Sackers

Finance & investment briefing

June 2014

Sackers' Finance & Investment Group takes a look at current issues of interest to pension scheme investors

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Abbreviations

AIF: Alternative investment fund

AIFM: Alternative investment fund managers

CCP: Central counterparty

CIV: Common investment vehicle

CSA: Credit support annex

DB: Defined benefit

DCLG: Department for Communities and Local Government

EBA: European Banking Authority

EIOPA: European Insurance and Occupational Pensions Authority

EMIR: European Market Infrastructure Regulation

ESMA: European Securities and Markets Authority

FTT: Financial Transaction Tax

FX: Foreign exchange

IORP: Institution for Occupational Retirement Provision

ISDA: International Swaps and Derivatives Association

LDI: Liability driven investment

LGPS: Local Government Pension Scheme

MiFID: Markets in Financial Instruments Directive

MiFIR: Markets in Financial Instruments Regulation

OTC: Over the counter derivatives

RRD: Recovery and Resolution Directive

RTS: Regulatory Technical Standards

TPR: The Pensions Regulator

UCITS: Undertakings for Collective Investment in Transferable Securities

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Finance & investment focus

"TPR turned its attention to investment risk and the need for trustees to take an integrated approach to funding, covenant and investment in the draft Code of Practice on Funding defined benefits that was published in December 2013, the final version of which is imminent at the time of going to press. But while trustees are getting used to TPR taking closer interest in their investment strategy, other regulators at national, EU and global level, are also beginning to focus on pension schemes as investors.

The Bank of England has started to look at potential risks to the financial system posed by non-banks and, given its macro-prudential policy mandate, is keen to understand how the investment behaviour of non-banks, including pension funds, affects risk in the financial system. Andrew Haldane, Executive Director of Financial Stability and a member of the Financial Policy Committee indicated that the Bank will publish a report later this year which considers whether insurers and pension schemes have the potential to amplify the risk cycle through their portfolio choices.

The Bank's research, together with other government led investigations, such as the Kay Review, demonstrate the attention being paid to pension schemes by the various regulators in the wake of the financial crisis, and the importance attributed to pension schemes in ensuring the proper functioning of financial markets. Although still relatively early days, such scrutiny could ultimately lead to yet further regulation of financial markets.

In the meantime, there are various regulatory changes in the pipeline which may affect pension schemes as investors, which we examine in this briefing.

We look forward to welcoming you at our seminar on understanding and managing counterparty credit risk at 5:00pm on Tuesday 1 July 2014. If you have not yet registered for this event, you can do so on our website."

Ian Cormican
Partner, Finance & Investment Group

European Market Infrastructure Regulation

EMIR requires users of OTCs to comply with a number of risk mitigation measures. At the heart of EMIR is the requirement for central clearing of designated OTCs with CCPs, but the regulations encompass a range of different measures.[1]

The clearing obligation

Clearing obligations expected to have an impact on the market

Following authorisation of the first CCPs and notification of the first classes of derivatives, clearing obligations are expected to apply from late 2014. Pension schemes are still exempt from clearing for all OTCs which reduce investment risk until 15 August 2015 (unless extended). Despite this exemption, we are already seeing a move among pension scheme investment managers to get ready to clear OTCs before this date as there may be pricing advantages. In any event, we recommend that schemes start to get ready for clearing now, so that they do not get caught out by a late rush.

The prospect of mandatory clearing in late 2014 has, reportedly, resulted in pricing uncertainties for some derivatives, because of an obligation commonly referred to as "frontloading". Frontloading of clearing obligations will apply to classes of derivatives entered into after a CCP has been authorised under EMIR to clear that class, but before the class itself becomes subject to the clearing obligation. The frontloading requirement therefore implies that contracts concluded on a bilateral basis following the authorisation of a CCP might become subject to the clearing obligation before their expiration date. A concern arises because the parties to the derivatives contract may not know at the time they enter into a transaction whether it will later become subject to the frontloading obligation. Following submissions from various industry bodies, ESMA indicated that it considers the frontloading procedure to create uncertainties for derivatives end users. ESMA wrote to the EU Commission in early May 2014, informing it of its intention to implement the frontloading requirement in a way that minimises uncertainty.[2]

Risk mitigation for non-cleared OTCs

Under Article 11(3) of EMIR, which deals with non-cleared OTC derivatives, financial counterparties (including pension schemes) must have risk management procedures in place that require the timely, accurate and appropriately segregated exchange of collateral relating to OTC derivative contracts. The European Regulators (ESMA, EBA and EIOPA) are now consulting on the draft RTS which set out the details of such risk mitigation techniques, in particular:

- the criteria for providing "initial margin" – an amount of collateral provided at the outset of a derivative transaction which is intended to provide an additional buffer for changes in value after a default, before a transaction can be terminated. Under an ISDA Credit Support Annex this would be the "independent amount"
- the criteria for providing "variation margin" – an amount of collateral reflecting the exposure of one party to the other as result of changes in the mark-to-market value of a derivative transaction
- the frequency of collateral transfers
- the valuation methodologies for initial margin
- the list of eligible collateral
- operational and technical capabilities which parties need to demonstrate as part of their risk management procedures and ability to exchange collateral
- requirements for receivers of collateral to assess the credit quality of the collateral
- eligibility criteria for collateral
- concentration limits for initial and variation margin.

1 Our March 2014 Briefing sets out key aspects, including the limited exemption from central clearing for pension schemes. For further details, see our Viewpoint: EMIR: Where have we got to, where do we still have to go? (16 May 2014)

2 ESMA letter to EU Commission on the frontloading requirement under EMIR (8 May 2014)

European Market Infrastructure Regulation cont.

Pension schemes could only collateralise up to 50% of exposure with gilts

Concentration limits

In our view, this is probably the most important (and potentially most detrimental) provision in the consultation. Pension schemes would be required to observe concentration limits when posting (and receiving) collateral. If you would like a list of collateral and concentration limits, please speak to your usual Sackers' contact.

An obvious example is that, if these limits apply, pension schemes could only collateralise up to 50% of a counterparty's OTC exposure to the pension scheme with gilts. The rest would have to be made up of, for example, cash or some other form of eligible collateral. This can make managing collateral for LDI portfolios more complex when combined with the margin rules for cleared derivatives, which normally require initial margin in the form of cash or gilts and variation margin in the form of cash. LDI portfolios tend to comprise cash and gilts but tend to avoid large cash holdings. As a result, access to cash for collateral purposes will need to be managed for both OTC and cleared derivatives.

Longevity swaps, which typically are backed by a specific pool of assets (often cash and gilts), could also be affected by these rules if large exposures were to arise.

The European regulators are alert to this issue, and have asked for views.

No initial margin

Pension schemes are unlikely to be required to provide Initial Margin (potentially only some of the biggest schemes may be affected). The obligation to provide Initial Margin is due to be phased in between December 2015 and December 2019. The obligation will ultimately only extend to entities with an aggregate month-end average notional amount of non-centrally cleared derivatives exceeding EUR 8bn.

Variation margin

Pension schemes will need to provide daily variation margin for non-cleared OTC derivatives. Most pension schemes using OTC derivatives will already be doing this under the terms of their ISDA Master Agreements. The obligation to provide variation margin would also extend to certain Foreign Exchange derivatives.

Eligible collateral

The list of eligible collateral includes (among others): cash, government bonds (issued by EU and non-EU governments), bonds issued by credit institutions and investment firms, corporate bonds and the most senior securitisation tranche (which is not a re-securitisation), convertible bonds, equities included in certain indices and shares or units in UCITS.

Processes

Pension schemes will have to show that various operational and policy processes are in place, some of which will have to be reflected in the relevant ISDAs. Our initial view is that current CSAs will deal with a number of these requirements. In practice these processes will have to be provided by managers.

Next steps

Consultation closes on 14 July 2014

The European regulators have asked for feedback on a number of questions. We intend to make a submission, focusing in particular on the impact of the introduction of concentration limits on the management of collateral.

The EU Commission has also been consulting on the treatment of FX financial instruments, with a view to addressing concerns about the lack of harmonisation between EU Member States as to where the boundary lies between what is an FX financial instrument and a spot FX contract.[3] The Commission's response is awaited.

3 EU Commission consultation: FX Financial Instruments (10 April 2014)

Financial regulation round-up

Financial Transaction Tax Directive

In February 2013, the EU Commission published its proposal for a new Directive on a common system of FTT. Very broadly, the tax would be levied on trades in "financial instruments" (including shares, bonds, derivatives and shares in collective instrument undertakings) that involve "financial institutions". "Financial institutions" for this purpose would include pension funds.

Eleven EU Member States agreed the adoption of this Directive but negotiations stalled during 2013, owing to disagreements between those in the "FTT zone".

Impact for countries outside the FTT zone

However, at a meeting of the EU's Economic and Financial Affairs Council in May this year, the intention of the participating countries to continue progressive implementation of the FTT was noted. Although few details are available at this stage, it is intended that the initial focus will be on the taxation of transactions in shares and certain derivatives, with implementation of the first stages by 1 January 2016.[4]

Although the UK is not in the FTT zone, the Directive will still have a practical impact since it will result in tax where there is some link between the transaction and the FTT zone. In 2013, the UK challenged the EU Council's authorisation of enhanced cooperation on a common framework of FTT, as well as the scope and objectives of the Commission's initial proposal. This initial action was dismissed by the European Court on 30 April 2014, but the UK's Chancellor, George Osborne, has not ruled out a further challenge to the proposals.

Alternative Investment Fund Managers Directive

The AIFM Directive, which aims to create a regulatory and supervisory framework for AIFMs within the EU, came into force on 21 July 2011. The AIFM Directive applies to managers of "collective investment undertakings" (other than those which are subject to UCITS) including hedge funds, private equity funds and real estate funds. EU Member States (including the UK) were required to implement the Directive in national law by 22 July 2013.

Check whether managers of AIFs are authorised

Implementation of the AIFM Directive in the UK is subject to a one year transitional period that ends on 22 July 2014. Following an announcement from HM Treasury in December 2013,[5] firms managing AIFs which apply for a variation of permission have not needed to be authorised by 22 July 2014, but are required to submit a complete application by that date and are expected to comply with the Directive from that date. Managers who are not authorised by 22 July 2014 and who are subject to a pending application, could run into difficulties if their application turns out to be deficient in a substantial way. In the event their application is rejected, these managers would not be authorised.

The practical point for pension schemes is to confirm with managers, when appropriate, that they are already authorised. If they are not, and they are relying on HM Treasury's announcement, schemes should be aware that such managers may be at risk of not receiving authorisation.

Recovery and Resolution Directive

The EU Parliament and EU Council recently approved the RRD which will introduce an EU-wide framework for the recovery and resolution of credit institutions and investment firms.

Liabilities to sponsor's pension scheme excluded from bail-in

Of key interest to trustees of DB pension schemes sponsored by such entities is that the liabilities of a failing institution to its pension scheme are excluded from the bail-in provisions, save where they relate to pensionable bonuses.

Member States are required to adopt the RRD into national law by 31 December 2014, to apply from 1 January 2015, except the bail-in provisions which will apply from 1 January 2016.

4 Press Release on the 3310th meeting of the Economic and Financial Affairs Council (6 May 2014)
5 AIFMD transitional arrangements update (HM Treasury, 19 December 2013)

MIFID / Public Sector pensions

Markets in Financial Instruments Directive

ESMA is consulting on the implementation process for the revised MiFID Directive and Regulation. This is the first step to turning the requirements into practical rules aimed at improving financial market transparency and strengthening investor protection.

Among other things, MiFID II/MiFIR bring the Organised Trading Facility within the MiFID framework and implement new safeguards for algorithmic and high frequency trading activities. They are also designed to enhance pre- and post-trade transparency provisions for both equities and non-equities, and to strengthen the role of supervisors. MiFID II also extends the Insurance Mediation Directive to include customer protection provisions on the distribution of insurance based investment products (IBIs).

Indirect impact for occupational pensions

As occupational pensions fall within the scope of the IORP Directive and most UK workplace pension schemes are therefore excluded from the definition of IBIs, the impact of MiFID II for such schemes should be limited. However, there will be an indirect effect for schemes as institutional investors, as it will affect the way in which managers trade within their portfolios.

The consultation closes on 1 August 2014, with MiFID II/MiFIR due to come into force by the end of 2016.

Restructuring LGPS investments

Proposals for structural reform of the LGPS

The DCLG is consulting on structural reform of the LGPS. The new consultation comes hot on the heels of changes to the LGPS benefit structure, the so called LGPS 2014 scheme, which implements a career average benefit structure following recommendations set out in the "Hutton" report.[6] DCLG's focus has now moved to the LGPS's £178 billion investment function.

DCLG's main aim is a reduction in the cost of investing, in particular the use of economies of scale to drive down managers' fees, reduce transaction cost and to eliminate or drive down investment consultancy, legal and other expenses. The current consultation makes two main proposals:

- the use of CIVs. There are currently 89 separate LGPS Funds in England and Wales. The proposals would aggregate the funds' investments through one or two CIVs. Allocation decisions would remain with the Councils but implementation would be achieved at the CIV level
- a move to passive investing over active management. DCLG believes that passive management generates the same returns as active management, at less cost.

Taken together, and if implemented on a compulsory basis, the proposals would represent a very significant evolution in the investment responsibilities of local authorities.

Earlier proposals for a full merger of LGPS sections have been taken off the table. DCLG could not see its way through issues around local accountability. Perhaps more importantly, the Department seems to have recognised that the costs associated with merger could be significant when set against perhaps uncertain benefits in terms of better investment returns. Many of the cost savings achievable on merger could also be achieved through CIVs and passive investing but at less initial cost, making the latter proposals low hanging fruit from the Government's perspective.

Discussions around merger had focused on whether larger funds achieve better investment returns, which proved to be a very controversial topic. The Department has, perhaps wisely, side-stepped the issue. However, in advocating a move to passive investing, DCLG may simply have substituted one controversy for another.

6 Independent Public Service Pensions Commission: final report (10 March 2011)

EU pensions agenda

Long-term financing of the EU economy: IORP II

The EU Commission has adopted a package of measures that are designed to stimulate new and different ways of unlocking long-term financing and support the EU's return to sustainable economic growth.[7] The Commission's Communication focuses on areas in which the Commission intends to strengthen long-term investment, for example, infrastructure, new technologies and innovation, and research and development.[8]

Implementation by December 2016

As long-term investors, occupational pensions play a key part in the Commission's plans. As such, one of the specific measures announced is a proposal for a new occupational pension funds directive ("IORP II")[9] which focuses on measures designed to improve governance and transparency, and to facilitate cross-border activity. We highlight below a number of measures which will be relevant in the context of a scheme's investment functions.

At this stage, no action is necessary. The Commission's intention is that the new Directive will be implemented by EU Member States by 1 December 2016. However, this is subject to finalisation and adoption of the proposals at EU level.[10]

Effective system of governance

Schemes will be required to have an effective system of governance including:

- an "adequate transparent organisational structure with a clear allocation and appropriate segregation of responsibilities and an effective system for ensuring the transmission of information"
- written policies in relation to risk management, internal audit, actuaries and outsourcing
- an effective system of internal controls.

Professional qualifications

Those persons who "effectively run" pension schemes must have "adequate professional qualifications". It is not yet clear whether trustees will be expected to have "professional qualifications" and, if so, what those qualifications would be.

Remuneration policy

Schemes will be required to have a "sound" remuneration policy for those "persons who effectively run" them. If this applies to investment consultants or managers (which we doubt is the intention), this policy will need to be developed.

Risk management function

Schemes will have to put in place a risk management system (appropriate to their size and complexity), which covers among other things, asset liability management, investment (in particular derivatives), liquidity and concentration risk management, operational risk management, and insurance and other risk mitigation techniques.

Depository

The draft Directive also includes detailed provisions for DC schemes requiring the appointment of a custodian or depository, including a requirement that assets be held in segregated accounts. It is proposed that Member States will have the ability to impose the depositary requirements on DB schemes in addition to DC. Whilst there is currently little detail on what is meant by "segregation", if interpreted strictly this could be problematic and costly.

7 Commission roadmap to meet the long-term financing needs of the European economy (27 March 2014)
8 Communication from the Commission to the European Parliament and the Council on Long-Term Financing of the European Economy (27 March 2014)
9 Proposal for a Directive on the activities and supervision of institutions for occupational retirement provision
10 See our Alert: Pensions back on the EU agenda (1 April 2014)

Sackers

Contact

Sackers is the UK's leading commercial law firm for pension scheme trustees and employers. Over fifty lawyers focus on pensions and its related areas, including Sackers' Finance & Investment Group, a team of lawyers who provide cutting edge advice to trustees and employers on all aspects of pension scheme finance and investment.

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