employer resources

The Act will add two new routes that the Regulator can follow in order to issue contribution notices.[6] The '*employer insolvency test*' will be available (in broad terms) if an act or omission materially reduces the amount of the 'section 75' employer debt that could (hypothetically) be recovered from the sponsoring employer. The '*employer resources test*' will apply if the act or failure to act reduces the value of those resources by an amount that is material relative to the estimated section 75 debt.

The *Pensions Regulator (Employer Resources Test) Regulations 2021* (known as the *Pensions Regulator (Contribution Notices) (Amendment) Regulations 2021* during the consultation exercise) have been laid before Parliament for approval,

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[3] <assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/994605/reporting-of-costs-charges-and-other-information-guidance-for-trustees-and-managers-october-2021.pdf>.

[4] <assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/994897/completing-the-annual-value-for-members-assessment-and-reporting-of-net-investment-returns.pdf>.

[5] *Future of the Defined Contribution Pension Market: The Case for Greater Consolidation*, <www.gov.uk/government/consultations/future-of-the-defined-contribution-pension-market-the-case-for-greater-consolidation>.

[6] A contribution notice obliges its recipient—the sponsoring employer or a person or company connected to it—to pay all or part of the estimated buy-out deficit to the scheme trustees (or the Pension Protection Fund, where appropriate), because of its involvement in certain acts or omissions.

and are set to come into force on 1 October 2021. They specify how a sponsoring employer's resources, and the effects of corporate activity thereon, will be quantified for the purposes of the new employer resources test.

In summary, the Government has confirmed that profits before tax will be the relevant measure of the scheme sponsor's resources. Some tweaks have been made to the original proposals (in addition to the name change). For example, the final Regulations cater for the existence of charities and other organizations that are not trading for profit, by reading references to *'profits*' as meaning '*net income*' in relevant cases.

In related news, the Regulator published a consultation draft of changes that it proposes to make to its *Code of Practice No. 12*, which provides guidance on the tests for contribution notices, to incorporate the new measures.[7] The consultation period ends on 7 July 2021, and the Code should be in force in time for the coming into force of the legislation, on 1 October 2021.

Info gathering

The *Pensions Regulator (Information Gathering Powers and Modification) Regulations 2021* specify the mandatory contents of the notice that the Regulator will be able to give, under powers to be introduced by the Act, to oblige a person of interest to submit to an interview.[8] They also set out the fixed and escalating penalties that will apply on failure to comply with the Regulator's various information-gathering powers (including those interview notices). The Regulations come into force on 1 October 2021.

For the purposes of the related consultation exercise, which ran from 18 March to 29 April 2021, the Regulations were called the *Pensions Regulator (Information Gathering Powers and Miscellaneous Amendments) Regulations 2021*.

Governance and reporting of climate change risk

The Department for Work and Pensions has published final Regulations and related statutory guidance on mandatory Task-force on Climate-related Financial Disclosures (TCFD) governance and reporting for occupational pension schemes, alongside a response to its second consultation exercise.[9]. It has made a small number of changes to the broad regulatory requirements, to provide simplification or clarification of the policy intent.

As noted within the consultation response, these measures will see the UK become the first G7 country in which trustees of pension schemes are required by law to consider, assess and report on the financial risks of climate change within their portfolios. The Regulations sit within the wider context of the UK Government writing the world's most ambitious climate-change target into law, with the goal of reducing emissions by 78 per cent by 2035, by reference to 1990 levels; and also form part of the Government's private finance strategy ahead of the COP26 meeting that will be held in Glasgow in November 2021. The Government expects that TCFD-aligned disclosures will become mandatory across the economy by 2025, and to have a significant proportion of the requirements in place by 2023.

What changed as a result of the second consultation?

- The definition of bulk annuity contacts has been clarified in that it does not, for example, require exact matching to benefit payments. Annuity contracts are excluded from the calculation of assets for determining whether a scheme is subject to the regulations, but should be included in scenario analysis;
- Where requirements only apply for part of a scheme year, reporting only needs to cover that part of the scheme year;
- Expectations around education have been clarified – trustees need to have sufficient knowledge and understanding to assess both opportunities and risk.
- Trustees need to have processes in place to ensure that persons undertaking governance activity for the scheme take adequate steps to identity, assess and manage climate related risks and opportunities. They must also ensure that processes in place are integrated into their overall risk management of the scheme;

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[7] <www.thepensionsregulator.gov.uk/en/document-library/consultations/code-of-practice-12-consultation>.
[8] SI 2021 No. 754.
[9] <www.gov.uk/government/consultations/taking-action-on-climate-risk-improving-governance-and-reporting-by-occupational-pension-schemes-response-and-consultation-on-regulations> and <assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/995679/statutory-guidance-final.pdf>.

- Scenario analysis must be undertaken in the first year the regulations apply, but can be undertaken before the date that the regulations apply – the same applies to the calculation of metrics. Once undertaken, scenario analysis must be repeated at least every three years;
- Scope 3 emissions data does not need to be collected in the first year of the requirements, but applies from the second year onwards; and
- Target setting must take place during the first year that the regulations apply, not at the start of the period, and performance must be measured within each scheme year.

'As far as they are able'

The response and accompanying guidance provides further detail on actions that trustees must carry out '*as far as they are able*': scenario analysis, obtaining data, calculating and using metrics, and measuring performance against trustee-set targets. 'As far as they are able' has been defined as '*taking all such steps as are reasonable and proportionate taking into account the costs incurred by scheme and the time required to be spent by the trustees or people acting on their behalf*'.

Chosen scenarios

As outlined in the table below, trustees must conduct scenario analysis for at least two scenarios. In selecting the scenarios, the guidance notes that trustees should consider not only the projected potential global average temperature rise but also the nature of the transition to that temperature rise. What this means is that there are a number of different scenarios leading to an eventual global average temperature rise of 2°C above pre-industrial levels, with differences in the assumptions made about the *type* of transition. The guidance specifically refers to a paper by the Network for Greening the Financial System that sets out representative scenarios which trustees may want to consider.[10]

What do the final requirements look like?

The substance of draft regulations has been largely retained. Areas of change are highlighted in bold:

TCFD area	Requirements
Scope and timing	• Applies to schemes with assets over £5bn at 1 March 2020 and Master Trusts from 1 October 2021 and to schemes with assets over £1bn at 1 Mach 2021 from 1 October 2022. Insurance contracts are excluded from assets for this purpose.
Governance	• Establish and maintain oversight of climate related risks and opportunities by no later than 1 October 2021 (schemes >£5bn and Master Trusts) or 1 October 2022 (schemes >£1bn). • Establish and maintain processes that allow the trustees to satisfy themselves that those managing the scheme are assessing and managing climate related risks and opportunities. "Those managing the scheme" means those who undertake governance activities in relation to the scheme and those who advise or assist the trustees with respect to governance activities, excluding legal advisers. • Trustees who are subject to the requirements must have knowledge and understanding of the principles relating to the identification, assessment and management of risks to occupational pension schemes arising from the effects of climate change.
Strategy	• Identify climate related risks and opportunities that will impact the investment and, for DB schemes, funding strategy of the scheme over different time horizons. The chosen time horizons must be disclosed. • Assess the impact of identified risks and opportunities on the scheme's investment and, for DB schemes, funding strategy. • Trustees will not be required to describe in their disclosures the climate-related risks and opportunities relevant to the scheme which are identified by persons other than the trustees.
Scenario analysis (a subsection of Strategy)	• Scenario analysis must be undertaken to assess the resilience of the scheme's assets, liabilities and investment and, for DB schemes, funding strategy to climate related risks in at least two scenarios (including one scenario that reflects an annual temperature rise of 1.5 to 2 degrees Celsius). • Undertake scenario analysis in the first year, **which may be undertaken during the scheme year ahead of the scheme being subject to the requirements**, and at least every three years thereafter. In other years trustees must review whether or not circumstances are such that they should refresh

[10] <www.ngfs.net/sites/default/files/medias/documents/820184_ngfs_scenarios_final_version_v6.pdf>.

TCFD area	Requirements
	their analysis; or, if they decide not to, explain why. **Whenever trustees undertake fresh scenario analysis the triennial cycle is automatically re-set.**
Risk management	• Adopt and maintain processes for identifying, assessing and managing climate-related risks. • Ensure the integration of climate-related risks into overall risk management processes of the scheme
Metrics (a subsection of Metrics and Targets)	• Trustees must select a minimum of two emissions-based metrics, one of which must be an absolute measure of emissions and one which must be an intensity-based measure of emissions. Trustees must also select one additional climate change metric to calculate in respect of the scheme's assets. • Trustees must obtain the scope 1, 2 and 3 greenhouse gas emissions and other data relevant to their chosen metrics and use this data to calculate their selected metrics. **Trustees will not have to collect and report on Scope 3 emissions in the first year they are subject to the requirements.** • Trustees must use the metrics they have calculated to identify and assess the climate-related risks and opportunities which are relevant to the scheme. • Trustees will be required, as far as they are able, to obtain the data required to calculate their chosen metrics on an annual basis.
Targets (a subsection of Metrics and Targets)	• Trustees must set a non-binding target for the scheme in relation to at least one of the metrics which they have selected to calculate. **Target setting should take place during the first scheme year for which the Regulations apply rather than on the first day on which the Regulations apply.** • On an annual basis (i.e. each scheme year) trustees must measure performance against the target and, taking into account the scheme's performance, they must decide whether to retain or replace the target. Where trustees elect to replace the target, a new target must be set.

Trustees should note the final regulatory requirements and begin to take steps to implement these additional governance requirements. It is crucial that those subject to the first wave of requirements have a plan in place to meet the governance requirements by 1 October 2021 at the latest. For those who have not already taken steps, education is a critical first step. We have organized a webinar for trustees, to be held on 8 July 2021.[11]

The requirement for compliance '*as far as they* [trustees] *are able*' is akin to a 'comply or explain' basis. Given the Government's ambitious aims, this is likely to be a way of using trustees to push asset managers and investee companies into compliance on climate plans. Whilst the scenario analysis element of TCFD may be seen as one of the trickier tasks that trustees must undertake, putting it into practice will (on the liability side at least) be similar to other scenario analyses that trustees have been undertaking for years now.

The TCFD itself has recently begun consultation on updated recommendations, with a focus on metrics. The DWP has confirmed that it will monitor that work and continue to engage with pension schemes to ensure that the Regulations and statutory guidance remain appropriate. In any event, it has undertaken to review the Regulations in 2023.

Local Government Pension Scheme (LGPS) funds are not yet subject to these TCFD governance and reporting requirements but we expect the Ministry for Housing, Communities and Local Government to consult on the subject in the near future. The shape of the requirements for LGPS funds is likely to be heavily informed by the DWP Regulations, so LGPS funds may plan accordingly.

[11] <www.hymans.co.uk/insights/webinars/getting-ready-for-tcfd/>.

Rule allows sub-RPI increases

The Court of Appeal has decided that a rule saying that pensions should increase in line with the Retail Prices Index '*or any other rate decided*' did *not* mean that the employer's discretion was limited to awarding a *higher* rate of increase.[12] Although the rule's drafting was in some respects unsatisfactory, there was no ambiguity in the language used, nor any obvious mistake made.

Background

The rules of the scheme in question say that the rate of increase on pensions in payment is the percentage increase in the RPI during the reference period, capped in the same way as statutory limited price indexation, '*or any other rate decided by the Principal Employer*'. The principal employer, scheme trustee and a representative member went to court to seek clarification of that phrase. The High Court judge's conclusion was that the rule would be given better reasonable and practical effect if it was construed to mean that the employer could substitute any *higher* rate only. That is to say, that the intention was to provide guaranteed annual increases each year, but give the employer discretion to award a higher rate of increase. His decision was influenced partly by a desire to interpret the rule so that it sat well with the statutory limited price increase requirements; and partly because the members who were transferred into the scheme from its two antecedents were told that it was being set up to provide them with the same benefits, and only one of the two predecessor schemes allowed the employer to alter the pension increase rate.

The employer appealed.

Appeal successful

The Court of Appeal overturned the High Court decision. In the leading judgment, Sir Geoffrey Vos, Master of the Rolls, said that it was not a case of sloppy or unclear drafting, and that the scope for importing a limitation into the rule was limited (despite certain advantages of doing so). Although it looked suspiciously like the draftsperson had simply pulled the phrase from the rules of one of the two predecessor schemes, without realizing that it had not appeared in the other's, he was not satisfied that there was evidence of a clear mistake, nor could he be sure what particular correction should be made if there *had* been an error:

> '*The objective observer might well think that the power could have been more felicitously drafted, but that is not enough to allow the court to depart from the clear language…*'.

His colleagues agreed, adding for example that because there was nothing very unusual about the dispute at hand, '*the language used… might be said to be the start and the end of any interpretation exercise*' (Lord Justice Coulson). Discussing past case law as authority for the propositions that judicial interpretation should take place in the light of commercial common sense, and should avoid excessive literalism or undue technicality, they concurred that that was only relevant in cases of ambiguity: '*If one simply reads the rules on their own there is no reason to give "any other rate" anything other than its ordinary meaning under which an "other rate" might be a lower rate or a higher rate*' (Lord Justice Nugee).

Other issues

The Master of the Rolls' preference for the employer's interpretation of the rule did not end there. He said that the words '*at any other rate*' could mean '*any other rate* or rates', because of a statutory rule of interpretation that the singular includes the plural. This allowed the employer to decide upon different rates for tranches of pension attributable to different periods of service. The employer could set the increase rate for more than one year, and did not need to wait until the relevant RPI figure became known for any particular year, as the rule did not specify when the employer's decision had to be made. The rule was also able to accommodate a zero rate of increase.

One of the appellate judges notes that the members may have ground for complaint based on communications material in which they were told that, if they transferred to the new scheme, their pensions would be subject to limited price indexation with the possibility of discretionary increases on top. It is also noted that the increase rule in one of the predecessor schemes is to be the subject of separate interpretation and rectification proceedings.

The ruling appears to solidify the limits of judges' ability to adopt a policy of 'purposive interpretation' when construing pension scheme provisions.

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[12] *Britvic PLC v Britvic Pensions Limited & Another* [2021] EWCA Civ 867.

Court rectifies scheme to reinstate RPI alternative wording

The High Court agreed to rectify a pension scheme trust deed to (re)insert words that the employer and trustee argued had been omitted in error.[13] This had the effect of changing the scheme from one with ostensibly 'hardwired' Retail Prices Index increases into one in which it is possible to substitute another inflation measure.

Background facts

In a version dating from 1992, the trust deed and rules of the scheme said that pensions in payment would increase annually by a '*prescribed percentage*' that was the lesser of five per cent and '*the percentage increase (if any) in the HM Government Retail Prices Index* ***or such other index as the actuary advises to be appropriate***' (our emphasis). When the deed was revised in 2004, this became '*the same percentage (if positive) as the percentage increase (if any) in the Retail Prices Index (within the meaning of section 51 of the Pensions Act*'. The possibility of the actuary recommending an alternative index was omitted, so that the scheme became, as the judge put it, '*hardwired to RPI*'. The change was not recognized until 2017.

Judgment

The judge agreed to make an order for rectification, saying that it was '*the clearest possible case for rectification of a pension deed based on an omission that was not noted by any of the persons involved.*' He commented about the quality of evidence required for rectification, noting that it did not particularly matter whether it was described as 'convincing', 'cogent', or 'compelling': what was '*of great importance*' was that the court was '*provided with evidence… that is the product of a very thorough review.*'

In this case the initial draft of the revised trust deed that was prepared by the parties' law firm for its own purposes, but not shared externally, contained the original wording about using another index. By the time it was sent out to the parties, the provision had been deleted, and only a cavet (^) appeared in its place, with nothing else to draw the reader's attention to the content of what had been removed. The evidence of the legal professionals involved in the drafting was that they had no recollection of why the alternative-index clause was omitted. One of the trustee directors had retained the copy of the draft deed that he had gone through and annotated: in the section on pension increases he had commented, '*same as old* [rule]'. In his memory there was no intention to depart from the original provision.

That three years had passed between discovery of the error and commencement of court proceedings was, said the judge, '*not surprising given the scope of the task'* of locating documents and interviewing witnesses.

The judge also noted that scheme members had been consulted, as a matter of good practice, about the proposal to seek rectification to correct the mistake in the trust deed and rules. Attention was drawn to two of the responses obtained, in which the members said that RPI increases had been a factor in their retirement decisions, and expressed surprise that the error had not been spotted by the experienced professionals involved at the time. The judge agreed that the place to pursue any complaint was with the Pensions Ombudsman. In accordance with judicial precedent, the scheme members were not 'bona fide purchasers for value' of the 'right' mistakenly conferred upon them, so they had no defence to the claim for rectification; and even assuming that there could be an estoppel (precluding the trustees and employer from pressing ahead with rectification), there was insufficient evidence of reliance or detriment. The judge therefore concluded that it was right for him to make an absolute order for rectification rather than to adjourn the hearing to provide the representative member's lawyer with an opportunity to make additional representations or obtain further instructions, or for the judge to make a qualified order that exempted those members, or give them (or a class of persons) permission to apply to the court.

The Court was not asked to order that another index should be used. That will be a decision for the trustees and company to make after they have obtained actuarial advice about whether some other index is appropriate.

[13] *Iggesund Paperboard (Workington) Limited & Another v Messenger* [2021] EWHC 627 (Ch).

OTS tax year change consideration

The Office for Tax Simplification (OTS) is exploring the ramifications of changing the UK's tax year so that it ends on 31 March or 31 December.[14]

The OTS notes that while the tax year for individuals runs from 6 April to 5 April for historical reasons, accounting systems for business typically use a month or quarter end. Many countries use a 31 December or 31 March accounting date for their governmental accounts (the UK uses 31 March). International companies commonly account to 31 December or 31 March.

The review will consider the costs and benefits of such a change, as well as the wider implications for areas such as tax credits and benefits. The OTS expects to publish a report during the summer of 2021.

Depending on the details, any change to the tax-year-end date would have considerable implications for pension schemes and their members. The effects on the annual allowance could be particularly problematic. A change of tax year would likely also require alterations to many (if not all) of Her Majesty's Revenue and Customs' IT systems, which is a cause for concern given the Government's track record for IT projects.

All in all, the benefits of changing the tax year end would need to be compelling in order to justify the additional work that the transition would entail.

HMRC newsletters June 2021

Her Majesty's Revenue and Customs (HMRC) has published *Pension Schemes Newsletter 130*.[15] It announces the extension of some COVID-driven relaxations to processes (mainly related to relief-at-source, but one allowing submission of annual statistical returns without signature) until 31 October 2021; all of the other temporary process changes that it had made ended on 30 June.

There are items about the migration from Pension Schemes Online to the Managing Pension Schemes service, the planned extension of the latter to administrators of retirement annuity contracts and deferred annuity contracts, and a reminder that HMRC is deleting dormant online credentials. Lastly, there's some guidance for SSAS and SIPP administrators about things can be done to offer relief from COVID-related hardship to connected tenants of properties owned by the schemes.

[14] <www.gov.uk/government/publications/ots-to-explore-potential-for-moving-the-end-of-the-tax-year>.

[15] <www.gov.uk/government/publications/pension-schemes-newsletter-130-june-2021/pension-schemes-newsletter-130-june-2021>.