Sackers

Finance & investment briefing

June 2018

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

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Abbreviations

CMA: Competition & Markets Authority

DEFRA: Department for Environment, Food & Rural Affairs

DWP: Department for Work and Pensions

EAC: Environmental Audit Committee

ESG: Environmental, social and governance

EU: European Union

FCA: Financial Conduct Authority

FRC: Financial Reporting Council

IMA: Investment management agreement

IORP: Institutions for occupational retirement provision

ISDA: International Swaps and Derivatives Association

ISDA 1992: The ISDA Master Agreement 1992

ISDA 2002: The ISDA Master Agreement 2002

LDI: Liability-driven investment

LIBOR: London Interbank Offer Rate

OTC: Over-the-counter

TPR: The Pensions Regulator

Finance & investment focus

"Quite appropriately, our Spring Issue (though at the time of writing it feels once again more like Winter) focuses on three issues which are beginning to push to the surface and will attract more focus over the next few years. Once again we kick off with ESG. Across our client base ESG is moving up the agenda, and not just in response to the Government's March letter to 25 of the largest pension schemes asking how climate change is factored into investment strategies. Changes to financial benchmarks, such as LIBOR, are keeping large specialist working groups in the financial services industry busy. It's time for pension schemes to start thinking about the potential impact on them and their investment strategy and valuation policies. Then there is the ongoing investigation into the investment consulting industry. The CMA has published further working papers – all with great significance for the pensions industry. We have summarised the key points for you. We conclude with a summary of a recent case on the calculation mechanism in the ISDA Master Agreements, but which we think can be a useful reference point when negotiating valuation clauses in IMAs more generally. We hope there is something of interest for you in this issue. Just to remind you, we are running a seminar on Buy-ins and Buy-outs on 24 May. We would be delighted if you could join us. As always, if you are left with any questions or comments, do get in touch."

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Environmental, social and governance investment

It is proving to be a busy year for ESG investment issues. At the beginning of March we had the Government's EAC writing to the largest 25 pension schemes to ask how they are factoring climate change risk into their investment strategies. More recently, the EAC has requested that DEFRA use powers under the Climate Change Act to formally require TPR, the FCA and the FRC to produce climate adaptation reports.

Later in the year, we are expecting the DWP to launch a consultation on changes to the Occupational Pension Schemes (Investment) Regulations 2005. Quite what the consultation will cover remains to be seen, but we are expecting a greater focus on trustees at least having to consider ESG, consistent with the requirements under IORP II (the new European Pensions Directive which came into force in January 2017). Under IORP II, all EU Member States will be required to legislate (by January 2019) for pension schemes to put effective risk management functions in place covering, among other things, "environmental, social and governance risks relating to the [pension scheme's] investment portfolio".

And that is not all that's happening in Europe. In January, the EU's High-Level Group on Sustainable Finance published their final report which included a recommendation that asset owners (including pension funds) examine the materiality of ESG risks consistent with the timeframe of their obligations to beneficiaries and, where financially material risks are identified, they should be acted on in the investment strategy.

For a broader look at ESG and more detail on the forthcoming changes you can read our new guide: "Where next for ESG? – An evolving approach for trustees".

Benchmarks

Significant changes are underway which will affect the provision of financial benchmarks, such as LIBOR.

New regulatory regime

On 1 January 2018, an EU Regulation came into effect which introduces a new regulatory regime for the supervision and administration of benchmarks. But, perhaps of greater importance for pension schemes, will be the planned replacement of interbank offer rates, such as LIBOR, with new risk-free rates (or RFRs) in 2021. Currently LIBOR is the key reference rate for the derivatives and cash markets (ie bonds and loans). As LIBOR disappears, these new RFRs will become the crucial rate for determining the price of financial transactions.

Impact for pension schemes

For pension schemes, the change from LIBOR to the RFRs could have an impact in a number of areas:

1. interest rates affect the valuation process. Trustees and their actuarial and investment advisers need to be alert to how this change could impact the valuation process
2. legacy derivative transactions, loans and bond trades referencing LIBOR need to be moved to the new applicable RFR
3. if different practices in the cash and derivatives markets were to emerge, then this could impact the composition of investment portfolios and hedges
4. legal documentation (such as ISDAs and IMAs) which reference LIBOR need to be amended to deal with the introduction of RFRs.

Start discussions now

The finance industry and regulators are working closely together to manage this transition. Trustees do not need to take immediate action, but should start discussions with their investment managers, investment consultants and actuaries to ensure potential consequences are identified and monitored.

Update: The investment consultants market investigation

The CMA published four more working papers relating to its investigation into investment consultants in April, bringing the total number of working papers to seven, all published in the first quarter of this year. The papers are interim documents supporting and reporting back on the CMA's progress during phase 2 of the process.

The working papers are not part of the formal provisional decision report; that will be published in July on current timetables. They do, however, provide some insight on the CMA's direction of travel and contain potentially significant requests for additional information from interested parties.

For those keeping track, the April papers are added to March's papers covering supply of fiduciary management services by investment consultancy firms, asset manager product recommendations and information on fees and quality.

We review the recent April working papers briefly below.

Trustee engagement

The CMA has surveyed trustee engagement with the industry and suggested remedies for perceived shortcomings in the trustee role should an adverse economic outcome ultimately be identified as part of the review.

The working paper contains some "emerging thinking" on remedies including measures to: inform trustees of switching costs, empower and incentivise trustees to engage, and reduce switching costs. These thoughts appear still to have some significant emerging to do.

Competitive landscape

Concentration within a sector is, in the CMA's view, a useful starting point for assessing that market. It's not necessarily an indication of poor competition, though it might be. The CMA's study is based on input from 45 firms and confirms an emerging finding that this market is not highly concentrated. The largest firm (Aon Hewitt) has a market share of less than 20% and the three largest firms (Aon Hewitt, Willis Towers Watson and Mercer) make up less than a 50% share of the market. In addition, there are well-established, mid-sized firms who enjoy a stronger position in some segments of the markets than the three leading firms. This finding may come as a surprise to some commentators.

Barriers to entry and expansion

The CMA's belief is that new entrants to a market, and in this case investment consultancy and fiduciary management markets, can be a significant stimulant to competition, so it wants to know if there are factors preventing new entrants. The CMA is tending to the view that there are barriers to entry and expansion into these fields, but not prohibitive barriers. At this stage, they have not noted an adverse effect on competition in this area.

Financial performance and profitability

The CMA looks for "excess" profitability as an indication of competition problems. It is a possible symptom of ineffective competition, not a cause. Focusing on a relatively tight cross section of the industry's firms, the CMA has found that the managers' margins are higher than the average operating margins in the index sample created by the CMA for the comparison. The working paper stresses that this is just one possible indicator of an adverse effect on competition.

It is clear that the CMA has been struggling to find an appropriate measure of financial performance for the sector and it is specifically seeking input from the industry more widely on the proper way to benchmark its findings.

Potential lessons from a ruling on interpretation of the ISDA 2002 close-out calculation

Interpretation of "close-out amount"

One of the key issues in *Lehman Brothers Special Financing Inc ("LBSF") v National Power Corporation ("NPC")* was how ISDA 2002's requirements for the calculation of the "close-out amount" (broadly, the replacement value of the transaction) should be interpreted. In particular, the judge considered whether the change in wording from "reasonably determines in good faith" in ISDA 1992, to "act in good faith and use commercially reasonable procedures in order to produce a commercially reasonable result" in ISDA 2002, had the effect of replacing a requirement for a rational decision with a requirement for an objectively reasonable decision.

Facts

The transaction was a principal-only US dollar / Philippine peso forward currency swap. It was common ground that, on early termination, it was for NPC to determine the close-out amount using "commercially reasonable procedures in order to produce a commercially reasonable result".

Decision

ISDA 2002 requires a higher objective standard

The judge explained that "[ISDA 2002] is to be interpreted in light of a relevant background that includes the [ISDA 1992], the applicable User's guide, and the fact that the ISDA Master Agreement is a standard document and is so widely used in international financial markets". Considering that it was "clear from the 2002 User's Guide…that the change to the wording was specifically designed to include (greater) objectivity", he concluded that ISDA 2002 "requires the Determining Party to use procedures that are, objectively, commercially reasonable in order to produce, objectively, a commercially reasonable result". In his view, this is a higher standard than rationality (which was required by ISDA 1992).

A number of results may be "commercially reasonable"

For example, on the facts, the judge found that it was "commercially reasonable" for the close-out amount to have been calculated as at the date on which firm (as opposed to indicative) quotations were available for a replacement transaction. In contrast, the judge commented that an alternative determination submitted by NPC did not use commercially reasonable procedures in order to produce a commercially reasonable result. This was because it used a single indicative quotation when a firm quotation and actual transaction were shortly to be available.

Also interesting is the judge's comment that, while a range of results may be commercially reasonable, the fact that there is a range does not mean the determining party can simply take the result that suits it best at one end of the range.

Lessons to learn

Points to note

This case makes clear that, when making its determination as to the close-out amount under ISDA 2002, a determining party must be careful to meet the objective standard. While it still allows for a range of approaches, this is a higher test than that required by ISDA 1992. There may however be a wider lesson that can be learnt from this for other IMAs where the investment manager's valuation of the assets under management is important (for example) in calculating fees and performance. Wording similar to that in the 2002 ISDA could be used to impose an objective standard on the manager when valuing the assets, which could be particularly helpful if the underlying assets are not easy to value.

Sackers

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