Sackers

Finance & investment briefing

December 2020

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

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Abbreviations

BCBS: Basel Committee on Banking Supervision

CMA: Competition and Markets Authority

DB: Defined benefit

DC: Defined contribution

DWP: Department for Work and Pensions

EEA: European Economic Area

EMIR: European Market Infrastructure Regulation

ESG: Environmental, social and governance

ESMA: European Securities and Markets Authority

EU: European Union

FCA: Financial Conduct Authority

HMRC: HM Revenue & Customs

IBOR: Interbank offered rate

IGC: Independent Governance Committee

IORPs: Institutions for Occupational Retirement Provision

IOSCO: International Organisation of Securities Commissions

ISDA: International Swaps and Derivatives Association

LDI: Liability-driven investment

LIBOR: London interbank offer rate

OTC: Over-the-counter

PCRIG: Pensions Climate Risk Industry Group

TCFD: Taskforce on Climate-related Financial Disclosures

TPR: The Pensions Regulator

Finance & investment focus

"Welcome to the December edition of our finance & investment briefing.

In this edition, we look at the recent consultation on changes to trustees' governance of and reporting on climate change. As we predicted in our ESG guide, larger schemes will be required to comply first, but (as we explain) those outside the first phases may have to adjust their systems to a similar timetable.

It is interesting to note that the increasing regulatory requirements here are being mirrored for pension trustees elsewhere in the world too, with the trustees of the REST super in Australia having settled their long-running dispute with one of their members by making a public commitment to enhance their consideration of climate change risks when setting their investment strategy.

At the timing of writing, the Brexit negotiations were still at stalemate, so many key issues remain outstanding. With "no deal" continuing to loom, we look at the most recent developments. We also take this opportunity to remind you of the forthcoming obligation to report your compliance with the CMA Order.

We may have been pretty accurate in our pensions' predictions for 2020, but clearly no-one would have envisaged the year we've had. We wish you all a peaceful holiday period and look forward to the time we can all meet again in person."

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Consultation: taking action on climate risk

The DWP's consultation on changes to occupational pension schemes' governance of and reporting on climate change closed on 7 October 2020. Our response can be viewed here.

TCFD recommendations

Proposals to embed TCFD recommendations into pensions law

In 2017, the TCFD published 11 recommendations for all organisations, aimed at identifying, assessing, managing and disclosing climate-related financial risks and opportunities. The DWP's proposals would embed these recommendations into pensions law and require trustees to publish an annual report which explains the action they have taken. Trustees will be supported by statutory guidance and will also be able to draw on PCRIG's non-statutory guidance (which was consulted on earlier in 2020).

The proposed requirements for satisfying the TCFD's recommendations are split between four areas:

- **Governance**: establish and maintain, on an ongoing basis, oversight of climate-related risks and opportunities, and processes by which trustees satisfy themselves that persons managing the scheme are assessing and managing those risks and opportunities.
- **Strategy**: identify, on an ongoing basis, climate-related risks and opportunities that will have an effect on the investment and, in the case of DB schemes, funding strategy, over the short, medium and long term, and assess the impact of those risks and opportunities. Schemes would be required to use scenario analysis at least annually to assess the scheme's resilience to climate-related risks.

Trustees to have regard to statutory guidance

- **Risk management**: adopt and maintain, on an ongoing basis, processes for identifying, assessing and managing climate-related risks, and integrating climate-related risks into the trustees' overall risk management.
- **Metrics and targets**:
  - select at least one appropriate greenhouse gas emissions-based metric and at least one other non-emissions-based metric, calculating them quarterly to assess scheme assets against climate-related risks and opportunities (and keep the metric selections under review)
  - at least annually, set a minimum of one target for one of the metrics calculated above and measure against the target(s) at least quarterly.

Timing

If implemented, the proposals will be phased in, with larger schemes being the first required to comply.

Schemes with assets ≥ £5bn, authorised master trusts and authorised collective money purchase schemes:

Larger schemes to comply from 1 October 2021

- must meet governance requirements for the current scheme year from 1 October 2021 to the end of that scheme year, and
- must publish a TCFD report on the scheme's or scheme sponsor's website within 7 months of the end of that scheme year, or by 31 December 2022 (if earlier). A link to this report must be included in the annual report and accounts for that scheme year and in annual benefit statements.

For schemes with assets < £5bn but ≥ £1bn, each of the above requirements will apply one year later. At this point, more than 75% of assets and 80% of members would be in schemes subject to the new requirements.

In 2024, the DWP intends to "take stock" and to consult on an extension to all schemes.

Consultation: taking action on climate risk

Challenges

Not possible to meaningfully report on all asset classes

- **Scope** – currently, all asset classes will count within the calculation for determining whether a scheme is within scope. However, we do not believe that it will be possible for schemes to report meaningfully on certain assets, such as bulk annuity (buy-in) policies, gilts, cash and derivatives, in relation to climate risk. Further, schemes holding heavily diversified pooled funds are likely to struggle to obtain the necessary data, let alone to report on it in a meaningful way.
- **Deadlines** – while straightforward, the proposed deadlines allow schemes with certain year-ends more time than others to produce their first annual TCFD report. This is intended to allow the Government to attain the goal, set out in its Green Finance Strategy, of all listed companies and large asset owners disclosing in line with the TCFD recommendations by the end of 2022. We have recommended bringing the drafting of the TCFD report into line with that of the scheme's annual report from the outset.

Meeting metrics may discourage engagement

- **Focus on target metrics** – use of metrics can often steer trustees to disinvestment, as it is the quickest way in which to meet a particular target, such as alignment with the Paris Agreement. While this may ultimately be necessary if a company fails to respond to engagement on climate-related issues, engagement should be the first step. A greater emphasis on engagement may be preferable in order to achieve behavioural change, the ultimate aim of all the climate change measures.
- **Lack of data** – the DWP acknowledges that trustees will be heavily dependent on data from other parts of the investment chain. Therefore, initially, it only intends to require trustees to comply with obligations on scenario analysis, calculating metrics and reporting against targets "as far as they are able". It is possible for schemes to engage third party providers to measure their portfolio against one or more specific metrics, but the cost of this may be prohibitive for some.

FCA

FCA plans "consistent" requirements

In an open letter to Guy Opperman, the Minister for Pensions and Financial Inclusion, the FCA explained that it intends to consult on implementing client-focused TCFD-aligned disclosures for asset managers and contract-based pension schemes in the first half of 2021. Its aim is to finalise rules by the end of 2021 and for the new obligations to come into force in 2022 (or begin to be phased in, starting with the largest or more interconnected firms).

Recognising the importance of corresponding obligations to the success of the DWP's proposals, the FCA states that it will be "mindful, in particular, of the information that asset owners such as occupational pension schemes will need to meet their regulatory obligations".

Next steps

There will be a further consultation on the draft regulations and accompanying statutory guidance in late 2020 or early 2021, and Guy Opperman intends to consult on mandatory Paris alignment (net zero) reporting "soon". Separately, we understand that PCRIG are hoping to finalise their non-statutory guidance at or around the same time.

Action

Schemes above the £5 billion threshold, and authorised master trusts, should start liaising with their advisers to prepare for the changes. The timing, as it currently stands, will be quite tight.

Be prepared!

Those outside phase one should remember that they will be required to address how their system of governance considers ESG factors (including climate change) when the new requirement to establish and operate "an effective system of governance including internal controls" comes into effect. We are expecting a consultation from TPR on this in late 2020 or early 2021. For further information on ESG and climate change for pension funds, please see our 2020 guide.

Confirming compliance with the CMA Order

Reminder of obligations

Following its investigation into the investment consultancy ("IC") market, the CMA issued an Order ("the Order") which (subject to certain exclusions) with effect from 10 December 2019:

Requires pension scheme trustees who wish to delegate investment decisions for 20% or more of their scheme assets to run a competitive tender when first purchasing fiduciary management services.

Requires pension scheme trustees who have already appointed a fiduciary manager (or managers) for 20% or more of their scheme assets without a tender, to put the service out to tender within five years of the appointment. If the five-year period has expired, or will do so within two years of the date on which the Order was made (10 June 2019), the tender must instead be run before the end of a two-year period beginning with the date of the Order, ie before the end of 9 June 2021.

Prohibits trustees from entering into a contract with an investment consultant, or from continuing to obtain IC services from an investment consultant, unless they have set them strategic objectives.

Compliance statement due by 7 January 2021

The Order also requires pension scheme trustees to submit a statement confirming compliance with the above obligations during the reporting period (10 December 2019 to 9 December 2020), together with a signed certificate (both in a form specified by the Order) to the CMA by 7 January 2021. The certificate must be signed by a director of any sole corporate trustee, the chair of trustees or, if there is no chair or the chair is unavailable, any other trustee. Please note that the statement and certificate should be prepared and submitted after the end of the reporting period.

See our Alert for details

The regulations which were due to integrate the Order into pensions law (and to switch compliance reporting to TPR) have been delayed due to Covid-19 and are now not expected until Q1 2021. Had they come into force on 6 April 2020, as had been expected, they would have required schemes to review the performance of their investment consultant against their objectives at least every 12 months. While not yet a requirement, according to TPR's guidance, such a review is best practice and an action trustees should consider undertaking.

Brexit

FCA updates temporary permissions regime

EEA firms can now notify the FCA (via its Connect system) if they wish to use its temporary permissions regime.

Passporting ends on 31 December 2020

Currently, financial services firms in any EEA member state can use the passporting regime to establish a presence or carry out permitted activities in any other member state. Investment funds can be marketed across the EEA under similar passporting provisions.

New temporary regime from 1 January 2021

When the passporting regime falls away, at the end of the transition period, EEA firms may need to seek authorisation to continue to access the UK market. For this reason, the FCA has created a temporary regime which will, for a limited period after the end of the transition period, allow inbound firms to continue operating in the UK within the scope of their passport permission (as it stands at the end of the transition period) while seeking full UK authorisation, if required.

FCA must receive notifications by end of 30 December 2020

Notifications must be submitted before the end of 30 December 2020. Those that have already submitted a notification need take no further action unless they need to update their details.

The Government has also established the financial services contracts regime. At the end of the transition period, this will enable EEA passporting firms that do not enter the temporary permissions regime to wind down their UK business in an orderly fashion. The regime will automatically apply to any EEA passporting firms that do not notify the FCA that they wish to enter the temporary permissions regime but have pre-existing contracts in the UK which would need a permission to service.

Continuation of pensions' clearing exemption?

The EU Regulation which extended pension schemes' temporary exemption from the clearing obligation for a further two years came into force in June 2019. It enables the exemption to be extended twice, by a further year, subject to certain conditions.

Regulations have been passed which "onshore" this exemption (ie bring it into UK law). This means it will continue to apply to both UK and EEA pension scheme arrangements after the transition period ends. However, to date, the EU has not made a reciprocal change.

ISDA asks European Commission to take action

On 7 September 2020, ISDA wrote to the European Commission and ESMA to "respectfully request" that the "Commission take action to ensure that the temporary exemption from the clearing obligation (and other connected exemptions) continues to be available to EU counterparties which enter into new OTC derivatives with UK pension scheme arrangements, as well as to EU entities which currently rely on the exemption as legal entities set up for the purpose of investment of UK IORPs". ISDA believes that the wide-ranging impacts of this exemption falling away at the end of the transition period are such that mitigating action is warranted.

Legal update

LIBOR

Mitigating the impact of LIBOR transition

ISDA published the long-awaited IBOR Fallbacks Supplement and the IBOR Fallbacks Protocol on 23 October 2020. As a brief recap:

- the IBOR Fallbacks Supplement sets out fallback rates which would apply to OTC derivatives transactions if LIBOR or other similar rates cease to be published or become non-representative. This automatically applies to new transactions that are concluded after 25 January 2021
- by contrast, the IBOR Fallbacks Protocol is intended to help derivative users amend existing OTC transactions referencing LIBOR and other similar rates by applying the terms of the IBOR Fallbacks Supplement to those transactions.

The application of fallbacks under the Supplement and Protocol is intended to reduce the risk of market turmoil arising from the anticipated phase-out of LIBOR in 2021, and the use of both those documents has been encouraged by the FCA. Separate efforts are also being made by derivative providers to agree changes to existing transactions as part of the broader effort to transition away from LIBOR.

Managers may seek trustee consent

Managers may ask trustees to consent to them adhering to the ISDA 2020 IBOR Fallbacks Protocol on the trustees' behalf in respect of existing transactions. In such circumstances, trustees may wish to make their consent conditional on any given manager's adherence being limited only to derivatives that they manage, in case other managers wish to take a different approach.

If the scheme has transactions which are not covered by managers' agency ISDAs (for example, under bespoke ISDAs negotiated by the trustees with a counterparty), the trustees may wish to consider whether to sign up to the Protocol to apply the Supplement to those transactions or to agree a specific ISDA amendment with the relevant counterparties to incorporate the Protocol provisions. Trustees may wish to get legal advice to ensure that no unintended consequences arise from doing this.

Reminder: initial margin

You may recall that BCBS and IOSCO delayed the final two stages of the implementation of initial margin ("IM") requirements to 1 September 2021 (phase 5) and 1 September 2022 (phase 6) respectively, due to the impact of Covid-19. More details on the extension are set out in our Q2 briefing.

Trustees should start preparing for the changes to IM requirements

The IM rules require trustees of certain schemes to exchange segregated collateral with their derivative providers. The rules are part of the regulatory forms designed to mitigate risks in the financial system following the global financial crisis in 2008/09. The timelines for the application of those rules to in-scope trustees are not affected by Brexit.

As mentioned in our Q1 briefing, the final phase-in of the IM requirements is a much more involved exercise than that relating to variation margin. There is a significant lead time involved in implementing IM requirements under EMIR and other margin regimes, and we would typically recommend that trustees and their managers begin preparations 18 months ahead of the relevant implementation date.

As a result, we would recommend that even those schemes in phase 6 begin their preparations in the coming months.

Sackers

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Sackers is the UK's leading commercial law firm for pension scheme trustees and employers. Over sixty 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, corporate investors and providers on all aspects of pension scheme finance and investment.

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