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PENSIONS ESSENTIALS

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THE PENSIONS REGULATOR IMPOSES CLIMATE RISK REPORTING FINE

The Pensions Regulator has issued its first fine to pension scheme trustees for failing to publish their annual climate change report by the statutory deadline. Although a fine was mandatory, the £5,000 fine imposed was twice the statutory minimum despite the delay in publication being due to an error in uploading the report to the website. The scheme will also be named in the Regulator's next compliance bulletin.

Trustees of larger pension schemes are required to produce an annual report on their management and governance of climate change risks and opportunities and publish it on a publicly available website within seven months of the scheme's most recent scheme year end. Following its review of the first tranche of reports, the Pensions Regulator (TPR) has issued a fine for £5,000 against scheme trustees for failing to publish a report in accordance with the statutory requirements.

After being unable to locate the relevant scheme's climate change report, which was due to be published by 31 July 2022, TPR contacted the scheme trustees. They had produced the report and the scheme administrators had uploaded it by the deadline, but a faulty URL meant it was not published on a publicly available website until 10 August. Penalties for failing to comply with the publication requirements are mandatory and TPR said that, in accordance with its monetary penalties policy, the fine was above the statutory minimum of £2,500 due to the nature of the breach and because the trustee was a corporate body.

As a reminder, the reporting requirements now apply to schemes with £1 billion or more in net assets on the first scheme year end date on or after 1 March 2021.

Trustees should consider two sets of guidance when preparing climate change reports:

- Governance and reporting of climate change risk: guidance for trustees of occupational schemes from the Department for Work and Pensions. Trustees of in-scope schemes are required to have regard to this guidance. If they diverge from it, they have to explain why in their report.
- TPR guidance on Governance and reporting of climate-related risks and opportunities. This indicates how TPR will exercise its regulatory powers and how it decides whether trustees have met the statutory requirements and had regard to the DWP statutory guidance in doing so.

TPR's monetary penalties policy sets out its approach to breaches of the Regulations:

- Failure to comply with the requirement to publish a climate change report will result in a mandatory fine of at least £2,500. Where a professional trustee is in place, the penalty will generally be higher. This penalty relates to publication of the report, not to its content.
- Other penalties and enforcement options are discretionary. Breaches of governance requirements that will affect member outcomes or make it more difficult for members to understand the report are likely to be treated more seriously than a failure to make disclosures.

Earlier this year, TPR published a review of climate reports, giving examples of where, in its view, they had omitted required information. For details, please see our *Pensions Bulletin April 2023*.

Next steps:

- The Regulator is taking a strict approach to climate risk reporting.
- Trustees need to check that both they, and relevant third parties, have completed reporting requirements in accordance with the precise requirements of the legislation.
- Where trustees are fined for failing to publish their annual report, they will be named in the Regulator's compliance and enforcement bulletin.

GUIDANCE FROM THE PENSIONS REGULATOR ON REGULATED APPORTIONMENT ARRANGEMENTS

A regulated apportionment arrangement (RAA) allows an employer in financial difficulties to sever its liabilities to an underfunded DB scheme where it would otherwise become insolvent. They are not used frequently and consent is required from both the Pensions Regulator and the PPF. The Pensions Regulator has published revised guidance for employers and trustees of schemes considering an RAA and says it will apply the same principles to arrangements which produce a similar outcome to an RAA.

The Pensions Regulator (TPR) has published updated guidance on RAAs, replacing its 2010 guidance and 2017 quick guide.

Broadly, an RAA allows an employer facing insolvency to cease participation in its defined benefit scheme and apportion most of its liabilities to another participating employer so that it may continue trading. An RAA may only be entered into if the conditions in the Employer Debt Regulations 2005 are met, including approval by TPR and no objection from the Pension Protection Fund (PPF). An RAA does not require the funding test to be met which means that the trustees do not need to be satisfied that any remaining employers will be likely to be able to fund the scheme or that the security of members' benefits will not be affected.

The guidance sets out the conditions for TPR approval, with examples of evidence it expects:

- The employer's insolvency must be inevitable within the next 12 months. TPR will look at whether the insolvency has been "engineered" and, if so, may consider using its anti-avoidance powers.
- Upfront cash consideration is significantly greater than the recovery expected for the scheme on insolvency.
- A better outcome could not be attained for the scheme by other means, such as by TPR issuing a contribution notice or financial support direction, or by collecting unpaid Section 75 debts.
- It would not be reasonable for the wider employer group or any entity within it to support the scheme or the employer in future.
- The scheme is receiving equitable treatment in comparison to the employer's other creditors, shareholders and other financial stakeholders. There is detail on how TPR assesses fair treatment. Trustees should assess what each creditor or other financial stakeholder would be expected to receive in the event of insolvency.
- The scheme receives an appropriate portion of the equity in the employer leaving the scheme.

It is significant that TPR says it will also apply its RAA principles to arrangements which produce a similar outcome to an RAA. As example of this would be where a clearance application is made in respect of an agreement to compromise the employer's Section 75 debt in return for a cash contribution enabling some member benefits to be secured (by an insurance policy) at a greater level than if the scheme were to enter the PPF ("PPF+ compromises"). This approach has also been taken in relation to a company voluntary arrangement, as confirmed by TPR's 2020 regulatory intervention report on the Arcadia schemes.

The guidance also sets out steps trustees and employers should take when considering an RAA:

- TPR should be involved in discussions when restructuring options are being considered by the scheme's employer. If a decision is made to proceed with an RAA, information including the level of mitigation proposed should be submitted in a draft application.
- Employers should discuss the proposal in detail with the trustees before approaching TPR. The application must include the trustees' view on the proposal.
- Trustees and their advisers should have considered and be able to demonstrate that the proposal satisfies the RAA principles and would be in the best interests of scheme members.
- The employers should make a clearance application. The template clearance application is designed for both clearance and RAA approval to be requested in one form.
- Employers should notify TPR and the trustees if there is a commercial deadline. An approval notice cannot be issued until 28 days after TPR issues a Determination Notice to approve the RAA.

Next steps:

- Sponsors and trustees should be aware of this new guidance, particularly where a sponsor is in distress.
- Although RAAs are unusual, the Regulator may decide to apply its RAA criteria in situations which it considers to be equivalent.

DATA TRANSFERS: ESTABLISHMENT OF UK-US DATA BRIDGE

Under UK data protection law, both trustees and employers are likely to be data controllers in relation to any member data they hold. Where that data is being transferred outside the UK, they are required to ensure that it is adequately protected. Protection can be ensured in several ways including by using contractual provisions or where the country to which the data is being transferred has been recognised by the UK as providing adequate levels of data protection. Regulations came into force on 12 October 2023 establishing a UK-US data "bridge" which will allow transfers of personal data from the UK to named US entities without the need for further protection.

Under the UK General Data Protection Regulation (UK GDPR), a "restricted transfer" of personal data (in other words, to a country outside the UK or where the UK GDPR does not apply) cannot be made unless one of three conditions applies:

- The transfer is to a country covered by UK adequacy regulations. Existing adequacy regulations cover the EU member states and certain other countries.
- Transfer mechanisms are used which provide protections for data subjects that are sufficiently similar to UK protections. This is the responsibility of the controller or processor initiating the transfer and one of the commonly used mechanisms is standard contractual clauses which deal with data protection. The Information Commissioner's Office (ICO) issued new standard clauses for relevant overseas data transfers in 2022. The previous EU standard contractual clauses continue to be valid where they are in existing agreements but only until 21 March 2024.
- One of a limited number of exceptions covers the transfer.

Details about these conditions and the issues to consider when planning to make overseas data transfers are contained in the ICO's Guide to international transfers.

The new Regulations relate to the first condition above - adequacy. They specify the US as a country which provides an adequate level of protection for personal data where the data is being transferred to US entities who participate in the UK Extension to the EU-US Data Privacy Framework and appear on the publicly available Data Privacy Framework website.

The Government has published an explanatory notice and factsheet on the new data bridge. The notice advises UK organisations to be mindful of the need to update privacy policies and document their own processing activities as necessary to reflect any changes in how they transfer personal data to the US.

Next steps:

- This may be helpful for trustees or sponsors who currently have contracts in place which allow for data transfers to the US.
- Where existing contracts rely on the use of old standard contractual clauses for US data transfers, they would have needed to be updated to reflect the new standard clauses by 21 March 2024. The new data bridge may mean that this is not required.

GOVERNMENT PROPOSALS TO INCREASE THE GENERAL LEVY

The Pensions Regulator, Pensions Ombudsman and aspects of the Money and Pensions Service are funded by a general levy on pension schemes. As the activities of these bodies have increased in recent years, so have their costs and this has resulted in a deficit. The Government has announced proposals to address the deficit. Its preferred option would see an increase in the general levy for all schemes with an additional premium payable for schemes with fewer than 10,000 members.

The Department for Work and Pensions (DWP) has published a consultation, closing on 13 November 2023, on proposed changes to the structure and rates of the general levy on occupational and personal pension schemes. The general levy funds core activities of the Pensions Regulator, the Pensions Ombudsman, and the pensions-related activities of the Money and Pensions Service. The amount levied on schemes is calculated by reference to member numbers and scheme type. The levy rates are reviewed annually by DWP.

DWP estimates that if levy rates were to remain unchanged, there would be a deficit of over £200m by 2031. Three options are outlined in the consultation to avoid this:

- **Option 1 - Continue with the current levy rates and levy structure**

  This option would freeze rates at this year's level until 2026/27 and retain the four categories of rate payer: defined benefit (DB) schemes, defined contribution (DC) schemes other than master trusts, master trusts and personal pension schemes. DWP says this option would see the deficit continue to grow and require greater rises at a later date.

- **Option 2 – Retain the current levy structure and increase rates by 6.5% per year**

  This option would bring the cumulative deficit back to a compliant level by 2031.

- **Option 3 – Increase rates by 4% per year with an additional premium rate for small schemes (with memberships up to 10,000) from 2026**

  This, the Government's preferred option, increases rates by 4% per year for all schemes and adds a premium to schemes which, as of April 2026, have memberships under 10,000. The premium allows for a lower initial increase for all schemes, while still paying off the deficit. DWP adds that this option would support wider Government initiatives to encourage consolidation, such as the new Value for Money Framework for DC schemes and that introducing the premium payment in 2026 would allow smaller schemes time to consolidate, "*giving two years to consider whether this is in their members' interests*".

The Government will aim to introduce changes to the levy rates from 2024/25 to 2026/27 following the consultation exercise.

The consultation also comments that the Government accepts that the Pensions Regulator's automatic enrolment compliance regime, currently not recovered by the levy, should be fully funded by the pensions industry; it will include this in a future consultation.

Next steps:

- Sponsors and trustees should be aware of the proposed increase to the general levy and that it has become fairly sizeable in recent years. Under the new proposals it would, for example, rise to over £1m for a DB scheme with 500,000 members for 2025/26.

- There has been criticism of the proposals in the light of a lack of consolidation options for schemes, given that the Government says its preferred option collects more from small schemes "*that choose not to consolidate*".

DRAFT GUIDANCE ON CONSIDERING SOCIAL FACTORS IN PENSION SCHEME INVESTMENT

Social risks form part of the environmental, social and governance considerations that trustees are required to take into account when drafting their Statement of Investment Principles. They include organisations' workforce practices, supply chain and modern slavery and company products and selling practices. The Taskforce on Social Factors, established by the Government earlier this year, has published draft guidance for trustees on their approach to social risks and opportunities in scheme investments. As trustees typically make decisions at portfolio or mandate level, the guide focuses on trustees' stewardship approach and oversight of advisers and fund managers. One of the recommendations is that the Government should set out formal expectations on addressing social factors, to be overseen by the Pensions Regulator.

The Taskforce on Social Factors has published a draft guide for consultation: *Considering social factors in pension scheme investments: Guide from the Taskforce on Social Factors*. The Taskforce, which has members from Government and regulators, was set up earlier this year, following a Government consultation on how pension scheme trustees assess social risks and opportunities. The guide is intended to help trustees identify and monitor social risks and opportunities in investment and develop a consensus in approach. It discusses the data trustees can use and includes a "materiality assessment framework" to evaluate investment portfolio exposure to social factor risks, as well as examples of baseline, good and best practice.

The guide takes the view that taking financially material social factors into consideration in investment aligns with trustees' fiduciary duties and that a failure to consider all long-term investment value drivers, including environmental, social and governance (ESG) issues, is a failure of fiduciary duty. It encourages trustees to take a long-term view of investments and recognise that ESG factors (social factors in particular) may become financial factors. It notes that trustees typically make decisions at portfolio or mandate level and therefore need to use their stewardship approach and oversight of advisers and fund managers to manage social risk and opportunities.

The Taskforce recommends that, as well as improving their understanding of social factors, trustees should:

- Have a good understanding of the way investment consultants approach social factors and set objectives related to these factors. The guide suggests points to include in mandates and side letters.
- Ensure that asset managers consider social factors, and that these are integrated into the investment strategy and stewardship of investments.
- Ensure that asset managers have a strong engagement track record, appropriate exclusion policies and display responsible behaviour as businesses and that proxy voting policies of asset managers align with the trustees' policies and investment beliefs.
- Consider their own practices in relation to social considerations.
- Consider social impact investment (positive social outcomes through the scheme's investments) where financial outcomes align with desired social outcomes.

The Taskforce also recommends that the Government should consider setting out "formal expectations" on addressing social factors for pension funds, to be overseen by the Pensions Regulator.

Next steps:

- The Government has yet to respond to the recommendations but has previously encouraged trustees to take social risks into account along with the wider discussions on ESG.
- The extent to which trustees can take into account non-financial factors in scheme investment is an area of uncertainty. Trustees should take legal advice and investment advice and exercise caution when considering non-financial factors.
- Trustees should check compliance with ESG and stewardship in their Statements of Investment Principles – the Pensions Regulator confirmed earlier this year that it has started a regulatory initiative on compliance.

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	From 1 October 2023: Inclusion of explanation of illiquid investment policies in default Statements of Investment Principles and disclosure of asset allocation data in Chair's Statement.	DC schemes only. Consultation expected on draft regulations for phased introduction of new Value for Money framework for all DC schemes (excepting some small schemes). Draft regulations to extend Collective Defined Contribution to multi-employer schemes expected Autumn 2023.
2	DB consolidation	Legislation "as soon as Parliamentary time allows", for new compulsory framework for superfunds	TPR updated interim guidance issued August 2023.
3	Changes to pensions tax allowances	Finance (No 2) Act 2023: removal of lifetime allowance charge (replaced with income tax charge on lump sums that could have triggered a charge) and changes to other allowances, from 6 April 2023.	Abolition of lifetime allowance and introduction of new tax-free cash allowances from 6 April 2024, through Finance Bill 2023-24.
4	Draft DB Funding Code of Practice	Part 2 of TPR consultation and draft Code issued 16 December 2022. Regulations and Code expected to be in force from April 2024 but may be delayed until October 2024.	DWP regulations issued for consultation July 2022. Once in force, the Code will apply to triennial valuations submitted thereafter. Consultation on covenant guidance in 2023.
5	TPR General Code of Practice	Revised Code expected shortly.	All schemes.
6	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 in 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.

No	Topic	Effective date or expected effective date	Further information/action
7	Pensions dashboards	Compulsory connection deadline of 31 October 2026 for all schemes with 100 or more active and/or deferred members at scheme year end between 1 April 2023 and 31 March 2024; staging timetable to be set out in DWP guidance.	All registerable UK-based schemes with active and/or deferred members.

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