Sackers

Finance & investment briefing

June 2017

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

EMIR: European Market Infrastructure Regulation

ESG: Environmental, social and corporate governance

ESMA: European Securities and Markets Authority

FCA: Financial Conduct Authority

IA: Investment Association

LDI: Liability driven investment

MiFID II: Markets in Financial Instruments Directive II

OTC: Over-the-counter

OTC derivatives: Over-the-counter derivative transactions

PLSA: Pensions and Lifetime Savings Association

PRIIPs: Packaged Retail and Insurance-based Investment Products Regulation

TPR: The Pensions Regulator

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In this issue

A focus on TPR DB investment guidance

Finance & investment focus

"Welcome to the second finance & investment briefing for 2017.

The biggest development over the last quarter has been the publication on 30 March 2017 of TPR's eagerly anticipated guidance for trustees on DB investment. In this briefing we take a look at some of the key themes emerging from the guidance.

Ian Cormican provides a general overview and takes a look at trustee investment governance arrangements. Sebastian Reger covers one of the principal messages emerging from the guidance – that trustees need to understand all risks in connection with their investment strategies. This goes beyond simply looking at the investment risk posed by a particular investment or strategy, as trustees will be required to understand how their investments are held, including the operational risks associated with them, and conduct appropriate due diligence when making investment decisions. Finally, Ralph McClelland covers ESG matters, which are embedded throughout the new guidance.

We hope you enjoy reading this briefing and strongly encourage trustees to take a few moments from their busy schedules to read the new guidance."

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Overview and governance

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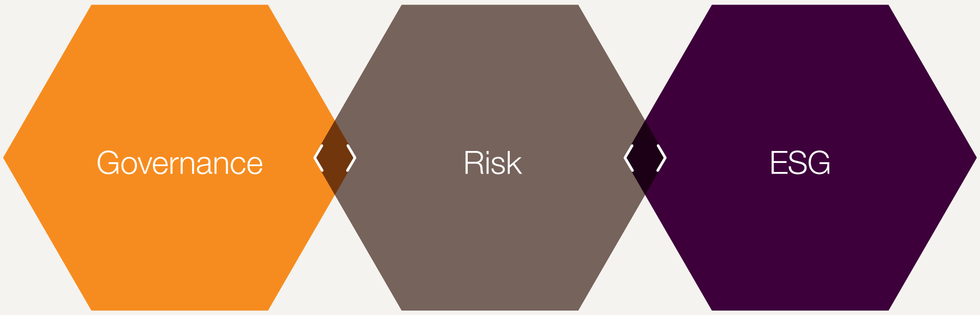
TPR's guidance on DB investment supplements and underpins the code of practice on funding DB pension schemes. It covers a wide range of investment issues including governance, matching and growth assets, risk, monitoring and ESG, and is designed to provide practical information and examples.

TPR's new guidance usefully draws together the key legal obligations of trustees and illustrates how trustees can work towards achieving effective investment governance.

However, it would be fair to say some of the examples are rather simplistic and TPR pays no more than lip service to the role of the employer. While it is clear that trustees hold the power to invest subject only to an obligation to consult with the employer, in reality, investment is one of a number of moving parts in the running of a pension scheme, alongside funding and covenant matters. In practice, the views of the employer (including their willingness to make resources available to the trustees are likely to be a significant factor in the approach which trustees take to investment strategy and investment governance.

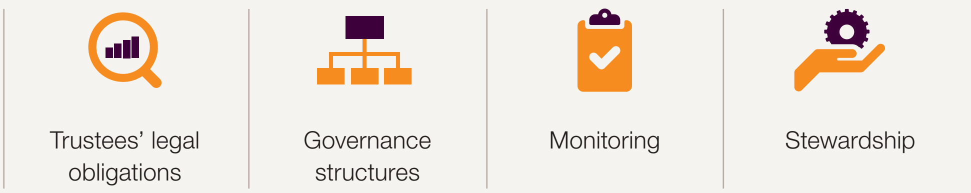
It is also worth noting that while TPR has a number of powers – for example to appoint or remove trustees in certain circumstances – which could potentially be exercised if trustees failed to properly exercise their investment power, it has no specific powers to directly influence investment decisions of trustees.

Nonetheless, we firmly believe that good governance leads to better outcomes and trustees should review their arrangements to ensure that they are effective and appropriate for their schemes.



Governance

The section on governance is divided into a number of key themes:



Overview and governance cont.

Delegation

Legal obligations

TPR reminds trustees that the fundamental purpose of their investment power is to generate returns to enable a scheme to pay promised benefits as they fall due. Trustees have a broad statutory power to invest but must have regard to any limitations in their trust deed and rules.

While trustees have ultimate responsibility for a scheme's investments they cannot, unless authorised by the FCA, undertake "regulated activities", which would include day-to-day investment decisions. Such activities must be delegated to an investment manager who is appropriately authorised under the Financial Services and Markets Act 2000. Trustees must be satisfied that delegates have the appropriate knowledge and experience for managing the scheme's investments, and that they are monitored to ensure they are carrying out their work competently and complying with applicable statutory requirements.

TPR emphasises the importance of subjecting contractual arrangements and fund documents for such investment managers to **legal review and negotiation**, to ensure that the statutory requirements are met.

TPR also reminds trustees of the circumstances in which they need to **obtain and consider investment advice**. Trustees should be in a position to **critically evaluate** the advice they receive.

Arrangements

Governance structures

Trustees need to adopt governance arrangements which enable people with the necessary skills, knowledge, advice and resource to make effective decisions in a timely manner.

The guidance recognises that the structure needed to deliver this will depend on a scheme's particular circumstances. These might include the available resource, the level of expertise and the complexity of the scheme's investment arrangements.

TPR reminds trustees that there are a range of structures, from investment sub-committees to fiduciary management, which may improve a scheme's governance.

However, while delegation may remove some of the workload, the trustee board ultimately remains liable for investment decisions. It is therefore vital that the extent of any delegation is clearly set out in a written agreement or terms of reference, and that the **actions of the delegates are monitored** on an ongoing basis.

Assessment

Monitoring

Regular assessment by trustees of the effectiveness of their investment decision-making and governance processes is important to the overall success of their strategy. The guidance sets out a number of examples to help trustees with this, such as the need to assess whether they have enough advice and knowledge to enable **considered and timely decision-making**, and whether performance is delivered cost effectively.

Influence

Stewardship

Stewardship activities, such as engagement and the exercise of voting rights, are often undertaken by a scheme's investment manager on the trustees' behalf. The guidance explains the need for trustees to **understand** their managers' stewardship policies and to **seek to influence** them where appropriate.

The importance of managing risk in DB investments

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The key message for trustees is that they need to understand all risks, investment and operational, inherent in their investment strategy. Risks need to be considered and, where possible, managed. Trustees need to work closely with their investment and legal advisers to ensure the agreed contractual terms achieve the trustees' investment objective and provide the level of required protection.

Understanding and managing risk is at the heart of the guidance. This is not just about investment risk, but in large parts about managing operational risk. An entire section of the guidance (section five) focuses on the implementation of the investment strategy. TPR's expectations as to how trustees conduct their affairs requires trustees to:

- understand the risks associated with implementing an investment strategy, including operational risk, in order to manage these risks and organise appropriate due diligence processes
- understand the security of scheme assets and take action if the security level is not appropriate
- ensure risks and costs of asset transitions are effectively managed, and
- understand the scheme's exposure to collateral movements (if any) to develop and maintain a collateral management plan.

Implementing an investment strategy is all about:

- exercising due diligence in selecting appropriate investment managers, custodians, derivative counterparties and administrators
- negotiating and documenting the contractual terms reflecting the outcome of the due diligence and the trustees' requirements, and
- monitoring compliance with contractual terms.

Although it should not come as a surprise, in our experience, the best outcome can only be achieved where trustees work closely with their investment and legal advisers. Ultimately, the trustees have to be able to fall back on their agreed contractual terms. It is therefore important that the drafting of all aspects of the relationship reflect the intended agreement.

In our view, there is no standard approach to implementing investment strategies and managing operational risk. It all depends on how each trustee board manages their affairs and the resources at their disposal. Where one trustee board requires their manager to exercise broad discretion, other trustee boards can fall back on sophisticated in-house investment.

Today's increasingly regulated investment environment imposes additional compliance obligations on trustees. Regulatory obligations form an important aspect of implementing investment strategies and the guidance asks trustees to bear in mind legislative and regulatory risks. Any trustees who have recently embarked on LDI-strategies will be all too familiar with EMIR and will understand how contractual terms need to allocate regulatory compliance risk appropriately.

ESG considerations

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In composing the DB investment guidance, TPR has not included a section addressing environmental, social and corporate governance (ESG) issues. Instead, trustees' responsibility to consider and act on ESG is baked into the guidance at a basic level. The consideration of ESG, TPR seems to suggest, is neither more nor less than an expression of trustees' fiduciary duties to pension scheme members.

TPR articulates its key expectations in this area throughout the guidance. Three themes can be identified:

Investment beliefs – trustees must consider financial factors in developing their beliefs and statement of investment principles. In TPR's view:

- well and responsibly managed companies will produce higher returns over the long-term
- investing responsibly and engaging as long-term owners reduces risk over time and may positively impact scheme returns, and
- climate change (and presumably other environmental factors) could be a long-term risk for a scheme and has the potential to impact a scheme's investment strategy.

Stewardship – TPR recognises that in practice stewardship will, in most cases, be a function for the investment manager. However, trustees are encouraged to understand and engage with their managers' policies with a view to achieving good stewardship standards.

Monitoring – in considering the implementation of trustees' beliefs and its approach to stewardship, careful consideration needs to be given to adequate reporting, and how that information is analysed and acted upon.

TPR also notes as a general point that trustees should ensure that the legal documentation is properly reviewed and appropriately negotiated – one issue will be ensuring that trustees' expectations on ESG issues are properly incorporated into the managers' terms of appointment.

TPR's statement of the law around this area shows the clear and unapologetic influence of the Law Commission's work. Some may be disappointed that TPR has stopped short of making any stronger statement on climate change risk (such as that made by Mark Carney), but it may well be that TPR considers this to be outside its legitimate remit.

The approach to ESG may also say something about how TPR sees trustees' governance role developing. There are links here to the "21st Century Trustee" initiative which discusses the trustees' role in the current environment, with a particular focus on governance. Trustees' ability to work with advisers to formulate reasoned and up-to-date investment beliefs, to implement a strategy which reflects those beliefs, and to monitor and evolve that process over time is, at its core, a matter of robust governance. Trustees are not expected to put ESG over and above their key investment duties. But a focus on ESG, (which has perhaps not had the attention it warrants as part of the overall investment process) is an area where trustees can take the lead in setting the agenda for their managers and holding those managers accountable to the standards they have set.

For more information on ESG see our guide – A practical approach to ESG

Legal update

Proposed new code

Investment Association consultation on charges and transaction cost disclosure

On 27 March 2017, the IA published a consultation paper proposing a new code for enhanced disclosure of charges and transaction costs. The aim of the new code is to develop a consistent and comprehensive framework to allow fund and asset managers to deliver underlying charges and transaction cost information in line with regulatory requirements.

The intention is to "help those charged with pension scheme oversight, notably trustees and Independent Governance Committees, to access and scrutinise investment costs within a clear framework". A new code would provide trustees with a blueprint for the reporting of charges and transaction costs, using a consistent approach across the market.

The consultation forms part of an ongoing industry-wide initiative on enhanced transparency. As well as facilitating the provision of data under MiFID II and PRIIPs, it is intended to be fully compliant with final rules for the UK DC market following the FCA's October 2016 consultation on transaction cost disclosure in workplace pensions (the response to which is awaited).

The deadline for responses to the consultation is 19 May 2017. The IA plans to publish a feedback statement and a final proposal in the third quarter of 2017. In addition, the IA plans to ask the FCA to incorporate the code into the rules in its Conduct of Business Sourcebook.

Changing landscape for indices and benchmarks

Indices and Benchmarks

- **New PLSA guide.** On 15 March 2017, the PLSA published a new "Made Simple Guide" on indices and benchmarks, which is designed to provide a "straightforward introduction to a complex area of investment management". The guide is intended to provide trustees with simple information when benchmarking and selecting an index.
- **ESMA regulatory and implementing technical standards.** On 30 March 2017, ESMA published its report containing the final draft regulatory technical standards and implementing technical standards required under the Benchmark Regulation. These standards are required under the Benchmark Regulation to implement the new rules on indices used as benchmarks in financial instruments and financial contracts to measure the performance of investment funds.
- **FCA update.** On 12 April 2017, the FCA published an update on the Benchmark Regulation highlighting the ESMA final report and stating its intention to publish a consultation paper on the UK implementation of the Benchmark Regulation in the "coming months".

Benchmarks are vital in pricing financial instruments and contracts, as well as being critical in managing risk. Any manipulation or unreliability of benchmarks can be detrimental to pension fund returns. The new guide and regulation seeks to standardise the administration and contribution of benchmarks, increasing transparency and formulising methodology.

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