Sackers

Finance & investment briefing

March 2022

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

Finance & investment briefing

March 2022

In this issue

Sweeping up the left-overs – trustee protections and residual risks in buy-out 3

Legal update 5

Abbreviations

CSDR: EU Central Securities Depositories Regulation (909/2014)

DC: Defined contribution

EEA: European Economic Area

ESG: Environmental, social and corporate governance

FCA: Financial Conduct Authority

IGC: Independent Governance Committee

LDI: Liability-driven investment

OTC: over the counter

PIE: pension increase exchange

PLSA: Pensions and Lifetime Savings Association

TPR: The Pension Regulator

WPC: The Work and Pensions Committee

Finance & investment focus

"Welcome to our first finance and investment briefing of 2022. I hope the new year has been treating you well and we hope to meet with more of you in person over the coming months.

In this issue, as part of our series of articles about the risk transfer market, we take a look at a subject which is important for trustees and sponsors who are embarking on a scheme buy-out: how can trustees approach the residual risks or "left overs" which are not dealt with under a simple bulk annuity contract? On pages 3-4 we consider the trustees' position by examining two scenarios of concern, discussing what options are available to trustees together with questioning how material the risk really is. For previous articles in this series please see our September 2021 and December 2021 briefings. If you have any questions on the issues raised please speak to your usual Sackers contact.

We catch-up on recent legal developments on page 5, with key themes focusing on climate change. We expect this area, along with other ESG issues, to remain high on the agenda this year."

Paul Philips
Partner, finance & investment group

paul.philips@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

Sweeping up the left-overs – trustee protections and residual risks in buy-out

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

A bulk annuity transaction is a transaction about risk. In our September 2021 briefing, we noted that bulk annuity providers do not take on all the risks associated with a pension scheme; there will always be left-overs which remain with the trustees after buy-in and buy-out. It is possible to pay an additional premium to some bulk annuity providers to purchase residual risks cover (see our December 2021 briefing). While this may add materially to the risks an annuity provider takes on, it will never amount to "all risks" (though that label has sometimes been misappropriated).

The trustee position

In the context of buy-out and winding-up a scheme, the trustees' obligation is primarily to the members, and ensuring the members' benefits are secured correctly. However, it is a nearly inevitable consequence of this process, that trustees will transition from a situation where their actions are indemnified out of the assets of the scheme (underwritten by a sponsoring employer), to one where the scheme has divested itself of all its assets, and wound up. If a member were to complain, the trustees (individuals or directors of a company) would have no assets to pay for professional advisers to meet the claim or, ultimately, to put the member right if the claim is valid.

Finding a home for the risk

The two main scenarios of concern here are:

1. that the trustees have mistakenly secured member benefits which do not match the member's legal entitlement. For example, perhaps a former executive member was promised an uplift to their pension which wasn't reflected in the policy terms
2. another quite different scenario might be a complaint by a member about the trustees' conduct. Perhaps the trustees have worked with the sponsor on a PIE exercise, which the member has chosen now to challenge.

Under a bulk purchase annuity

The starting position is that a buy-out policy will only cover the benefit described in the policy. In the above scenarios, the member's complaint has arisen because they believe the policy does not correctly reflect their benefit, so by definition the insurer is not going to be on the hook for what the member believes they are entitled to.

If the trustees have negotiated residual risks cover from their bulk annuity provider, the question becomes whether the terms of that additional cover would capture these particular complaints. It will of course depend on the circumstances, but there is a good chance that the two types of complaint described would not be caught.

In the case of the former executive claiming an uplift (scenario one), presumably he is able to evidence his entitlement with some written documentation. If this offer was contained in documentation provided to the insurer as part of the residual risks' due diligence process they might be prepared to adjust the benefit. However, in those circumstances you would think that both the trustees and the insurer would have identified the mismatch in reviewing the documents and adjusted the benefit. It may be more likely that this complaint has arisen because these records had been misplaced, in which case they would not have been disclosed to the insurers. Insurers will generally seek to exclude liability arising from documents they have not seen and might therefore exclude this complaint.

The second scenario relates to a complaint about the way the trustees have handled a PIE exercise. This is a very standard exclusion from residual risks cover.

In both examples, it's important to stress that in neither case would a typical residual risks policy provide cover for the trustees' own legal costs and expenses. This is because bulk annuity policies cover member benefits, not the cost and expenses of the trustees.

Sweeping up the left-overs – trustee protections and residual risks in buy-out cont.

Other options

Company indemnity	Our view is that trustees on the road to buy out should always seek to make a broad company indemnity a pre-condition. The indemnity should be from a substantial company, uncapped and of unlimited duration. Of course, an indemnity is only as good as the company offering it, and not all trustees have the luxury of this option. It is also very difficult to address the risk of a company's circumstances changing, either through declining fortunes or corporate activity. The indemnity might be rock solid on day one, but what about five or ten years down the road?
Run-off cover	Many trustees often therefore also seek run-off cover from a third party general insurer. To stress, this is a different and additional insurance policy to the bulk annuity contract, written by a general insurance provider specialising in this sort of business. The buy-out policy will ultimately be in members' names; the run-off policy will be for the benefit of the trustees specifically. Run-off cover is not mutually exclusive with a company indemnity. In an ideal world, the trustees will have both and, indeed, from the corporate perspective this may be the more desirable arrangement because the run-off cover mitigates the risk of a company indemnity being called upon. For many years, run-off cover was a standard and fairly predictable product. In recent years, the market has been in a state of considerable flux and policies of this sort are currently harder to obtain, more expensive and on more restrictive terms. Trustees can expect to see hard caps on cover and term limits, as a standard now.

How material is the risk, really?

Whilst it is easy to become alarmed it is very important to keep the scope of these left-over risks in perspective. Schemes that buy out are typically mature, and will have had many pensions in payment over decades. For a well-run scheme, the reality is that any likely claims should have been flushed out. Pensioners tend to focus on the value of their benefit most acutely when they first come into payment, and the passage of time tends to diminish the likelihood of a claim.

Similarly, the process of buy in, and then buying out, typically involves extensive checks on the scheme data and, to some extent, the documentation. Schemes can mitigate their risk by focusing on this checking process, particularly in terms of the legal documentation which is often a secondary focus as compared to the data.

There are also material obstacles to successfully prosecuting a claim once the scheme is wound up. Trustees are typically the subject of broad exonerations and discharges, both statutory and under deed. Similarly, many trustees are incorporated and will therefore benefit from the considerable protections afforded by a corporate structure.

These factors should be of real comfort because, if a claim were brought, its chances of success may be low or very low. Of course, a claim does not need to be a strong one to be made, and the trustees will want to consider how they would meet the costs and expenses associated with a claim, even one unikely to succeed.

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

Legal update

The European Central Securities Depositories Regulation

New requirements in force 1 February 2022

The CSDR has the objective of harmonising practices and improving settlement safety and efficiency in central depositaries in the EEA. Provisions relating to allocations, confirmations and penalties for failed and late settlements came into force on 1 February 2022. The CSDR also envisaged a mandatory buy-in regime, but the implementation of that has been postponed.

Whilst the UK is not implementing the CSDR, UK investors can be affected if they settle transactions on European regulation central depositaries. It is therefore likely that custodians will want to look at introducing relevant provisions into their operating procedures for clients systems that are designed to work with the CSDR and to help avoid failed and late settlement, and to deal with any penalties which arise under the new system.

FCA publishes policy on enhancing climate-related disclosures

Enhancing climate-related disclosures

On 17 December 2021, the FCA published a policy statement on enhancing climate-related disclosures by asset managers, including FCA-regulated pension providers. With a view to providing greater transparency and consistency, they will be required to disclose how they take climate-related risks and opportunities into account in managing investments. The rules came into effect from 1 January 2022.

PLSA "Made Simple" guides

New PLSA guides

The PLSA has published two new "Made Simple" guides:

- the ESG guide sets out relevant terms, and explains ESG as a concept and how it can be integrated into the investment strategy and oversight of pension schemes. The PLSA also puts forward a template ESG policy for schemes, providing a suggested checklist of steps to take to become "ESG-compliant"
- "Cost transparency made simple" aims to give "a good working knowledge of the various costs associated with managing a pension scheme", so trustees can make "more informed decisions" on behalf of their membership.

TPR publishes guidance on climate-related risks and opportunities

TPR publishes final guidance

On 16 December 2021, TPR published the final version of its guidance to help trustees of certain schemes meet tougher standards of governance and reporting in relation to climate-related risks and opportunities (see our Alert), following consultation last summer. In a consultation response, published alongside the guidance, TPR tells trustees they must ensure the advice they get from external experts is "relevant and helpful".

In addition, an updated version of its monetary penalty policy was published, to include an "Appendix 3: Breaches of the Climate Change Governance and Reporting Regulations", alongside some minor tidying changes. Changes related to other aspects of the Pension Schemes Act 2021 are still awaited.

TPR states that it will contact trustees of schemes that may have moved into scope of the rules since the last valuation to ensure they are aware of their duties.

WPC publishes response to pension stewardship and COP26 report

Initiatives for pension schemes in achieving the goals of the Paris Agreement

The WPC published its Fourth Report of Session 2021–22, Pension stewardship and COP26, in September 2021. On 17 December 2021, the Government's Response to the WPC's recommendations was published. In its response, the government sets out its initiatives in relation to the role of pension schemes in achieving the Paris Agreement goals. This includes the climate-related disclosures for occupational pension schemes required by the Occupational Pension Schemes (Climate Change Governance and Reporting) Regulations 2021.

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

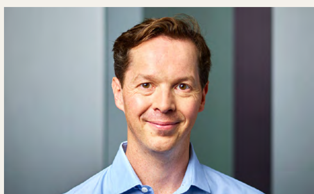
Key areas of expertise include: longevity transactions, funding negotiations, risk transfer transactions, LDI, fiduciary management and governance.

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, climate change risk, responsible and impact investing.

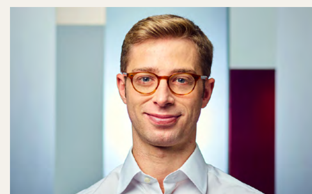
Jacqui Reid
Partner
D +44 20 7615 9550
E jacqui.reid@sackers.com

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, DB consolidators, 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 developments affecting retirement savings by signing up to our free publications on www.sackers.com/knowledge/publications. These include 7 Days, our weekly round up, Alerts where topical issues in pensions are covered in depth and Briefings which summarise essential issues in pensions.

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 February 2022