Sackers

Finance & investment briefing

December 2015

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

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Abbreviations

DB: Defined benefit

DC: Defined contribution

CCP: Central Counterparty

DWP: Department for Work & Pensions

ECON: EU Parliament Committee for Economic and Monetary Affairs

EMIR: European Market Infrastructure Regulation

ESG: Environmental, social and governance

ESMA: European Securities and Markets Authority

FSB: Financial Stability Board

FSCS: Financial Services Compensation Scheme

FTT: Financial Transaction Tax

HMRC: HM Revenue & Customs

ICMA: International Capital Market Association

GMRA: Global Master Repurchase Agreement

GMSLA: Global Master Securities Lending Agreement

IMA: Investment management agreement

OTC: Over the counter

PRA: Prudential Regulatory Authority

TPR: The Pensions Regulator

Finance & investment focus

"Pension scheme trustees have to be aware of, and manage, numerous risks within their schemes, including longevity, inflation, interest rate and the risk of employer default. In this issue, Stuart O'Brien highlights five things to know about medically underwritten buy-ins – an increasingly popular risk management tool over the last twelve months. On the DC side, Anna Copestake examines key risks for asset security in the context of DC platforms.

It seems there is never a dull moment on the regulatory front. Just as trustees had begun to get used to the idea of reporting obligations for OTC derivatives, a new EU regulation has been adopted which requires reporting of repo and stock lending transactions. Sebastian Reger looks at the implications.

Elsewhere in the news, the Government has rejected the Law Commission's advice to clarify how trustees can consider ESG factors in their investment decisions on the basis that it would not necessarily lead to greater clarity.

Finally, as this is our last briefing of 2015, I hope you have a great Christmas and New Year!"

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Five things to know about medically underwritten buy-ins

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What are they?

Prevalent in the individual annuity market for many years, medically underwritten annuities are increasingly being used as a de-risking tool in place of conventional buy-ins. The terms are typically very similar, with a bulk annuity policy being purchased by trustees to match the liabilities of some or all of the scheme's members. But the difference lies in how the quotation price is derived. In a medically underwritten policy, the insurer will price the policy after gathering health and lifestyle information for the members to be insured. This information allows the insurer to estimate member longevity more accurately and therefore price the policy more competitively.

What is top-slicing?

There are upper limits in terms of the number of members who can practically be covered by a medically underwritten buy-in. For this reason, most transactions to date have sought to cover only a subset of a scheme's members. Typically, around half of a DB scheme's liabilities can be concentrated in just 10% of its members (frequently former management and senior employees). The usual approach, therefore, is to "top-slice" a small number of the largest pensions in payment, removing the concentration of longevity risk associated with these members. Many of the deals done to date have covered fewer than 100 members in a given scheme.

Why do it?

Aside from removing concentration of longevity risk, schemes which have "top-sliced" frequently report considerable cost savings over traditional buy-ins. Historically, this may have been due to competition in the market, with specialist insurers looking to establish and grow their presence. But the fundamentals of annuity pricing also play a part. In a conventional buy-in, pricing is based on factors such as age, gender, postcode and the amount of pension in payment. For members with larger pensions in more affluent areas, an insurer will often assume long life expectancy. But with medical and lifestyle information, they may be able to estimate life expectancy more accurately and remove priced-in margins of prudence from their assumptions.

How do you go about assessing members' health?

The process of gathering health and lifestyle data on a scheme's members is usually outsourced by the insurer to a third party - there are a number of specialist organisations which do this. A typical process involves a letter to members and a short questionnaire seeking permission for a follow-up telephone conversation and/or permission to obtain a report from the member's GP. Member response rates can be surprisingly high, with many schemes reporting around three quarters of members contacted actively engaging in the process. The information is then shared with the insurance company. In a competitive tender process, medical information gathered by the third party may be shared with a number of insurers before quotes are provided.

Can it end up being more expensive?

In theory, the process of gathering health and lifestyle information could reveal significantly above average health and much longer than expected life expectancy, meaning that the medically underwritten quotation price could be higher than for a conventional buy-in. However, as conventional annuity pricing usually incorporates a large margin of prudence for longevity of higher paid pensioners, experience to date is that higher pricing on a medically underwritten basis is not often seen. Similarly, pricing of a conventional buy-in policy for non top-sliced members should not be adversely affected. But if trustees are contemplating a larger scale buy-in in conjunction with a top-sliced medically underwritten one, this is something that will need careful consideration.

Focus on DC platforms: asset security

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Trustees are increasingly accessing DC investments through a platform, one of the most attractive features being the ability to access a range of managers' funds through a single structure. However, not all trustees feel comfortable that they understand the risks and mitigations associated with investing through a platform.

Why do trustees need to know?

TPR's DC Code requires trustees to give "due consideration to [DC] asset protection and understand what would happen in the event of a problem". As part of their review, it suggested that trustees consider counterparty risks, the creditworthiness of the DC provider and the extent to which a loss of assets might be covered by a compensation scheme or indemnity insurance.

Managing key risks

Provider default

This is the risk associated with the platform provider's covenant. An understanding of the provider's financial reserves and confirmation from the provider of how they meet the PRA's minimum requirements can bring trustees some comfort. Trustees should also understand the level of FSCS cover that may be available if the provider were to suffer an insolvency event.

"Cross-contamination"

This is the risk that the platform provider writes risk-related business (such as annuities or life assurance), which could affect the provider's ability to fulfil its obligations under the contract with the trustees. Trustees should understand what business the platform provider writes and what measures it has in place to mitigate the cross-contamination risk. There is also an equivalent risk associated with the underlying funds that should be thought through.

Third party default

As trustees do not have a direct contractual relationship with third party fund managers, there is a risk associated with the platform provider's recourse to assets. Trustees should understand any protections available to aid the provider's recourse. For example, any insulation against third party default resulting from the structure of the fund, or any floating charges granted over the fund's assets where accessed through reinsurance arrangements.

Key questions for trustees

- Do I understand how the scheme's DC arrangements are structured, both at platform provider level and the underlying funds that sit on the platform?
- What are the key risks associated with each of those structures?
- What protections or mitigating features are present for each risk?

Approach

As TPR recognises, this is a complex area. DC investment structures can be multifaceted, involving a number of counterparties. Assessments of asset security within these structures can be carried out with varying degrees of granularity.

Trustees should keep a watching brief

The key approach is one of due diligence. Asking the right questions of providers and advisers and understanding the answers.

It is also not a one-off exercise. As the business of providers and managers changes, so does the degree of risk associated with corresponding investments.

Reporting and transparency: repos and stock loans

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New EU regulation will soon require pension schemes to:

- report details of their repo and stock lending transactions to trade repositories
- retain all transaction details for at least five years following the termination of a transaction and
- get the express consent from their repo and stock lending counterparties before they can reuse (or "rehypothecate") any collateral received under a repo or stock loan transaction.

These measures are set out in a new EU Regulation on Reporting and Transparency of Securities Financing Transactions which was adopted by the European Parliament on 29 October 2015 (it still has to be passed by the EU Council before becomes law). Further implementing legislation will be required before the reporting obligation can take full effect, meaning that schemes are unlikely to have to report before 2017.

By now, pension schemes and their investment managers should have started to come to terms with the reporting obligation for OTC derivatives. The obligations for repos and stock lending transactions should follow the agreed process for OTC derivatives. The reporting of repos and stock lending transactions will need to be taken up with the relevant investment managers closer to the obligation going live. Changes to IMAs may also be required.

The need to obtain express consent for the reuse of collateral may require changes to schemes' GMRAs and GMSLAs. We expect that the industry body overseeing the relevant documentation (the ICMA and ISLA respectively) will consider the need for amendments. We continue to monitor developments.

Pension schemes should raise the issue with their managers to ensure that managers will only reuse collateral where the necessary consent has been obtained.

This regulation is part of a broader drive to strengthen oversight and regulation of the shadow banking sector. The proposed new regulation will only address some of the recommendations which the FSB made in respect of repos and stock lending transactions. Further regulation should be expected around haircuts on non-centrally cleared repo and stock loan transactions to prevent excessive leverage and to mitigate concentration risk and default risk. These measures (whatever form they may take) could affect the pricing of these transactions.

Legal update

Recovery of VAT on pension fund management costs

VAT on invoices for general administration fees for work commissioned by and delivered to the trustees of UK occupational pension schemes has been recoverable by employers under VAT Notice 700/17. However, HMRC revised its position in the light of two European cases, concluding that an employer could recover input tax in relation to the management of its pension scheme (here, investment management and day-to-day administration) only if there is contemporaneous evidence that it:

- is the recipient of the services
- is party to the contract for those services and
- has paid for them.

See our Alert: VAT on professional fund management costs – latest news for more details

In March 2015, HMRC outlined its position on the use of tripartite contracts to evidence an employer's entitlement to deduct VAT paid on services relating to the management of DB schemes. HMRC's latest Brief (17/15) confirms the position and outlines HMRC's views on how use of these structures affect an employer's ability to apply a Corporation Tax deduction. The October 2015 Brief also addresses other options, including the supply of scheme administration services to an employer by the trustees, and the inclusion of a corporate pension scheme trustee in an employer's VAT group.

To give employers and trustees time to evaluate the latest brief and decide what arrangements to put in place, the transitional period allowing businesses to continue using the VAT treatment outlined in Notice 700/17 has been extended to 31 December 2016. Employers and trustees will welcome this extension and should use the time to discuss the issue with their tax and legal advisers.

Investment regulations: No change to ESG requirements

Following a report by the Law Commission in 2014, the DWP consulted between February and April 2015 on possible changes to the Investment Regulations. Two key themes were considered: the difference between financial and non-financial factors when taking decisions about investments; and the role that a "stewardship" approach can play when taking decisions about investments.

Consultation closes 9 December 2015

In its response to the consultation, the DWP has confirmed that no changes will be made to the investment regulations, as it considers this to be an area where guidance can be more effective than regulatory change, in particular because it can be kept up to date over time.

As part of a wider consultation, the DWP is now seeking views and evidence on the disclosure of information about how a scheme makes investments. This includes information on the selection, monitoring, retention and realisation of investments; stewardship; and the selection, appointment and monitoring of investment managers and other agents.

EMIR: extension of clearing exemption confirmed

EMIR imposes an obligation on pension schemes to clear those OTC derivative transactions which the European Regulator, ESMA, mandates for clearing.

Pension schemes may take advantage of an exemption from the clearing requirement. The exemption applies to all OTC derivative transactions that are "objectively measurable as reducing investment risks directly relating to the financial solvency of pension schemes". This exemption has been extended for a further two years, until 16 August 2017. While the market has been operating on the basis of the extension for a little while, the extension only came into force on 16 September 2015.

Legal update cont.

EU Regulatory framework for financial services

The EU Commission launched a call for evidence on the EU regulatory framework for financial services on 30 September 2015. The consultation, which closes on 6 January 2016, seeks feedback on the rules affecting the ability of the economy to finance itself and growth, and unnecessary regulatory burdens. The Commission hopes to gain a clearer understanding of the interaction of the individual rules and cumulative impact of the legislation as a whole.

Consultation closes 6 January 2016

Meanwhile, the ECON committee is amending a draft report on the way forward towards a more efficient and effective EU framework for Financial Regulation and a Capital Markets Union. The Commission has been called on, in its review of EMIR, "to examine the effect that lowering collateral accepted by CCPs could have upon the resilience of CCPs and consider whether certain market participants such as pension funds should be permanently exempt from central clearing should their participation decrease the stability of the overall financial system due to alternative non-cash collateral being accepted".

FCA asset management market study

The FCA is carrying out a study to understand whether competition in the asset management market is working effectively, with the aim of enabling investors to get value for money when purchasing asset management services. The key areas for assessment are:

- how asset managers compete to deliver value
- whether asset managers are motivated and able to control costs along the value chain
- what effect investment consultants have on competition for institutional asset management.

The FCA will also examine whether there are any barriers to innovation and/or technological advances in asset management.

Deadline for comments: 18 December 2015

The study was launched on 18 November and, although the FCA is not consulting formally on its terms of reference for the study, it welcomes any comments on the issues raised by 18 December 2015. The FCA aims to publish its interim findings in the summer of 2016, with a final report due in early 2017.

Financial Transaction Tax

Back 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.

Further developments in 2016?

Eleven EU Member States have accepted, in principle, the adoption of the FTT. Progress has been slow, but in September 2015 the Member States in the "FTT Zone" held talks to discuss 25 "building blocks" of the initiative. Issues currently under review include the impact of an FTT on pension schemes, and whether they should be exempt from the tax. Political commitment from the FTT Zone may be forthcoming in January 2016.

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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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