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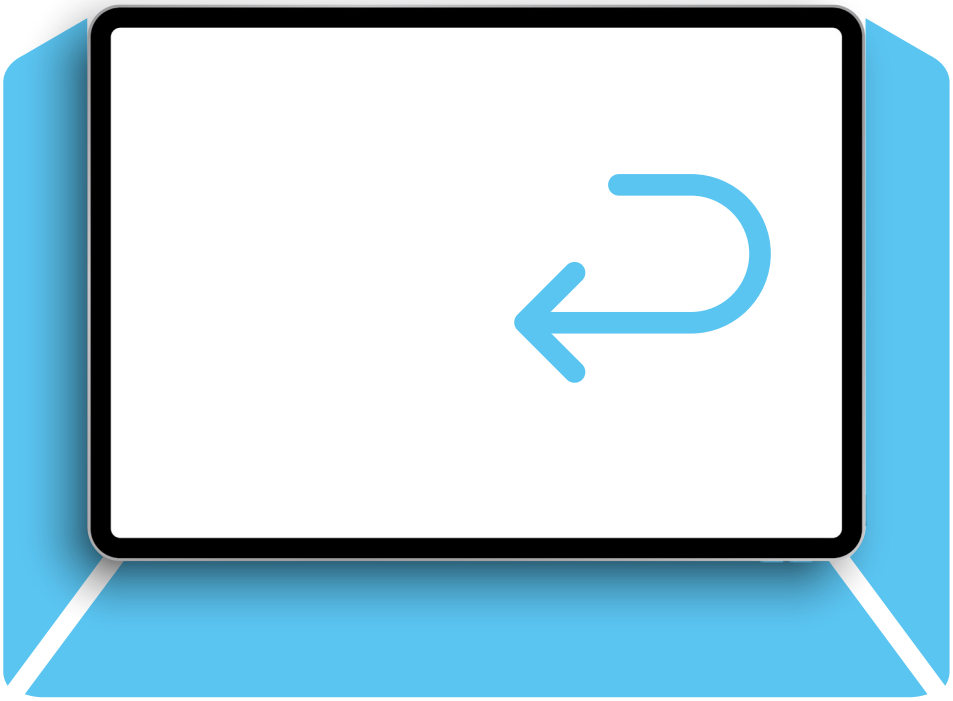


The right returns

Our pensions investment newsletter

Winter 2022

Contents

Introduction

Welcome to the Winter 2022 edition of the Right Returns.

December 2022 brings to a close what has turned out to be a challenging year for pension schemes generally, and particularly in relation to the their investments. We've seen the release of the first round of TCFD reports from the largest schemes and mastertrusts and many more schemes are now in the midst of their reports due out in 2023. We've been through, although are certainly not over, huge market uncertainty prompted by the former Prime Minister's fiscal event but influenced by wider macro-economic considerations around the world. Many schemes have also been waiting to see what The Pensions Regulator has in store for them in the revised DB Funding Code and the Single Code of Practice, neither of which, at the date of writing, have been published by TPR.

In this final edition of the Right Returns for 2022:

- we take an in depth look at the LDI liquidity crisis and what trustees should be doing now
- we look at the issue of Diversity, Equity and Inclusion and how important it should be on trustee agendas
- we have updates from Finance Day at COP 27 and next steps on the Government's Net Zero Strategy
- we take a look at the new Consumer Duty and what it may mean for pension schemes
- we look at developments in the DC space around the use of illiquid assets

In addition we take a look at what changes came into effect on 1 October 2022 and what should be on your horizon scanning agenda.

As always we appreciate any feedback that you have on the Right Returns. The Eversheds Pensions Investment team would like to extend our thanks to all you for the interaction we have over the year and we appreciate all of the knowledge sharing and work we do for you. I would also like to thank all of my colleagues who help put this newsletter together each quarter for all their hard work! Wishing everyone a safe and happy holiday season.

Mark Latimour
Partner

Reflecting on the LDI liquidity crisis

The government's "mini Budget" was presented to Parliament just over two months ago and triggered a period of unprecedented upheaval in the UK gilt market that affected pension schemes and their sponsors in ways that, for many, are still being determined and understood.

In the following article, we reflect on why LDI is used, how it works, what went wrong and how the Bank of England intervened. At a similar time to publishing this newsletter, we have published a **Speedbrief** which sets out a 20-point list of suggested actions for schemes to consider. Schemes may find it helpful to read that Speedbrief in conjunction with this article.

What is LDI and how does it work?
Why do schemes use LDI?

Liability-driven investing is an investment approach that aims to move scheme assets in line with changes in the present value of scheme liabilities – up or down. The actual movement in scheme liabilities is determined by variables such as price inflation and member longevity, which are uncertain. Actuaries therefore put a present value on scheme liabilities for funding purposes by estimating the aggregate future cashflow payments from a scheme. However, as liabilities lie in the future, a scheme can expect to earn a return on its invested assets before benefits become due. Aggregate projected cashflows are therefore reduced using a discount rate – this is usually expressed as the yield on UK government bonds, plus a percentage (with a lower percentage indicating a more prudent investment strategy). Accordingly, LDI aims to move scheme assets in line with the movement in UK gilt yields.

The basic features of LDI

LDI cannot move assets perfectly in line with liabilities (a buy-in policy is the only instrument that can do that). LDI can be effected by buying and holding gilts physically, but this is considered inefficient from an investment perspective. Instead, most LDI strategies give schemes exposure to gilts synthetically using derivative contracts (to give economic exposure without direct ownership). Schemes access these LDI strategies in different ways depending on their size, sophistication and governance budget: some very large schemes run their LDI portfolios in-house, other large schemes have segregated LDI accounts with asset managers, smaller schemes use LDI pooled funds as building blocks to create a hedge. In general, the more bespoke the approach for a scheme, the more exact the liability match the LDI strategy is capable of producing for that particular scheme.

How schemes benefit from using LDI

There is an inverse relationship between UK gilt yields and scheme liabilities because of the discount rate that is used in calculating liabilities. So, when gilt yields fall, scheme liabilities rise – and vice versa. LDI works so that the investment is worth more when yields fall – this increases assets with liabilities and so protects the scheme's funding position. Conversely, the value of an LDI holding falls when yields rise – but that is considered acceptable from a funding perspective because scheme liabilities have fallen. This inverse economic effect is achieved by using swaps. Swaps are financial instruments which come in varying forms depending on their purpose. The main instruments used in LDI strategies are interest-rate swaps, inflation swaps and gilt repurchase agreements (or "repos").

Different strategic approaches to LDI

There can be different strategic approaches to LDI from scheme trustees (and sponsors). A minority of trustees have held the view that quantitative easing has kept gilt yields artificially low and some reversion to historic average levels of yield is inevitable. A larger proportion of trustees have preferred to hedge as much risk as possible to keep their scheme's funding level stable – and sponsors tend to be supportive of such strategies. Other schemes have "hedged their hedge" by, for example, hedging only 90% of their liabilities (enabling them to benefit to an extent if yields rise).

Leverage – achieved by collateral

Leverage is an inherent feature of using derivatives for LDI – it enables proportionately greater exposure to be gained for any given investment. For example, if an LDI strategy is "three times leveraged", it will provide £3 of exposure for every £1 invested. So, if a scheme invests £100m in LDI at three times leverage, it will get £300m of exposure (in theory releasing £200m of capital for investment, say, in growth-seeking assets to help close a funding deficit).

In practice, leverage is achieved by collateral being held in the middle of the contractual relationship and hypothecated for the benefit of the party in whose favour the contract has moved at any one time. So, if £100m is invested in an LDI arrangement at the outset, it will effectively be held as gilts in the collateral pool. Regular calculations are then undertaken to determine which party is "in the money" and, if more collateral is needed, the other posts it. The calculation assumes an immediate closing out of all positions, so collateral manages the credit exposure of the party in the money. Schemes using LDI therefore need to be ready in case they find themselves out of the money and are required to post collateral.

How trustees could find themselves out of the money

Interest rate swaps provide a relatively simple example. With such swaps, a bank counterparty might promise to pay the scheme a fixed rate of interest (e.g. 4%) on a notional amount for a specified period. In return, the scheme promises to pay the bank a floating rate of interest (e.g. SONIA plus 2%) on the same notional amount for the same period. When the floating rate is below 4%, the scheme will be "in the money" to that extent and the bank may need to post collateral to be held in favour of the scheme. When the floating rate is above 4%, the scheme will be "out of the money" to that extent and may need to post collateral to be held in favour of the bank. Interest rates have been increasing during 2022, primarily due to inflation, and so schemes have been finding that they have been required to post collateral under their interest rate swap programmes.

But there is also a risk that the collateral "pool" could fall in value

As collateral pools are typically comprised of gilts, a fall in gilt prices will cause the value of the collateral pool to reduce. This directly causes the amount of leverage to increase, meaning that additional collateral has to be posted to "rebalance" back to the target level of leverage.

The following table illustrates this using an example:

Example	At outset	Gilt prices fall by £60m	Additional investment of £40m to restore 3x leverage
Amount invested	£100m	£40m	£80m
Gilt exposure obtained	£300m	£240m	£240m
Leverage	3x	6x	3x

In the example below, the additional investment is achieved by the trustees posting a further £40m of collateral (albeit this is less than the amount by which gilt prices have fallen). This typically has to be done by transferring cash or gilts – but most schemes will not hold gilts (or other eligible collateral) outside of their collateral pool, so schemes in this position are required to liquidate other assets in order to post cash as collateral.

Liquidity waterfalls

To ensure collateral calls from derivative counterparties can be met, trustees have liquidity "waterfalls" or liquidity "ladders" in place. These are trustees' plans for the order in which scheme assets will be accessed and liquidated, if necessary, to post as collateral. A typical waterfall could involve the following order of priority: excess cash in scheme bank account (if any), gilts held outside the LDI mandate (if any), other assets in the "matching" portfolio (e.g. investment-grade corporate bonds), holdings in diversified growth/multi-asset funds, assets in the "growth" portfolio (e.g. equity holdings), other less liquid assets. To broadly maintain the strategic balance of the portfolio, the waterfall might set limits for the liquidation of assets at each step/rung of the ladder. Some trustees (typically those with segregated LDI accounts) give their LDI managers conditional access to designated scheme assets so they can be transferred or sold by the manager to liquidate cash for collateral.

What happened with the mini Budget?
A sudden and significant fall in gilt prices

The Chancellor of the Exchequer presented the government's Growth Plan to Parliament on 23 September 2022. This constituted a fiscal event and so was colloquially termed a "mini Budget". It entailed significant additional government spending (through energy price support schemes and tax cuts), but did not explain how such spending would be paid for and did not give OBR budget forecasts or costings. The implication was that the spending would simply be funded through additional government borrowing. The government borrows money by issuing gilts to investors – investors buy these bonds in return for future capital repayment plus interest. There is market appetite for UK government bonds because of their very low default risk and long duration. But the price investors are willing to pay for gilts varies. When the mini Budget was presented, the market was concerned about the credibility of the UK Growth Plan, so gilt prices fell (as investors were not willing to pay as much for UK gilts and a higher return was demanded). In other words, the UK was considered riskier, so borrowing costs increased.

A sudden and significant increase in gilt yields

There is an inverse relationship between gilt prices and gilt yields. Accordingly, as gilt prices fell rapidly, so gilt yields rose rapidly. Overall, rising gilt yields are good for pension schemes, as discount rates are linked to them and so the present value of liabilities falls. However, for schemes using LDI, rising gilt yields meant trustees found themselves out of the money with their bank counterparties and the fall in gilt prices lowered the value of their collateral pools. So collateral was called for to restore leverage to agreed levels. Since most schemes do not hold gilts outside of their LDI portfolios, trustees had to liquidate other assets to meet the collateral calls. Some schemes voluntarily reduced their hedging ratio to pare back the collateral needed – but lowering exposure involved selling gilts.

The scale and speed of the increase was too much

It is important to remember that gilt yields had been rising steadily for some time – but the operative word is "steadily". The steady pace of gilt yield increases before 23 September 2022 meant schemes were able to meet collateral calls in an orderly way. This was because the scale of the rebalancing required was relatively moderate and trustees were given time to do it. The difference on 23, 26 and 27 September was that the calls for collateral were significant and immediate. Some schemes crystallised (paper) losses, liquidated assets at a haircut and reduced their scheme's overall level of expected return. Other schemes failed to meet collateral calls and had their hedge reduced (exposing them to a reversion in gilt yields and a worsened funding position).

The Bank of England's intervention

The Bank of England intervened on 28 September 2022 to address this dysfunction in the gilt market. This was the first time the Bank had ever intervened in the gilt market pursuant to its statutory "financial stability" objective. It did so by announcing that it would undertake "temporary and targeted" quantitative easing by electronically printing money and buying gilts. It said it would buy up to £5bn of gilts a day for the next 13 days of trading (to 14 October 2022), focusing on conventional gilts at longer maturities. This £65bn of intervention put pensions and LDI on the front page of The Sun (under the heading "Kw-armageddon!" on 28 September).

The true extent of the problem

On 5 October 2022, the Bank's Deputy Governor wrote to the Chair of the Treasury Select Committee to explain why the Bank intervened. The letter reveals that the Bank's intervention was required to avert a catastrophe on the scale of the 2008 financial crisis. It was not just that schemes had faced a liquidity crisis and some had to accept hedging cuts and wider impacts on their funding position. A systemic risk had stemmed from pooled LDI funds:

"The Bank was informed by a number of LDI fund managers that, at the prevailing yields, multiple LDI funds were likely to fall into negative net asset value. As a result, it was likely that these funds would have to begin the process of winding up the following morning. Had the Bank not intervened ... DB pension fund investments in those pooled LDI funds would be worth zero."

However, extreme as that outcome would have been, the systemic risk was that:

"In that eventuality, a large quantity of gilts, held as collateral by banks that had lent to these LDI funds, was likely to be sold on the market ... This would amplify the stresses on the financial system and further impair the gilt market, which would in turn have forced other institutions to sell assets to raise liquidity and add to self-reinforcing falls in asset prices. This would have resulted in even more severely disrupted core gilt market functioning, which in turn may have led to an excessive and sudden tightening of financing conditions for the real economy. The Bank acted to restore core market functioning and reduce the material risks to financial stability and contagion to credit conditions for UK households and businesses."

What happened after the Bank of England intervened

The Bank's announcement of its decision to intervene was sufficient to support the price of gilts and stablise gilt yields, giving schemes and LDI pooled funds time to rebuild liquidity and deleverage. The Bank did not use up its £5bn daily gilt buying budget over the first eight business days of its operation, so it announced that it would carry forward the unused balance by increasing its budget for the following days. It also announced that index-linked gilts would be within scope too. In the end, the Bank purchased £13.5bn of gilts. It also implemented certain other measures centred on supporting the gilt repo market beyond 14 October, one of which was permanent. As 14 October approached, there were concerns about a cliff-edge effect causing gilt yields to spoke again, but the Bank's position was effectively that the problem had a political cause and so required a political solution. That is what was eventually delivered by the various steps that were subsequently taken by the former Prime Minister and the Conversative party.

Government and regulators to the fore

The Work and Pensions Select Committee has launched an inquiry into what happened and have issued a call for evidence. The Committee is asking questions such as whether DB schemes had adequate governance arrangements in place, whether LDI is still essentially fit for purpose or whether changes are needed and whether tPR has taken the right approach to regulating the use of LDI. It may be that this investigation leads to policy changes which result in legislative and regulatory reform for pension schemes' use and management of leverage in LDI strategies.

Announcements by regulators in the UK, Ireland and Luxembourg

According to the Bank of England, 1,800 UK pension schemes invest in 175 LDI pooled funds, all of which are domiciled (and regulated) in Ireland or Luxembourg. On 30 November 2022, the **Irish** and **Lux** regulators issued statements on the resilience of sterling-denominated LDI pooled funds in their jurisdictions. On the same day, the Pensions Regulator issued **additional guidance** for trustees, supplementing the **guidance** it issued on 12 October, and the FCA issued its own **statement**. All trustees using LDI should read the Regulator's guidance.

What should schemes do next?
For many schemes, the precise impact of the events that followed the mini Budget is still being determined and time will need to be devoted over the coming months to reflect on what happened and work out what to do next. Our recent **Speedbrief** setting out 20 suggested actions for schemes to consider might be a helpful reference point.

Simon Daniel
Partner

Stefanie Sahla-Jones
Partner

Diversity, Equity and Inclusion

To DEI or not to DEI?

At a time when politics and the economy are in the spotlight, and some DB funds may be facing existential liquidity challenges, talking about diversity, equity and inclusion ("**DEI**") may seem like a "nice to have" rather than a key issue for trustees.

But we would counter that suggestion. There are at least three solid reasons why trustees should treat DEI as an essential part of their plan, and should be addressing it right now.

First, good DEI is arguably central to the discharge of trustees' fiduciary duties. There is a growing body of research – by McKinsey[1] and Forbes[2] among others – which demonstrates that commercial organisations with strong DEI credentials make better decisions, make them more quickly, and generate superior returns as a result.

Of course, the validity of this research depends, in part at least, on what you're measuring and how. But while there may be scope for argument at the margins, it's hard to dispute the broad direction of travel in the results. You might also argue that the research isn't directly applicable to trustee boards which aren't commercial organisations like those which were surveyed in the research. But a trustee board is still a critical decision-making team, responsible for a large number of strategic decisions in relation to the scheme including on funding and investment, complying with law and regulation and reaching discretionary decisions on a range of issues. There is no reason to suggest that the conclusions reached in the commercial sector research by McKinsey and Forbes won't equally apply to trustee boards. If that's right, then having strong DEI credentials goes to the heart of how trustees discharge their fiduciary duties. In other words, it's central, not an optional "nice to have".

The second reason for trustees to engage with DEI is that the regulators are already requiring this. Whether you accept the conclusions of the research or not, the FCA[3], Financial Reporting Council ("**FRC**") and the Pensions Regulator ("**TPR**") have all recently emphasised the importance of strong DEI credentials. Any trustee board which has been through a submission to the FRC's Stewardship Code[4] will know that DEI is an inherent part of it: the introduction tells signatories to consider diversity (among other issues) when applying the twelve Principles underpinning the Code, and Principle 2 calls diversity out specifically. The same goes for the FRC's Corporate Governance Code.

TPR is also prioritising DEI as an issue for trustees. It recently issued its action plan on DEI[5], and we've certainly seen at least one example of TPR, in its one to one supervision of a scheme, asking very direct and specific questions about how the scheme was embracing DEI in its operations, and in particular how DEI played a part in the make-up of the trustee board. There is no reason why the same questions won't be asked of any other scheme. The indications are also that TPR's Single Code – likely to be issued shortly – will include a module on DEI. So trustees had better be ready.

1 *Why Diversity Matters* (2015), *Delivering through diversity* (2018), *Diversity Wins: How inclusion matters* (2020)
2 E.g. Diversity in the workplace is now more important than ever (2020)
3 See: **Diversity, equity and inclusion | FCA**
4 Available at **www.fsb.org.uk.**
5 **Promoting high standards of diversity and inclusion among our regulated community | The Pensions Regulator**

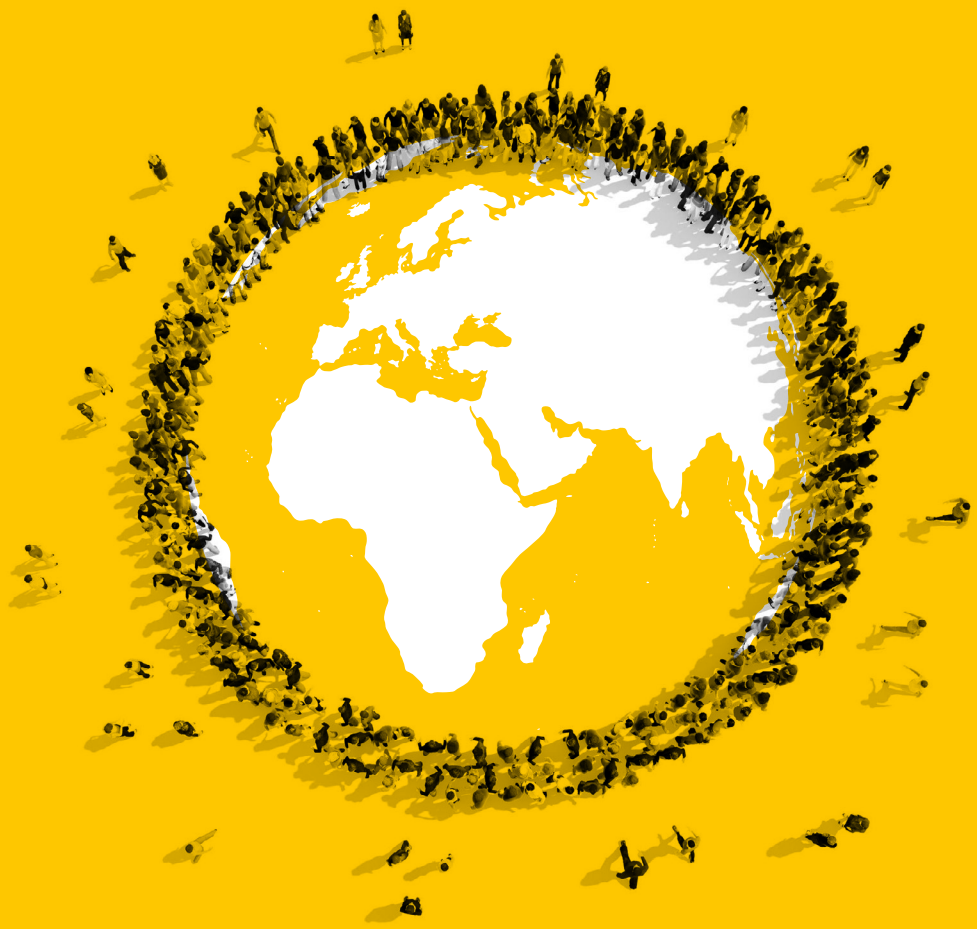
The third reason for tackling DEI now is that it links very directly to trustees' ESG and responsible business agendas. There has been plenty of focus on the "E" in terms of making updates to statements of investment principles, setting policies and reporting against the Taskforce on Climate-Related Financial Disclosures regime under the 2021 climate regulations.[6] The "S" is gaining momentum – the DWP issued a response to its call for evidence earlier this year, which suggests that it is going to expect more focus on social factors going forward.[7] DEI fits perfectly into the "S" and the "G" elements: it is a social factor like many other factors which go to how business is conducted in the broadest sense and, bearing in mind the growing body of research mentioned above, clearly a governance factor for important decision making bodies like trustee boards.

In conclusion, DEI isn't an optional nice-to-have for trustee boards – it's fundamental to the discharge of their legal and fiduciary obligations. Trustees should be prepared for searching questions on DEI from their regulators: TPR for example is clearly concerned that trustees aren't taking it seriously enough and is unlikely to take no for an answer.

David Fairs in his December 2021 blog put it succinctly: *"Trustee boards that are not diverse risk knowledge gaps, entrenched ideas, biased thinking and poor decision making which puts savers at a disadvantage"*. And if you want to hear David add more colour to TPR's approach on DEI, our recent "Barker's Dozen" (and a bit) podcast is definitely worth a listen.[8]

A version of this article appeared in our November 2022 edition of **DC Practical Notes**.

Michael Jones
Partner



6 Occupational Pension Schemes (Climate Change Governance and Reporting) Regulations SI 2021/839, as amended.
7 **Consideration of social risks and opportunities by occupational pension schemes - GOV.UK (www.gov.uk)**
8 **https://listen.eversheds-sutherland.com/barkers-dozen-diversity-equity-and-1**

An update on COP 27 – Finance Day

The first of COP27's thematic days saw participants focus on climate finance, which is seen as the key to achieving the goals set out in the Paris Agreement and addressing the climate crisis. In this article we have summarised some of the key announcements and pledges coming out of the day.

Key Announcements and Pledges:

- Egypt's finance minister suggested that the amounts required to implement the climate commitments made by countries and companies required trillions, rather than billions, of dollars. Mr Maait said that COP27 would be a success if it could achieve *"more financing at a reasonable cost and on reasonable terms"*.
- US Climate Envoy John Kerry announced plans to introduce a new carbon credit scheme (the 'Energy Transition Accelerator') enabling polluting companies to purchase carbon credits, compensating for their own emissions. The money raised from such purchases will be directed towards assisting developing countries in their move towards renewable energy.

  Key details as to how the Energy Transition Accelerator will operate in practice are yet to be decided, and the US will work in partnership with the Rockefeller Foundation and the Bezos Earth Fund to further develop these plans with a view to having the scheme up and running before COP28.

  Critics suggested that rather than compensating for high emissions with the purchase of relatively cheap credits to meet their environmental targets, companies should instead be focused on reducing their actual emissions. Kerry made clear that fossil fuel companies would not be able to purchase these credits.
- Xie Zhenhua indicated that China could be willing to contribute to compensation for the losses and damages suffered by poorer nations as a result of climate impacts.

  The controversial loss and damage payments (which have been referred to by some as 'climate reparations') are seen as a key demand of developing nations at COP27, following last year's progress in Glasgow. Austria and New Zealand have now made commitments to put forward funding towards loss and damage, which follows Scotland's First Minister Nicola Sturgeon stating earlier in the week that further financial commitment would be announced during COP27.
- The UK's credit export agency will introduce "climate resilient debt clauses" in its lending to developing countries. These clauses will operate to stop debt payments for two years in the event that a climate disaster occurs, enabling funds to be directed towards dealing with the climate emergency. The UK called for all creditors, domestically and internationally to explore adopting similar clauses in their lending.

  In the light of the UK's Transition Plan Taskforce's Disclosure Framework and Implementation Guidance being published for consultation, the UK's Treasury Minister welcomed the next step towards companies demonstrating how they will align their business with net zero. The framework is intended to enable companies to demonstrate what measures they are taking to meet their goals, setting out recommendations for disclosure.

- UN experts have published a list of projects with a combined worth of $120 billion in the hope of demonstrating that there is a "meaningful pipeline of investible opportunities ... across the economies that need finance most". Dozens of projects were listed, including 19 in Africa alone.

  The release of the list will enable banks and other lenders/investors to assess the projects and eventually provide finance. The team behind the release said that *"we now need a creative collaboration between project developers and public, private and concessionary finance, to unlock this investment potential and turn assets into flows"*.

- A group of over 85 African insurers have pledged to provide $14 billion of cover to help the continent's most vulnerable communities deal with climate disaster risks. The group stated that they were trying to create a local market-based funding tool for resilience.

Matthew Allen, Global Head of Financial Services at Eversheds Sutherland, comments

"Financial markets have an enormously important role to play in the fight against climate change. Whether providing sustainability linked debt finance to taxonomy compliant businesses and projects, acting as sponsors of private market investment into green assets and businesses or creating liquidity in market instruments designed to fund the energy transition in emerging markets, institutions including banks, asset managers and insurers are key enablers of change. Trust, transparency and good customer outcomes are however key to the resilience and longevity of institutional and private market funding. Capital allocation in ESG backed investments continues to grow exponentially but sentiment can rapidly change when returns weaken or market integrity is put at risk. We therefore expect to see a continued and robust focus on disclosures, due diligence and asset liquidity by regulators on both sides of the Atlantic in the period ahead."

Eversheds Sutherland's comprehensive website covering all aspects of COP 27 can be found **here**.

Tom Meyrick
Principal Associate

Government focus on revised Net Zero Strategy after deciding not to appeal High Court ruling

The Government have decided not to pursue an appeal of the High Court's ruling that the UK Government's Net Zero Strategy is unlawfully in breach of the Climate Change Act 2008.

According to Friends of the Earth, one of the parties who challenged the Government in the High Court, the Government has confirmed in a letter to the court and the parties involved that it will not pursue an appeal despite having previously sought permission to do so.

The Government now has until the end of March 2023 to come up with a revised Net Zero Strategy that shows how the targets set under the Climate Change Act 2008 will be met.

[Source: Govt not appealing ruling that Net Zero Strategy is unlawful | Friends of the Earth]

The Government may have already commenced its action plan for its revised Net Zero Strategy having commissioned a **review** in September 2022 into its approach to delivering its net zero target. The purpose of this independent review will focus on how the Government's net zero approach can deliver maximum economic growth, support UK energy security and affordability for consumers and business and minimise costs borne by business and consumers in the short term.

This review will produce a report including a set of recommendations which will be submitted to the BEIS Secretary of State by the end of December 2022.

[Source: Net zero review: terms of reference - GOV.UK (www.gov.uk)]

Tom Meyrick
Principal Associate

Consumer Duty

Our short summary
The FCA's new Consumer Duty doesn't apply to trustees of occupational pension schemes.

- however, the Consumer Duty is likely to apply to trustees' FCA-authorised service providers
- this means trustees may need to consider the Consumer Duty in relation to:
  a) contractual and commercial terms with regulated service providers caught by the Consumer Duty
  b) due diligence and monitoring of service providers caught by the Consumer Duty
  c) information flows with service providers caught by the Consumer Duty in relation to member demographics and member engagement/feedback.

What is the Consumer Duty?
The Financial Conduct Authority has introduced a Consumer Duty (Principle 12), setting higher standards of consumer protection across financial services.

The Consumer Duty consists of:

- **a new Consumer Principle:** "a firm must act to deliver good outcomes for retail customers" (currently, firms are required to treat customers fairly)
- **overarching cross-cutting rules:** requiring firms to act in good faith, avoid causing foreseeable harm and enable and support customers to pursue their financial objectives
- **outcomes rules:** which say firms must ensure consumers receive communications they can understand, products and services must offer fair value, and firms must provide the support customers need

The Consumer Duty applies to all firms authorised by the FCA in respect of products and services involving "retail customers", which will include members of personal pension schemes and beneficiaries of occupational pension schemes. It imposes obligations on firms towards retail customers of products irrespective of whether the customer is a direct client of the firm.

For new and existing products and services, firms have until 31 July 2023 to make changes to ensure compliance with these new higher standards. For closed books, the rules will not apply until 31 July 2024.

What is the scope of the Consumer Duty?
The new Consumer Duty only applies to a firm's "retail market business".

"Retail market business" includes a firm's regulated and ancillary activities in a distribution chain (including a manufacturer and a distributor) which involves a retail customer (but excludes certain activities).

In most instances, there will be a distribution chain. In its **Final non-Handbook Guidance 22/5**, the FCA includes all firms involved in the manufacture, provision, sale and on-going administration and management of a product or service to the end retail customer.

"Retail customer" includes, where a firm carries out activities in relation to an occupational pension scheme, any person who is (or would be) a beneficiary in relation to investments held in that occupational pension scheme. The FCA says that "*while, legally, the trust is the firm's customer, in practice, scheme members would still regard the pension in the same way as an individual pension, and the FCA authorised firm is likely to have a role in ensuring good outcomes for members.*"

Retail market business excludes certain activities. These exclusions are complex and in many cases will be fact-specific. Broadly, a firm will not be caught by the Consumer Duty if it:

- manufactures a product that is only marketed and approved for distribution to non-retail customers (and does not enable another firm to distribute another product to a retail customer)

In this context, "manufacture" means creating or developing a product; "product" means distributing a specified investment to retail customers or providing the regulated activity directly to a retail customer; and "distribute" means offering, recommending, advising on, or proposing a product.

- carries on activities in relation to "non-retail financial instruments" (i.e. financial instruments that are directed only to professional clients)
- makes an offer or associated promotional communications in relation to a financial instrument which meets specific criteria (e.g. it is traded on a regulated market)

What constitutes material influence?
In our view, it is unlikely that firms providing services or products to trustees of occupational pension schemes would meet one of the exceptions within "retail market business" because they will not be "manufacturing a product", nor will they be carrying on activities in relation to non-retail financial instruments only.

Therefore, the Consumer Duty will apply to a firm's retail market business if the firm has the ability to determine or materially influence retail customer outcomes.

In determining "material influence", firms must consider the retail customers (i.e. pension scheme beneficiaries) at the end of the distribution chain (whether or not they are a direct client) and if they can determine or materially influence outcomes for them.

This will be scheme-specific and will depend on whether a firm is, in practice, exercising discretion over customer outcomes. In its **Final non-Handbook Guidance 22/5**, the FCA says the Consumer Duty applies to firms that can influence material aspects of, or determine:

- the design or operation of retail products or services, including their price and value
- the distribution of retail products or services
- preparing and approving communications that are to be issued to retail customers
- engaging in customer support for retail customers

How does the Consumer Duty apply to occupational pension schemes?
The FCA's Consumer Duty does not apply directly to trustees of occupational pension schemes. The FCA makes this expressly clear in its **Policy Statement 22/9** implementing the Consumer Duty.

However, trustees and their service providers will need to be aware of the scope and application of the Consumer Duty as it may affect: (i) the contractual and commercial relationship between trustees and service providers; (ii) the obligations of service providers to beneficiaries of the pension scheme; (iii) information flows with service providers caught by the Consumer Duty in relation to member demographics and member engagement/feedback; and (iii) trustees' due diligence and monitoring of service providers caught by the Consumer Duty.

The Consumer Duty is more likely to apply in a DC context than a DB context. In a DB context, the retail customer outcomes are defined by the scheme's benefit structure, the trustee and the scheme administration rather than third party service providers.

The FCA expressly says that the Consumer Duty would not apply to a firm whose role is limited to operating within a mandate determined by another firm (e.g. the trustee) in the distribution chain. This would be the case where an investment manager is managing part of the portfolio of a DB pension scheme, where the trustee is entirely independent of the manager.

But in a DC context, the position is less clear-cut and will depend on scheme-specific circumstances and the firm's role in providing services to the scheme.

For example, the majority of trustees of DC pension schemes invest assets through unit-linked policies, where they purchase units in a notional pool of assets and receive a return based on the performance of the notional pool. The value of unit-linked policies is directly linked to the investment performance of the underlying unit-linked funds. The policy provider is the owner of the units and is typically responsible for carrying out due diligence on underlying fund managers in which it invests. In our view, this shows a direct correlation between the provider's activities and the value for money and outcomes experienced by the underlying scheme beneficiaries. In this situation, the provider is likely to be caught by the Consumer Duty as a distributer of the funds (and potentially a manufacturer of the platform).

How does the Consumer Duty apply to personal pension schemes?
Providers of workplace GPPs, SIPPs and other personal pension schemes will be subject to the new Consumer Duty. Boards should have agreed their implementation plans by the end of October 2022 to ensure their schemes will be in a position to comply with the new rules by July next year.

Given the relative complexity and longevity of pensions compared to other financial products, the following areas will require careful consideration:

- As part of the consultation, the FCA picked up on respondents' concerns with how the fair value outcome under the new Consumer Duty would fit with the existing requirement for Independent Governance Committees (IGCs) to undertake value for money assessments in the context of workplace schemes. The FCA confirmed that as part of implementing the fair value outcome, firms must consider the IGC's assessment. It remains to be seen how this will all fit with the joint regulatory framework on value for money, which is due to be consulted on later in the year.
- Pension schemes will also need to review their customer communication strategy and materials in light of the new Consumer Duty. They should question whether they are providing enough information for their target customers to make an informed decision; if it is being provided at the right time in the pension lifecycle; and if it is presented in an accessible way. As part of this, firms should not lose sight of the wider regulatory pension and tax disclosure requirements and any necessary adjustments for vulnerable customers.
- Finally, as the new Consumer Duty applies across the whole distribution chain, compliance will require greater collaboration between all parties: pension providers, fund managers, asset managers, advisers and insurance companies. Each will need to be clear on where they consider their responsibilities to start and end and this should be reflected in the commercial service agreements between the firms.

A version of this article appeared in our November 2022 edition of **DC Practical Notes**.

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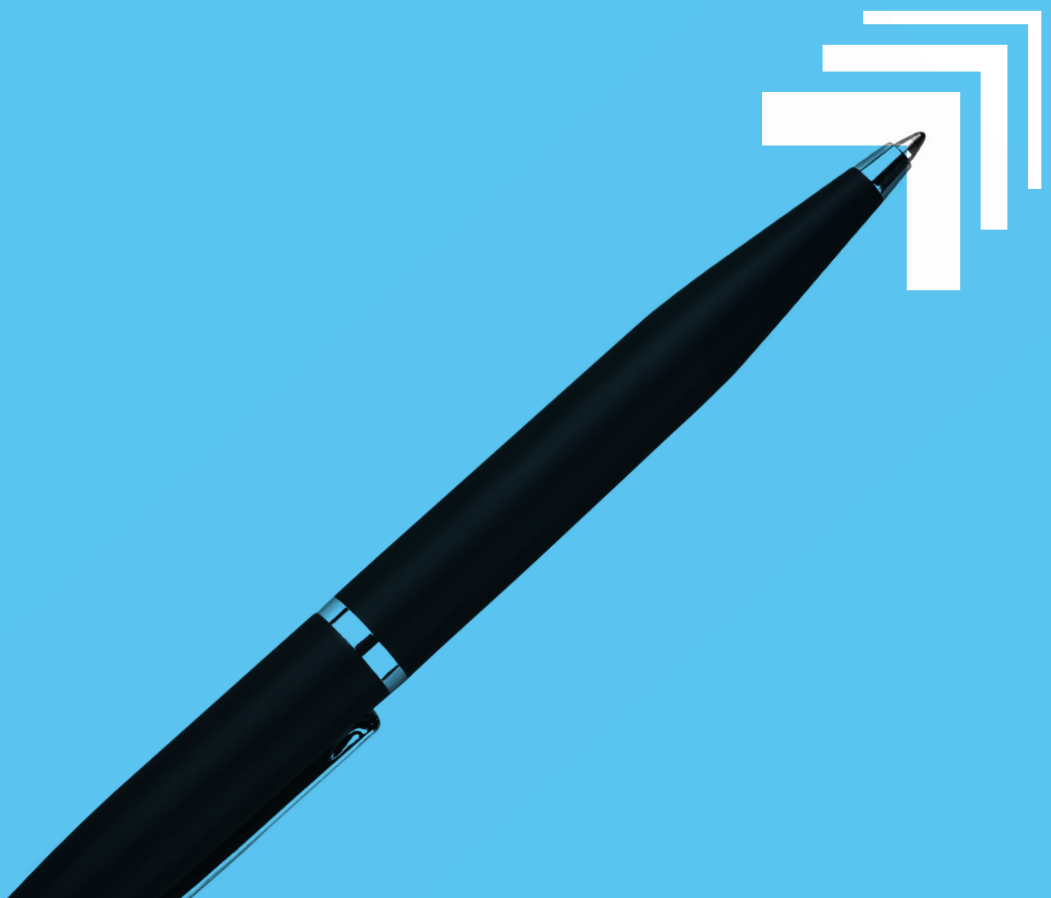


Consumer Duty

How to determine whether it applies to occupational pension schemes?

Does the Trustee have FCA-regulated service/product providers (e.g. bundled admin/investment provider, investment managers, fiduciary manager, platform provider, insurance products)? (the "Firm")

→ **No** → **Consumer duty is not relevant**

↓ **Yes**

In relation to the Firm, do the services or products provided to the Trustee constitute "retail market business"?
Need to follow steps 1 and 2 to determine if this is the case

↓

Step 1: Do the Firm's regulated or ancillary activities involve a "retail customer"?
(See below the key definitions applicable to occupational pension schemes)

- Means a customer who is not a "professional client"
  Note: trustee of an occupational pension scheme will usually be a "per se professional client"
- Means a unitholder, investor, or beneficial owner of units or shares in a UK UCITS, AIF or CIS, excluding a professional client
- Where the Firm is involved in a distribution chain, it means any person who is the end retail customer in a distribution chain but is not a direct client of the firm
- Where a Firm carries out activities in relation to an occupational pension scheme, it means any person who is a beneficiary of investments held in that scheme

↓ **Yes** → **Step 2:** Do any of the following exclusions A, B, or C apply
(these are the key exclusions applicable to occupational pension schemes)?

↓ **No** → **Consumer Duty is not relevant**

- **Exclusion A:** Is the Firm manufacturing a product that: (i) is only marketed and approved for distribution to non-retail customers; and (ii) is not used to distribute another product to a retail customer or operate a specified investment held by a retail customer?
- **Exclusion B:** Are activities in relation to "non-retail financial instruments"?
  i.e. not intended for retail customers and marketing materials include clear disclosures that only for professional clients; or minimum investment of £50k
- **Exclusion C:** Is the Firm promoting a financial instrument for an issuer, holder or owner of the instrument that meets certain conditions (e.g. traded on regulated market)?

↓ **No** → Does the Firm have the ability to determine or materially influence retail customer outcomes?

↓ **Yes** → **Consumer duty is not relevant**

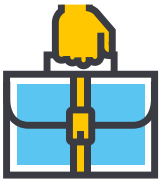
↓ **Yes**

Consumer Duty applies to the Firm in respect of retail customers (i.e. underlying beneficiaries of the occupational pension scheme)

Firm likely to require additional information from Trustee. Trustee to consider implications for its governance and management of service/product providers

↓ **No**

Consumer duty is not relevant



Developments in relation to illiquid investment in DC Scheme

The DWP has published a **Consultation: Broadening the investment opportunities of DC pension schemes** setting out draft regulations and statutory guidance which require schemes to state their policy on illiquid investment within their Statement of Investment Principles ("**SIP**") and for DC schemes to disclose their asset allocations in their annual Chair's Statement.

The draft regulations will also allow trustees to remove performance-based fees from their charge cap calculations where they feel it is in their members' best interests.

The DWP proposes that the new requirements will apply on the first occasion when trustees update their default SIP after 1 October 2023, with a requirement that the policy on illiquid assets must be included in all default SIPs from 1 October 2024.

1. Disclose and explain - illiquid investments

The DWP believes disclosure of schemes' policies on illiquid investments and their asset allocations will improve the availability of investment information to members and employers and provide them with the certainty that schemes are providing members with the best possible value.

We do not believe this policy will achieve the stated aim and in our initial consultation response, we expressed our concern at the additional governance burden these disclosures will bring DC schemes. Already schemes are overburdened with a whirlwind of compliance obligations – SIPs, implementation statements, Taskforce on Climate-Related Financial Disclosures ("TCFD") reports (for those in scope) and Chair's statements. Whilst we consider TCFD reporting to be a positive step in embedding management of climate risk and improving overall governance of schemes, we would question the overall benefit of other public disclosures, when factoring in the time and resources required to be fully compliant with legal requirements and new statutory guidance.

To accompany the disclosure of illiquid investments, the DWP has proposed the following definition of "illiquid assets": "assets which cannot easily or quickly be sold or exchanged for cash and, where assets are invested in a collective investment scheme, includes any such assets held by the collective investment scheme". This definition would require trustees to "look through" multi-asset investments to underlying investments so that all illiquid exposures are clearly covered in disclosures and all schemes calculate their asset allocations at asset-level rather than fund-level.

By requiring schemes to disclose at asset-level, it will further increase the governance and compliance cost and schemes will need to start planning with their asset managers about how best to gather the information.

2. Disclosure of asset allocation

The DWP has also decided to push forward with its proposals to require trustees of DC schemes to report in the Chair's statement the percentage of scheme assets allocated to different asset classes within their default arrangement.

The DWP has decided to remove the £100m threshold to ensure all schemes, regardless of size, would be captured by the proposed requirements.

The DWP has set out a recommended approach for how schemes could present their asset allocation in the draft statutory guidance, in the interests of providing a consistent and standardised approach. However, this is not proposed to be a requirement. Schemes will ultimately be able to decide themselves how they would like to best present this data to members.

3. Performance fees

To facilitate investment in private markets (e.g. infrastructure, private equity and venture capital), the DWP has proposed that trustees will be able to exclude performance fees from the charge cap from 6 April 2023.

This follows several years of stakeholder engagement, industry feedback and consultation in relation to private market investment for DC schemes. For further background, see our **autumn 2021 edition of DC Practical Notes**.

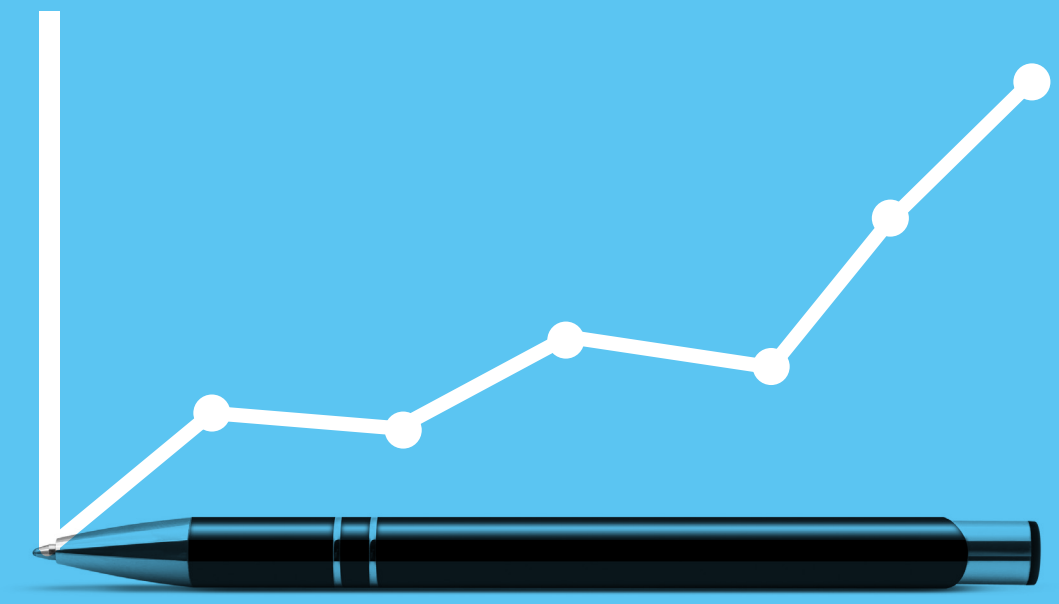
The DWP will introduce a new definition of "specified performance-based fee", which relates to a fee paid when returns from investments exceed a specific benchmark (known as a hurdle rate) or a specific amount (known as a high-water mark), which may be variable or fixed and must be agreed with trustees prior to investing.

Trustees must agree with the fund manager ways of mitigating the risk that fees increase due to short-term fluctuations in performance or valuations.

The performance fee will join a list of out-of-scope charges, including transaction costs, costs of winding up the pension scheme and costs solely attributed to holding physical assets, such as land or buildings. Trustees will need to calculate and disclose any performance-based fee charges that members incur in the Chair's statement and include performance-based fees in their value for members' assessment.

A version of this article appeared in our November 2022 edition of **DC Practical Notes**.

Michael Jones
Partner



1 October 2022 – what came into effect?

On 1 October 2022, new legislation and statutory guidance for trustees of occupational pension schemes came into effect. Here is a reminder:

1. Portfolio alignment metric

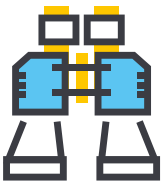
From 1 October 2022, large occupational pension schemes subject to the TCFD reporting requirement must calculate and report a new "portfolio alignment" metric as part of their climate-change reporting (in addition to the existing metrics). Trustees have the flexibility to select the type of portfolio alignment metric which best reflects their scheme-specific circumstances. Please see our recent **Speedbrief** for further detail.

2. Statutory guidance on implementation statements

From 1 October 2022, the DWP's new statutory guidance on implementation statements ('**ISs**') came into effect – it applies to ISs for any scheme year ending on or after 1 October 2022. Trustees should take action now so that they are ready to report in line with the statutory guidance. The DWP expects trustees to set their own voting policy or monitor their investment managers' policies and report in the ISs whether voting activity reflects their voting and stewardship priorities. In other words, there should be a clear governance link between trustees' stewardship priorities and their exercise of significant votes. Please see our recent **Speedbrief** for further detail.

3. Sun-setting of CMA Order for occupational pension schemes

From 1 October 2022, pensions legislation (sun-setting regulations) replaced the CMA Order requirements for occupational pension schemes. There is now an express requirement for trustees to review investment consultants' performance against their objectives on an annual basis and to review the objectives themselves at least every three years or after any "significant change in investment policy" (mirroring the requirement for SIPs). Please see our **Speedbrief** for more detail.



Investment Horizon Scanning

What should be on your investment committee agenda?

The last few years has seen an incredible amount of change for pension scheme trustees in relation to their governance and reporting obligations in relation to investment.

In addition to the new requirements around governance and reporting, external pressure from specialist groups as well as statements from the Government and The Pensions Regulator mean this trend of increasing change is likely to continue. Here we look at future developments that need to be on the agenda for trustees and their investment committees.

Increasing disclosure in implementation statements
Trustees are already required to publish an implementation statement each year setting out how they've given effect to the principles set out in their SIP. In late 2021, the DWP **consulted** on changes to its guidance which sets out its expectations in relation to disclosing voting and stewardship activities in the implementation statements (see our SpeedBrief **here**). The consultation closed in January 2022 and we are awaiting the outcome of the consultation. However, under the proposed changes, trustees will be expected to make fairly detailed disclosures in connection with voting and stewardship and to explain why their policies were in the best interests of their membership.

Why should this be on the agenda: Trustees should be aware of the possibility of increasing requirements around disclosing of their activities and the need to assess why their policies are in members' interests. If the guidance is updated this could apply from the next published implementation statement and trustees should start to consider whether they have the arrangements in place to facilitate this disclosure.

Compliance with investment aspects of the Single Code of Practice
The Pension Regulator's consultation on the draft **Single Code of Practice** covers most aspects of the governance and administration of pension schemes. More than a consolidation, it includes changes to many of The Pension Regulator's expectations around best practice for schemes. Importantly it includes more explicit expectations around the need for pension scheme trustees to include consideration of ESG factors in their governance systems. It states that schemes should consider ESG matters in their investment decision-making process. In addition it makes it clear that The Pensions Regulator expects trustees to take legal advice in relation to the investment arrangements they enter into.

Why should this be on the agenda: Trustees need to be prepared to comply (or explain why they do not comply) with the Single Code of Practice. Trustees, particularly those not in-scope for TCFD reporting, should carefully consider their investment governance framework to ensure it is consistent with the Single Code of Practice and seek to address areas where it falls short.

Latest update: On 22 September, Charles Counsell, TPR Chief Executive, said there will be further progress on the Single Code soon. Since that update the LDI crisis and change of Government may have delayed the publication of the Single Code of Practice, but there is still no definitive statement on timing.

TCFD reporting – first reports and requirements for £1bn+ schemes
With TCFD reporting coming into force from 1 October 2021 for the largest schemes, the first TCFD reports are due out this year. Although The Pensions Regulator has indicated it does not expect to issue **fines in relation to the first wave of reports** (other than for failure to publish or take reasonable steps to comply), trustees will need to ensure reports are prepared with a mind for the regulatory and public scrutiny they will likely receive. In addition, from 1 October 2022, schemes with over £1bn of assets will need to comply with the requirements of the new regulations and this will mean adequate governance and reporting systems need to be put in place.

Why should this be on the agenda: For schemes publishing their first report, there is likely to be a large amount of scrutiny on the reports. For schemes with more than £1bn of assets, the challenges of collecting and assessing the data, setting metrics, putting in place relevant policies and acting on them within the next 12 months should not be underestimated.

Broadening investment opportunities for DC Schemes
In October the Government published its **Consultation on broadening investment opportunities for DC schemes** the consultation included draft regulations and draft statutory guidance and follows on from earlier proposals to exclude performance fees from the DC charge cap and increase disclosures around illiquid assets. In particular the regulations will require:

- DC schemes to set out their policy on investing in illiquid assets in their default fund SIP. Where schemes hold illiquid assets they will also have to provide some additional information about the assets they hold. Where they do not, they will need to explain why. The new requirements should apply on the first occasion when the default fund SIP, or main SIP for collective money purchase schemes, is updated after 01 October 2023, with a longstop date of 01 October 2024
- DC schemes required to prepare a chair's statement (regardless of size) will need to include information about the percentage of assets allocated to eight specified asset classes

In addition, schemes will be able to exclude "specified performance fees" from the default fund charge cap, but additional disclosures will be needed in the chair's statement regarding those fees.

The consultation closed on 10 November 2022 and the Government has stated it is intending to progress with the legislation. We have included a full article on these changes in this edition of the Right Returns.

Why should it be on the agenda: Trustees will need to consider making changes to both the content of their SIP and also the format and content of their Chair's Statement – both of which may end up being longer as a result on the changes. Trustees will also need to consider their investment policy, including in relation to illiquid assets and whether to look to exclude performance fees from the default fund charge cap.

Funding Regulations Consultation
In July, the DWP launched its long awaited consultation on new draft funding and investment regulations for DB schemes. These set out some of the detail of the proposed framework for the government's new DB funding regime. These broadly state that the scheme must aim to be fully funded on a low risk basis (with low risk investments and low dependency on the sponsoring employer) by the time they are "significantly mature". They also introduce some new terminology, define for the first time in legislation what "employer covenant" means and specify that any deficit "must be recovered as soon as the employer can reasonably afford".

Why should it be on the agenda: Once the new regime is in final form, there will be much work for trustees (and employers) to do in setting out their journey plans. Trustees could start thinking about some actions now, including how the proposed approach could potentially affect your scheme and if your DB scheme does not currently have a chair of trustees, start planning for this. This issue of the Right Returns contains a detailed article on potential actions for trustees.

Latest Update: On 22 September, Charles Counsell, TPR Chief Executive, said TPR expect to publish the draft code of practice on funding later in the calendar year. At the time of writing, there is no further update as to timing.

TPR's Diversity and Inclusion Action Plan
On 27 September 2022, the Regulator set out its Action Plan which includes how the Regulator intends to promote high standards of diversity and inclusion in occupational pension schemes, building on work done by its Diversity & Inclusion Working Group set up in January 2021. The Regulator says that: *"A diverse pensions governing body made up of people who have a broad range of characteristics, backgrounds, life experiences, expertise, and skills will tend to lead to wider discussion and better decision making, which should result in long-term improvements to savers' outcomes. To improve equality and diversity the board needs a culture of inclusion and an effective chair who promotes this."* Research indicates recruitment, engagement, and resource are key barriers to trustees taking more action on D&I. This indicates that there is a need for support to understand the benefits and how to adopt different recruitment approaches to increase the pool of potential candidates.

The Action Plan states that The Regulator will set out its expectations around D&I in the single code. This will be supported by practical guidance, case studies and tools for employers, trustees and advisers. The guidance will cover: what diversity and inclusion means for governing bodies; attracting diverse candidates to the trustee role; engaging with the employer; creating and maintaining an inclusive culture and ensuring member communications are inclusive.

Why should it be on the agenda: Although the importance of diversity and inclusion may start with the trustee board, it does not end there. It is likely we will hear more from the Regulator on how trustees should approach diversity and inclusion when selecting and retaining service providers, including investment managers. Trustees should start to consider now what steps they can take towards high standards of diversity and inclusion.

Becoming a signatory to the Stewardship Code
The Government appears to have a clear agenda of encouraging trustees of pension schemes to aim for signatory status to the Financial Reporting Council's Stewardship Code (see our previous **DC Practical Notes** for more details). The process is not for the faint of heart, out of the previous 105 applications to the FRC, only 74% were successful because of the demanding and thorough process. The FRC has provided **feedback** on the latest submissions and includes key areas for prospective signatories to focus on when submitting applications.

Why should it be on the agenda: For large schemes, there is a clear drive from the Government to align with the Stewardship Code. For any trustee considering signing up to the Stewardship Code, the significant work required for an application should not be underestimated and planning should commence well in advance of any proposed application.

Please don't hesitate to contact your usual Eversheds Sutherland advisor or us for more detail on any of these issues.

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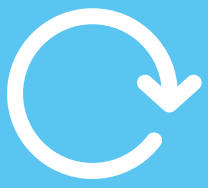

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