Sackers

Finance & investment briefing

June 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

CPI: Consumer prices index

CPIH: a variant of CPI including owner occupiers' housing costs

DB: Defined benefit

DC: Defined contribution

DRCs: Deficit reduction contributions

DWP: Department for Work and Pensions

EMIR: the European market infrastructure regulation ((EU) No 648/2012)

ESG: Environmental, social and governance

ESMA: European Securities and Markets Authority

EU: European Union

FCA: Financial Conduct Authority

IGC: Independent Governance Committee

IOSCO: International Organisation of Securities Commissions

LDI: Liability-driven investment

OTC: Over-the-counter

PCRIG: Pensions Climate Risk Industry Group

PLSA: Pensions and Lifetime Savings Association

RPI: Retail prices index

SIP: Statement of Investment Principles

TPR: The Pensions Regulator

UFPLS: Uncrystallised funds pension lump sum

UKSA: UK Statistics Authority

Finance & investment focus

"Welcome to June's edition of the finance & investment briefing.

After weeks of social distancing, at Sackers we are well adjusted to the highs and lows of home working. We can also see that our clients have continued to operate through circumstances which have made adjectives like "unprecedented", "extraordinary" or "exceptional" clichéd. As an industry delivering incomes to the most vulnerable demographic, the importance of this achievement should not be overlooked.

This month we are leveraging our clients' experience to focus on practical tips for operating during the pandemic. The financial impact of this crisis may take years to work out, but for now focusing on the legal and operational problems at hand is tangible and important.

In the remainder of our briefing, we summarise TPR's recent guidance on investment issues in response to COVID-19. In a rare piece of non-virus related news, we also flag some developments in Cayman Islands' money laundering rules. Our final section provides what we hope will be a helpful deadline tracker for the rest of the year, flagging some key dates which have been delayed as well as those which have not."

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Covid-19: practical issues relating to investments

Covid-19 is requiring trustees to prioritise certain activities to safeguard their members' interests and to ensure benefits continue to be paid. A key activity for trustees during this period will be to consider and to discuss the investment implications with their consultants. In this briefing, we concentrate on a number of practical issues and queries that we are seeing which are particularly relevant to the investment of scheme assets.

1 Managing risk of fraud

Many consultants and advisers have relaxed their identity verification processes to enable business to continue more easily during lockdown. Understandably, this raises concerns regarding the risk of fraud.

Trustees' agreements with their administrators, investment managers and custodians should include provisions under which the adviser will accept liability for any fraudulent activities by one of their employees. Where any fraud is committed by a third-party, a manager's liability will depend on whether they exercised reasonable care in accepting the instruction.

In our view, risks may be higher in relation to pooled funds as they often include very protective provision for their managers where instructions are given electronically (as it is inevitably more difficult to confirm their origin). However, this would not generally enable a manager to escape liability if they have clearly failed to exercise reasonable care, which would include having appropriate verification procedures.

Trustees should liaise with their advisers regarding their revised procedures to ensure sufficient safeguards (for example, the use of a call-back before proceeding) are applied.

2 Buy-ins and longevity hedging

Buy-in policies and longevity contracts typically include ongoing administrative obligations for trustees; in particular, regular existence checking and reporting back to the insurer. Breach of these obligations may enable the insurer to make adjustments to the policy payments and, in extreme circumstances, can have other more serious consequences. Trustees may wish to seek reassurance from their administrators that they are able to continue supporting trustees in meeting their obligations, or to contact their buy-in provider to discuss any concerns.

In relation to prospective transactions, we are seeing some aggressive pricing by buy-in providers. Trustees should look carefully at the terms of any price-locks and understand the implications of insurer friendly carve-outs related to extreme market movement. They will, of course, also work with their consultants to identify potentially significant transaction costs in the current environment.

3 Insurers and bank counterparties

Insurers and banks will not be immune to the effects of Covid-19 on the economy. Trustees may wish to seek reports from their counterparties on the current position. There may be triggers in agreements with counterparties relating to credit rating downgrades (most likely for banks) or a deterioration in solvency capital position (most likely with insurance companies) that allow trustees to call for additional margin, or in some cases to terminate. In any event it is important to monitor the impact on key counterparties.

4 Pooled funds – closure / gating / distress

Exceptional market circumstances can put strain on funds, and otherwise liquid vehicles may have broad powers to suspend dealing. This could be inconvenient for DB schemes, but is of particular practical significance in the context of DC. Where a member has selected a fund which has suspended dealing, trustees may be unable either to invest new contributions in these funds or to disinvest. This illiquidity may cause practical difficulties in relation to member activity, leaving members unable to, for example, switch funds, transfer to another scheme, or take their benefits.

Not for the first time, property funds have found themselves particularly susceptible to these pressures and the current inability to value properties has led to the gating or closure of a number of DC property funds.

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Trustees must agree a practical way forward with their investment and legal advisers, whilst negotiating the regulatory obligations to which they are subject. Where the fund is self-select (as most property funds are), member consent would ideally be sought to invest their money elsewhere until the property fund becomes available. Investor consent will not be instantaneous, and trustees will need to find a home for contributions in the meantime. Where the fund is part of the default, trustees should check their powers to vary its constitution and take advice on the most appropriate alternative.

In either scenario, it may well be impossible to avoid holding funds in cash or cash like assets for at least a period. Care should be taken in relation to default fund rules in these exceptional circumstances.

With regards to disinvestment, trustees should ask their legal advisers to check the scheme's rules and explain the options. It may be possible to prevent members switching while a fund is gated, or to make partial transfers / allow partial retirements. Whatever is ultimately decided, member communications will be key.

The same market pressures are giving rise to other issues in relation to pooled fund assets, including instances of alternatives managers seeking to raise additional capital, including from investors. Such requests are likely to be both complex and time sensitive. Trustees will naturally be focused on what is, at core, a difficult commercial situation. However, they should also be aware of other legal and regulatory obligations which may apply, such as the need to take investment advice as to the suitability of the investment, constraints on the trustees' ability to take "day-to-day" investment decisions and the need for care in review of the associated legal documentation (which may have been rushed through by a manager under intense commercial pressure).

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Changes to initial margin deadlines

BCBS and IOSCO have announced that the final two stages of the implementation of initial margin requirements will be delayed by a year in light of the impact of Covid-19.

As a result, schemes with an aggregate average notional amount ("AANA") of non-cleared OTC derivatives greater than €50 billion will be subject to the requirements from 1 September 2021 (phase 5) and schemes with an AANA greater than €8 billion will be subject to the requirements from 1 September 2022 (phase 6).

The extension is intended to permit in-scope entities to focus efforts on managing risks that have arisen in relation to market volatility and displacement of staff.

BCBS and IOSCO were charged by the G20 with ensuring that consistent global standards are adopted for collateral exchange by entities which trade non-cleared OTC derivatives. In order to implement the changes to the timetable, regulators will need to update their local regulations. In the EU, for instance, the initial margin requirements under EMIR will need to be formally amended by the issue of a delegated regulation.

There is a significant lead time involved in implementing initial margin 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. For schemes in phase 6, the extension will mean that there is additional time before the trustees and their managers will need to consider the issue. However, we would expect that schemes in phase 5 will remain focused on implementation.

Covid-19: practical issues relating to investments

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Stewardship

Not only is stewardship a key component of pension scheme trustees' fiduciary duty to their beneficiaries, information on their approach must be included in the scheme's SIP and, with effect from this October, trustees must report and publish an annual statement on how their policies have been implemented (see our 2020 ESG guide for further details).

The PLSA has reminded pension schemes to assess how the companies in which they invest respond to the pandemic and to be prepared to hold directors to account, as decisions made now may impact their long-term investment prospects. "How companies behave now towards their workforces will likely have a material impact on their future revenue, operating costs and even the post-Covid-19 regulatory environment. This in turn has consequences for scheme investors' risk-adjusted returns and ultimately for the value of beneficiaries' savings."

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New investments

There may be particular practical difficulties relating to new investments around signing formalities, document production and the validation of documents for "know your client ("KYC") or anti-money laundering purposes. Issues include the availability (or not) of wet ink signatures, access to original documentation for certification, practicalities associated with the production of standard KYC checks such as passports and utility bills and compliance with stricter formalities such as notarisation, where usually sought.

Requiring particular care are investments structured as limited partnership interests (most common but not exclusively in the context of private equity, private credit and infrastructure). The formality requirements of deeds are more exacting and where a trustee is accustomed to a witnessed signature, it may simply be impracticable to get an appropriate witness whilst observing social distancing protocols.

Thankfully most of these issues can be overcome, but added care and additional input may be needed. Trustees will want to encourage advisors to identify any practical hurdles early, and to discuss them with the fund manager or administrator. Our experience is that most are being pragmatic; accepting the usual alternatives to wet-ink signatures and taking a sensible line in relation to what levels of certification will be required.

As TPR has flagged, trustees may also wish to revisit their usual arrangements for delegated authority and authorised signatories to ensure that their governance is adapted to these circumstances. (Please see our News item – Practical issues on remote execution and decision making for further information.)

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Instructions to custodians

Some custody agreements still provide for instructions to be provided by fax. This may not be practicable in the current environment. Trustees should ensure that agreements allow for them or their investment managers to provide instructions by appropriate alternative means.

TPR Guidance on Investments

TPR responded to COVID-19 by publishing guidance on 27 March 2020. The guidance covers a range of topics and includes helpful commentary in particular on funding and contribution holiday proposals. It also contains specific recommendations on investment issues.

TPR's commentary will not contain any surprises for trustees, but investment sub-committees will want to be aware of TPR's comments, and may wish to signal awareness and compliance in their minutes.

The key guidance includes:

- **Scheme's cashflow.** Trustees should understand their scheme's cashflow requirements and how they will be met. TPR flags "cash strain" associated with likely increases in member movement, possible drops in investment income, cash calls associated with collateral movement or suspension of DRCs.
- **Specific risks.** As you would expect, trustees are encouraged to identify, review and take steps to manage any risks specific either to their scheme portfolios or to their sponsors.
- **Review implementation.** Where the trustees have made an investment decision in principle which has not yet been implemented, they are encouraged to review whether it remains appropriate to proceed. Trustees are warned not to introduce risks or crystallise losses.
- **Governance.** As we highlight above (see section 7 on page 5), it may be appropriate for trustees to review their investment governance structures to ensure they can continue to function and make decisions effectively. As a practical point, the trustee's delegations and lists of authorised signatories should be reviewed to ensure that execution of new investment (and other) documentation remains practicable.
- **Risk management governance framework.** TPR expects trustees to monitor the investment performance of their scheme through this period and to determine whether they should make any changes to their investment and risk management governance framework.

Cayman Islands – Anti-Money Laundering Regulations

A number of changes are to be made to the Cayman Islands' Anti-Money Laundering Regulations. We expect these to impact the standard onboarding documentation associated with future and possibly existing investments currently made through a Cayman Islands vehicle (common across a range of alternative asset classes), as managers bring their funds into compliance with the revised anti-money laundering environment.

Most significantly, from 5 August 2020, Cayman Islands funds and their administrators will no longer be able to rely on a foreign client or investor classification system based on listed equivalent jurisdictions. This list currently includes the UK. Instead, the providers will have to take a risk-based approach and determine their own level of money laundering and terrorist financing risk associated with the jurisdiction. This may allow the provider to apply a simplified level of due diligence for some investors.

Other changes relate to the circumstances in which an investor's beneficial owners must be recorded in investment materials. These rules should not affect pension funds investors, but historically we have encountered difficulties in the terminology and legal language in fund documentation relating to similar provisions. Overseas regulatory requirements are not always easy to apply to the circumstances of a UK occupational pension scheme. As these new rules filter down over the coming year, additional scrutiny may be required to ensure that subscription documentation is correctly filled out. Trustees will want to ensure their pension scheme investors are not incorrectly classified and thereby subjected to additional anti-money laundering requirements.

It may take some time for funds and administrators to adapt to these new rules, but our hope is that UK pension scheme clients will ultimately be able to take advantage of simplified due diligence.

Date | Revised date

Key dates

6 April 2020
FCA

- IGCs must consider and report on their firm's policies on ESG issues, member concerns, and stewardship (for the products they oversee) and oversee the value for money of investment pathway solutions for pension drawdown (pathway solutions). Until the requirement for pathway solutions is in force (see below), IGCs should assess their proposed design
- Changes to the information that firms give consumers entering pension drawdown or taking an income for the first time (including an UFPLS) and the annual information given to these customers. (The FCA appreciates that a short delay may be unavoidable, but expects firms to implement these rules as soon as reasonably practicable. If this is later than 31 May 2020, firms are expected to notify the FCA.)

15 June 2020

ESMA's consultation on solutions for OTC derivatives clearing for pension scheme arrangements (currently covered by the EMIR refit exemption) closes

30 June 2020

Current end date for TPR's Covid-19 reporting and enforcement easements

2 July 2020

PCRIG's consultation on new non-statutory guidance for occupational pension schemes on assessing, managing and reporting climate-related risks closes

21 August 2020

Consultation on the reform to RPI methodology closes

2 September 2020

TPR's first consultation on a revised code for scheme funding closes

1 October 2020

FCA's consultation on proposals to enhance climate-related disclosures by listed issuers and clarification of existing disclosure obligations closes

1 October 2020

- Additional information in respect of asset managers and stewardship required in SIPs
- Requirement for DB schemes to publish their SIPs comes into force
- Requirement for trustees to produce and publish online an implementation statement in relation to their SIPs comes into force (content and timing depends on type of scheme and scheme year-end)

(For further information on these changes, including a sample timetable, please see our 2020 ESG guide)

1 February 2021

- Further FCA requirements for drawdown products, including provision of investment pathways
- FCA changes on switching (intended to make it easier for consumers to move from one platform to another without liquidating their assets)

1 September 2021

Phase 5 of the implementation of initial margin requirements

1 September 2022

Phase 6 of the implementation of initial margin requirements

To be confirmed

- Pension Schemes Bill 2019-21. The Bill includes a power for regulations to "impose requirements on the trustees or managers of an occupational pension scheme of a prescribed description with a view to securing that there is effective governance of the scheme with respect to the effects of climate change". These requirements could include reviewing the exposure of the scheme to climate change risks, determining a strategy for managing the scheme's exposure and publishing information relating to the effects of climate change on the scheme
- DWP regulations which will implement the CMA order on investment consultants and fiduciary managers (see our Alert) have been paused due to Covid-19. (Following a consultation in 2019, they had been expected to come into force on 6 April 2020.)
- Consultation on TPR's single code of practice (which is required to include details of how trustees' systems of governance should consider ESG factors and assess new or emerging risks (including climate change) has been postponed until further notice

Contact

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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