

## Finance & investment briefing

December 2014

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



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## Abbreviations

**DC:** Defined contribution

**DCLG:** Department for Communities and Local Government

**EMIR:** European Market Infrastructure Regulation

**FSCS:** Financial Services Compensation Scheme

**FRC:** Financial Reporting Council

**FSB:** Financial Stability Board

**HMRC:** HM Revenue & Customs

**ISDA:** International Swaps and Derivatives Association

**LGPS:** Local Government Pension Scheme

**NAPF:** National Association of Pension Funds

**PRA:** Prudential Regulation Authority

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## Finance & investment focus

“As the nights draw in and we look forward to the festive season, we also take stock of a busy quarter and plan for the many changes on the horizon in 2015.

Clearing of over-the-counter derivatives transactions under EMIR continues to be an important consideration for pension schemes, as Sebastian Reger explains on page 3. Meanwhile, it's impossible to write about pensions these days without mention of DC – Anna Copestake analyses the results of our survey from the recent NAPF conference.

Lord Hill's appointment as EU Commissioner for Financial Stability, Financial Services and Capital Markets has so far received thumbs up from the UK pensions industry. But with a specific focus on long-term investment and innovation in capital markets, we will watch carefully as his action plan for the creation of the Capital Markets Union unfolds in 2015.

With all this and more, it's a relief that there was no rush to rip up asset-backed funding structures on 19 September – a risk had the Scottish vote gone the other way.

With best wishes for Christmas and the New Year.”



**Paul Phillips**

Partner, Head of Finance & Investment Group

[paul.phillips@sackers.com](mailto:paul.phillips@sackers.com)

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# Five things to know about the clearing of derivatives



## Sebastian Reger, Associate Director, provides an overview of clearing

sebastian.reger@sackers.com

### “Why do I need to know about this?”



EMIR has introduced a number of compulsory risk mitigation techniques for pension schemes which use over-the-counter derivative transactions (“OTC transactions”). One of the cornerstones of EMIR is to make the clearing of certain designated OTC transactions mandatory for pension schemes and other entities which are also classified as “financial counterparties” (including banks and insurance companies).

### “What is clearing?”



Clearing works by interposing a safe third party entity (the clearing house, or clearing counterparty (“CCP”)) between the pension scheme and its OTC transaction counterparty. This means the pension scheme will no longer take credit risk on its counterparty, because all payment obligations to the pension scheme will now be assumed by the CCP. Pension schemes will have access to CCPs via a Clearing Member. Clearing Members will be financial institutions which have applied to become a member of a CCP and have been admitted in line with the criteria established by the CCP.

### “Which transactions will be affected?”



The first wave of OTC transactions needing to be cleared will be various interest rate derivatives and credit default swaps referencing certain iTraxx indices. The second wave will cover FX transactions involving USD and various other currencies. Other classes of OTC transactions will follow but currently no further proposals have been published. Equity derivatives, commodity derivatives and credit default swaps referencing single names (such as a credit default swap referencing a FTSE 100 company) have specifically been taken out of the mandatory clearing process for the time being. In addition, inflation derivatives cannot currently be cleared.

### “What’s the timetable?”



The obligation to clear OTC transactions will be phased in over time, depending on the type of derivative and categorisation of the derivative user.

Pension schemes currently benefit from an exemption to the general obligation to clear all mandatory OTC transactions. Provided these transactions are objectively measurable as reducing investment risk which relates directly to the financial solvency of the pension scheme, they will not have to be cleared until the exemption expires in August 2015 (or later, if extended). There are different views on how broad the exemption is. We can advise you on where we think the line should be drawn.

### “What should I do next?”



As transactions start to be cleared, it is expected that cleared swaps will start to price more attractively than non-cleared swaps of the same class.

Preparing for the clearing process now will give pension schemes the option to decide whether to clear early on a voluntary basis in case price advantages emerge.

We can help you navigate the legal risks and detailed contractual terms that come with clearing.

### PRA consults on protections for insurance policyholders

The PRA's latest consultation, [CP21/14](#), aims to bring existing insurance compensation rules into line with the PRA's statutory objectives – of promoting the safety and soundness of financial institutions and contributing to the securing of an appropriate degree of protection for policyholders – and contribute to the future operational effectiveness of the FSCS in providing continuity of cover, the payment of benefits falling due and compensation in the event of the failure of an insurance firm.

Among other things, the PRA proposes to increase the compensation limit for certain long-term insurance products to 100% cover (from the current 90%) for:

- annuities in the pay-out phase
- claims arising from death or incapacity.

It is proposed that compensation for pension and investment life savings (wrapper products) in the accumulation phase will be maintained at 90% cover, on the basis that while individuals are not locked in to such policies over the long-term, they are less vulnerable to a sudden reduction in income.

Certain operational changes are also proposed for issues faced by the FSCS following an insurer being declared in default.

The consultation closes on 6 January 2015.

#### Increased compensation for annuities in payment?

### New ISDA Protocol

ISDA has published a new "[Resolution Stay Protocol](#)" which it has developed in conjunction with the FSB. The Protocol is designed to impose a stay on cross-default and early termination rights on adhering counterparties within standard ISDA derivatives contracts, in the event that one of them is subject to resolution action in its jurisdiction.

The Protocol is a legal device to amend all existing ISDAs between the 18 global banks that have signed-up to the Protocol and their counterparties who have signed up to the same Protocol. Adherence is usually achieved by signing a simple letter and all parties who have adhered to the Protocol will be listed on the ISDA website.

The purpose of suspending various termination rights is to assist regulators with their recovery and resolution plans by ensuring that derivative contracts with a bank cannot be terminated. A party signing-up to this Protocol will give up its right to close out its derivative contracts with a bank, which is subject to administrators or special resolution proceedings.

We can assist you in considering whether it is appropriate for you to adhere to the Protocol.

It is intended that the Protocol will have effect from 1 January 2015, in respect of both new and existing trades. It was opened for adherence on 12 November 2014. The Protocol, together with FAQs and a list of adhering parties, is now available on the [ISDA website](#).

#### New ISDA Protocol open for adherence

### Corporate governance

#### UK Corporate Governance Code updated

In September 2014, the FRC issued an updated version of the [UK Corporate Governance Code](#). Key aims of the revised code are to enhance the quality of information that investors receive about the long-term health and strategy of listed companies and to raise the bar for risk management.

Changes in the new Code (which applies to accounting periods beginning on or after 1 October 2014), include:

- a requirement for companies to assess their principle risks and explain how they are being managed or mitigated
- a statement as to whether a company believes it will be able to continue in operation and meet its liabilities over the period specified in the statement (which is expected to be significantly longer than 12 months)
- regular monitoring of risk management and internal control systems, with a review (at least annually) of their effectiveness
- greater emphasis on ensuring that executive remuneration policies are designed to promote the long-term success of the company
- an explanation, when publishing general meeting results, as to how a company intends to engage with shareholders when a significant percentage of them have voted against any resolution.

**Updated Code applies to accounting periods beginning on / after 1 October 2014**

#### NAPF corporate governance policy and voting guidelines

The NAPF assesses how companies match-up against its own corporate governance policy, monitors developments in good practice and seeks improvements from both companies and investment managers in the best interests of pension funds.

Ahead of updating its corporate governance policy, it has published its second annual [AGM season report](#). Among other things, the NAPF notes that the extensive reforms to corporate reporting for 2014, with a particular focus on remuneration, have resulted in more information being available to investors. However, due to the sheer scale of additional reporting requirements, investors, as well as companies, are still getting up to speed with the wealth of new information available.

### Reclaiming tax on investment income

HMRC has published [new guidance](#) for registered pension schemes on how trustees can reclaim UK Income Tax that has been deducted from a scheme's investment income.

Trustees (or a third party authorised by them) need to complete and return to HMRC [form ASPSS 146](#) and provide specimen signatures for those who will send the repayment claims.

Schemes can claim a refund up to four years after the end of the tax year in which the tax was deducted. For example, for the tax year ending 5 April 2015 the claim deadline is 5 April 2019.

**New HMRC guidance**



**Anna Copestake**  
Senior Associate

[anna.copestake@sackers.com](mailto:anna.copestake@sackers.com)

## Insight from the NAPF Annual Conference 2014

Sackers took a stand at the NAPF Annual Conference 2014 in Liverpool. Unsurprisingly, the conference had a large DC focus and generated a lot of debate around DC investment decisions and the approaches being taken in light of recent policy changes.

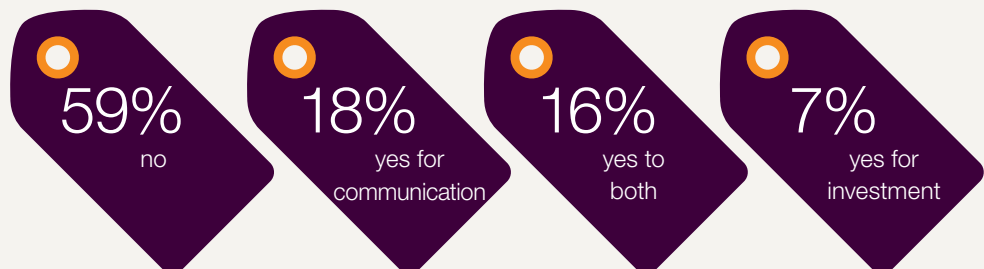
Having lured people to our stand with a promise of bacon rolls and tins of sweets, we asked them to fill out a short DC survey. 24% of respondents considered choosing investment options to be their scheme's greatest challenge (only just beaten to the top spot by member communications with 25%) reflecting the generous amount of debate around how to make these choices on behalf of members. When probed about their approach to choosing investment options, only 7% of respondents said they categorised their members into different sections for investment purposes. Member segmentation is a fast developing area but one in which potential pitfalls, such as age discrimination or incomplete or inaccurate member data, should not be ignored.

Finally, more than half of respondents had reviewed their default fund but a substantial number had not yet done so. This leaves them short of time for making any changes ahead of the introduction, in April 2015, of the 0.75% charge cap on default funds used for automatic enrolment.

Have you reviewed your default fund to assess whether it will comply with the forthcoming charge cap?



Do you categorise your members for communication and/or investment purposes?



You can view the full results of our [DC survey](#) on our website.

# LGPS: New governance requirements for 2015



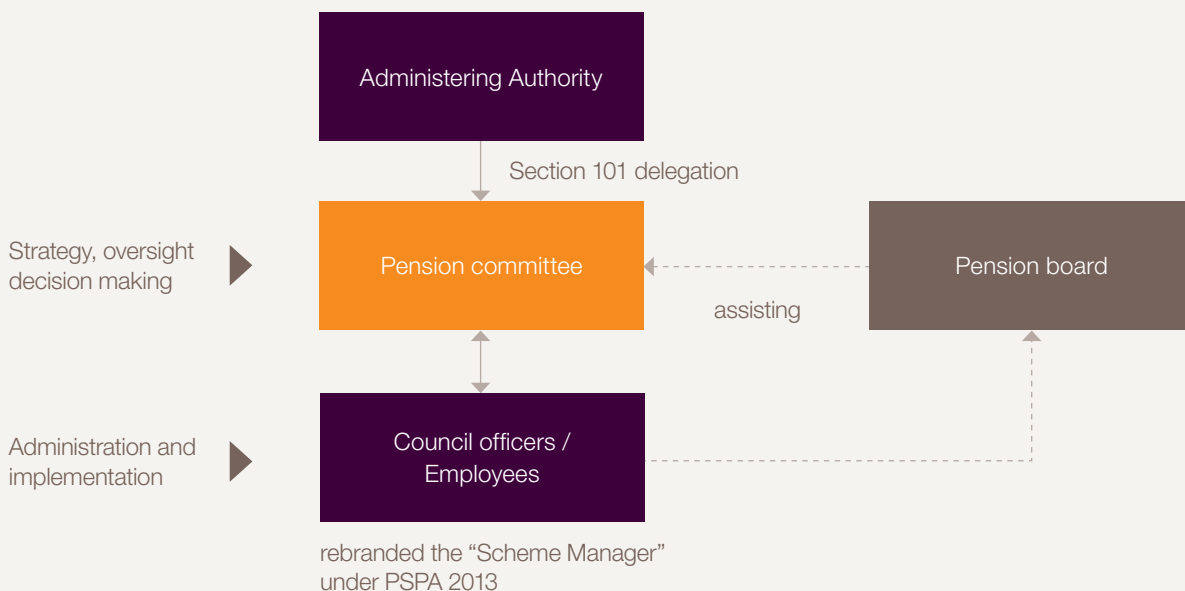
**Ralph McClelland**  
Associate Director

[ralph.mcclelland@sackers.com](mailto:ralph.mcclelland@sackers.com)

From April 2015, each section of the £180 billion LGPS will be required to establish a Local Pensions Board (LPB). The LPB will exist to “assist” the Administering Authority in all of its LGPS functions, including investment.

Administering Authorities have a statutory requirement to administer their section of the LGPS, including a requirement to maintain and invest a fund to meet their pensions liabilities. There is no separate pension fund trust and there are no trustees of that fund.

In practice, the Authorities’ pensions functions, including investment, are delegated to a pensions committee (or committees). It is those committees which will now be subject to the scrutiny of the LPBs.



LPBs have met with considerable resistance within the LGPS community. The argument is that the delegated pensions committees (under s.101 Local Government Act 1972) are already subject to the oversight of the local Council and already have well defined governance arrangements. You can generally find a pensions committee governance compliance statement online with a bit of searching - the same could not currently be said of most private pension schemes.

In the end, DCLG persisted and LPBs are now a reality. They will need to be resourced by already overstretched Authorities, who will also need to find suitably experienced board members. The board must include equal numbers of employer and member representatives. It may include others – a role for independent trustees perhaps?

Authorities are in the process of setting up their LPBs, finding members and defining remits. In doing so, they will be aware of possible changes to the LGPS investment regulations and the imminent consultation on structural reform. They should not overlook how important the newly minted consolidated LGPS annual report will be. This report aggregates, for the first time, the annual returns of all 89 sections and will evolve to show more and more information about investment returns and, crucially, fees. Value for money in investment will be a huge issue for the LGPS and LPBs have a part to play in that discussion.

## 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.



**Paul Phillips**  
Partner  
D 020 7615 9523  
E paul.phillips@sackers.com

Key areas of expertise include: de-risking, LDI, longevity transactions, OTC derivatives and repurchase agreements, investment management, transition and custody arrangements.



**Ian Cormican**  
Partner  
D 020 7615 9501  
E ian.cormican@sackers.com

Key areas of expertise include: longevity swaps, buy-ins and buy-outs, liability driven investment (LDI), fiduciary management and governance.



**Stuart O'Brien**  
Partner  
D 020 7615 9539  
E stuart.obrien@sackers.com

Key areas of expertise include: investment management agreements, buy-ins and buy-outs, LDI, ESG issues, stewardship, socially-responsible and ethical investing.



**Vicky Carr**  
Partner  
D 020 7615 9570  
E vicky.carr@sackers.com

Key areas of expertise include: guarantees, escrow arrangements, other contingent assets, in-specie contributions, asset-backed funding structures and banking reform.



**Ian D'Costa**  
Associate Director  
D 020 7615 9534  
E ian.dcosta@sackers.com

Key areas of expertise include: infrastructure investment, private equity, hedge funds, longevity swaps and LDI.



**Sebastian Reger**  
Associate Director  
D 020 7615 9039  
E sebastian.reger@sackers.com

Key areas of expertise include: longevity swaps, LDI, OTC derivatives, managed and static security and collateral structures, transfer of asset portfolios, repurchase transactions and securities lending.



**Ralph McClelland**  
Associate Director  
D 020 7615 9532  
E ralph.mcclelland@sackers.com

Key areas of expertise include: fiduciary management, Local Government Pension Scheme investment issues, custody and longevity swaps.

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