Sackers

Finance & investment briefing

December 2021

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

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Abbreviations

DB: Defined benefit

DC: Defined contribution

DWP: Department for Work and Pensions

ESG: Environmental, social and corporate governance

GHG: Greenhouse gas

GMP: Guaranteed Minimum Pension

IGC: Independent Governance Committee

LDI: Liability-driven investment

MMMM: Make My Money Matter

OTC: over the counter

PCRIG: Pensions Climate Risk Industry Group

SIP: Statement of Investment Principles

TCFD: Taskforce on Climate-related Financial Disclosures

TPR: The Pension Regulator

UK: United Kingdom

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Finance & investment focus

“Welcome to our fourth and final finance & investment briefing for 2021. As the nights continue to draw in and warmer coats are dusted off from our winter wardrobes, we head towards the end of the year focusing on many of the issues that were topical at the start of the year.

Risk transfer work remains unabated and we are pleased to have advised on some of the most significant deals this year, particular highlights being advising the trustees of the Signet Group Pension Scheme on its buy-in with Rothesay Life and advising the sponsor of the Metal Box Pension Scheme on its £2.2bn full scheme buy-out with PIC, understood to be the biggest bulk annuity deal of 2021 so far. The latter included a number of innovative solutions to issues that can otherwise bog-down a large scheme buy-out, including GMP equalisation/conversion, and a funding structure between the company and pension scheme to manage the realisation of a portfolio of illiquid investments. The transaction also provided comprehensive coverage of the scheme’s residual risks. On page 5 of this briefing we look at what residual risks coverage typically includes, where its limitations might be and some of the issues trustees and sponsors will need to think about in deciding how to approach a transaction with this as an objective. In our March 2022 briefing we will explore the related topics of run-off cover and company indemnification.

Climate change regulation also remains at the forefront of trustee concerns. Schemes with assets over £5bn and DC master trusts will already have had to get to grips with the new requirements under the Occupational Pension Schemes (Climate Change Governance and Reporting) Regulations 2021 which applied to them from 1 October this year. Next year, it will be the turn of those schemes with assets in excess of £1bn. On pages 3 and 4 we look at the key compliance actions trustees of these schemes will need to take and offer some top tips from our experience of advising schemes already in scope this year. As ever, the overriding “top tip” is to start work early on preparations, particularly in relation to climate-related metrics and scenario analysis. A round-up of further developments on net zero and other climate-related matters follows on page 7.”

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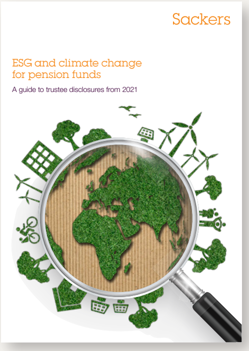
TCFD: next steps for £1bn plus schemes



Download our ESG guide

ESG and climate change continue to be a key focus for trustees. From 1 October 2021, larger schemes (whose net assets are £5bn or more and master trusts) have been required to comply with the Occupational Pension Schemes (Climate Change Governance and Reporting) Regulations 2021 ("the Regulations"). Schemes with £1bn or more of assets will be in scope from 1 October 2022.

As ESG related matters have risen in prominence, the consideration of climate-related issues has become part and parcel of trustees' trusts law and regulatory duties. For further details and background please see our Guide and Alert. In order to ensure trustees are fully considering this risk and acting in the best interests of pension scheme beneficiaries, the DWP has embedded the current recommendations of the TCFD into UK law under the Regulations. The Regulations are accompanied by statutory guidance published by the DWP, as well as voluntary, non-statutory guidance for trustees from PCRIG on the integration of climate risk into decision-making. TPR also consulted earlier this year on their own guidance on governance and reporting of climate-related risks and opportunities. The proposed TPR guidance describes what trustees need to do and report on in their annual climate change (or TCFD) report to comply with the Regulations.

The Regulations impose requirements on trustees of schemes in scope for the identification, assessment and management of climate-related risks and opportunities and publication of an annual TCFD report on a publicly available website. The requirements fall under four broad headings used by the TCFD of: governance, strategy, risk management, and requirements to select and calculate climate-related metrics and to set and measure performance against targets. In summary, trustees must:

	Trustee essentials	Top tips
Governance	Establish and maintain, on an ongoing basis, oversight of the climate-related risks and opportunities which are relevant to the scheme. Trustees must also establish and maintain processes to satisfy themselves that persons undertaking governance on their behalf (and/or who advise or assist the trustees in respect to governance) are taking adequate steps to identify, assess and manage climate-related risks and opportunities which are relevant to the scheme.	• Allow appropriate time and ongoing training to ensure sufficient understanding of climate issues. • Consider the roles and responsibilities within the trustee board for climate-related issues. • Consider how processes for the selection, review and monitoring of the scheme's asset managers takes account of climate change issues. • Consider recording governance structures in a climate policy or governance framework document in order to evidence approach from 1 October 2021 (or 1 October 2022 for schemes with £1bn or more of assets).
Strategy	Identify and assess, on an ongoing basis, the impact of climate-related risks and opportunities which they consider will have an effect over the short, medium and long term on the scheme's investment strategy.	• When implementing a scheme's investment strategy, asset managers should be assessed on the extent to which they address climate risk and take advantage of related opportunities. • Where stewardship activities are delegated to asset managers, trustees should familiarise themselves with the managers' stewardship policies in relation to climate-related issues, ensure these are in line with trustees' climate-related investment beliefs, and hold their managers to account in relation to their engagement activities and voting record on climate issues.
Scenario analysis	As far as they are able, undertake scenario analysis assessing the impact on the scheme's assets and liabilities and the resilience of the scheme's investment strategy for at least two scenarios.	• Undertake scenario analysis in the first scheme year in which the regulations apply (for schemes with a 31 December year end, this might mean that scenario analysis has to be carried out within three months of the regulations applying). • Ensure sufficient time is allowed for training to understand the models used and be clear on its

TCFD: next steps for £1bn plus schemes cont.

Strategy & Scenario analysis cont.		application for each "sectionalised" section in a DB scheme and for each "popular" arrangement in a DC scheme.
Risk management	Establish and maintain, on an ongoing basis, processes for identifying, assessing and effectively managing climate-related risks which are relevant to the scheme and integrating them into the trustees' overall risk management.	• Revisit risk registers and add climate-related risks as a consideration. • Consider risks in both the scheme's investments and (in the case of DB schemes) funding and sponsor covenant. • Consider how often to revisit the assessment of climate-related risks.
Metrics	Select certain climate-related metrics to monitor and report on an annual basis. The current requirement is that such metrics should include at least one absolute emissions metric and one emissions intensity metric, as well as one additional climate change metric. However, amendments to the Regulations have been proposed by the DWP in a consultation launched on 21 October 2021. Assuming these come into force, trustees will be required to additionally obtain and report a fourth "portfolio alignment metric" describing the extent to which their investments are aligned with the goal of limiting the increase in the global average temperature to 1.5°C above pre-industrial levels. In relation to all emissions-based metrics, trustees will be required, as far as they are able, to use Scope 1 and 2 GHG emissions in the first scheme year they are subject to the requirements, and then Scope 1, 2 and 3 in all subsequent years.	• Emissions-based metrics provide some visibility into the past carbon exposure of assets at a fixed point in time but may provide little insight into possible future exposure. Trustees may wish to consider the limitations and backward-looking nature of such metrics. • Proposed new requirements to obtain and report on a fourth "portfolio alignment metric" raise a number of questions in terms of accessibility, coverage and quality of the underlying data. The proposals provide trustees with a wide degree of flexibility in terms of the methodology to be used given that the market has not yet coalesced around a single approach, and methodological standardisation is yet to emerge. Trustees will need to allow time to consider how they are going to approach this. • Metrics chosen should be those helpful when making informed decisions about financial risks and opportunities in portfolios. Trustees should take care not to get carried away with metrics and target setting for its own sake.
Targets	Set a non-binding target for the scheme in relation to at least one of their chosen metrics and, so far as they are able, measure and report performance against it on an annual basis.	

Timings for £1bn plus schemes

Trustees of schemes with relevant assets (net assets excluding bulk annuity and individual annuity contracts) ≥£1bn:

- must meet the climate change governance requirements for the current scheme year from 1 October 2022 to the end of that scheme year, and
- must publish the report on a publicly available website within 7 months of the end of that scheme year, and a link must be included in the Annual Report and Accounts for that scheme.

Please see our Guide for a series of timelines for DB and DC schemes of different sizes and with scheme year ends of either 31 December or 31 March.

Schemes whose net assets are £1 billion or more should now be gearing up to be compliant by 1 October 2022. The Regulations not only set out what trustees of schemes in scope must disclose, but also prescribe specific actions that must be undertaken first. Trustees of mid-sized schemes should be starting to consider these actions now and making sure that climate-related risks and opportunities are integral to their usual governance procedures.

Residual risks cover

Larger buy-in and buy-out transactions increasingly involve trustees paying an additional premium for some elements of “residual risks” cover. In this article, we look at what this cover encompasses, where its limitations are and why trustees and sponsors should think very carefully before pursuing some forms of residual risk cover.

The need for residual risks cover arises because the scope of a buy-in or buy-out’s cover is linked to the quality of the data and benefit specification. A member or benefit that is not described in the data or benefit specification will not be covered, so a member who can demonstrate that the trustee should have paid something different to what is insured may still have a claim against the trustee or sponsor. We explored this further in our September briefing.

Residual risks cover is additional insurance cover for specific types of risk which could give rise to a difference between what has been insured and the member’s legal entitlement. Residual risks cover is typically an add-on to a bulk annuity policy (unlike trustee run-off cover which is offered by a third party, general insurer) but it is not offered by all of the bulk annuity providers and is typically only available for larger transactions. Cost will vary, but the usual range is typically an additional 0.5% to 2% of the premium.

“Residual risks” has been referred to within the market as “all risks” or “data risks” cover. “All risks” has, rightly, fallen out of fashion because it is highly misleading. Residual risks cover will not cover all risks associated with a pension scheme. It is perhaps better to think of this type of cover in the same way one might consider the additional, optional heads of cover that can be purchased with home or car insurance.

The most common elements of residual risks cover are:

- Data risk – the risk of incorrect member data in the scheme record
- Missing beneficiaries – the scheme’s administrative record has missed a member
- Benefit errors – scheme benefits have been misinterpreted or mis-administered

It may be possible to negotiate full residual risks cover, but from the trustee perspective, it is very important to understand that the residual risks proposition presented at the outset of a transaction is contingent. The cover the trustee/sponsor will eventually pay for will ultimately be subject to potentially significant exclusions and exceptions.

Structural limitations

In the first place, the scope of residual risks cover is structurally limited by reference to the bulk annuity policy to which is it linked. In a partial buy-in scenario (where only a part of the member population has been secured), the scope of additional cover will need to be linked to the population in question. For example, a policy relating to a scheme section would not be expected to cover risks relating to another section. In any event, bulk annuity providers will not be prepared to cover members who transferred out, or commuted, prior to the transaction, and for the same reason will carve out winding-up lump sums and pension increase exchange exercises etc. More fundamentally, it’s important to note that no bulk annuity provider will cover costs relating to trustee professional fees and expenses. Bulk annuity providers are in the business of writing annuity type cover for members; they are not set up to cost and underwrite the trustee’s expenses associated with unpicking any errors that emerge.

Residual risks cover cont.

Standard exceptions

Insurers will also typically look to build in a range of potentially significant exceptions arising either from their standard practices, or, which relate specifically to checks that they will need to do on the scheme.

Standard exceptions may include:

- Document execution – the risk that a scheme document has been improperly executed
- Change in legislation – the risk that the law has changed
- Undisclosed documentation – potential member claims based on any document that has not been disclosed to the insurer

These carve-outs (especially undisclosed documentation) are potentially very material, particularly given the long and often complex history of many final salary pension schemes.

Due diligence

The final type of exclusion arises from circumstances particular to a scheme identified through due diligence. It should not be a surprise that if an insurer is asked to take on potentially significant additional risks, they will carry out thorough due diligence to understand those risks. The lawyers tasked with carrying out this exercise will ask for comprehensive disclosure of scheme documentation (including deeds, booklets, communications, historic minutes, previous legal advice, etc) and will be instructed to look for problems. Even in well run schemes, they are likely to find them.

Although insurers' approaches vary and, with the right leverage, negotiation may be possible, the starting position is that if an insurer identifies a risk as part of their due diligence exercise, they will either carve that risk out of their cover or price it in on the most cautious basis. To give an example, it might emerge that a population of members (due to poorly worded member communications or an ambiguously worded rule) had a potential claim to more generous pension increases. The easiest thing for the insurer to do would be to exclude the identified issue from the scope of cover. Alternatively, the insurer could price the benefit on the basis of the more generous increase. Neither outcome is particularly desirable from a trustee or sponsor perspective.

Trustees considering residual risks cover should do so with their eyes open. Due diligence is likened to digging up the drains: the process is costly, apt to lead to delays and you will not necessarily like what you find. Trustees, as fiduciaries, may well find themselves under a duty to investigate whatever is found. Not all such issues are ultimately material. The fact that it may be difficult to positively prove that a resolution was properly passed in the mid-1980s is not the same as definite evidence that it was not properly passed. However, a legal analysis will fix on such technical uncertainties.

Other options

Residual risks cover is not the only option for trustees and sponsors. In our March briefing we will explore run-off cover and company indemnification.

Legal update

Net zero

Pensions schemes are coming under increasing pressure to make net-zero commitments.

On 11 October 2021, Make My Money Matter ("MMMM") published analysis showing that over 70 of the 100 largest UK pension schemes have yet to make robust net-zero commitments, adding more pressure on schemes to make such commitments.

MMMM have however acknowledged that progress has been made with an estimated £800 billion of UK pension money now in schemes robustly tackling climate change issues.

On 8 October 2021, HSBC's pensions scheme announced its commitment to achieve net-zero GHG emissions across its £36bn DB and open DC assets by 2050 or sooner. The commitment includes targeting a real economy emissions reduction interim target of 50% by 2030 or sooner for its equity and corporate bond mandates. The £13bn TfL Pension Fund also announced, on 1 October, their plan to achieve a 55% reduction in its carbon emissions by 2030 at the latest and a 100% reduction no later than 2045 as against the 2016 baseline.

In addition, on 30 September 2021, the Committee for Work and Pensions published a report, ahead of the COP26 climate conference, on building consensus on the roles of pension schemes in tackling climate change. As part of the recommendations the committee encourages "schemes to consider setting net zero targets and recommends that TPR should provide guidance".

This is an increasingly developing area, and trustees will need to consider carefully how their net zero commitments align with their legal and fiduciary duties. We expect there will be more to come in 2022.

Climate change and investment – new consultation

On 21 October 2021, the DWP published a consultation seeking views on proposals to require trustees of larger occupational pension schemes (schemes with £1bn or more in relevant assets), authorised master trusts and authorised collective money purchase schemes to measure and report on the alignment of their investment portfolios with Paris Agreement targets. It also consults on new guidance in relation to SIPs and implementation statements.

Under the proposals, with effect from 1 October 2022, trustees of these schemes would be required to calculate and disclose a portfolio alignment metric describing the extent to which their investments are aligned with the goal of limiting the increase in the global average temperature to 1.5°C above pre-industrial levels. Where the requirement to select a portfolio metric comes into force part way through a scheme year, it would apply in the part scheme year that runs from 1 October 2022.

The consultation also seeks to address "deficiencies in scheme governance" in relation to stewardship and voting by proposing new draft statutory and non-statutory guidance which sets out stewardship and ESG best practice in relation to SIPs, and the DWP's expectations across the implementation statement.

The consultation closes on 6 January 2022. For more detail, see our Alert.

Briefing paper on Pension Scheme Investments and Climate Change

On 7 October 2021, the House of Commons Library updated its briefing paper on Pension Scheme Investments and Climate change, which looks at the requirements on pension schemes to take account of the risks and opportunities of climate change in their investments and report on how they have done so (see our Alert).

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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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