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FIFTY YEARS OF PARTNERSHIP 50

Finance & investment briefing

June 2016

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

EIOPA: European Insurance and Occupational Pensions Authority

EMIR: European Market Infrastructure Regulation

ESG: Environmental, social and corporate governance

EU: European Union

FCA: Financial Conduct Authority

FSMA: Financial Services and Markets Act 2000

FTT: Financial Transaction Tax

IORP: Institutions for Occupational Retirement Provision

MiFID II: Markets in Financial Instruments Directive II

OTC: Over-the-counter

PLSA: Pensions and Lifetime Savings Association

PSA: Pensions Schemes Act 2015

SIP: Statement of Investment Principles

TPR: The Pensions Regulator

VAT: Value Added Tax

Finance & investment focus

"Welcome to the June issue of our finance & investment briefing. I can't help but think that we are experiencing the calm before the storm. This summer has plenty in store to entertain, surprise and shock us: above average temperatures and thunderstorms courtesy of El Niño; perhaps a surprise from one of the British teams at the Euros in the year when a 5000/1 outsider won the Premier League; Olympic games in a country embroiled in political and social turmoil and against the backdrop of a global doping scandal; the US presidential race; and, not least, the small matter of the EU Referendum. Without taking sides, Ian Cormican contributes to the referendum debate, looking at considerations for pension schemes should the vote go in favour of "Brexit".

In more conventional pensions news, TPR has published new "how to" guides to help trustees implement the new DC code (due in force in July 2016). Check out our legal update on page 6 for more background.

Also in this edition we go "back to basics" and highlight some important factors to remember when negotiating investment management agreements.

We will be back in September when we will turn our attention to the new mandatory collateral rules for non-cleared OTC Derivatives and the necessary re-documentation exercise."

Sebastian Reger
Partner, finance & investment group

sebastian.reger@sackers.com

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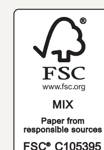

Focus on Brexit

Ian Cormican
Partner, finance & investment group

ian.cormican@sackers.com

Action points

- **Ensure ongoing integrated risk management is up-to-date**
- **Review counterparty arrangements to understand potential exposure**
- **Monitor scheme funding positions and investment strategy**

It is unlikely to have escaped the notice of many readers that, on 23 June 2016, the UK will hold a referendum in which eligible voters will be asked "Should the United Kingdom remain a member of the European Union or leave the European Union?".

In the event that the UK does vote for "Brexit", what could that mean for UK pension schemes?

Market volatility

Markets have been volatile since the start of 2016 and will inevitably remain jittery in the run-up to the referendum. Should the UK vote to leave the EU, markets are likely to remain unsettled during the two year period (or potentially longer) in which the UK will negotiate the terms of its withdrawal.

Trustees will want to consider the implications of the referendum on their investment strategy, both in minimising the effects of short term volatility around the date of the referendum and, if the UK votes to leave the EU, in monitoring their strategy in light of changing market conditions.

Trustees and employers should ensure their ongoing integrated risk management processes are up-to-date and that they understand any actions which will be required should the effect of a vote for Brexit on the scheme's investments result in a worsening of the funding position.

Hedging

Trustees will need to be aware of the potential impact of a vote for Brexit on their hedging arrangements. For example, the value of collateral posted in the form of gilts or bonds could reduce if Brexit were to result in a downgrade of the UK's credit rating or that of bond issuers such as UK financial institutions.

Similarly, a downgrade of UK financial institutions may have implications under derivative contracts, including triggering increased collateral requirements or termination rights. Should any overseas counterparty banks move away from the UK following a vote for Brexit, this may also have contractual implications.

While it is difficult to plan for such an event, trustees may want to review their counterparty arrangements to enable them to both understand their potential exposure and respond quickly to events.

Legislation

Much of the UK legislation affecting pension schemes has its roots in the EU. "IORP" or the workplace pensions Directive, which deals with funding, investment and governance among other things, is one of several EU Directives which has been incorporated into UK legislation and which affects the day-to-day operation of workplace pensions in the UK.

The financial sector is also extensively regulated through EU legislation such as EMIR and MiFID II.

While it seems likely that equivalent legislation would remain in place following a vote for Brexit, this will ultimately depend on both the form of the relationship agreed between Britain and the EU and the political appetite in the UK to dispense with or amend existing UK legislation.

Employer covenant

A Brexit vote clearly has the potential to directly affect a scheme's funding position and investment strategy. The changing trading environment could also have an adverse impact on the business of the sponsoring employer.

Trustees should monitor the implications of this and consider whether additional security is required. Existing contingent assets should be checked to see whether any reporting requirements or funding triggers might come into play.

Back to basics: investment management agreements

Ralph McCelland, Associate Director

ralph.mcclelland@sackers.com

We look at a few key issues to consider when negotiating an investment management agreement

Liability and indemnities

Trustees should ensure that their investment manager accepts liability for fraud, wilful default and negligence. It may also be appropriate to include breach of contract. They should also check that the investment manager has an appropriate level of liability insurance in place to meet any claims against it and require that they maintain such insurance. While it is difficult to envisage circumstances in which the actions of the trustees could cause a loss to the investment manager, trustees will often be asked to provide an indemnity. Trustees should check that they have power to provide such an indemnity and seek to limit both the extent of their liability under it and the circumstances in which it applies.

Who is the manager?

Having carefully conducted due diligence in selecting a manager, trustees will want to be sure that that party in fact fulfils the role of discretionary investment manager.

The manager should not be able to assign its obligations under the agreement without trustee consent. Similarly, trustees will want to know if, and to what extent, the manager may delegate its functions.

Trustees will not have any direct contractual relationship with any delegate and so, to the extent delegation is permitted, the manager should remain liable for the delegate's acts and omissions.

Scope of discretion

Trustees need to check that the mandate is consistent with their investment powers and with their statement of investment principles. The manager should be required to comply with these.

The scope of the manager's discretion and the investments which the manager is permitted to make should be carefully prescribed. For example, is the manager permitted to use derivatives? If so, will the trustees impose any counterparty requirements?

Finally, the investment guidelines may cover not just the assets in which the manager is permitted to invest but the level of risk the manager is allowed to take.

Fees

Fee structures, in particular performance fees, can be complex.

In the context of performance fees, trustees should check benchmarks carefully and look for features such as a "high water mark" to ensure managers are not rewarded for "outperformance" which in fact only represents recovery from previous underperformance.

Termination

While all parties will hope, at the outset, for a successful relationship, it is important to consider an exit strategy.

If the manager were to terminate the agreement, the trustees would need time to select and appoint a replacement manager. As such, the manager should be required to give between three to six months prior written notice of termination.

On the other hand, if the manager is underperforming, the trustees may wish to terminate the agreement with immediate effect. Even in those circumstances, the agreement should make provision for the manager to assist in the handover of the assets to a replacement manager.

Clearing: interest rate derivatives

Sebastian Reger
Partner, finance & investment group

sebastian.reger@sackers.com

Getting ready for clearing should now be firmly on the agenda for all schemes which use over-the-counter derivatives.

The deadline for the mandatory clearing of interest rate derivatives is approaching fast:

- For "category II" schemes (those with an aggregate month-end average of outstanding gross notional amounts of non-centrally cleared derivatives for January, February and March 2016 of EUR 8 billion), mandatory clearing will apply from 21 December 2016.
- For schemes in "category III" (those which are not Category II), mandatory clearing will apply from 21 June 2017.

Clearing of interest rate derivatives can be delayed until the transitional exemption for pension schemes expires in August 2017, but this should not stop schemes from agreeing the contractual framework and putting in place the operational plumbing. We are expecting there to be a rush for the "clearing door" as we get closer to the deadline and schemes need to make sure they do not get caught out. Once the deadlines and the pension scheme exemption have expired, schemes will not be able to enter into any new interest rate derivatives unless they are cleared.

If a manager has not yet been in touch, now is the time to speak to them to ensure they are doing everything necessary to be ready for clearing.

How will clearing impact investment strategy?

Trustees also need to start to think about their investment strategy in the light of clearing. While clearing helps to mitigate counterparty credit risk, it does not eliminate risk altogether. Trustees, managers and advisers therefore need to consider the new sources of risk and how these can best be managed. For example:

- Pension schemes access clearing houses through clearing members which can reduce available trading lines. Should a hedging strategy take into account the possibility of clearing access being reduced for new and existing transactions?
- Clearing members can call for collateral in excess of that required by the clearing house. What are the obligations of the clearing member in respect of that excess collateral?
- Does the scheme have sufficient access to liquid collateral, or does the scheme have to enter into collateral transformation trades through repos and stockloans? How does the scheme ensure access to collateral in times of stress?

These are just some of the questions which trustees and their advisers should have on their radar.

Legal update

TPR: DC investment governance guide

On 13 April 2016, TPR launched a consultation on a series of six new "how to" guides aimed at assisting trustees to implement the draft revised DC code, which is due to come into force in July 2016.

TPR has developed a guide to cover and support each section of the new draft DC code, including section 4 on "investment governance". Trustees remain ultimately responsible for a scheme's investments, regardless of certain tasks and decisions in respect of investments often being delegated to others. TPR's draft DC investment governance guide therefore explains:

- how to choose and establish a suitable delegation structure, including use of investment sub-committees, appropriate consideration of fiduciary management and the importance of setting out clear terms of reference for all parties involved in investment decision making
- how to consider both financial and non-financial factors material to the performance of an investment and related sustainability considerations
- how trustees can get involved in stewardship activities, such as exercising voting rights on shares, or influencing their managers' policies where pooled funds are used
- options for designing fund choices, including default arrangements, that are suitable for the scheme's members
- examples of matters to take into account in reviewing the SIP, default strategy and performance of any default arrangements
- the importance of considering the costs involved in transitioning investments
- how to assess security of the scheme's assets.

See our Alert: TPR explains "how to" implement new DC code for more details

The guides are not intended to be prescriptive but rather provide practical information and examples of approaches trustees could take in order to meet the standards set out in the code.

TPR may include further examples of good practice in the guides, based on responses received as part of the consultation process. Final guides are expected to be published by July 2016 when the new DC code comes into force.

EIOPA proposal for standardised risk assessment

EIOPA proposes risk assessment

On 14 April 2016, EIOPA published its opinion on a "common framework for risk assessment and transparency for IORPs".

"At this time", EIOPA is not recommending the harmonisation of capital funding requirements for pension schemes. It does however propose the adoption of a "standardised risk assessment to calculate the impact of common, pre-defined stress scenarios on the common framework's balance sheet of a pension fund". The assessment would include all available security and benefit adjustment mechanisms, such as sponsor support, pension protection schemes and benefit reductions.

For smaller workplace pension schemes, EIOPA suggests that a proportionate and, as appropriate, simplified approach is adopted in order to minimise the burden.

Gabriel Bernardino, Chairman of EIOPA, stated that the opinion presented "a major step forward towards realistic, risk-sensitive information on the financial situation of pension funds."

Legal update cont.

Proposal withdrawn

Financial Transaction Tax Directive

The EU Commission has withdrawn proposals for a new Directive on a common system of FTT and for a new VAT regime for the financial services industry.

Eleven Member States had previously accepted, in principle, the adoption of the FTT and in September 2015 the Member States in the "FTT Zone" held talks to discuss "building blocks" of the initiative.

Royal assent

Bank of England and Financial Services Act receives Royal Assent

On 4 May 2016 the Bank of England and Financial Services Act 2016 received Royal Assent.

Among other things, the new legislation extends the scope of the Pension Wise service offering free and impartial guidance to pension holders considering selling the income from their annuities to a third party.

The new Act also makes certain amendments to FSMA, including the introduction of a requirement on the FCA to implement rules:

- requiring certain authorised firms to check that holders of a relevant annuity have received appropriate financial advice before they may sell their annuity
- to ensure a ban on specified exit charges being imposed on pension scheme members who convert or transfer pension benefits after they have reached pension age but before retirement.

The Act also amends the PSA to correct an omission and allow "appointed representatives" of authorised financial advisers to advise on the conversion and transfer of "safeguarded benefits" (generally DB), for the purposes of the advice safeguards established in the PSA.

New guides to help trustees with multi-asset credit, systematic investing and ESG

PLSA launches new "Made Simple" guides and DB taskforce

The PLSA has launched three further guides in its "Made Simple" series. The first, "Multi-Asset Credit", is intended to help pension funds address concerns that they have in accessing global credit markets. The second, "Systematic Investing", explains what systematic investing is, how it works, how it has performed previously, and what to consider in relation to investing in such funds. The third, "Environmental, Social and Corporate Governance" aims to provide a practical approach in incorporating ESG into investment strategy.

In addition, the PLSA announced the launch of a DB taskforce "to tackle the problems faced by defined benefit pension schemes". The taskforce involves group of industry experts and academics, who aim to seek "views and evidence from schemes, sponsors, regulators, government and intermediaries to allow it to get to the heart of the issues" affecting DB schemes.

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Contact

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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.

Sebastian Reger
Partner
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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Sacker & Partners LLP
20 Gresham Street
London EC2V 7JE
T +44 (0)20 7329 6699
E enquiries@sackers.com
www.sackers.com

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