Sackers

Finance & investment briefing

September 2021

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

Finance & investment briefing

September 2021

In this issue

Bulk annuity contracts: thinking about risks in risk transfer 3

Fiduciary management 5

Legal update 7

Abbreviations

CMA: Competition and Markets Authority

DB: Defined benefit

DC: Defined contribution

DWP: Department for Work and Pensions

ESG: Environmental, social and corporate governance

FCA: Financial Conduct Authority

IGC: Independent Governance Committee

LDI: Liability-driven investment

LTAF: Long term asset fund

OTC: Over the counter

PLSA: Pensions and Lifetime Savings Association

TCFD: Taskforce on Climate-related Financial Disclosures

UK: United Kingdom

Finance & investment focus

"We can't promise that our September briefing will match the highs (and inevitable lows) of either this summer's Euros or the Tokyo Olympics, but there is still plenty of action to follow in the pension investment and risk transfer arena.

This edition kicks off with the first in a series of articles on risk transfer, residual risks and trustee protections. With many schemes finding that buy-out is becoming achievable, perhaps sooner than anticipated, we consider what risks a bulk annuity provider will cover and how trustees can manage any risks that remain. Those wanting to hear more on this subject may wish to attend our next seminar "Buy-ins and buy-outs – how to transfer risks successfully" on 21st September 2021, in which we will reflect on some knottier aspects of buy-in and buy-out transactions, including deal preparation, benefit specification due diligence, residual risks and trustee protections. For details and to sign up, visit the events page on our website.

The effects of the mandatory re-tendering requirements in the Investment Consultancy and Fiduciary Management Market Investigation Order 2019 are starting to filter through. We explore some of the issues around appointing a fiduciary manager on pages 5-6.

Finally, we catch up on the latest developments in responsible investment standards and climate-related disclosures and governance."

Ian Cormican
Partner, finance & investment group

ian.cormican@sackers.com

Electronic format

You can access electronic copies of all our publications at:

www.sackers.com/knowledge/publications

Environment

In line with our approach to corporate social responsibility (CSR), we monitor closely the number of copies printed of this publication. The paper and print manufacturing has been done in compliance with ISO14001 environmental management standards. Our paper, Revive 100% silk is derived from 100% pre and post-consumer waste, which is certified for FSC® chain of custody.

For more information on our CSR policy, please visit our website at www.sackers.com/about/csr

Bulk annuity contracts: thinking about risks in risk transfer

This article is the first in a series of articles on risk transfer, residual risks and trustee protections

All risks?

A bulk annuity transaction is a transaction about risk. Funding and administering a DB pension scheme involves lots of risks; a bulk annuity transaction looks to transfer some of those risks from the scheme and its sponsor to an insurer. The key word here is "some". A common assumption is that all risks must transfer. The insurer position is more nuanced.

Just as the *Lord of the Ring's* Gandalf is neither late nor early, but arrives precisely when he means to, an insurer's goal in a buy-in or buy-out is to take on precisely those risks that they intend. As is often the case, the more nuanced position is the better one. A successful buy-out or buy-in is not one where all risks pass to an insurer. In practice, the most important and material risks will pass, but the transfer of all risks is never achieved and should not be the aspiration. A successful transaction is one where the trustee and sponsor have understood what risks the insurer means to take on and have properly mitigated those it will not.

Liabilities and benefits

As the main point of an annuity policy is to secure pension liabilities, it's worth focusing on these first. A bulk annuity contract (whether a buy-in or a buy-out) is intended to track very closely the benefits of the scheme being secured. It is tempting to talk about the insurer "securing the benefit", but in practice the insurer will take on the liabilities as a body of administrative data, interpreted by a short benefit specification. The insurer does not adopt the scheme's trust documentation, nor, in a typical transaction, will it accept responsibility for errors in scheme data. To the extent that a member can demonstrate that they are entitled to a benefit different to the one insured, that liability is likely to remain with the trustee.

The benefit specification

It is important to think about the practicalities. Typically, a scheme's data record is old and may have passed through the hands of multiple administrators. There may be merged-in sections where records and institutional memory may have been lost to a greater or lesser extent. The insurer will interpret the administrative data supplied to it by reference to a benefit specification which is an abbreviated description of the scheme's benefit. Importantly, the insurer does not agree to administer the benefit in accordance with the scheme's documentation (as the trustee is required to do). After buy-in, the insurer will not check the trust deed and rules or other documentation. It will rely on the short benefit specification attached to the contract. When one considers the volume of historic deeds, booklets, member communications etc which are associated with the example above – a multi section, nearly 70 year old scheme – this may cause pause for thought.

How are discrepancies dealt with?

There are several ways discrepancies might arise as between what is insured and the scheme benefit. The trustee may be forced to simplify or crystalise benefit features. For example, unusual increase rules may be impractical or very difficult for the insurer to price or administer, discretionary benefit rules can cause problems if the insurer is not willing to make the necessary decisions, or, if a long-term buy-in is contemplated, the trustee may choose to simplify or take a view on a particular issue. These changes need careful consideration, but ordinarily are unlikely to lead to a member complaint.

Then there is the possibility of error. It could emerge that the administrative record failed to include the details of a member entitled to a pension or that the data record reflected an incorrect final salary figure, or there could also be errors in the scheme rules. For example, a consolidation might have incorrectly adopted a historic increase or revaluation rules. In these cases, the insurer's obligation would be to pay the benefit in accordance with the data and specification supplied to it. A member, unable to recover the correct benefit from the insurer, would naturally turn to the trustee and employer.

Managing potential risk

Careful preparation is the best mitigation to these sorts of risks. For a well-run scheme that has gone through a sensible process in preparing its data and specification, these risks should by their nature be low. In some cases, and for an additional premium, certain heads of residual risks can also be secured. For example, an insurer might be prepared to accept the risks associated with errors in the data or of the misapplication of the benefit specification to the data. Residual risks cover involves the insurer taking on more risks. As you would expect, this typically means more due diligence and the approach to this needs careful thought, not least in terms of timing. In any event, while it may ultimately be possible to get broad residual risks cover, there are always carve-outs which need to be looked at thoroughly. We will return to residual risks in our December briefing.

Importantly, bulk annuity providers are currently not writing general insurance policies aimed at covering risks particular to the trustee themself (as opposed to the members). This would, for example, mean that a claim brought against the trustee in relation to its conduct or decision making would clearly fall outside the scope of a bulk annuity policy. An important limb to this is costs and expenses. While a scheme is ongoing, the trustee's expenses in defending a claim brought against it would usually be indemnified from scheme assets. After the scheme is wound-up, that layer of protection falls away. Not only should the trustee be considering how to put members right in relation to residual categories of risk, but it must also consider their own practical position were any claim brought. While there are usually considerable practical difficulties to a claim against a trustee being successfully prosecuted, a claim need not be a strong one for substantial expenses to be incurred.

We will return to trustee protections in our March 2022 briefing.

Fiduciary management

There has been an increase in the number of new fiduciary management appointments over this last year, a number of which have resulted from the mandatory re-tendering requirements set by the CMA in 2019 pursuant to the Investment Consultancy and Fiduciary Management Market Investigation Order 2019 (the "CMA Order"). The new requirements on fiduciary managers to publish costs and charges in a consistent (and therefore more transparent) manner has also assisted trustee decision making in this area.

What is fiduciary management?

Fiduciary management is a service where a provider executes the scheme's investment policy under a significant delegation of powers from the trustee. The fiduciary provider will generally manage and deal with day-to-day investment decisions in respect of scheme assets on the trustee's behalf. The trustee remains responsible for setting the overall investment strategy (often receiving investment advice from the relevant fiduciary manager) and for monitoring the fiduciary manager's implementation of the investment strategy. The service is predominantly used for DB schemes but is occasionally also used for DC schemes.

There is no one-size-fits-all approach to fiduciary management and there is flexibility to make it work for a particular scheme's needs. For instance:

- some mandates will apply to the whole of the scheme's assets whilst others will apply only to a portion of the assets
- while the day-to-day implementation of the investment strategy will lie with the fiduciary manager, certain overarching decisions will still be made in consultation with the trustee in some arrangements
- some schemes go further and prefer to have a fiduciary manager for the implementation piece only, retaining an investment adviser to assist with strategic decisions, and
- in some cases, a third-party adviser is appointed to assist with oversight of the arrangement.

Is the CMA Order still relevant to fiduciary management appointments?

The CMA Order applied two requirements which are potentially relevant to a fiduciary management appointment, the first being the requirement for certain appointments to be subject to mandatory tendering/re-tendering and the second relating to objective setting for those fiduciary managers providing investment consultancy services.

It has been proposed that these two elements of the CMA Order will be replaced by regulations prepared by the DWP, though the timing of this has been postponed due to COVID-19. The Government now intends to implement these regulations in the first half of 2022, but in the meantime the CMA Order continues to apply.

Further information on the requirements of the CMA Order can be found in our Alert and Briefing. In summary:

- where a fiduciary manager is appointed on or after 10 December 2019 and in aggregate more than 20% of scheme assets are delegated, they will be subject to the tendering exercise
- similar re-tendering requirements to existing mandates and those which were appointed on or prior to 10 June 2016 had to be re-tendered by 9 June 2021 at the latest, and
- there are other cases where the re-tendering requirements may still apply to existing appointments entered into prior to 10 December 2019, such as in relation to certain managers which were appointed between 2016 and 2019 or for those schemes where assets under fiduciary management begin to exceed 20% of scheme assets in aggregate.

The draft DWP regulations that were published have some material changes from the tests applied in the CMA Order and, therefore, the impact of the final regulations remains to be seen.

Fiduciary management cont.

How are trustees' general legal duties impacted by fiduciary management?	While fiduciary management involves the delegation of decision making power to the fiduciary manager, the trustee still retains its general fiduciary duties to the scheme, including the duty to act in the best interests of members and beneficiaries. There are a number of duties and decisions which the trustee is unable to delegate to a fiduciary manager. These generally relate to the trustee's responsibility as a steward of the scheme, such as decisions relating to the strategic asset allocation to be adopted for the scheme, though the fiduciary manager may provide advice on such matters.
What is the trustee's role in a fiduciary model?	As a result of its legal duties, the trustee's role under the fiduciary model is to make the strategic decisions and have oversight and decision-making power about whether to retain or replace the fiduciary manager. The implementation and the monitoring of any relationships with sub-investment managers will be handled by the fiduciary manager, with oversight by the trustee.
What significance does the trustee's role have in practice and what are the legal implications of this?	Given the extent of the delegation, the selection and monitoring of the fiduciary manager often takes on much more prominence than the selection and monitoring of a traditional investment manager, and trustees would be well advised to have a robust process in place. While investment advice on the selection of the fiduciary manager may not be legally required, it is generally recommended. As oversight will generally be provided by way of reporting, it will be particularly important that such reporting is provided in a manner which meets the scheme's needs. In identifying managers whose approach is aligned with the trustee's investment beliefs, alongside the commercial factors like investment performance together with fees and costs, trustees often find it important to look closely at managers' experience and approach to factors like ESG. In a fiduciary management structure, it is also more likely that trustees will be less involved in decisions relating to regulatory obligations, such as those that apply to trading uncleared OTC derivatives. Careful attention should be given to a manager's obligations in the documentation and any reporting that is required to give the manager reassurance in this regard. Where fiduciary oversight managers or investment advisers are used as part of the structure, it will be important to set clear roles and responsibilities between the advisers and to ensure that steps are taken to facilitate effective communication between the advisers.

If you have any questions on any of the above, please speak to your usual Sackers contact.

Legal update

FCA consultation on new category of long-term asset fund

FCA is considering consultation responses and looking to publish a final policy statement and handbook rules later in 2021

On 7 May 2021, the FCA launched a consultation on proposals for a new category of fund, a long-term asset fund ("LTAF"), with the aim of providing a fund structure specifically designed to accommodate relatively illiquid assets. The LTAF would be aimed at DC providers and schemes which may be interested in investing part of their assets in an LTAF. The Government announced in the 2021 Budget that it is looking to encourage pension funds to direct more of their capital towards the country's economic recovery, with the establishment of the UK's first LTAF in 2021.

The Pension Charges Survey (see 7 Days) found that "approximately two-thirds of providers reported that they had zero direct investments in illiquids in their default fund(s) [and] about a third had a small proportion, typically between 1.5% to 7.0%". The consultation also, therefore, proposes amending the "permitted link" rules to enable pension schemes to consider the proportion of illiquid assets across their investment portfolios, rather than to restrict the proportion of illiquid assets in each underlying fund in which they invest.

PLSA consultation on responsible investment standards

Consultation closes on 3 September 2021

On 30 June 2021, the PLSA launched a consultation on a new Responsible Investment Quality Mark ("RIQM"), which is intended to recognise pension schemes that meet the highest standards for incorporating ESG factors across their operations. The aim is to offer:

- a "new standard to which schemes can aspire"
- the "opportunity to share best practice among schemes", and
- a scheme member-focused way "to demonstrate activities in this area".

The assessment approach is designed to be flexible to the scale and resources of the relevant scheme.

FCA consults on climate-related disclosure rules

Consultations close on 10 September 2021 and the FCA intends to confirm its policy on climate-related disclosures before the end of the year

The FCA has launched a consultation on proposals to introduce climate-related financial disclosure rules and guidance for asset managers, life insurers, and FCA-regulated pension providers. Under the proposals, firms would be required to publish an annual TCFD report on how they take climate-related risks and opportunities into account in managing or administering investments on behalf of clients and consumers. Firms would also be required to produce a baseline set of consistent comparable disclosures in respect of their products and portfolios, including a core set of metrics.

The FCA is also consulting on extending climate-related disclosure requirements to issuers of standard listed equity shares. These issuers will be required to include a statement in their annual financial report setting out whether they have made disclosures consistent with the TCFD's recommendations. Where they have not done so, an explanation will be needed as to why, what steps they are taking to do so, and over what timescale.

Guidance will be published to assist those in scope of this new requirement, but this is not included in the current consultation. The new rule is intended to take effect for accounting periods beginning on or after 1 January 2022.

The FCA is also looking for stakeholder "discussion and engagement" on other topical ESG issues including those related to green, social or sustainable debt instruments, and the increasingly prominent role of ESG data and rating providers. It intends to publish a feedback statement in the first half of 2022.

Sackers

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.

Paul Phillips
Partner
D +44 20 7615 9523
E paul.phillips@sackers.com

Key areas of expertise include: risk transfer transactions, LDI, longevity transactions, OTC derivatives and repurchase agreements, investment management, transition and custody arrangements.

Ian Cormican
Partner
D +44 20 7615 9501
E ian.cormican@sackers.com

Key areas of expertise include: longevity transactions, funding negotiations, risk transfer transactions, LDI, fiduciary management and governance.

Stuart O'Brien
Partner
D +44 20 7615 9539
E stuart.obrien@sackers.com

Key areas of expertise include: risk transfer transactions, LDI, investment management agreements, ESG issues including fiduciary duties, policy, stewardship, responsible and impact investing.

Jacqui Reid
Partner
D +44 20 7615 9550
E jacqui.reid@sackers.com

Key areas of expertise include: DC investment strategy, regulation and industry best practice for IGCs and providers, member engagement and value for money.

Ralph McClelland
Partner
D +44 20 7615 9532
E ralph.mcclelland@sackers.com

Key areas of expertise include: risk transfer transactions including buy-ins and buy-outs, fiduciary management, custody arrangements, all types of pooled investment products and ESG.

James Geer
Associate director
D +44 20 7615 9007
E james.geer@sackers.com

Key areas of expertise include: derivatives, financial regulation, structured finance and risk transfer transactions.

Sign up

Stay up to date with all the latest legal and regulatory developments affecting pensions and retirement savings by signing up to our free publications on www.sackers.com/knowledge/publications. These include our weekly round-up, 7 Days, Alerts where topical issues are covered in depth, and Briefings which give practical commentary and perspectives on essential issues.

Sacker & Partners LLP
20 Gresham Street
London EC2V 7JE
T +44 20 7329 6699
E enquiries@sackers.com
www.sackers.com

Nothing stated in this document should be treated as an authoritative statement of the law on any particular aspect or in any specific case. Action should not be taken on the basis of this document alone. For specific advice on any particular aspect you should speak to your usual Sackers contact. © Sacker & Partners LLP August 2021