SLAUGHTER AND MAY/

PENSIONS ESSENTIALS

February 2024

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NEW REGULATIONS ON FUNDING AND INVESTMENT STRATEGIES

*The final regulations on the new funding regime in the Pension Schemes Act 2021 have been issued and are due to come into force on 6 April 2024. They provide details about the funding and investment strategy (**FIS**) that DB trustees will need to put in place and the considerations that should underpin its preparation and content. The first time trustees will need to have a FIS and a statement setting it out is 15 months from the effective date of the first valuation obtained on or after 22 September 2024.*

Once the relevant provisions are in force (anticipated to be 6 April 2024), the Pension Schemes Act 2021 will amend the funding regime to require trustees to have a FIS which specifies the funding level a scheme should have achieved at a particular date and the investments it should have. This should be set out in a statement along with some additional information. The new regulations require the FIS to set out a journey plan showing how the scheme will be fully funded when it reaches the "**relevant date**" (chosen by the trustees and not later than the end of the scheme year in which the scheme will reach "**significant maturity**"). The strategy for reaching full funding should generally assume that assets are invested in a "**low dependency investment allocation**" by the relevant date.

The regulations provide that a scheme reaches "**significant maturity**" when the duration of its liabilities is the number of years specified by the Pensions Regulator in the Funding Code (yet to be finalised) and determined in accordance with a formula. The economic assumptions used in the formula must be based on conditions on 31 March 2023 (to avoid the relevant date changing because of changes in economic conditions). Trustees can also take into account whether the scheme is open to new members or future accrual, providing that their assumptions are "*reasonable*" and consider the covenant strength of the employer.

The definition of "**low dependency investment allocation**" no longer requires assets to be broadly cashflow matched to liabilities as the 2022 draft regulations did. It is now defined as meaning that the assets of the scheme are invested in a way that is highly resilient to short term adverse changes in market conditions and further employer contributions are not expected to be required. The low dependency investment allocation does not apply to any surplus at the relevant date and schemes are intended to be allowed more flexibility in relation to the way surplus assets are invested.

The final regulations contain revised provisions in relation to employer covenant. Trustees need to assess covenant strength to determine the level of risk that can be factored into actuarial assumptions. Employer covenant is "*the financial ability of the employer, in relation to its legal obligations to the scheme, to support the scheme*" and can take into account the expected support from contingent assets. Trustees will need to consider "*how long [they]... can be reasonably certain that the employer will be able to continue to support the scheme*" and that the other matters that they have taken into account in assessing the covenant will remain accurate. Unlike the draft regulations, there is no formalised role for the Pensions Regulator in the covenant assessment process.

The first time trustees will need to have a FIS and a statement in place is 15 months from the effective date of the first valuation obtained on or after 22 September 2024. The timing is

intended to align the new requirements with the valuation tranches that TPR uses in its annual funding statements.

Finally, regulations will require trustees to follow the principle that funding deficits have to be recovered as soon as the employer can reasonably afford when setting recovery plans. However, in the response to consultation the Government recognises "*the importance of investment in UK business to drive innovation and growth and want[s] to enable such investment wherever possible*" and has therefore included an additional (but secondary) consideration for trustees to take into account "*the impact of the recovery plan on sustainable growth of the employer*".

For more details on the new funding regime, see our Client Briefing.

Practical points:

- *Watch out for publication of the Code of Practice and template for the statement.*
- *Consider work required to comply with new requirements and identify when scheme needs to comply.*
- *Talk to covenant advisers about whether the new provisions will alter way in which covenant assessment is undertaken.*

USE OF SURPLUS AND PROTECTIONS FOR MEMBERS

Following proposals trailed in the Mansion House reforms announced last November, the Government has launched a consultation on introducing measures to make surplus extraction easier and establish a public sector consolidator. The consultation considers what would be necessary to allow surplus to be taken out of ongoing schemes and what protection would be needed for members. It also asks whether permitting schemes to pay a higher levy in return for a 100% PPF underpin would be helpful.

In July 2023, the Government issued a call for evidence on options for DB schemes which focussed on enabling a more flexible use of DB scheme assets. It asked whether facilitating the extraction of surplus in ongoing schemes would encourage more risk to be taken in DB scheme investment strategies and allow greater investment in UK assets, including productive finance assets. In November, the Government said that the responses to this question were mixed and suggested that "*even if schemes were incentivised to re-risk, increased investment in UK productive finance would not necessarily follow...*"

Despite mixed views from the industry, the Government is consulting on proposals which would facilitate accessing surplus as well as establishing a public sector consolidator via the PPF for schemes that are unattractive to commercial consolidators. The key points from the consultation are set out below.

Surplus: There are three elements to the proposals around surplus extraction:

- **Making it possible**: Evidence suggests that many schemes do not permit refunds of ongoing surplus and legislation does not allow scheme rules to be amended to permit it. The consultation paper asks whether a statutory power to amend scheme rules or to make surplus payments would encourage sharing of surplus and what any such power should look like.
- **Tax**: Schemes' ability to make one-off payments to members is limited because any reduction in pension after a one-off payment makes future payments unauthorised. Views are invited on whether allowing one-off payments would support surplus being used to enhance benefits.
- **Protection for members**: A number of measures are being considered to ensure security of benefits if surplus is extracted, including requiring schemes to fund to minimum funding levels (including a margin for prudence) which have yet to be determined. It is also intended that there will be additional guidance for trustees on paying out surplus.

Whilst the Government thinks these measures are likely to be sufficient to allow surplus extraction and protect members, it asks whether the industry would value additional security via an optional 100% PPF underpin in exchange for a higher levy. Views are invited on the design of any such underpin and the calculation of the levy. The PPF has done initial costings and assuming the option is only available to schemes with investment grade sponsors that meet prudent funding requirements,

the estimated levy would be around 0.6% of buy-out liabilities per year. There would be no cross-subsidy from the PPF's existing funds.

Public sector consolidator: The Government intends to establish a public sector consolidator administered by the PPF by 2026. It would provide an alternative end-game for schemes that are "*unattractive to commercial consolidation providers*" and enable "*greater investment higher growth UK assets*". The proposals are intended to minimise any distortion of the superfund and buy-out markets and the key features of the new public sector consolidator could include:

- A limit on the size of consolidator or on the annual amount that could transfer to it.
- A requirement for schemes transferring to it to demonstrate an inability to secure buy-out or transfer to a commercial consolidator.
- Severing of employer covenant and assets held in an unsegregated fund, separated from existing PPF funds.
- Meeting the same funding standards as commercial consolidators. Views are invited on how security provided by the superfund capital buffer can be replicated and if Government underwriting would be needed.
- Providing members with the actuarial equivalent of scheme benefits via a small number of standardised benefit structures.
- Allowing schemes with a deficit to transfer where the sponsor makes good the shortfall over time - if the sponsor became insolvent, benefits would be reduced.

The consultation closes on 19 April 2024 and as well as asking specific questions, it contains a short survey for DB schemes asking about attitudes to surplus and potential interest in a public consolidator.

***Practical points*:**

- *Consider whether to respond to the consultation.*
- *Watch out for more detail on proposals.*
- *Consider whether the changes might be relevant to your scheme.*

RECENT CASES ON SCHEME AMENDMENTS

Two recent cases considered the impact of restrictions in amendment powers, whether they were complied with and what happens where they were not. In addition, one of them looked at whether transitional provisions benefitting members over a certain age could amount to unlawful age discrimination. In both cases, the court adopted a highly pragmatic approach and veered away from finding amendments were invalid where possible.

In *Newell Trustees Limited v Newell Rubbermaid UK Services*, the scheme rules prevented amendments which "*would prejudice or impair the benefits accrued in respect of membership up to that time*". In 1992, members under 40 were automatically transferred to a new DC section of the Scheme. Those aged 40-44 had the option of staying in the DB section or transferring to the DC section and those over 45 were left in the DB section with no option to transfer. The trustee sought confirmation as to whether the amendments providing for this were valid.

Amongst other things, the judge held that the amendment power did not prevent the conversion of DB benefits to DC benefits. For the restriction to bite, it was necessary to show that the DC benefits "would" have been worse than DB benefits at the time of conversion. This could not be said as it depended on investment returns and salary increases over time and in fact, a percentage of members were better off in the DC section.

However, the amendment power did prevent the final salary link from being broken as the protection given to salary links by such provisions was well-established in case-law. A continuing salary link could be provided in a DC context by applying an underpin to the benefits of the relevant members equal to the value of their benefits at the date of transfer to the DC section, revalued by reference to actual salary increases. If this was higher than the amount transferred, the DC accounts would be increased by the shortfall plus the investment returns it would have earned had it been invested in the default strategy.

The judge also considered whether it could be said that the members who had elected to transfer had created a binding contract which effectively overrode the Scheme rules. The answer to this was yes as the basic elements of a contract were all present, particularly as the members had a genuine choice whether to agree to transfer and were offered an enhancement by the employer for doing so.

Finally, the issue of age discrimination was raised as older members were allowed to remain in the DB section. The judge concluded:

- The employer and trustee made a one-off decision in the 1990s to create a DC section with transitional age-related eligibility provisions which was lawful at the time. The fact that benefits might be lower in the DC section did not result from action taken later by the trustee after age discrimination became unlawful.
- The treatment of younger members was justified as the arrangements had the legitimate aim of ensuring inter-generational fairness and cushioning older employees from any adverse outcome as a result of making changes close to their retirement. There was also no basis to say that the means of achieving this aim were not proportionate as this came down to whether the age chosen struck the right balance between achieving the aim and the impact on the younger members and the parties had acted on advice and a line had to be drawn somewhere.
- UK law says that age discrimination only applies in relation to pensionable service after 1 December 2006. Although it has previously been held that this limit is incompatible with European law, this only applies where claims were brought before the completion of Brexit (31 December 2020).

In *Avon Cosmetics v Dalriada Trustees* the amendment power prevented any amendment that prejudicially affected "*benefits accrued or secured up to the date on which the amendment takes effect*". In 2003, the DB section was closed to accrual and a new CARE section (based on career average earnings) was set up. Accrued DB benefits were to be calculated by reference to salary at the date of the change and revalued up to retirement. Some members were better off as a result of the change as their salary increases over the period were lower than the rate of revaluation applied to their benefits but others were worse off. The question before the court was whether the amendment was wholly invalid or only invalid in relation to those members who were worse off as a result.

The court held that the amendment was valid in relation to those members who were better off and invalid in respect of those who had lost out. Where an amendment can be conceptually separated into a valid and invalid exercise of a power and the two are in substance conceptually different, it is possible to save the valid part. In this case, the concepts of better and worse off members were sufficiently different and identifiable, even if there were timing issues in relation to categorising individuals.

The court also had to be satisfied that if the person exercising the power had properly appreciated the true limits on it, they would still have done the same thing. This test is an objective one and does not involve a consideration of state of mind or actual intention. Here, the substantial purpose of the amendments was to remove the salary link by closing the DB section to future accrual and proving revaluation. If the amendment power prevented severing the salary link for members who were worse off, preserving it for other members was precisely within the objective intention.

The practical result was that an underpin needed to be applied so where a member was worse off as a result of the salary link being severed, they would get a higher level of benefits calculated by reference to their actual final salary.

Both cases show non-pensions judges taking a highly pragmatic view of the efficacy of amendments, seemingly motivated by a desire to cause as little disruption to benefits as possible. They also demonstrate the need to consider the wording in amendment powers very carefully. However, they do leave open a number of questions. In particular, the Avon case did not consider the fact that the amendment power was a joint trustee/employer power and the employer's objective intention in making the amendment was unlikely to be an outcome which resulted in more costly benefits.

***Practical points*:**

- *Carefully consider restrictive wording in amendment powers.*
- *If there are historic amending deeds which are problematic, consider if these cases help.*

COURT OF APPEAL DECISION ON INTERPRETATION OF CONTRIBUTION PROVISIONS AND ROLE OF ACTUARY

In the case of Railways Pension Trustee v Atos, the Court of Appeal considered how a shortfall rule in a shared cost section of the Railways Pension Scheme should operate in the context of regulations which effectively required the employer to meet the cost of any underfunding. It also held that in exercising a power to "determine" contributions the actuary should exercise professional judgement, rather than simply undertaking a mathematical calculation exercise and that collectability of contributions and likelihood of member opt-out are relevant factors for the actuary to consider.

The Railways Pension Scheme was set up on privatisation of the rail industry. Members who had benefits under the predecessor British Rail scheme were given statutory protection under the Protection Order. In 2013, a valuation of the Atos section showed a deficit of £6m which had since risen to £18.1m. As a shared cost scheme, employer and member contributions would normally be payable in the ratio 60:40. Where a valuation showed a deficit, the relevant rule provided for agreement between the employer and trustee on how to make good the shortfall, with a power for the Actuary to "determine" contributions and potentially cut back benefits if agreement was not reached within a specified time period. The rules also provided that the scheme also had to be operated in accordance with the Protection Regulations, which required employer contributions which were, in the opinion of the actuary, sufficient to fund protected members' benefits.

Upholding the decision of the High Court, the Court of Appeal confirmed that in agreeing arrangements to make good the shortfall, the trustee had a fiduciary duty to consider collectability and affordability for members. It also found that when exercising a power to "determine" contributions, the actuary has a choice whether to increase contributions at all and if so, by how much. The actuary should not simply undertake a mechanical calculation exercise, but exercise professional judgement, in the light of all the relevant detailed knowledge of the Scheme, having applied actuarial assumptions and methodology and subject to all relevant professional guidance but this did not mean that the actuary had any fiduciary duties. In setting contribution rates, the collectability of contributions as well as the likelihood of member opt-out were also relevant factors for the actuary to consider.

The Court of Appeal also held that the shortfall rule was not an exhaustive regime for eliminating deficits; the requirement in the relevant rule to "make good the shortfall" did not mean it had to be made good in full. It was important to give proper weight to textual analysis by concentrating on the words which were used and to place less emphasis on the factual matrix. There are no special rules for the interpretation of pension schemes, and their provisions should wherever possible be construed to give reasonable and practical effect to them.

The Court of Appeal upheld the decision of the High Court that the Protection Order effectively imposed a freestanding balance of cost funding obligation on the employer (in contrast with the shared cost obligations under the scheme rules).

Practical points:

- *Where the actuary's role under the rules includes a power to "determine" contributions, this is likely to require an exercise of professional judgement.*
- *A single scheme rule may not provide the entire answer to a point of interpretation.*
- *Scheme rules should be interpreted by focusing on the words used in the context of the rules as a whole and a purposive approach should be used where appropriate.*

UPDATE ON ABOLITION OF THE LIFETIME ALLOWANCE

The 6 April implementation date for the removal of the lifetime allowance and implementation of two new tax free allowances is fast approaching and the Finance Bill has received Royal Assent. However, there are still a number of areas where HMRC continues to adjust its approach. As a result, HMRC's regular newsletters are an essential source of information and highlight proposed changes.

Some of the key confirmations provided by HMRC in its recent Newsletter 155 and the February LTA newsletter are:

- **Pension commencement excess lump sum (PCELS):** In a helpful move for high value retirements, there will be no "permitted maximum" for a PCELS, which will replace the lifetime allowance excess lump sum (LTAELS) in the new

regime. The current, problematic, formula will be removed from the legislation by way of regulations which HMRC intend to introduce ahead of 6 April 2006. This should mean that the same options around pension commutation can be offered to members before and after 6 April 2024. A requirement for the PCELS to link to a pension, which wasn't present for LTAELS, remains, but this requirement is typically met.

- **LTA statements in 2024/25:** There is a requirement in the new legislation for one off LTA statements to be provided in 2024/25 where individuals/personal representatives would not otherwise receive one. There has been concern about the scope of this requirement. HMRC has confirmed the statements are only required where a member has had a previous benefit crystallisation event and is not a pensioner but has remaining uncrystallised rights in the scheme (so is a "member"). This scenario is likely to be rare in DB schemes, but might occur in a DC scheme where, for example, uncrystallised funds pension lump sums have been paid but there has been no drawdown. The newsletter (wrongly) states the percentage of lifetime allowance "available" (rather than expended) must be included on these statements.

- **Transitional tax free certificates:** These certificates may be relevant where an individual has crystallised benefits before 6 April 2024. An individual/personal representative can ask a registered pension scheme to certify the actual tax free amounts used by them across all registered pension schemes, before their first "relevant benefit crystallisation event" under the new regime, but must first provide "complete evidence". The certificate should be presented to schemes subsequently paying benefits, who would otherwise operate the standard default calculation, which makes various assumptions, including that full tax free cash has been taken on retirement.

  HMRC has committed to providing early guidance on the certification process for both members and schemes, including examples of what might be considered due diligence by schemes and accepted as complete evidence. As this is a completely novel process, this guidance will be essential when designing robust processes. HMRC's view is that the standard calculation will work for the majority of affected members, but industry expectation is that there will be a wide range of scenarios in which certificates might be requested.

- **Reporting:** HMRC had already announced in the December LTA Newsletter that the legislation will be amended so that schemes will only have to report under Event 24 any taxable lump sums/lump sum death benefits above the available new allowances, and such lump sums where the member's allowance is not exceeded due to reliance on a protection or enhancement factor. Also, that personal representatives will continue to provide information on death benefit lump sum payments to HMRC, and HMRC will continue to calculate and assess the tax due from beneficiaries.

  Newsletter 155 confirms further amendments to scheme's reporting requirements. Whilst the summary in the newsletter is not altogether clear, it appears that HMRC's intention is that schemes will not have to report on the availability of allowances where lump sums are paid on death, but will only have a reporting obligation where lump sums paid on a death exceed the standard lump sum and death benefit allowance.

Practical points:

- *Scheme administrators should ensure that they are aware of the changes.*
- *Trustees should ensure that administrators are ready for the abolition of the LTA on 6 April 2024.*

INVESTMENT – ESG AND SUSTAINABILITY

ESG and sustainability continue to be important issues for trustees. The PLSA has recently updated its stewardship and voting guidelines and the Pensions Regulator has issued a blog on ESG risks and opportunities and wider issues which trustees should be considering. In addition, the Financial Markets Law Committee has recently published a paper on trustee duties in the context of sustainability and climate change.

The PLSA's recently updated guidance on stewardship and voting aims to set out a comprehensive framework on how key stewardship should be addressed by trustees. The update reflects developments over the last 12 months and is split into sections that mirror the UK Corporate Governance Code. There are also sections on climate change and sustainability, social factors and workforce, and capital allocation and structure and a final section which encourages trustees to step back and assess the company holistically. The section on social factors has been included to encourage schemes to

continue to focus on responsible investment as the PLSA perceives that the Government has recently "deprioritised" ESG factors as it looks for capital to maximise growth.

The guidelines also look at the need for companies to have policies on cybersecurity and consider the impact of AI and there is a focus on executive pay in the context of the cost of living crisis. Each section seeks to address what good company behaviour looks like and how trustees should consider voting.

The Pensions Regulator also continues to focus on sustainability. A recent blog said climate reporting should be fully integrated into day-to-day governance for in-scope schemes. The expectation is that trustees will also continue to improve their understanding of wider material ESG considerations. The Regulator suggests that trustees may wish to consider becoming early adopters of new social and environmental investment frameworks such as the UK Transition Plan Taskforce, Taskforce for Nature-related Financial Disclosures or Taskforce for Social Factors and they "*would do well to familiarise themselves with them*". Trustees could also set objectives for investment consultants relating to nature and social factors tailored to their scheme and consider increasing collaboration with others and sharing knowledge. The blog also highlights that climate change transition plans can help trustees to reach informed decisions around climate issues.

The Financial Markets Law Committee has published a paper on trustee decision making in context of sustainability and climate change which considers the challenges that these factors can present. It provides trustees with an overview of the law and the uncertainties and problems that exist and offers suggestions as to how, in practice, trustees can take into account sustainability and climate change in a manner consistent with their fiduciary duties, including acting in the best financial interests of the scheme's beneficiaries. In particular, the paper says that sustainability and climate change will usually amount to a financial factor that trustees can take into account when exercising investment powers. It has been suggested to the Work and Pensions Committee that the paper could be adopted by the Pensions Regulator as guidance for trustees.

Finally, you may be interested in joining our seminar on 18 April on how sustainability regulations will impact business in 2024. We will be joined by expert speakers, looking to share their insights on the key challenges companies are facing as the sustainability regulations come in. Click here to register.

Practical points:

- *Continue to consider what the scheme's ESG investment policy should look like.*
- *Consider new sustainability initiatives and how far they should be factored into investment policies.*

PENSION LEGISLATION AND REGULATION WATCH LIST

No	Topic	Effective date or expected effective date	Further information/action
1	Changes to DC scheme governance and disclosure	Later in 2024.	Consultation expected on phased introduction of new value for money framework for all DC schemes (excepting some small schemes). Draft regulations to extend CDC to multi-employer schemes expected early 2024. Proposals on consolidators for small DC deferred pots expected late 2024, a taskforce has been set up.
2	DB consolidation	Legislation "as soon as Parliamentary time allows", for new compulsory framework for superfunds. Public consolidator to be established by 2026, consultation on features closes on 19 April 2024.	TPR updated interim guidance - issued August 2023. Consultation is ongoing on PPF becoming a public consolidator and the conditions that should attach to its operation as such.
3	Changes to pensions tax allowances	Removal of lifetime allowance due on 6 April 2024 together with introduction of new tax-free cash allowances.	Abolition of lifetime allowance and introduction of new tax-free cash allowances from 6 April 2024, through a new Finance Act.
4	Repayment of surplus	The reduction in the tax charge is due to take effect on 6 April 2024 Current consultation closes on 19 April 2024.	Tax charge on repaying surplus to be reduced from 35% to 25%. Consultation underway on facilitating repayment of surplus in ongoing schemes and appropriate safeguards for members.
5	New DB funding and investment strategy requirements	Regulations come into force 6 April 2024. Funding and investment strategy and statement in place 15 months from date of the first valuation obtained on or after 22 September 2024. Revised Code of Practice from TPR expected to be published summer 2024.	Consultation on covenant guidance expected in 2024. The final version of the funding regulations which set out detail around the funding and investment strategy and the statement of strategy have been issued. More detail is expected in the final form of TPR's Code of Practice and the template strategy statement.
6			

No	Topic	Effective date or expected effective date	Further information/action
7	Pensions dashboards	Compulsory connection deadline of 31 October 2026 for schemes with 100 or more active and/or deferred members at year end between 1 April 2023 and 31 March 2024; staging timetable to be set out in DWP guidance. Application for deferral (in limited circumstances existing at 9 August 2023) must be made by 8 August 2024.	All registerable UK-based schemes with active and/or deferred members.
8	Corporate transparency	Regulations under the Economic Crime and Corporate Transparency Act 2023, expected to come into force in March 2024, will introduce requirements on identity verification, corporate directors and limited partnerships.	All corporate trustees and schemes using Scottish Limited Partnerships.

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