Sackers

Finance & investment briefing

June 2015

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

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Abbreviations

BoE: Bank of England

CASS: Client Assets Sourcebook

CCP: Central Counterparty

CMU: Capital Markets Union

DB: Defined benefit

DC: Defined contribution

ECON: EU Parliament Committee on Economic and Monetary Affairs

ELTIF: European long-term investment funds

EMIR: European Market Infrastructure Regulation

ESMA: European Securities and Markets Authority

FCA: Financial Conduct Authority

HMRC: HM Revenue & Customs

HMT: HM Treasury

IMA: Investment management agreement

MiFID II: Markets in Financial Instruments Directive II

MiFIR: Markets in Financial Instruments Regulation

NAPF: National Association of Pension Funds

OTC: Over-the-counter

RFB: Ring-fenced bank

RTS: Regulatory Technical Standards

SIP: Statement of investment principles

TPR: The Pensions Regulator

VAT: Value added tax

Finance & investment focus

"The newly available flexible DC benefits have stolen much of the limelight in terms of pensions developments. But there is more on the horizon for pension schemes than whether to offer any of the new options.

In this briefing, Ian D'Costa examines HMRC's latest Brief on the deduction of VAT on pension fund management costs, in particular the use of tripartite agreements between trustees, employers and fund managers. And Ralph McClelland considers the lessons for trustees arising from the fines recently imposed for failure to comply with the FCA's custody rules.

We also reveal the results of our investment survey, having polled delegates at the NAPF Investment Conference earlier this year. Among other things, we asked what will be shaping trustees' investment agendas over the coming year.

Last but not least, I am delighted to take this opportunity to congratulate Sebastian Reger on his promotion to partner. An experienced structured finance lawyer, with a particular focus on derivatives and structured investments, Seb joined Sackers in January 2014 to boost the firm's finance and investment group, in response to increased need from pension fund clients for complex investment structures and investment related legal advice."

Paul Philips
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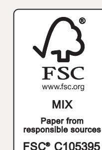

Five things to know about VAT

Ian D'Costa,
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The rules have changed

Following the decisions of the European Court in the cases of PPG Holdings BV and the ATP PensionService (see our December 2014 Alert: VAT on professional fees for details), HMRC has revised its position in respect of what VAT can be deducted by employers with pension schemes.

However, a transitional period is underway and "current" VAT arrangements for DB schemes can remain in place until 31 December 2015.

DB schemes

Revenue and Customs Brief 8 (2015) focuses on IMAs and administration contracts and explains that HMRC will no longer differentiate in its VAT treatment between investment management services and administration services. This means that the employer will be able to deduct 100% of the VAT, provided it receives the supply of these services. Ultimately, this will mean an eventual end to the current 70/30 split.

For an employer to be able to deduct VAT in respect of these services in the future, HMRC is advocating the adoption of tripartite contracts. HMRC requires that such contracts must contain certain specified features. Among other things, they must stipulate that the employer pays for the services and that the services are supplied to the employer. Other, potentially more contentious, features will also need to be included in the contracts, including termination rights for the employer (albeit subject to trustee consent), and a right for both the employer and trustee to sue the service provider.

Recharging to the scheme

In order for the employer to be able to deduct VAT, the employer will need to receive a valid invoice for the full cost of the services from the supplier and the employer will need to pay the service provider directly.

HMRC's guidance is clear that the employer cannot use a DB scheme to pay for the services. This includes the scheme paying the costs and the employer making a corresponding increase to the schedule of contributions. The employer is also prevented from recharging the costs to the scheme, as this would amount to an onward taxable supply on which VAT would be due.

DC schemes

HMRC has, for the time being, adopted a different approach in relation to DC schemes. Until the ATP case, HMRC had not considered DC schemes to be "Special Investment Funds". As such, HMRC treated all services connected with DC schemes as falling outside the VAT exemption for fund management services.

Now, however, third party fund management and administration services which are integral to the operation of the DC scheme will fall within the exemption. By way of example, this will include investment management services. DC schemes may therefore want to consider submitting retrospective claims for overpaid VAT.

The future

HMRC's policy in respect of DC schemes has already changed and the transitional relief in respect of DB schemes will end in December 2015.

So far, HMRC has only clarified its position in relation to the appointment of administrators and investment managers in respect of DB schemes and has promised further guidance for DC schemes.

HMRC is also intending to provide further guidance in respect of VAT grouping and other professional appointments (such as lawyers, actuaries and auditors) in the second half of 2015.

Focus on custody: implications of the FCA's £126 million fine

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On 15 April 2015, the FCA fined two Bank of New York Mellon (BNY Mellon) custody banks £126 million for failing to comply with FCA rules relating to the safe custody of assets and client money.

Why were they fined?

The FCA found a failure to arrange adequate protection of safe custody of assets (the FCA's Principal 10) and a number of breaches of CASS Chapter 6 (the Custody Rules). The breaches took place between 1 November 2007 and 12 August 2013. Key points related to:

- separation of the custodian's own assets from those of its clients
- adequate, entity specific record-keeping
- reconciliation of sub-custodians' records with those of the global custodian
- use of assets held in an omnibus account for contract settlement without the consent of all of the clients with assets in that account.

The FCA noted that, of the breaches identified, all but one had been drawn to BNY Mellon's attention by the FCA itself, meaning that the issues had not been picked up by the firm's own compliance monitoring.

Why does this matter?

The Custody Rules are in place because custodians are systematically important financial counterparties – the BNY Mellon entities in question had charge of around £1.5 trillion of assets between them. The rules are intended to protect banks' clients in an insolvency scenario and, importantly, to speed up the process of dealing with assets on such insolvency. Accurate and entity specific labelling of assets (at global and sub-custodian level), together with regular reconciliation, are key to achieving these aims.

Implications for pension scheme trustees

This case will be of interest to pension scheme trustees, many of whom have significant counterparty exposure to custodian banks.

No actual loss was caused to BNY Mellon's customers as a result of the breaches identified. This means that a client who could point to a breach of contract would not have any loss to sue on if they wished to pursue the matter with BNY Mellon.

However, trustees are not only concerned with recovering assets; they have an interest in how quickly their assets would be recovered on insolvency. In practice, trustees should be confident that the custodian has systems in place to ensure an efficient and orderly winding-up. The question is not just whether a scheme's assets (or, more accurately, equivalent assets) will be returned but also how long it will be before liquidity can be restored following a custodian bank's failure.

Trustees, as important custodian clients, may have a role to play in ensuring that the highest standards are maintained. Trustees should therefore engage with their custodians to understand how their assets are being held, and seek assurances that the custodians are, in fact, adhering to the minimum standards they have undertaken contractually and those which are imposed by the FCA.

In practice: investment survey

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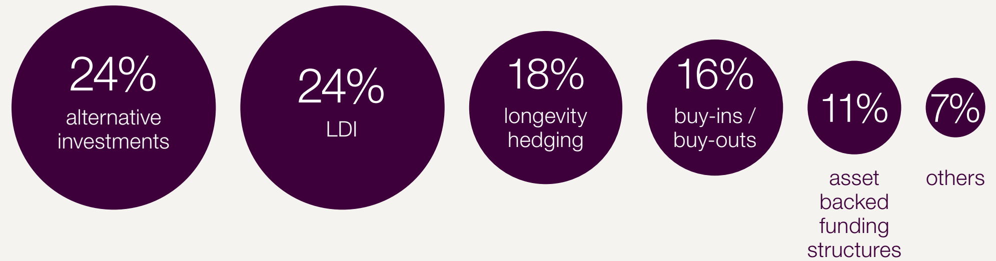
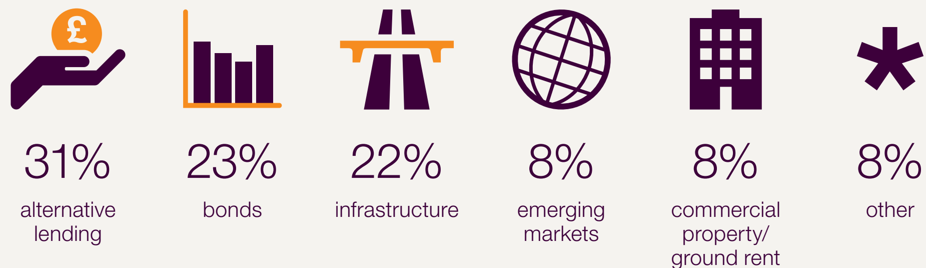
Sackers conducted a poll among trustees and pensions professionals at the March 2015 NAPF Investment conference asking for views on investment related issues. Here are some of the key findings.

What will shape your investment agenda for the next 12 months?



In the current low returns environment an emphasis on alternative investments to increase diversification is not surprising. What does stand out is that 18% of respondents have longevity hedging on their agendas; perhaps a result of the continued innovation in this field through captives and/or disintermediated solutions?

Where do you see potential increases to your asset allocation?



With yields so low on gilts and index linked corporate bonds being scarce, our respondents appear to be looking to alternative lending, infrastructure, commercial property (and perhaps some bonds mandates) as an alternative way of generating cash flows that also help in the journey to match asset liabilities more closely.

How frequently will you be reviewing your DC default funds following the new requirements to prepare a SIP?

The Pensions Regulator recommends a regular review of investment strategy and new regulations will require a three yearly review as a minimum once they come into force. We think the Regulator would probably be pleased to learn that over 60% of respondents already plan to review at least once a year and, perhaps more so, that only 4% have an ad hoc approach as to the frequency of reviews.

Legal update

Banking reform

Ring-fencing of banks

Legislation is now in force which will require the ring-fencing of affected banks by 1 January 2019. Broadly, UK deposit takers which hold more than £25 billion in "core deposits" (generally deposits of individuals, other than high net worth individuals and small/medium enterprises) will be required to place a "ring-fence" around those deposits.

Ring-fencing of pension liabilities

Regulations will require affected banks (those required to ring-fence core deposits) to ring-fence their pension liabilities from 1 January 2026 (they may opt to do so earlier). In essence, an RFB will not be able to be or become liable for pension liabilities relating to a non-RFB employees' service after that date. This means that an RFB cannot be an employer in the same pension scheme (or the same section of a sectionalised scheme) as a non-RFB after that date. In addition, an RFB will not be able to provide guarantees in respect of a non-RFB's liabilities. With effect from 5 March 2015, banks will also need to apply to TPR for clearance before entering into any corporate restructuring to achieve ring-fencing in relation to core deposits or pensions, if doing so is likely to be materially detrimental to the pension scheme.

Bail-in power

Since 1 January 2015, the BoE has had the power to write down or convert into equity certain eligible unsecured bank liabilities. The good news for pension scheme trustees is that pension liabilities are largely excluded from the bail-in power.

Depositor preference

Depositor preference also came into force on 1 January 2015. Upon a bank insolvency, claims in respect of core deposits now have preferential status, meaning they rank ahead of floating charge holders and unsecured creditors, such as a bank pension scheme's unsecured section 75 debt claim. Previously such deposit claims ranked alongside the claims of unsecured creditors.

Benchmark regulation

An index (a statistical measure), used as a reference price for a financial instrument (such as an interest rate swap) or contract, becomes a benchmark. A wide range of benchmarks is currently in use, from public entities to independent benchmark providers.

Regulation adopted by ECON committee

In the wake of the alleged manipulation of the LIBOR and EURIBOR interest rate benchmarks, the EU Commission has been working on a proposal for a regulation on indices used as benchmarks, with a view to improving governance and controls over the benchmark process. On 31 March 2015, the EU Parliament's ECON Committee announced that it has voted to adopt its draft report on the proposed Benchmark Regulation. The next stage is for the proposal to be considered by the Parliament in plenary session in September 2015. The FCA has said that it will continue to support HMT in EU level negotiations on behalf of the UK.

Capital Markets Union

CMU to provide new opportunities for pension schemes?

The CMU aims to break down barriers blocking cross-border investments in the EU which prevent businesses getting access to finance. The Commission also wants to clear the obstacles that prevent those who need financing from reaching investors and make the investment chain as efficient as possible. The EU Commission is expected to report back on its Green Paper, "Building a Capital Markets Union", by July 2015.

Pensions are seen as a key aspect of the CMU. The EU Commission anticipates that the growth of occupational and private pensions in the EU could result in an increased flow of funds into a more diverse range of investment needs through capital market instruments and facilitate a move towards market based financing.

Legal update cont.

EMIR: latest news

On 6 March 2015 ESMA published revised draft RTS on the clearing obligations of interest rate swaps. These RTS are currently awaiting endorsement by the European Commission. Pension schemes will, depending on their derivatives usage, be classified as a category 2 or 3 entity:

Timetable for interest rate swap clearing

- category 2 entities will have to clear 12 months after RTS come into force and may be subject to a frontloading obligation
- category 3 entities will have to clear 18 months after RTS come into force and will not be subject to a frontloading obligation.

A pension scheme will be classified as category 2 if its aggregate month-end average of outstanding gross notional amounts of non-centrally cleared derivatives is above €8 billion in the three months after the RTS is published in the official journal of the EU, excluding the month of publication.

Revised framework for margin requirements

A revised framework for margin requirements for non-centrally cleared derivatives was published in March 2015. The most important change for pension schemes is the delay in implementing mandatory variation margin rules. It is now proposed that variation margin will not be required until 1 March 2017 (instead of 1 December 2015).

European long-term investment funds

In force in 2015?

The EU Commission is in the process of introducing a framework for collective investments aimed at increasing the pool of capital available for long-term investment in the EU economy by creating a new form of fund vehicle, the ELTIF. By virtue of the asset classes that the new funds will be allowed to invest in, ELTIFs are expected to provide investors with long-term, stable returns. Pension funds are recognised as key players in this area, given their need for long-term assets to match their long-term liabilities.

On 20 April 2015, the Council of the EU announced its adoption of the ELTIF Regulation. This follows the adoption of the regulation by the EU Parliament in March. The new regulation is expected to be in force by the end of 2015.

Market in Financial Instruments Directive II

MiFID II applies to defined categories of investment services and activities relating to defined categories of financial instruments. The Directive and Regulation (MiFIR) must be implemented by EU Member States in their national legislation by 3 July 2016, and be brought into force by 3 January 2017.

HMT consultation closes 18 June 2015

On 23 April 2015, ESMA launched a consultation on draft guidelines for the establishment of a knowledge and competence framework that will set principles for individuals in MiFID firms that give investment advice or information, with a view to improving investor protection.

Meanwhile in the UK, the FCA published a discussion paper on 26 March 2015 on the areas of MiFID II over which it has discretion in relation to implementation within the UK and a formal consultation is due later in 2015. In addition, HMT is consulting on the governments' intended approach to the implementation of MiFID II and the key issues that need to be addressed.

See our March 2015 briefing for a detailed focus on MiFID II.

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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