

Finance & investment briefing

September 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

FCA: Financial Conduct Authority

IMA: Investment Management Agreement

OTC: Over-the-counter

S2P: State Second Pension

SIP: Statement of Investment Principles

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Finance & investment focus

“Welcome to our third finance & investment briefing of 2017.

The regulation of the asset management industry has been the subject of a lot of discussion this summer, with the FCA following up its final report with two consultations. In this issue of the briefing Sebastian Reger takes a closer look at two themes that emerge from this: how to help investors achieve the maximum risk adjusted return possible and the aim of raising cultural and governance standards in financial services. In the article Sebastian considers how this might impact on schemes.

Government, the PLSA and the FCA have all recently focussed on consolidation as a potential way to save costs and improve governance. Ian Cormican shares his views on the key points that will affect any move towards larger scale in DB schemes. We also provide an update on the collateral rules for derivatives under EMIR and the Law Commission's report on social investment published in June.

Last but not least, I am delighted to take this opportunity to congratulate Ralph McClelland on his promotion to partner. Ralph is an experienced finance and investment specialist with a strong pensions background.”



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Proposed changes to the asset management sector



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A spoonful of sugar? Considering the FCA's prescription for the Asset Management Industry

The FCA is proposing considerable changes to the way asset managers have to conduct client business and organise their own internal affairs. How will this impact trustees?

Background

The summer of 2017 saw the regulation of the asset management industry coming into sharp focus. In June, the FCA published its final report on the asset management industry. This was followed by two consultations. The first asks for feedback on the remedies proposed by the Market Study, while the second recommends an extension of the Senior Managers & Certification Regime to all FCA firms. Together, the changes would force the asset management industry to modify its internal governance processes and its approach to dealing with investors.

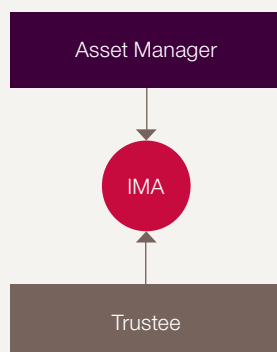
Dealings between trustees and asset managers

Trustees of DB pension schemes rely on asset managers. The potential impact of the proposed measures will depend on how their relationship is structured. There are two possibilities:

1

Directly

When trustees set up segregated investment mandates through an IMA with an asset manager

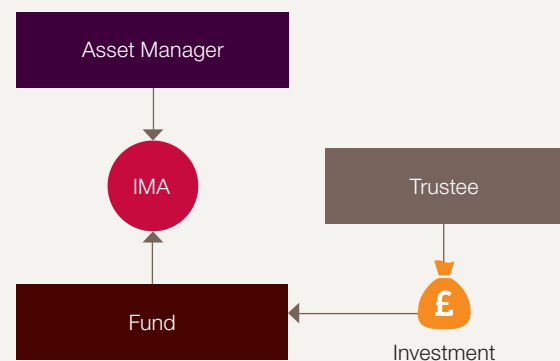


Segregated Mandate: direct IMA

2

Indirectly

When trustees invest in pooled funds where the fund vehicle will contract with an asset manager



Pooled Fund: no direct IMA

The proposed measures in detail

We want to focus on two key themes from the FCA's review:

- first, the FCA is looking for direct measures to help investors achieve the maximum risk adjusted return possible, and
- second, the FCA is aiming to raise the cultural and governance standards in financial services.

Proposed changes to the asset management sector cont.

Pooled fund measures may benefit trustees

Achieving the maximum risk adjusted return

The measures which aim to help investors achieve the maximum risk adjusted return are really targeted at pooled-fund arrangements. The FCA is predominantly concerned with increasing the protection for investors who are less able to find better value for money. We therefore do not expect that these will have a significant direct impact on segregated investment mandates. Trustees will need to continue to negotiate an appropriate protection package in their IMAs. However, where trustees invest in pooled funds some of these measures should benefit trustees as well. For example:

- an attempt to eliminate 'unearned' profits for asset managers by requiring fund managers to return risk-free box profits to the fund (this is where asset managers matched sale and purchase orders by different investors but retained the bid-offer spread), and make it simpler to switch investors to cheaper share classes
- increased transparency around fees (such as single all-in fees and consistent and standardised disclosures of charges), and
- the establishment of benchmarks which enable investors to compare performance.

Duty to act in investors' best interests?

Some headlines suggested that the FCA is proposing to impose a duty on asset managers to act in investors' best interests. This is somewhat misleading. It would be more accurate to describe the FCA's proposal as refining an already existing regulatory obligation to act in the best interests of investors. (But trustees should note that a failure to comply with this regulatory duty may not give them direct recourse against asset managers.) The FCA now expects authorised fund managers to consider 'value for money' for investors as part of the existing regulatory obligation to act in investors' best interests. This reflects the FCA's view that the most effective way to strengthen the requirements to act in the best interests of investors is through regulatory reform rather than asking government to enact a statutory fiduciary duty of care.

Extension of Senior Managers Regime

Raising the cultural and governance standards in financial services

The FCA aims to raise the standards of conduct of everyone who works in financial services. In addition to imposing general conduct rules, the FCA is intending to make senior people in firms more responsible and accountable for their actions. This is the purpose of the so-called "Senior Managers & Certification Regime". So far this regime applies to banks, building societies, credit unions and PRA-designated investment firms. The intention is now to roll it out to almost all financial services firms, including asset management firms.

Once implemented, employees of asset managers will have to adhere to universal conduct rules (eg "you must act with integrity" and "you must pay due regard to the interest of customers and treat them fairly"), and asset management firms will have to consider their internal control functions, allocation of responsibilities and appointment of senior roles in light of the new prescribed responsibilities.

Improved governance

A parallel initiative aims to strengthen the governance framework in pooled investment fund structures to introduce independent control and oversight. The purpose is to support the obligation to act in the best interests of investors.

It is worth noting that the FCA estimates that the extension of the Senior Managers & Certification Regime to all FCA firms will result in one-off costs to the industry (which includes insurers) of approximately £550m and ongoing costs of between £140m and £190.5m.

At best, these measures will affect trustees indirectly. We do not expect them to add any additional protections to the contractual arrangement between trustees and asset managers. As a result, trustees will have to ensure their IMAs continue to deal with the allocation of risk and protection.

The potential for consolidation



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The Government, the PLSA DB Taskforce and, most recently, the FCA have suggested that consolidation may be the best way to save costs and improve governance, at least for smaller schemes.

What do we mean by consolidation?

Consolidation could encompass anything from asset pooling through to the development of some form of superfund which can absorb existing schemes, relieving employers and trustees of their obligations. Asset pooling is already in train for the investments of the Local Government Pension Scheme which is in the process of creating six “British Wealth Funds”, each with at least £25bn of scheme assets. This is intended to drive down investment costs and also to enable investment in infrastructure.

This transition to asset pools is not without its challenges, but the Government can ultimately exert some control in the public sector. In contrast, when considering asset pooling in the private sector there are additional hurdles in respect of alignment of interest among unconnected schemes and employers as well as concerns around surrendering control.

It is also questionable whether, given the unique benefit structures, liability profiles and cash-flow requirements of individual private sector schemes, existing investment strategies can be easily unravelled or combined and scaled-up in the manner that an asset pool suggests.

Full consolidation?

As it stands, the legislative framework for private sector occupational pension schemes presents several, significant, barriers to wholesale consolidation.



Benefit design

There is no consensus on whether a consolidated vehicle would only create significant economies of scale if it were able to provide harmonised benefits. What is clear is that current pensions legislation would make it difficult for this to happen. Members' benefits can generally be changed going forward, but this would not help the many schemes which are already closed to future accrual. Rights which have already been accrued cannot be altered unless the member consents.



Employer debt

Broadly, the employer debt legislation attributes liability for a multi-employer scheme's deficit between its participating employers at the earlier of their exit, insolvency or the scheme winding-up. While it does permit liability to be apportioned, subject to certain requirements, an employer in a consolidated unsegregated scheme would be at risk of becoming liable for the other participating employers' buy-out deficits.

The potential for consolidation cont.



Scheme funding

Similar challenges are presented by the scheme funding regime.

Without segregation, one actuarial valuation would be carried out for the scheme as a whole. One of the bases on which participating employers' contribution levels are calculated is the employer covenant (an employer's obligation and financial ability to support the scheme now and in the future). Why would an employer with a strong covenant join a group of weaker employers? Not only could it be left with a greater deficit than its own if / when the scheme winds-up, but it may also have to bear higher contributions from day one.



Transfers

It is not currently possible to transfer members from a DB scheme which used to be contracted-out of S2P to a scheme which has never been contracted-out. As contracting-out ceased to exist on 6 April 2016, this prevents a new scheme being used as a consolidating vehicle.

In addition, pensions legislation only permits bulk transfers to be made without consent in certain, limited, circumstances.



Trustee duties

Depending on the balance of powers in a pension scheme, the trustees may be required to consent to a transfer to a consolidated vehicle.

As trustees have a duty to safeguard their members' benefits and must act in the interests of their membership as a whole, to agree they are likely to want to be satisfied that their members' benefits would be at least as secure in the consolidated vehicle as in their existing scheme. This will require some analysis of the relative funding levels as well as, potentially, sponsor covenant and investment strategy. It is unlikely that this will be a straightforward decision for trustees.

Conclusion

A move to scale, in some form, seems to be gaining momentum. However, there will need to be some fundamental changes to pensions legislation before a significant consolidation of schemes becomes a reality.

EMIR collateral rules

Further measures intended to ensure that counterparty credit risk is appropriately managed came into force on 1 March 2017.

These new rules require trustees to “establish, apply and document risk management procedures for the exchange of collateral for non-centrally cleared OTC derivative contracts”.

EMIR specifically requires the trustees to:

- ensure the relevant contractual arrangements comply with prescribed minimum standards – standard ISDA agreements would normally meet these requirements but trustees should obtain confirmation from their managers and / or legal advisers
- periodically confirm that the contractual arrangements are legally enforceable – trustees should ask their legal advisers to analyse and confirm the position.

It is clear that the steps outlined in the legislation are not exhaustive. Trustees must also consider what additional processes would be appropriate, given their particular circumstances.

In practice, the scheme’s investment managers should already have procedures in place to manage counterparty credit risk and collateral moves. However, for trustees to meet their obligations under EMIR, they should have a formal process in place for monitoring their manager’s actions. With the changes to legislation, current processes may no longer be suitable and should be reviewed and, if necessary, revised.

Trustees should put in place a short written policy which addresses all the issues covered above as well as any matters specific to their scheme. The policy should be reviewed at least annually.

**Into force on
1 March 2017**

**Risk management
procedures**

**Review and revise
processes**



Action

Social investment

Last year the Law Commission was asked to look at how far pension funds may or should consider issues of social impact when making investment decisions. Following a call for evidence in late 2016, the Law Commission published a report on its findings in June 2017.

The project builds on the Law Commission’s 2014 report, Fiduciary Duties of Investment Intermediaries and accompanying guidance, which considered when pension trustees can take environmental and social factors into account when making investment decisions.

This latest report concludes that most barriers to social investment by pension funds tend to be structural and behavioural, rather than legal or regulatory. Proposed options for addressing these barriers include a suggestion that the Government consider whether pension schemes should be required to ask their members, periodically, for their views on social investment and non-financial factors.

The report also repeats its 2014 recommendations that changes be made to the Occupational Pension Schemes (Investment) Regulations 2005, namely so that the regulations:

- distinguish more clearly between financial and non-financial factors
- require trustees to state their policy on stewardship in their SIPs.

Such changes would be consistent with the impending requirements of the European IORP II Directive, which came into force in January 2017 and must be incorporated by EU Member States into national legislation by 13 January 2019.

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

**Changes would
apply to all SIPs**

Contact

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