Sackers

Finance & investment briefing

December 2018

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

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Abbreviations

AIF: Alternative investment fund

AIFM: Alternative investment fund manager

DC: Defined contribution

DWP: Department for Work and Pensions

ESG: Environmental, social and governance

FCA: Financial Conduct Authority

FPC: Financial Policy Committee

IGC: Independent Governance Committee

IMA: Investment management agreement

ISDA: International Swaps and Derivatives Association

LIBOR: London Interbank Offered Rate

PLSA: Pensions and Lifetime Savings Association

PRA: Prudential Regulation Authority

SIP: Statement of Investment Principles

TPR: The Pensions Regulator

Finance & investment focus

“Welcome to our last finance & investment briefing of 2018.

It follows hot on the heels of our visit to the PLSA Annual Conference in Liverpool, where broadcaster Andrew Marr suggested that the potential for a tax raising budget should be a greater concern for the pensions industry than Brexit. He may be correct, but the uncertainty around potential Brexit outcomes means that we cannot completely ignore it. In this edition, Paul Phillips considers what the legal implications might be for pension scheme investments and financial contracts.

Another subject which cannot be ignored is the change in the investment regulations to address ESG issues. It is clear that the Government expects trustees to engage fully with ESG considerations and to put in place a bespoke policy which is specific to the circumstances of their scheme. The FCA is also consulting on ESG in the context of workplace personal pension schemes and we highlight this in our legal update, along with a note on preparations for the switch from LIBOR to risk-free rates.

Thank you for reading our briefing and if you would like to discuss any of these issues further please speak to your usual contact at Sackers.”

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Potential implications of Brexit

What are the potential implications for schemes' investments and financial contracts?

By the time you read this, there may be an "in principle" deal between the EU and the UK. Even then, it will be subject to parliamentary approval both in the UK and EU, so uncertainty will prevail for some time. At the time of writing, there appears to be a high risk that there will be "no deal" or that any deal that is reached may not address all the uncertainties around financial services. If there is a successful deal, the implications will depend on the details of that deal.

With that in mind, we highlight some key areas from the point of view of a UK pension scheme that invests in funds or uses providers that have an EU 27 base. We can only touch the surface here but hope the following will be helpful.

1 Funds

A lot of schemes have investments in funds that are located in EU 27 countries. Brexit should not have any direct impact on trustees' ability to hold such investments, but may have an impact on the managers' business models. For example, an Irish AIF that uses a UK AIFM may want to restructure to appoint an Irish AIFM. This could have cost implications for the fund and it is worth checking with managers whether they are planning any material changes.

Contractual issues

2 Derivatives and other contracts with EU 27 counterparties

Any derivatives, repurchase transactions or other contracts that trustees have entered into with EU 27 counterparties are likely to be governed by English law. That choice of law will continue to be recognised post-Brexit (even if there is no deal) pursuant to the Rome I and Rome II Regulations. The contract may also state that the UK courts have jurisdiction over any dispute. The choice of courts is a more complex matter. In brief, in a no deal scenario, if the UK signs up to the Hague convention, then a contract which gives exclusive jurisdiction to the English courts would be recognised in EU 27 countries (though that would not be possible for some time after exit). In the meantime, or if the UK does not sign up to the Hague convention, it will be a matter of local law in the relevant EU 27 country.

Regulatory issues

3 What is the regulatory position if a scheme has transactions with an EU 27 bank or counterparty that has been relying on "passported" EU authorisation to do business in the UK?

If there is no deal, the UK has said that it will apply a "Temporary Permissions Regime". This would allow EU 27 firms and funds to state if they wished to continue to do business in the UK. Temporary permission would then apply for up to three years, but the firm would need to apply for full FCA authorisation during that three year period. In any event, this is not a permanent solution: firms may want to set up a local subsidiary if they wish to continue to do business in the UK over the longer term, to avoid dual regulation.

ESG – changes in investment regulations: next steps

For more detail on the DWP response see our Alert

On 11 September 2018, the DWP published a response to the consultation on changes to the Occupational Pension Schemes (Investment) Regulations 2005 together with a final version of the regulations, now called the Pension Protection Fund (Pensionable Service) and Occupational Pension Schemes (Investment and Disclosure) (Amendment and Modification) Regulations 2018 ("the Regulations").

- From 1 October 2019, trustees will be required to set out, in their SIP how they take account of "financially material considerations". These are specifically defined in the Regulations as including, but are not limited to, ESG factors and climate change. Trustees will also have to have a policy on stewardship.
- "Relevant schemes" (broadly schemes offering DC benefits) will be required to publish their SIP on a website and, on and from 1 October 2020, produce and publish an implementation statement setting out how they have implemented their investment policies, and explaining and giving reasons for any change made to them.

ESG – changes in investment regulations: next steps cont.

Steps trustees can take now

We recommend trustees begin preparations in relation to the above requirements sooner rather than later. Trustees may wish to consider the following, in conjunction with their investment consultants, as a starting point to prepare for the 1 October 2019 deadline.

Take Stock

Consider the current position of the scheme

- What does your SIP currently say?
- How are the scheme assets currently invested? ESG considerations will be very different for an actively managed portfolio compared to a passive one.
- What is the approach of your current managers? Consider what questions to raise with managers to gather relevant information. Please speak to your usual Sackers contact for assistance with this.
- What is your consultant's approach? Are managers already rated by them for ESG performance?
- What is the view of your employer? Employers will have their own policies. Employer consultation is required before the SIP is revised, therefore it may be beneficial to engage early on this issue.

Formulate policy

The policy should be bespoke in relation to the scheme – template wording will not be appropriate

- Allow time for discussion and analysis. Trustees may want to start with their investment beliefs, and consider whether these should be updated.
- Spend time on training. This is a complex topic. Trustees should allow time to familiarise themselves with the issues and jargon.
- Develop a policy. Trustees may wish to consider putting in place a bespoke responsible investment policy tailored to the circumstances of the scheme. This may form part of (or supplement) the SIP.

Note that the new Governance Regulations (see our Alert) also require TPR to update its codes of practice to factor ESG and climate change considerations into trustees' systems of governance and "own risk assessments".

Implement

What is appropriate for the scheme?

Some trustees may decide to make changes to their underlying investment strategy, but for many it will be a case of working with what is already in place. In any event, trustees should:

- make clear to managers what reporting is expected in relation to ESG issues. Ensure that strategy and objectives are specific and appropriate for the scheme. Explicit voting and engagement requirements should be specified
- for new appointments, consider what specific ESG criteria to use, adopt and implement
- for existing engagements, consider what wording could be used in IMA and side letters.

Review

Ongoing obligation

Having considered the above, trustees will want to reflect on whether their manager's actions are in line with the schemes objectives, beliefs and strategy.

Trustees may also want to think about measuring and reporting on their exposure to climate change.

Consideration of a scheme's investment principles and policies will be an ongoing process.

Going Further

For those trustees who want to take a more active stance on ESG, consider what extra steps can be taken to explore these issues (such as joining relevant investor groups or implementing ESG specific reporting packages). For further ideas, please speak to your usual Sackers contact.

Legal update

The FCA is seeking feedback on its Discussion Paper by 31 January 2019

FCA publishes discussion paper on the impact of climate change and green finance on financial services

On 15 October 2018, the FCA published a Discussion Paper on the impacts of climate change and green finance, setting out how they are relevant to the FCA's statutory objectives of protecting consumers, protecting market integrity and promoting competition.

The paper seeks input on areas in which the FCA considers a greater regulatory focus is warranted, including pensions, ensuring that those making investment decisions take account of risks including climate change.

The paper confirms the FCA's intention to consult on rule changes requiring IGCs to report on their firm's policies on evaluating ESG considerations, including climate change; how they take account of members' ethical and other concerns; and stewardship. At the same time, the FCA will also consult on introducing related guidance for providers of workplace personal pension schemes, to clarify how they should consider financial factors (such as ESG and climate change risks and opportunities) and non-financial factors (such as responding to members' ethical concerns) when making investment decisions. The FCA intends to consult on a single package of changes in the first quarter of 2019.

The paper also highlights the impact of climate change on disclosures in capital markets. The FCA notes that, to date, issuers of securities have not had a consistent approach to climate related disclosures and questions whether regulatory encouragement is needed to ensure greater consistency of disclosures. One method to achieve this would be to require issuers to provide a statement explaining whether or not they have followed the Task Force on Climate-related Financial Disclosures' recommendations in preparing their disclosures; and if they have not, they could be required to explain why.

The FCA welcomed the PRA's consultation published at the same time on enhancing banks' and insurers' approaches to managing the financial risks from climate change.

The deadline for responses is 14 December 2018

Joint FCA and PRA "Dear CEO" letters on firms' preparations for transition from LIBOR to risk-free rates

LIBOR and other similar rates are embedded into many derivatives and other financial products. LIBOR is likely to stop being published by the end of 2021. The transition away from LIBOR will not be straightforward, and for many products it may not be appropriate to simply fall back on an equivalent overnight risk-free rate. ISDA has been consulting on appropriate fall backs: the ISDA consultation ended on 22 October 2018 – we may return to this topic in a future update.

In the meantime, on 19 September 2018, the PRA and FCA jointly published a "Dear CEO" letter to banking firms on firms' preparations for the transition from LIBOR to risk-free rates.

The letter requests assurance that firms' senior managers and boards understand the risks associated with the LIBOR transition (as part of the ongoing global benchmark reform effort) and are taking appropriate measures to transition to alternative rates before the end of 2021.

The Letter provides background to the reforms to LIBOR, and states that "the extent to which LIBOR is deeply embedded in current business practices means that transition will be complex and will take time… insufficient preparations for transition to alternative rates could have a negative impact on the safety and soundness of firms and cause harm to their clients and to the markets in which they operate".

By 14 December 2018, firms are requested to provide a board approved summary of a firm's assessment of key risks relating to LIBOR discontinuation and details of actions that firm plans to take to mitigate those risks. Firms must also identify the senior manager(s) who will oversee the provision of the response to the letter and the implementation of its transition plans.

The FCA and PRA will review the responses and consider appropriate next steps, and they will also supplement the FPC's monitoring of the risks associated with LIBOR discontinuation and transition.

Sackers

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, corporate investors and providers on all aspects of pension scheme finance and investment.

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