Finance & investment briefing

September 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

CCP: Central clearing counterparty

EMIR: European Market Infrastructure Regulation

ESMA: European Securities and Markets Authority

ESG: Environmental, social and corporate governance

EU: European Union

FCP: Financial counterparties

GMRA: Global Master Repurchase Agreement

GMSLA: Global Master Securities Lending Agreement

ISDA: International Swaps and Derivatives Association, Inc.

LDI: Liability driven investment

OTC: Over-the-counter

PPF: Pension Protection Fund

TPR: The Pensions Regulator

Finance & investment focus

"Welcome to the September issue of our finance & investment briefing. In our last briefing, my clairvoyant colleague Sebastian Reger foretold of surprises from a British team at the Euros and shocks in the US presidential race and EU Referendum. As the implications of Brexit now begin to play out in real time, the overwhelming message is that trustees should not panic, but continue to monitor their funding and investment positions in line with their established integrated risk management processes. For further details please see our Alert.

However, for many pension schemes the possibility of an economic slowdown could exacerbate existing funding difficulties, particularly for DB schemes sponsored by already financially stressed employers. The plight of the BHS Scheme has dominated the press following the publication of the select committee report, but there are many other examples of less high profile schemes where employers are struggling to provide financial support.

Consequently, in this issue we focus on schemes in distress. Andrew Worthington goes "back to basics" looking at the trustee role during a PPF assessment period and Tom Jackman and Vicky Carr consider the establishment of a "new normal" for funding structures. Meanwhile Sebastian examines events of default in ISDAs, GMRAs and GMSLAs – sadly he has resisted my request to write this month's horoscope.

Finally, our next seminar, in which we will look at ESG and responsible investing, will be held on 15 November 2016. For details and to sign up, please see our website."

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Investment duties during a PPF assessment period

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Should a sponsoring employer to a scheme suffer a qualifying insolvency event, the scheme will enter an assessment period during which the PPF will determine whether the scheme satisfies the criteria for entry into the PPF. We look at the role of trustees during such period.

Duties continue

During an assessment period the trustees retain responsibility for the pension scheme, including:

- managing scheme investments, managers and advisers
- monitoring scheme assets
- maintaining good scheme governance
- paying benefits to members in accordance with the scheme's admissible rules (ie ignoring recent rule changes and discretionary increases).

Trustees must continue to invest the scheme's assets in accordance with the scheme's rules, statutory powers and their duties under trust law.

Consider revising the investment strategy

The PPF expect that trustees will review their scheme's investment strategy and consider whether:

- the asset allocation is appropriate, broadly matching the scheme's liabilities so far as possible in order to minimise the risk of deficit volatility
- the scheme's investment strategy correlates with the PPF's own strategy.

Trustees should work with both their existing investment advisers and the PPF's investment team to determine an appropriate investment strategy.

Trustees must notify the PPF of any "significant" changes in the investment of scheme assets within 14 days, although best practice is to do so before making a change.

Comply with any PPF directions in relation to investments

The PPF has the power to issue directions to various parties, including trustees, during an assessment period with the aim of either:

- ensuring the assets of a scheme remain at a level where the PPF will not need to assume responsibility for it
- minimising the gap between the value of the assets and the cost of providing PPF compensation.

This power may be used to issue a direction in relation to the investment of the scheme's assets, allowing the PPF to make changes to the investment strategy if it does not believe that the trustees have reviewed it in accordance with the scheme's changed circumstances.

Administration and contracts

Trustees are expected to prepare a project plan at the start of an assessment period, to include information in relation to the trustees' review of the investment strategy. The PPF caseworker assigned to the scheme will monitor progress against the plan throughout the assessment period.

Trustees should provide the PPF with a review of the scheme's investments and, at least quarterly, a copy of asset valuations.

The PPF will also review any contracts between trustees and investment managers, looking particularly at exit clauses to determine whether they can be terminated immediately or must remain in place until all final activities have taken place.

Scheme specific funding – the "new normal"?

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The Pensions Act 2004 established the scheme specific funding regime, but just as it was beginning to bed down, along came the credit crunch. The basics of the legislation have not changed, but the economic circumstances led to changes in its practical application.

Back in the late noughties, valuations conducted against the backdrop of historically low gilt yields, significant economic uncertainty and weakened employer covenants seemed anomalous, but life in the world of scheme funding has stubbornly refused to go "back to normal".

Things have now developed to a point where most accept that we will never go back to where we were before. Perhaps Brexit will prove to be a driver for another significant shift. TPR's July 2016 statement warns that volatile markets could have a "material impact on a scheme's funding position" whilst urging trustees to consider the longer term view and "not be overly focused on short-term market movements". A clear picture is yet to emerge but in the meantime, it is hard to escape the conclusion that a "new normal" has been established. So it is worth taking stock and thinking about what that "new normal" really looks like.

Funding, investment and employer covenant

For some years now, TPR's guidance has divided scheme funding into three key elements: funding, investment and employer covenant; with changes to any one element potentially impacting on one or both of the others. This remains a helpful analysis, but it also begs the question of where to start when actually faced with a valuation process.

Logically, covenant is the best place to start because covenant is what it is at any given time, and, in any case, trustees should be monitoring covenant on an ongoing basis. It may be difficult to assess, but if trustees have formed a view on the employer covenant strength, it stabilises one of the "moving parts" and forms the backdrop for the whole process.

Coordinating funding and investment can be more challenging, and legally it can be a curious mix. Trustees have absolute discretion over investment strategy, yet that strategy must necessarily work hand in glove with the contribution structure (which must usually be agreed with the employer) to produce a viable recovery plan.

It is always preferable if trustees can work constructively with the employer to agree a mutually acceptable outcome, but even then it is important that trustees understand the legal position, as it informs their bargaining position.

Where there is difficulty in securing agreement, the legal position becomes even more important, but it can be hard to get a grip on the sometimes complex blend between scheme rules, legislation and TPR guidance.

TPR

And of course there is the role of TPR. TPR has revised its guidance several times, it has introduced "early engagement" and it now has a statutory objective to minimise any adverse impact on the sustainable growth of an employer. But where has all of that taken us?

On the positive side, we have a better understanding of TPR's approach – where its normal boundaries lie and the circumstances in which it may be more flexible (for example, accepting a longer than normal recovery period). This helps to put some parameters around funding discussions.

Less positively, TPR appears somewhat reluctant to exercise its powers, especially when it comes to "breaking the deadlock" by imposing a recovery plan. Though the threat of imminent action has been a catalyst for progress in the odd case, in practice an impasse may be allowed to continue until some other catalyst moves things forward.

Scheme specific funding – the “new normal”? cont.

What else informs the “new normal”? Far more schemes are now closed to accrual, and increasingly valuations are looking towards an “endgame”, perhaps targeting self-sufficiency (or even buyout). Alongside the obvious investment considerations, measures to manage the risk of trapped surplus are also more common, such as contribution rates which fluctuate from year to year in line with the funding position and escrow accounts.

Contingent assets

In terms of contingent assets, an escrow account is really the exception to the general rule that trustees should favour cash into the scheme (because the employer may be legitimately concerned about surplus). If a pension scheme has a fairly sizeable deficit on a “technical provisions” basis, however, trustees are unlikely to accept that payments of contributions are made into an escrow rather than the scheme. In that scenario, an escrow could still be used, for example, to support the level of scheme investment risk – if the investments do not deliver the assumed return, monies can tip from the escrow to the scheme to make good the difference.

Contingent assets as a whole have become increasingly popular as deficits have ballooned in the face of the “new normal” environment. Employers may not have the cash available to them to fund a deficit over the timescale preferred by the trustees. In addition to escrow arrangements, contingent assets such as parental guarantees, letters of credit, surety bonds, charges over assets and asset-backed contribution structures, can represent a workable compromise which allow the employer to fund the deficit over a longer recovery period while offering trustees protection against the occurrence of certain events, such as employer insolvency.

The “new normal” – a stable framework?

Back in the late noughties, few would have predicted what the current landscape looks like. This “new normal” will no doubt continue to evolve, but for the time being we have a reached a point where – leaving Brexit to one side – the legal and regulatory framework is comparatively stable. But that does not make it easy – the parameters will be different depending on the particular circumstances of the scheme and its sponsor. It is called “scheme specific funding”, after all.

Sponsor insolvency: ISDAs, GMRAs and GMSLAs

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ISDAs, GMRAs and GMSLAs (the standard agreement for documenting, respectively, derivative transactions, repos and security lending transactions) for pension schemes tend to follow a market standard. Most will contain at least one provision which could either immediately, or after some time, be triggered as a result of a scheme sponsor's insolvency.

Events of default protect a party against counterparty credit risk. If an event of default is triggered, the non-defaulting party may terminate all open transactions. We consider three of the most common provisions and highlight potential issues for trustees.

Sponsor insolvency triggers an event of default in respect of the scheme

This type of event of default can take different forms. Common examples include:

- the insolvency of the sponsoring employer triggers an event of default
- the commencement of a PPF assessment period (which in turn is triggered by the insolvency of the sponsor) triggers an event of default.

For trustees, this can be very challenging and disruptive. For example, it could result in a scheme losing hedging positions overnight and exposing it to the costs of re-establishing the same positions with another counterparty. Meanwhile the scheme must continue to pay benefits and invest its assets.

An event of default along these lines is often initially proposed by bank counterparties, but does not tend to survive the negotiations.

Following a PPF assessment period, the scheme is accepted into the PPF, but the PPF does not accept responsibility for the transactions or wants to amend the terms of the transactions

This type of event of default has become a common feature and tends to follow the draft endorsed by the PPF in its public statement of 8 March 2010.

Following a PPF assessment period, the scheme is not accepted into the PPF

This event requires particular attention, because both trustees and bank counterparties will look to protect their legitimate interests. If a scheme is not admitted to the PPF then trustees will, most likely, look to secure the scheme's benefits in the insurance market. This can take time, and trustees need as much stability and certainty as possible to achieve an insurance solution. If bank counterparties can terminate all hedges while the trustees are looking to enter into insurance contracts then this can be disruptive, and potentially worsen the funding position of the scheme. Bank counterparties, on the other hand, do not want to face "zombie schemes" and see assets being paid over to an insurer, leaving the bank with an increased credit exposure.

If the trustee and bank counterparties cannot agree on a compromise position as part of the negotiations, trustees need to engage with their managers and bank counterparties as soon as it becomes clear that the scheme will not be accepted into the PPF to understand the potential impact of this type of event of default.

Legal update

EMIR: on the horizon

EMIR came into force on 16 August 2012 and the clearing and margin requirements for category 2 and category 3 firms are due to come into effect from December 2016. Category 2 firms are also subject to the frontloading obligation that requires FCP to clear OTC derivative contracts entered into or novated on or after a given frontloading start date before the entry into force of the clearing obligation. The timetable is as follows:

Clearing obligation and frontloading timeline

	Category 2 (FCP whose notional trade exceeds €8 bn)	**Category 3** (FCP whose notional trade is below €8 bn)
Clearing obligation interest rate derivatives	21 December 2016	21 June 2017* (possibly delayed to 21 June 2019)
Frontloading interest rate derivatives	21 May 2016	N/A
Clearing obligation credit default swaps	9 August 2017	9 February 2018* (possibly delayed to 9 February 2020)
Frontloading credit default swaps	9 October 2016	N/A

Pension scheme exemption

Pensions schemes will, depending on their derivatives usage, be classified as a category 2 or 3 entity. Under the transitional provisions, pension schemes may take advantage of an exemption to the clearing obligation in respect of all OTC derivative transactions which are "objectively measurable as reducing investment risks directly to the financial solvency of pension schemes". This exemption option remains available until 16 August 2017.

Consultation paper to delay clearing obligation for category 3

* On 13 July 2016, ESMA published a consultation paper on delaying the phase-in period by two years in respect of the clearing obligation for category 3 firms. ESMA has proposed the delay to provide additional time for smaller firms to comply with the clearing obligation and connect to a CCP whilst not compromising the EMIR objective of reducing systemic risk.

The consultation closes on 5 September 2016 and ESMA will review all responses with a view to publishing a final report by the end of 2016.

Margin rules phase-in delay

The EMIR margin rules are due to be phased in from 1 September 2016 in respect of average aggregate notional amount of non-centrally cleared derivative transactions >€3 trillion. Further phase-in dates are then due in respect of lower thresholds, however, the EU has delayed the phase-in of margin rules which are now expected to begin in mid-2017, though the date is still to be confirmed.

ISDA: regulatory margin

Standard disclosure letter published

On 30 June 2016 ISDA published a Regulatory Margin Self-Disclosure Letter. The letter is intended to help market participants comply with regulatory margin regimes for uncleared derivatives transactions in various jurisdictions. New requirements on the exchange of collateral (initial and variation margin) between counterparties to uncleared derivatives are being implemented globally (see "EMIR: on the horizon" above).

The standard disclosure letter aims to assist market participants with providing FCP with the information that is necessary to establish the extent to which their trading relationship will fall subject to the margin requirements of one or more of the new regimes.

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