Finance & investment briefing

December 2016

Sackers' finance & investment group takes a look at current issues of interest to pension scheme investors

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Abbreviations

CSA: ISDA credit support annex

EMIR: European Market Infrastructure Regulation

ESG: Environmental, social and corporate governance

EU: European Union

FCA: Financial Conduct Authority

FCP: Financial counterparty

FX derivative: Foreign exchange derivative

ICSA: Institute of Chartered Secretaries and Administrators

IGC: Independent governance committee

ISDA: International Swaps and Derivatives Association, Inc.

LDI: Liability driven investment

OTC: Over-the-counter

OTC Derivatives: Over-the-counter derivative transactions

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In this issue

Finance & investment focus

"Welcome to the final 2016 issue of our finance & investment briefing. This year has seen a number of changes across both regulation and politics which impact on pension fund investment, many of which have longer term implications we have yet to feel. We've kept this issue free of discussion of "Brexit" to avoid fatigue on the subject (and in recognition of the uncertainties).

In our recent seminar, we examined ESG and responsible investing and produced a guide for pension trustees giving a practical approach to such issues, which considers long-term strategy as well as topical issues following recent high profile press coverage.

We finish the year with a market update on buy-ins and buy-outs by Stuart O'Brien. Sebastian Reger takes a look at developments in collateral requirements for non-cleared OTC Derivatives and Joe Riviere provides a timely reminder of the key legal aspects of document execution in light of the technological push towards virtual and e-signatures.

As we look forward to 2017, Sackers' finance & investment group will once again be attending the PLSA Investment Conference in March – please see our website for further details.

With best wishes for Christmas and the New Year."

Paul Philips
Partner, finance & investment group

paul.philips@sackers.com

Environment

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Back to basics: the execution of documents

Joe Riviere
Associate
joe.riviere@sackers.com

Executing documents correctly is of prime importance to trustees and employers. The courts have taken a firm view on the invalidity of incorrectly executed documents so it is vital that execution formalities are understood and fully complied with.

Simple contract or deed?

Some transactions require the use of deeds instead of simple contracts. In a pensions context, this may include the appointment of a new trustee or the granting of security. Deeds are also generally used for pension scheme governing documentation.

Deeds have differing execution formalities to simple contracts. It is therefore important to identify whether an agreement has to be executed by way of deed to ensure the correct formalities are being followed.

Counterparts

Counterparts are useful when the parties are unable to physically meet in the same place to execute documents. A counterpart is an exact copy of the original document. Each party to the transaction will sign separate identical copies of the same document that together form a single agreement.

In order to sign documents in counterpart the applicable contract or deed should include wording which expressly provides for this. It is also best practice to ensure that a company only execute one counterpart – one company's execution should not be split across two counterparts (eg a director should not sign on one counterpart and the secretary of the same company on another).

Key questions trustees should consider

- Do your signatories know how to execute agreements?
- Do you have an internal policy on the execution of deeds and contracts?
- Do you maintain an up-to-date list of authorised signatories, including sample signatures?
- Do you have in place appropriate powers of attorney?
- Do your governing documents include any specific provisions relating to signing documents?

Virtual signings

A "virtual signing" is where the signing parties email the executed documents to the coordinating lawyer. Virtual signings are becoming increasingly commonplace as they avoid the practical and timing difficulties of holding a face to face meeting or circulating physical copies of documents for signature.

Documents executed by way of a virtual signing will be fully enforceable as long as the correct procedure is followed.

There are several methods that can be used, so it is important for signatories to follow signing instructions very carefully.

E-signatures

Perhaps unsurprisingly, the next development is to facilitate the electronic signing of documents. This uses so-called e-signatures. Examples of an e-signature include a person typing their name into a contract or inserting their name on a contract through a web-based signature platform. We will update our clients as the legal practice develops.

Collateral for non-cleared OTC Derivatives

Sebastian Reger
Partner, finance & investment group

sebastian.reger@sackers.com

Pension schemes will have to comply with a new collateral regime for all non-cleared OTC Derivatives in 2017, including formalising risk management procedures and signing up to new documentation.

Background: regulation of OTC Derivatives

The key regulation is EMIR which was introduced in 2012. It applies directly in all countries of the EU and implements the globally (G20) agreed regulatory standards for OTC Derivatives. Similar laws are being implemented in the other major jurisdictions, most notably Dodd-Frank in the US.

The weight of the regulatory obligations depends on the classification of an entity. EMIR distinguishes between financial counterparties (FCPs) and non-financial counterparties. FCPs are subject to more onerous obligations. Most UK pension schemes will be classified as FCPs.

The regulatory obligations are being phased in over time. So far the main focus of the regulation has been on reporting and exchanging information. We are now seeing the implementation of the two remaining, yet most significant, building blocks of the regulatory package:

- the mandatory clearing of certain designated OTC Derivatives, and
- the obligation to exchange collateral for non-cleared OTC Derivatives.

Collateralising OTC Derivatives

The typical UK pension scheme using OTC Derivatives will already be collateralising its OTC Derivative positions, usually under the credit support annex (CSA) to the ISDA Master Agreement.

The parties to OTC Derivatives will regularly (often daily) determine the net market value of all OTC Derivatives which are governed by the same ISDA Master Agreement, to establish which of the two parties is exposed to the other party on a net basis. The exposed party is entitled to receive collateral (typically cash and/or gilts). The purpose of the collateral is to provide a form of security against a default by the counterparty. Following a default by the counterparty, the exposed party should be able to apply the collateral against amounts owed to it in respect of its OTC Derivatives.

Two kinds of collateral are generally recognised:

"Initial margin" (or the "Independent Amount" to use its ISDA term) – which is a lump sum and intended to cover fluctuations in the market value between the last posting of collateral and the determination of the termination value of the OTC Derivatives.

"Variation margin" – which covers daily fluctuations in the market value of the OTC Derivatives. Most pension schemes and their (bank) counterparties will only exchange collateral to cover the variation margin.

Of course, exposure to counterparty default can only be eliminated completely if the collateral held equals the exposure. Whether the collateral is adequate will depend on (a) how the value of the OTC Derivatives has moved since the last collateral posting (eg has the exposure increased) and (b) the market value of the collateral itself.

Collateral for non-cleared OTC Derivatives cont.

The new mandatory collateral framework

Going forward, whenever a pension scheme enters into a non-cleared OTC Derivative it will have to comply with the new mandatory collateral framework. This framework is set out in an EU Regulation which supplements EMIR.

Mandatory collateral obligations were supposed to be phased in across the major jurisdictions from 1 September 2016. Pension schemes were expected to have to comply with the variation margin rules from 1 March 2017. Although the global timetable has not changed, the start date in the EU has been delayed as the rules have not been finalised. Still, in practical terms, pension schemes should treat 1 March 2017 as an indicative deadline for the variation margin obligation to go live.

The obligation to provide and collect variation margin will apply to all UK pension schemes which are FCPs. However, only the largest schemes (those with an aggregate average notional amount of non-centrally cleared OTC Derivatives in excess of EUR 8bn) will have to post and collect initial margin from 2020.

Pension schemes with CSAs that provide for daily collateral on the basis of cash and gilts are already on course to comply with the new mandatory rules but there are additional requirements.

The new mandatory collateral framework

- sets out methodologies for the calculation of collateral
- prescribes the type of eligible collateral
- applies concentration limits
- imposes time limits for transfers
- requires trustees to establish risk management procedures.

How will the new collateral framework affect pension schemes?

- Probably the biggest change is the requirement on counterparties to *"establish, apply and document risk management procedures for the exchange of collateral"*. This includes a regular independent legal review of the enforceability of the exchange of collateral agreements.

Action: Trustees need to develop policies (in conjunction with their managers) on how to comply with these obligations.

- The new rules could affect the amount of collateral that is required to be posted or collected (as a result of a change in the calculation and the timings for transfer) and also requires certain FX derivatives to be collateralised (which had previously often been excluded from the collateral provisions).

Action: Pension schemes should discuss these changes with their investment consultants and asset managers to ensure collateral needs can be satisfied.

- Finally, the standard legal documentation governing collateral exchanges (the CSA) has been revised and updated to cope with the new collateral regime. Banks have, and will ask, counterparties to sign up to new documentation, including pension schemes in due course.

Action: Pension schemes must be ready to update all of their CSAs over the next few months.

For more details speak to Sebastian and Paul.

Buy-ins and buy-outs: market update

Stuart O'Brien
Partner, finance & investment group

stuart.obrien@sackers.com

After a slow start to 2016, the bulk annuity market continues to gather pace as we approach the end of the year. While we wait to see what the remainder of 2016 will hold, here we take a look at some interesting developments to date.

Prudential have formally announced that they are no longer quoting in the bulk annuity market. Following the merger of Just Retirement and Partnership in April 2016, there are now seven insurers actively quoting for bulk annuity business. Although there appears to be considerable appetite amongst that group for pension schemes in the right position.

The ICI Pension Fund has completed five buy-ins with Legal & General and Scottish Widows. These represent the latest in a series of buy-ins concluded by the scheme since March 2014 (totalling approximately £8bn of liabilities). What is interesting is how these have been transacted in tranches. The process of putting in place a "master agreement" with the insurers, then adding liabilities in bite-sized chunks at opportune moments, may set a precedent for similar approaches among other large schemes looking to take a staggered method to their de-risking.

Insurance Act 2015 in force

The new Insurance Act 2015 is also now in force and applies to insurance contracts entered into, or varied, on or after 12 August 2016. The Act introduces a newly framed duty on the policyholder to make a "fair presentation of the risk" they are asking the insurer to take on.

For trustees entering into bulk annuities, this means they need to disclose every material circumstance that the trustees (or in the case of a corporate trustee, its trustee directors) know or ought to know. The Act clarifies that a policyholder "ought to know" those matters which would have been revealed by a reasonable search, so trustees will need to take care in how they approach data and benefit specification issues. This will be particularly relevant for trustees looking to take out "all-risks" policies, where trustees may need to give careful thought as to how they conduct and document their own enquiries with their advisers. Where the trustees' enquiries prove inconclusive, thought may also need to be given as to how best to put the insurer on notice that it needs to make its own further enquiries.

Where the Act is seemingly most helpful to trustees is in relation to remedies for breach. The Act clarifies that it will only be possible for an insurer to avoid a policy and keep the premium where there has been a deliberate or reckless misrepresentation or non-disclosure. In other cases, the consequences will depend on what the insurer would have done had it known the true facts. For data and benefit specification issues, most buy-in policies will already include a detailed reconciliation and "true-up" process to be followed post completion, so an established mechanism already exists for the insurer to re-price based on corrected data. Against that backdrop, it may be that the Act will have a minimal impact in practice on most buy-ins.

As always, schemes looking at buy-ins and buy-outs should allow as much time as possible for preparation. The schemes best placed to take advantage of pricing opportunities will always be those which already have their data and benefit specifications in order and a clear idea of what they are trying to achieve.

Legal update

See our Alert for more details: **FCA consults on transaction cost disclosure in workplace pensions**

FCA consults on transaction cost disclosure in workplace pensions

On 5 October 2016, the FCA published a consultation paper which proposes rules and guidance to standardise the disclosure of transaction costs in workplace pensions. Trustees and IGCs are required to report on and assess transaction costs in an annual statement. However, there is currently no corresponding obligation on parties managing pension investments to disclose this information.

The FCA proposes a consistent approach to the disclosure of transaction costs, together with a requirement for those managing investments to report administration charges and transaction costs to an IGC or to the trustees of an occupational pension scheme.

The consultation closes on 4 January 2017, with the FCA intending to publish its rules in a Policy Statement in the second quarter of 2017.

See our Alert for more details: ICSA consultation: **The practice of minuting meetings – Sackers' response to consultation**

ICSA publishes guidance on minute taking

On 19 September 2016, ICSA: The Governance Institute published guidance on the practice of minute taking, together with a feedback statement on the consultation conducted between May-July 2016.

The guidance states that there is no "right way" to draft minutes, noting that "it is up to each individual organisation to decide how best its meetings should be recorded". Therefore the guidance aims to avoid "undue prescription", and instead focuses on being principles-based. As well as covering the legal and regulatory framework, and drafting principles, the guidance also considers issues of access to minutes, retention of notes, and recording meetings.

Although not specifically aimed at pension scheme trustees, the guidance will be relevant to trustee boards which are established as companies under one of the Companies Acts.

In force 1 November 2016

LGPS: new regulations

The Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016 came into force on 1 November 2016.

The regulations make provision in relation to the management and investment of pension funds held by administering authorities and which are required to maintain such funds by the Local Government Pension Scheme Regulations 2013.

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, employers and providers 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, funding negotiations, buy-ins and buy-outs, 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, custody, the Local Government Pension Scheme, and all types of pooled investment products including private equity, hedge funds and infrastructure.

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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