SLAUGHTER AND MAY/

PENSIONS BULLETIN

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In this month's Pensions Bulletin, we cover:

1. A statement from the Pensions Regulator (TPR) on recent extreme market volatility and impact for defined benefit pension schemes on their liability-driven investment strategies.
2. Climate risk governance and disclosure requirements now apply to schemes with £1 billion or more in net assets, and all schemes in scope have to adopt a new portfolio alignment metric for measuring climate risk.
3. A new blog sets out TPR's expectations on mergers and acquisitions, aimed primarily at sponsor company directors and bidders.
4. Government continues to promote investment in illiquid assets with new draft disclosure requirements for DC trustees, planned to take effect from October 2023.
5. TPR has published an action plan on diversity and inclusion in trustee boards and says its expectations will be included in the final version of the Single Code of Practice.
6. Pension Protection Fund has launched its annual levy consultation, proposing a lower levy and a simpler levy calculation.

We include our regular watch list of current and future developments.

LIABILITY-DRIVEN INVESTMENT IN THE CURRENT ECONOMIC CLIMATE

The Pensions Regulator (TPR) has issued a statement on the impact of recent movements in financial markets on liability-driven investment (LDI). A number of pension schemes have had to take emergency measures to meet cash margin calls in relation to their LDI investments, including selling assets and in some cases taking loans from sponsors.

As a result of the recent movements in gilt yields, DB pension schemes using derivatives and asset swaps as part of their investment strategies have faced unexpected demands for cash in relation to collateral assets posted by the trustees as counterparty. This has led in turn in some cases to requests for short-term loans from employers to trustees. Although the majority of schemes have good collateral and sensible liquidity waterfalls in place in accordance with TPR guidance, the number and speed of cash calls caused many schemes to have to find cash quickly. The Bank of England's temporary purchase of gilts eased some of the pressure on schemes but concerns remain. On 12 October, TPR issued a statement: *Managing investment and liquidity risk in the current economic climate*. TPR expects DB scheme trustees to take the following action in the near-term:

- **Review operational processes.** Trustees should consider its governance processes for buying and selling investments, as well as its decision-making requirements – such as granting LDI managers power of attorney of some scheme assets to enable swifter trading.
- **Review liquidity position.** It is likely that the balance of liquid to illiquid investments will have changed; trustees should discuss their current liquidity position with their advisers and review previous cash management and disinvestment plans. Trustees might discuss with their employer the potential for additional collateral, accelerating future contributions or providing liquidity by other means. A loan arrangement may be an option but trustees would need to take legal and financial advice. If maintaining a hedged position is considered appropriate, trustees should consider whether they have sufficient liquidity to meet collateral calls in a more volatile environment within the required timeframe.
- **Review liability hedging position.** Some LDI funds are likely to move to a lower level of leverage, which will reduce the hedge ratio for trustees with investments in these funds. Trustees should consider their position with their investment advisers. Where trustees are entering into LDI, they must consider the level of leverage and the implications of collateral calls.
- **Review funding and risk position.** Many schemes are likely to see an improvement in funding and may be approaching funding triggers. The balance of risk in the scheme's portfolio should be reviewed.
- **Consider the impact of current yields on other areas of the scheme.** Trustees should monitor the appropriateness of the assumptions used in calculating transfer values and review the transfer value basis. Trustees should remain vigilant and follow best practice on scams.

TPR repeats some of this advice (such as reviewing investment strategy and operational factors and remaining vigilant on suspicious transfers) for DC trustees. It also advises DC trustees to communicate with savers who are approaching retirement to make them aware of their options and emphasise the importance of seeking financial advice.

TPR has said (responding to a letter from the House of Commons' Work and Pensions Committee) that it will be updating its *guidance on DB investments*. The current guidance mentions LDI only briefly, advising trustees to take appropriate steps to manage the additional risks. TPR also mentioned, in a blog in August, that the issue of liquidity management will be addressed in the DB Funding Code consultation expected later this year.

Next steps for employers and trustees: Trustees will have been looking at liquidity constraints within the scheme to meet future margin calls in relation to their LDI portfolios and whether the same level of gearing within their LDI portfolios should be maintained. Some schemes will have had to take out emergency loans with sponsors to raise cash. Once these immediate concerns have been addressed, trustees will need to consider more strategic advice with employers on what impact changes in gilt prices have had on the scheme's funding and investment strategy.

EXTENSION OF CLIMATE RISK GOVERNANCE AND REPORTING REGIME

Climate risk governance and disclosure requirements have been extended from 1 October 2022 to apply to schemes with £1 billion or more in net assets. Trustees of all schemes in scope also have to adopt a new portfolio alignment metric for measuring climate risk from that date.

Trustees of authorised master trusts and schemes of £5 billion or more have been subject to the governance and disclosure requirements from October last year. Trustees of schemes with assets of £1 billion or more became subject to the requirements from 1 October 2022. The current requirements are summarised in the box below.

Scheme net assets in billions (Bn)	*Governance requirements apply from 1 October*	*Publish report within seven months of end of scheme year underway 1 October*
£5Bn+ on first scheme year end date on or after 1 March 2020	2021 (unless later audited accounts)	2021 (for metric on portfolio alignment only, 2022)
£1Bn+ on first scheme year end date on or after 1 March 2021	2022 (unless later audited accounts)	2022

One of the governance requirements in the Climate Change Governance and Reporting Regulations 2021 is for trustees to select and ("as far as they are able") calculate an absolute emissions and an emissions intensity metric for scheme assets, both measuring greenhouse gas emissions (GHG). Trustees must also select one additional climate change metric, not directly related to GHG. The Regulations have been amended so that trustees now need to calculate and report on a **portfolio alignment metric** for any scheme year ending after 1 October 2022. The new metric describes the extent to which scheme investments are aligned with the Paris Agreement goal of pursuing efforts to limit the global average temperature increase to 1.5 degrees Celsius above pre-industrial levels. In order to reach that goal, emissions attributable to scheme assets must reach net zero by 2050.

Trustees already in scope may have selected a portfolio alignment metric as their "additional climate change metric" for the part of the scheme year that falls before 1 October 2022. However, from 1 October 2022 onwards, trustees need to select a further additional climate change metric to remain compliant with the Regulations (since the portfolio alignment metric is no longer an additional climate change metric). (For more detail, please see our Pensions Bulletin July 2022.)

The Pensions Regulator (TPR) has updated its *guidance on Governance and reporting of climate-related risks and opportunities* to cover the new metric. The guidance was first issued in December 2021 and a step-by step example was added earlier this year (please see our Pensions Bulletin February 2022). In the new version, TPR acknowledges the difficulties in obtaining data. In the example on selecting metrics, TPR suggests that "*given current limitations, the trustees agree to calculate the portfolio alignment metric initially using a binary target approach and to review their approach as industry methodologies develop*". When reporting, trustees should describe the key components of the methodology used in calculating the portfolio alignment metric, including key assumptions and allowances for data gaps.

Another ESG-related obligation that took effect from 1 October is the requirement to follow *Guidance* from the Department for Work and Pensions on stewardship and shareholder reporting in Implementation Statements. The guidance applies to Implementation Statements that trustees are required to prepare in respect of scheme years ending on or after 1 October 2022. The guidance is statutory - trustees must have regard to it when complying with the requirements in the Disclosure Regulations. (The guidance also covers trustees' Statements of Investment Principles on which the Implementation Statements report, but those sections are "best practice" not statutory guidance. For more details, please see our Pensions Bulletin July 2022.)

Next steps for trustees and employers: Trustees of schemes within scope, including those who started reporting from 1 October 2022, should now be using the new portfolio alignment metric. The amendment is not phased in; the requirement to select a metric applies in the part scheme-year that runs from 1 October 2022. Schemes not yet in scope should note that, in 2023, the Government will consider extending these rules to smaller schemes.

THE PENSIONS REGULATOR'S WARNINGS ON MERGERS AND ACQUISITIONS

In a new blog aimed primarily at sponsor company directors and bidders, the Pensions Regulator (TPR) says it will continue to monitor the market for major corporate transactions via its intelligence sources, engaging where there may be a risk to members.

A blog by Mike Birch, TPR Director of Supervision, considers mergers and acquisitions involving defined benefit (DB) schemes. Trustees are expected to be "robust" when defending the interests of scheme members and are advised to follow TPR guidance, in particular the 2020 guidance on *Protecting schemes from sponsoring employer distress* and its latest Annual Funding Statement. TPR expects trustees to engage with employers, and any prospective purchasers, to understand the status of a proposed transaction, its expected timescales, and its potential impact on the scheme covenant. Given the complexity, trustees should consider using independent advisers to assist with their assessment. Trustees should not weaken the funding position and journey plan to facilitate a transaction unless they can clearly demonstrate with reasonable certainty the benefit of doing so, and can secure appropriate protections against risk. TPR encourages trustees and employers to contact TPR if they have concerns about a transaction.

The rest of the blog concentrates on TPR's expectation that company boards and bidders communicate with schemes as a primary creditor, advising that:

- Employers should immediately alert trustees about a proposed corporate transaction and trustees should be provided with direct access to the bidder and their advisers at the earliest opportunity. TPR suggests that trustees' strict confidentiality provisions are a response to employers' concerns about market sensitivity and regulatory notification provisions.
- Bidders, including private equity firms, should demonstrate that they have a clear, credible and well thought out business plan which considers the scheme's long-term funding objective. Where the transaction affects the strength of the employer's ability to support the scheme, TPR expects this to be reflected in tangible protections for the scheme. A legally binding agreement should be reached with the trustees before completion, and strong governance protections should be put in place to ensure the independence of the trustee board, including removing or mitigating conflicts of interests. Here, TPR refers to its *guidance on conflicts of interest*.
- Bidders should not "move the goalposts". TPR has concerns about deals that are struck, only to be replaced later with a less robust plan (which is more favourable to the "new" company and its revised board) once a transaction has taken place.

Next steps for trustees and employers: Sponsors and trustees should be aware that the blog covers familiar themes from TPR setting out its expectations on transactions. However, a key missing piece of information remains the delayed regulations on the new notification requirements for DB schemes in relation to corporate and financing activity.

GOVERNMENT PROPOSALS TO ENCOURAGE DC SCHEME INVESTMENT IN ILLIQUID ASSETS

The Department for Work and Pensions (DWP) has confirmed that it plans to go ahead with proposals to encourage trustees of defined contribution (DC) schemes to invest in illiquid assets. The DWP is consulting on draft regulations and statutory guidance to require DC schemes, from October 2023, to disclose their policies on illiquid investment in default arrangements in their Statements of Investment Principles (SIPs) and to disclose the percentage of assets in default funds allocated to different asset classes in their annual Chair's Statement. As announced in last month's Growth Plan, the DWP also proposes to remove performance-based fees from the charge cap of auto-enrolment DC schemes.

The DWP has published a consultation, closing shortly (on 10 November 2022), on *Broadening the investment opportunities of defined contribution pension schemes*. This is a follow up to the consultation earlier this year on facilitating investment in illiquid assets. The draft regulations require trustees of occupational DC schemes to:

1. Include an explanation in their SIP of their **policies on illiquid investment** in default arrangements. Schemes required to produce a SIP will have to add the new disclosures to the first Default SIP published after 1 October 2023 and at the latest by 1 October 2024. For subsequent disclosures, the timing will mirror the current requirement to review a SIP every three years and/or where there is significant change in investment policy.

2. Report in their annual Chair's statement on the **percentage of scheme assets allocated to different asset classes** within the default arrangement. The Government has decided to remove the £1million threshold proposed in the earlier consultation – all schemes required to produce a Chair's Statement, regardless of size, would be captured by the requirements. Asset allocation disclosure would apply for the Chair's Statement for the first scheme year ending after 1 October 2023.

The Government says its key driver for the proposals is that "*it would be beneficial to other schemes, members, employers and regulators to understand the rationale behind choosing to invest (or not) in illiquid assets*". The DWP repeats its assertion from the previous consultation that it is not requiring schemes to change their asset allocation, but rather "*to encourage them to reflect on the decisions they have already made, and the decisions they will make, as part of their ongoing fiduciary duty to create an investment approach that works in the best interests of their members*".

Trustees will be required to "look through" multi-asset investments to underlying investments, so that all illiquid exposures are covered in disclosures and all schemes calculate their asset allocations at asset-level rather than fund-level.

In a change to the original proposal on **policies on illiquid investment**, the required disclosure will be in the Default SIP, except for collective money purchase schemes where there is no Default SIP and so the disclosure would be in the main SIP. The contents of the policy statement will be as proposed in the earlier consultation:

- whether or not investments held by the default arrangement include illiquid assets;
- where they do, a description of the age profile of the members; an explanation of whether assets are held directly or via a collective investment scheme; an explanation of the types of illiquid assets and of why the trustees have chosen to invest in them, including their assessment of the advantages to members as compared to investments in other asset classes;
- where the assets do not include illiquid assets, an explanation of why the trustees have chosen not to invest in illiquid assets; and
- whether trustees have any plans to invest in illiquid assets or increase their investment in the future.

Under the second proposal, DC schemes would have to disclose the **percentage of assets allocated** to each of the seven main asset classes: cash; bonds; listed equities; private equity (including venture capital and growth equity); property; infrastructure; and private debt. Disclosures will be required at the highest level; the draft statutory guidance includes more detailed explanations, to enable trustees to decide what level of granularity is most appropriate for their members.

The DWP recognises ongoing concerns about the suitability of the Chair's Statement for these disclosures, referring to the conclusions of the post-implementation review (published in April 2021) that there are flaws in both the requirements for content and in enforcement by the Pensions Regulator. The DWP is engaging with industry representatives and the Pensions Regulator to consider how to address the issues.

In addition, the DWP also confirms its proposal to **exempt performance-based fees from the charge cap** for default arrangements of occupational DC schemes used for auto-enrolment. The Government considers that the charge cap (0.75% of funds under management within the default arrangement) limits DC schemes' ability to invest in illiquid assets that come with performance fees and is pressing ahead with the amendment, despite mixed responses to its earlier consultation. Schemes will be able to apply the exemption as soon as the draft regulations come into force, currently anticipated to be 6 April 2023. There are transitional arrangements to deal with the removal of the current option (introduced from 1 October 2021) to smooth the incurrence of performance fees over a five-year moving average when setting compliance with the charge cap.

Next steps for trustees: Trustees should consider with their advisers the extent of their current holding in illiquid assets. Despite the assurances in the consultation papers, there will be concerns that this could be another area where Government regulation may cut across the trustees' fiduciary duty to invest in the best financial interests of their members.

THE PENSIONS REGULATOR'S ACTION PLAN TO INCREASE TRUSTEE DIVERSITY AND INCLUSION

Until now, the Pension Regulator (TPR) has not formalised its expectations on equality, diversity and inclusion (ED&I) requirements for trustee boards, but TPR's recently published action plan says that these will be included in the final version of its upcoming Single Code of Practice.

TPR has published an action plan to increase diversity and inclusion on trustee boards, following research that showed, for example, that of the 10% of defined benefit schemes and 14% of defined contribution schemes that have been collecting trustee diversity data, 40% (DB) and nearly 50% (DC) stated they had no plans on using the information.

The ED&I action plan says TPR and the Diversity and Inclusion Industry Working Group will:

- Set out clear ED&I expectations in the new Single Code of Practice. TPR says that, following consultation on the Code, TPR received feedback that industry would welcome the addition of clear expectations on ED&I.
- Provide guidance for trustees on TPR's expectations (to be updated regularly), at the end of 2022/early 2023.
- Establish a mechanism for TPR to collect and use data about diversity in order to measure its success.
- Work with stakeholders on enabling employers, Chairs, and professional trustees to be influential in diverse recruitment and creating a culture of inclusion.
- Engage with trustees through TPR supervision to identify barriers to diversity and to underline best practice.

Next steps for employers and trustees: It is difficult to know what this means in practice until we see the Code, expected "soon".

PENSION PROTECTION FUND PROPOSALS FOR 2023/4 LEVY

The Pension Protection Fund (PPF) has launched its annual levy consultation, proposing a lower levy and a simpler levy calculation.

The PPF has published a consultation on the 2023/2024 levy rules for the issue of invoices in Autumn 2023. The consultation closes on 10 November 2022 and the final rules and Policy Statement are expected to be published at the end of December 2022. Proposed key dates for submission of documents to the PPF start from 31 March 2023.

The PPF estimates that it will collect £200m, a reduction of £190m on 2022/23, and that almost all levy payers will see a reduction in their levy. Two changes underpin a substantial proportion of the reduction in next year's levy:

- The PPF is reducing the sensitivity of the levy to changes in insolvency risk by halving the incremental increase between levy bands. For example, a change from band 1 to band 10 will result in a four-fold increase in levy, as opposed to a 14-fold increase under present rates.
- There will be a reduction in the levy scaling factor by 23 per cent and scheme-based levy multiplier by 10 per cent. The risk-based levy cap remains at 0.25 per cent of scheme liabilities.

The proposed 2023/24 rules incorporate the new asset classes the Pensions Regulator (TPR) is planning to introduce for the 2023 scheme return (for details, please see our Pensions Bulletin November 2021). The reclassification uses a tiered approach based on scheme size (by liabilities on a Section 179 basis):

- A simplified approach (Tier 1) will apply to smaller schemes with liabilities at the latest valuation below £30m.
- Larger schemes (Tiers 2 and 3) will be asked for more detailed data, with Tier 3 schemes (£1.5bn or more in liabilities) continuing to carry out the bespoke stress calculation, as required under the levy rules.

As a result of the reclassification, the PPF proposes to update its asset and liability stress factors; the main change is to apply one asset stress for all UK quoted equities at -16 per cent.

As previously announced, the 2022/23 adjustment for employers adversely affected by the pandemic is not being continued.

Next steps for trustees and employers: Trustees will need to be ready to collect the new asset information in time for the 2023 scheme return. The more detailed asset breakdown should be relatively straightforward for most schemes to provide and, in many cases, will already be included in regular reporting from investment managers.

PENSION LEGISLATION AND REGULATION WATCH LIST

No	Topic	Expected effective date	Further information/action
1	DC scheme governance and disclosure, including the annual Chair's Statement and the charge cap	First scheme year ending after 31 December 2021 - detailed "value for members" assessments for schemes with assets below £100m. (First scheme year ending after 1 October 2021 - return on investments from default and self-select funds included in Chair's Statement; and 5 October 2021 - total value of assets reported in annual scheme return.) For charging years ending after 6 April 2022: £100 de minimis pot size below which flat fees cannot be charged.	DC schemes only. Consultation on draft regulations on inclusion of explanation of illiquid investment policies in default SIPs and draft regulations and statutory guidance on disclosure of asset allocation data in Chair's Statement (from 1 October 2023); consultation on removal of performance-based fees from the charge cap for default arrangements used for DC auto-enrolment schemes (from 6 April 2023).
2	New notification requirements for DB schemes in relation to corporate and financing activity and change to the notification process	Response to consultation on draft Notifiable Events (Amendment) Regulations was expected Summer 2022.	TPR will consult on update to Code of Practice 2 (Notifiable Events) and accompanying guidance once DWP have published their finalised regulations and consultation response.
3	Draft DB Funding Code of Practice	Part 2 of TPR consultation and draft Code expected in 2022 after DWP regulations finalised; further communication from TPR during the Autumn. Code to be operational from October 2023.	DWP regulations issued for consultation July 2022. Once in force, the Code will apply to triennial valuations submitted thereafter.

No	Topic	Expected effective date	Further information/action
4	TPR Single Code of Practice	Revised Code to be issued "during 2022".	All schemes.
5	Register certain trusts with the Trust Registration Service	Registration by 1 September 2022.	Applies to some trusts relating to pension and life assurance benefits where no exemption applies (e.g. bare trusts set up on distribution of a lump sum).
6	Trustee oversight of fiduciary managers and investment consultants	1 October 2022. Requirement for trustees to make annual compliance reports to the CMA ceased 1 October 2022.	All DB and DC schemes (with minor exceptions). Occupational Pension Schemes (Governance and Registration) (Amendment) Regulations 2022 largely replicate existing regime under the Competition and Markets Authority Order 2019. TPR guidance issued August 2022.
7	Climate risk governance and reporting requirements	1 October 2022	For schemes with £1 billion or more in net assets, governance to be in place for the scheme year underway, and the first annual report to be published within seven months of the end of the scheme year. Trustees of schemes in scope have to adopt a portfolio alignment metric for measuring climate risk from 1 October 2022.
8	Stewardship and voting reporting in Implementation Statements: statutory guidance	Statutory guidance applies to Implementation Statements for scheme years ending on or after 1 October 2022.	All schemes required to prepare Implementation Statements. Guidance on Statements of Investment Principles is non-statutory.
9	Simpler annual benefit statements	1 October 2022.	DC schemes used for auto-enrolment.

No	Topic	Expected effective date	Further information/action
10	Changes to the scheme asset information collected through scheme returns	Scheme returns from 2023.	DB schemes.
11	Pensions dashboards	Compulsory connection deadlines from August 2023.	All registerable UK-based schemes with active and/or deferred members. Draft regulations laid before Parliament October 2022; TPR to consult on compliance and enforcement policy immediately after.

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