Sackers

Finance & investment briefing

September 2014

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

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Abbreviations

AIFMD: Alternative Investment Fund Managers Directive

BIS: The Department for Business, Innovation and Skills

CCPs: Central counterparties

DWP: Department for Work and Pensions

EEA: European Economic Area

EESC: European Economic and Social Committee

EMIR: The European Market Infrastructure Regulations

ESMA: European Securities and Markets Authority

FCA: Financial Conduct Authority

LDI: Liability driven investment

NAPF: National Association of Pension Funds

OTCs: Over the counter derivatives

TPR: The Pensions Regulator

UCITS: Undertakings for Collective Investment in Transferable Securities

Finance & investment focus

"I have recently returned from the sunny climes of Rhodes and was surprised to discover, given the well documented financial woes of the Greek economy, that the baggage handling system at the island airport was far superior to that of its much bigger counterpart in England. It just goes to show that you shouldn't make assumptions on the safety of your property based solely on the country you are in. A thought which applies equally well to pension scheme assets and custodians. And so in this issue, Ralph McClelland, Associate Director, turns the spotlight on global custody arrangements and gives his top five custody tips.

As we go to press, like many, we are keenly awaiting the outcome of the Scottish independence vote. According to recent polls, support for the "Yes" vote has been gaining ground. Amongst other things, this has potential implications for schemes that have asset-backed funding structures in place involving Scottish limited partnerships and those schemes which have members in both Scotland and England, which could become "cross-border" schemes with the consequent requirement to be fully funded at all times. All will become clear on 19 September.

Finally, I am looking forward to attending the NAPF Annual Conference in October. Sackers will have a stand in the exhibition hall and we hope to see as many of you as possible (morning bacon and sausage rolls will be available….!)"

Vicky Carr
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Top five custody tips for pension scheme trustees

Ralph McClelland, Associate Director, shares his five practical tips to consider when looking at pension scheme custodian appointments

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"What's it all about, Alfie?"

Custodians are key investment intermediaries. The starting point for trustees is always to understand what role or, more accurately, roles the custodian will be performing. A custodian's core function is the safekeeping of assets, but it is also likely to be involved in a range of other functions, such as reporting, tax reclaims and settlement processing. Custodians can also offer additional services, like stock lending.

Each appointment is different. If your scheme has a complicated portfolio with large segregated mandates, there may be a lot more for the custodian to do and a closer interrogation of the custody appointment may be justified.

"There's no place like home"

A global custodian agreement is a gateway to custody services throughout the world. In appointing a custodian, trustees need to consider the countries in which their assets are based. Custodians tend to work either through a network of third party banks, or through their own chain of affiliates if they have an appropriate global footprint. The custodian's liability terms will, to some extent, depend on how the custodian operates. For a scheme with material exposure to foreign jurisdictions, it will be important to scrutinise the custodian's offering in this respect.

"Show me the money!"

Custodians hold cash in the same way as any other bank. This means that a trustee has only a contractual right to be repaid cash deposited with a custodian or sub-custodian. If the custodian becomes insolvent, trustees will rank as unsecured creditors. Schemes with substantial overseas assets may find that foreign denominated cash is held for periods of time by a third party sub-custodian bank in a foreign jurisdiction.

Cash exposure can be managed. Consider how your cash is held and whether any risks need to be mitigated.

"Is it safe?"

A custodian's core function is to keep its clients' assets safe. In practice, this means ensuring the trustees are reasonably certain they will be able to recover the scheme's assets from an insolvent custodian, within a reasonable period of time. The scheme's assets should not be available to a custodian's general creditors in the event of the custodian's insolvent liquidation. Custodians hold securities in a variety of ways depending on the type of assets and the jurisdiction in which they are held. Security often boils down to the record keeping practices of the custodian, its sub-custodian and central securities depository.

While perfect asset security may not be achievable, discuss with your custodian their preferred approach, check they are doing what they claim to be doing and, where appropriate, agree more robust practices.

"You're gonna need a bigger boat"

Custody can move to centre stage when trustees start exploring collateralised arrangements, including segregated derivatives portfolios. These sorts of deals may need specialised collateral management infrastructure which the custodian has to facilitate. In the derivatives space, the implementation of central clearing (introduced in Europe by EMIR) is also leading to important changes in this area.

If your scheme is likely to need this sort of support, this will be a key point for discussion.

Legal update

New guidance for trustees

Fiduciary duties: trustee guidance on the horizon

The Law Commission has concluded that legislation is not required to codify the law in relation to fiduciary duties as they apply to pension fund trustees.

Following the publication of the Kay Review of equity markets, BIS and the DWP asked the Law Commission to investigate how the law of fiduciary duties applies to investment intermediaries and to evaluate whether the law works in the interest of end investors. The Law Commission chose the pensions landscape in which to conduct its investigations, publishing its report on 1 July 2014.

While it does not recommend the introduction of legislation in this area, the Law Commission has published guidance for trustees which it recommends is included in one of TPR's codes of practice for trust-based schemes (and is adopted by the FCA in relation to contract-based schemes). See our Alert: "Fiduciary duties of trustees and others" (3 July 2014) for more details.

Extension of the exemption for pension schemes?

EMIR: latest news

EMIR sets out risk mitigation measures in relation to OTCs within the EEA. At the heart of EMIR is the requirement for central clearing of certain OTCs with newly established CCPs, but the regulations encompass a range of different measures.

Pension schemes are "financial counterparties" under EMIR and will therefore be subject to its requirements. EMIR will directly affect any scheme with OTCs, for example as part of a liability driven investment programme. There may also be indirect implications if a scheme has pooled fund investments that use OTCs.

Central clearing: getting clearing ready now?

ESMA is currently consulting stakeholders on the scope for mandatory clearing of interest rate swaps and credit default swaps. As part of the consultation process, it looks likely that mandatory clearing of the relevant derivatives will be phased in over time. Pension schemes will probably have to start to clear the first transactions (which do not benefit from the pension scheme clearing exemption) in the course of the first half of 2016. The pension scheme clearing exemption applies to hedging transactions and runs until August 2015. However, the EU Commission is expected to consider extending this to August 2017.

Market participants are of the view that, over time, a pricing advantage may emerge in respect of cleared OTC derivative transactions. This raises the question as to whether pension schemes should start to get ready for clearing now.

The final decision as to whether to clear earlier than required by EMIR will have to take into account a number of factors, such as the potential loss of netting and the management of collateral. But from a legal perspective, there is no harm in getting to grips with the issues and the documentation as early as possible. Ultimately, clearing is inevitable and early engagement with the issue will give pension schemes more time to get comfortable with the complexities of clearing, and perhaps even help to shape the evolution of the terms under which pension schemes can access clearing.

Compliance with the EMIR reporting obligation

On 21 August 2014, the FCA published a new webpage: "EMIR reporting - is the industry ready?", with its latest observations on compliance with the EMIR reporting requirements, as well as details of firms' preparation towards compliance with EMIR derivatives contracts reporting. The FCA notes that, overall, the vast majority of derivatives contracts are being reported. Schemes should consult with their managers to ensure that all reporting is done to the required standard.

Legal update cont.

In force 2016

Investor protection under UCITS V

Published in July 2014, the text of the new UCITS Directive (UCITS V) has been adopted by the EU Parliament and Council. Introduced in the wake of the financial crisis, the revised EU framework for the management and distribution of retail investment funds introduces changes relating to the depositary function, manager remuneration and sanctions, bringing them into line with the AIFMD provisions.

UCITS V came into force on 17 September 2014. Member States have until 18 March 2016 to adopt its provisions into national law. Managers of funds that are subject to the UCITS provisions will need to take steps to ensure that such funds are adapted to comply with the new provisions.

Long-term investment provisions criticised

Pensions Directive: changes sought to long-term investment provisions

The EESC – a consultative body which passes the opinions from European economic and social interest groups to the EU Council, Commission and Parliament – has endorsed most of the proposed changes to the EU Pensions Directive but, in its opinion of 10 July 2014, has called for a number of changes to the provisions on long-term investments.

In particular, the EESC disagrees with the Commission's view of workplace pensions as purely financial market institutions – an approach which it considers fails to acknowledge and respect their specific circumstances. The EESC notes that the overarching goal of pension schemes (including workplace pensions) is to ensure an adequate and stable level of benefits for their beneficiaries. As such, it considers that supporting capital markets, including long-term investments, can only ever be a secondary objective which is conditional on not being detrimental to the interests of scheme members and beneficiaries.

Questions for your manager

Stewardship: NAPF question time

The NAPF publishes monthly topical questions that are designed to aid trustees in considering the effectiveness of their managers' stewardship activity. The questions are for use during regular manager reviews, with a view to understanding managers' approaches and activities and to ensure that they are adhering to the stewardship policies.

The latest "questions for your manager" focus on the use of the enhanced voting rights that were introduced in 2013 and the first ever Stewardship and Corporate Governance codes introduced by the Japanese Government in February 2013.

Open consultations

Banking reform

In July 2014, HM Treasury issued two consultations which are relevant to bank and building society pension schemes.

The first relates to the transposition of the EU Recovery and Resolution Directive and includes provisions relating to depositor preference and the exclusion from bail-in of pension liabilities, other than those relating to pensionable bonuses. This consultation closes on 28 September 2014.

The second is a consultation on draft regulations to give effect to the ring-fencing of pension liabilities, which closes on 15 October 2014. Sackers is currently reviewing and considering both of these on behalf of its clients.

Making the most of your de-risking opportunities

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Sponsors and trustees looking at options for reducing risk in their pension scheme typically have a choice between longevity risk transfers, buy-ins, buyouts and LDI mandates. Whilst each has its own pros and cons, longevity risk transfers and LDI mandates have been particularly affected by current market conditions and regulatory changes.

Longevity risk transfers: an alternative approach

On a longevity risk transfer, a pension scheme will transact with a bank (under a derivative contract) or an insurance company (under an insurance contract) to transfer its longevity risk. The bank or insurer then passes all or part of the risk to a reinsurer, making them effectively an intermediary between the scheme and the reinsurance market. However, we have seen fewer banks and insurers willing to play this role in recent years, whilst capacity in the reinsurance market has been increasing. In the light of this, an alternative can be to use a "captive insurance company" in place of the bank or insurer.

A captive insurance company is one which is owned by the insured – this could be the pension scheme or the sponsoring employer. The main attraction of this approach is the saving on the fee that would ordinarily have been payable to the intermediary (but there will be other costs involved in managing this structure).

Key questions to ask

Careful due diligence should be undertaken at the outset to assess the viability of this structural solution.

If it is intended that the captive insurance company will become part of the scheme sponsor's group, how will the scheme's credit exposure to the sponsor be affected?

Likewise, if the captive insurance company is to be owned by the scheme, there are a number of points which need to be ironed out before proceeding. For example, can it be achieved within the existing pension scheme set-up? What additional liabilities will the arrangement mean for the scheme? Who will administer the longevity risk transfer? How will the reinsurance market deal with such a structure?

Whilst a number of recent longevity risk transfers have adopted the first approach, the second is, as yet, untested.

LDI mandates: navigating the regulatory maze

An LDI portfolio typically uses a combination of physical assets and derivatives to deal with interest rate and inflation risks. But with EMIR entering its final implementation phase, schemes will eventually need to clear certain derivatives and collateralise all non-cleared derivatives. This means that consideration will need to be given to the impact of the new regulatory approach on a scheme's LDI strategy.

All derivative positions will need to be collateralised, with cleared derivatives subject to the collateral rules of the relevant clearing house, and non-cleared derivatives subject to the collateral rules agreed with the relevant counterparty (subject to the EMIR requirements on eligibility and concentration limits).

Ready access to appropriate collateral will be a key consideration and will need to be managed, as returns on the LDI portfolio can be adversely affected where large cash collateral holdings are needed. A scheme's collateral requirements should therefore be understood, and stress-tested, to know whether they can withstand negative movement in the market.

The new collateral rules will apply across the market and will be binding on, amongst others, banks and insurance companies. Consideration should be given as to whether a general demand for certain types of assets, such as gilts, which can be used as collateral, might affect the return on the scheme's LDI portfolio.

In practice: finance & investment for pension schemes

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Sackers advises on Interserve buy-in

A Sackers team, led by finance & investment partner Stuart O'Brien, recently advised the Trustee of the Interserve Pension Scheme on a buy-in arrangement with Aviva covering £300 million of pensioner liabilities. The buy-in will help Interserve, the UK based international support services and construction group, reduce its pension scheme risk by protecting around 35 per cent of the Scheme's liabilities from fluctuating interest rates, inflation and mortality risk.

David Trapnell, Chairman of the Trustee Board, said: "This transaction represents a significant risk reduction step for the Interserve Pension Scheme, reducing funding volatility and providing additional protection for all our members' benefits."

Introducing flexibility

One of the interesting things about the contract was that it contained a number of flexibilities not frequently seen in a buy-in. For death benefits, where a buy-in contract will often cover a wide-ranging selection of different types of discretionary benefits for different benefit categories, trustees will usually need to take time "crystallising" their discretions before they enter into the contract. In other words, they will normally need to think first about what scenarios might cause them to exercise a discretion whether or not to pay a benefit, and then make sure that the policy with the insurer matches. However, the approach taken here was far more flexible and terms were agreed with Aviva that will allow the Interserve Trustee to continue to exercise their full range of discretions as before, without having to tie their hands under the contract. The Trustee also agreed an approach with Aviva on interest rate coverage that gives the Trustee some flexibility, while at the same time achieving good value for the premium paid.

A practical solution

The size of this buy-in puts it in the top 20 of publically announced transactions completed over the last five years. Sackers worked closely with the Trustee, Aviva and LCP to agree a flexible and practical solution in just four months, highlighting how efficient transactions such as this can be when all parties commit to pre-determined timescales and thanks to the collaborative approach of all parties. It is yet another indication of schemes taking steps to de-risk when good opportunities arise.

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Trustee training

We can offer bespoke training sessions aimed at all those involved in finance and investment transactions for pension schemes. We have developed a module which explores the credit risk inherent in trustees' relationships with various counterparties, including sponsoring employers, investment banks, clearing houses, custodians and insurance companies. The session considers the potential impact of counterparties defaulting on their obligations, and how the risks associated with such default can be managed, focusing on:

- cleared and non-cleared derivative transactions
- custody arrangements
- contingent assets
- asset-backed funding structures
- investment platforms for defined contribution schemes.

By the end of the session, participants would have a clear overview of the consequences of counterparty default in a number of scenarios and the tools available to protect trustees.

If you are interested in arranging a training session, please contact Ian Cormican.

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 and 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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