Sackers

Finance & investment briefing

June 2022

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

IGC: Independent Governance Committee

LDI: Liability-driven investment

OTC: over the counter

SIP: Statement of Investment Principles

TPR: The Pensions Regulator

Finance & investment focus

"The last quarter has been challenging for investors with rising interest rates, rising inflation and the impact on markets of world events including Russia's invasion of Ukraine and the impact of further Covid-19 lockdowns in China.

From an investment perspective, some schemes will be sheltered from these issues to a greater or lesser extent by hedging and other derisking transactions. In this issue, we reflect on Sackers involvement in the risk transfer market during 2021. Please look out for our risk transfer guide, which will consider developments in more detail.

We also discuss those factors which trustees should have in mind if considering establishing a policy of excluding certain investments from a pension scheme's portfolio, something which has been at the front of many trustees' minds in recent weeks when looking at their scheme's exposure to Russia.

On a brighter note, we are looking forward to seeing many of our clients and pensions industry colleagues at the Pensions and Lifetime Savings Association's Investment Conference in Edinburgh at the end of May. Do come and meet us at our stand in the conference hall."

Ralph McClelland
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Risk transfer highlights 2021

£4.4bn

Total bulk annuity transactions for 2021

We advised on 24% of the bulk annuity market over the last three years

Five transactions on or above

£300m+

Seven transactions on or above

£100m+

We advised on over

14%

of the bulk annuity market in 2021

We act for

40

of the top 200 pension funds in the UK (source: Pension Funds Online)

Advised on over 55 bulk annuity transactions

totalling over £29bn+

in the last 5yrs

The biggest annuity deal in the market in 2021 and one of the largest single-transaction full scheme buy-outs ever undertaken

£2.2bn

Our biggest bulk annuity transaction

Crown Holdings, Sponsor of The Metal Box Pension Scheme, October 2021, Buy-in to Buy-out, PIC

We advised Crown Holdings on a full scheme buy-out with residual risks moving to buy-out within one month of buy-in. This transaction included numerous innovative solutions to issues that ordinarily bog down a large scheme buy-out including:

- GMP equalisation/conversion
- residual risks cover
- funding structure between the company and pension scheme to manage the realisation of a portfolio of illiquid investments.

We are currently advising trustees on three longevity transactions

Other key transactions of 2021 over £100m on which Sackers advised

£620m

Undisclosed, December 2021, Buy-out

£350m

Air Canada (UK) Pension Trust Fund, December 2021, Buy-in

£310m

Reuters Supplementary Scheme, September 2021, L&G, Buy-in

£300m

Undisclosed, February 2021, Buy-out

£250m

Undisclosed, December 2021, Buy-in

£236m

Signet Group Pension Scheme, July 2021, Rothesay Life, Buy-in

Navigating investment exclusions

Current events continue to test the way in which pension scheme trustees' fiduciary obligations relate to their investment powers. The invasion of Ukraine has naturally led many trustees to consider the extent to which their schemes are exposed to Russia, either directly or indirectly, and whether trustees should have an outright prohibition on investment in certain Russian entities.

This has brought into sharper focus the extent to which trustees can adopt a policy of excluding certain assets and the reasons for doing so.

Divestment and exclusion

There are already many potential investments which pension trustees have considered excluding from their portfolios, including, for example, weapons, pornography, tobacco and coal. Everyone will be able to think of other industries or sectors which could be added to such a list.

In general, pension scheme trustees have tended to take the view that engagement with the companies they invest in (via the scheme's investment managers) is the most effective tool for changing behaviour. However, in some cases, engagement becomes impossible or has reached its limits and/or the risk of holding the asset outweighs the benefits and so a policy of divestment and exclusion is considered.

The key, then, is establishing the legal basis for exclusion. The law generally prohibits trustees from making political statements or imposing their own moral view on the assets entrusted to them. Screening out companies or industries on purely ethical grounds (as opposed to financial) has always been legally problematic.

Views of the scheme's members

While trustees cannot impose their own moral views, there is a potential legal route based on the views of the scheme's beneficiaries. This sounds superficially attractive but, in practice, it is probably the trickiest to implement from a legal point of view. There remains some debate about the precise nature of the legal test but the law sets the bar very high. Not only is the support of the membership as a whole required, but any exclusion must be shown not to incur a risk of financial detriment to the pension scheme.

Safely meeting these tests presents a significant, and probably insurmountable, hurdle for most pension schemes. An exception may well be arguable for pension schemes in the charity sector. For example, it seems unlikely trustees could be criticised for avoiding investments in alcohol if the employer (and the pension scheme's members) is wholly committed to a charity whose aims are preventing or curing liver disease.

So how can trustees navigate through this?

In practice, trustees will need to base their investment decisions on "financial factors".

While the distinction between financial and "non-financial" factors is not always a bright line, the key is that trustees must base their investment decisions on what is financially relevant to the pension scheme's purpose of paying pensions at the time the investment decision is made. There are a number of ways in which this might work.

Navigating investment exclusions cont.

Risk/return

Is there a financial justification for a specific exclusion?

If an adviser can confirm that there is an under-priced regulatory or reputational risk within sector X or Y and that can be shown to present a financial risk to the trustees' investment in the long term, is that sufficient for disinvestment? A number of trustees have recently taken this position, for example, in relation to companies involved in thermal coal extraction, where there may be concerns as to those companies' assets becoming stranded.

Even here, however, trustees will still need to square a few circles:

- how legitimate is it for the trustees themselves to make that judgement call? Where delegation is made to an investment manager to actively manage a portfolio, a specific decision to limit the manager's discretion to decide what is in the best financial interests of the portfolio needs some careful thought. Trustees may need to test their rationale against a market view
- in practice, divesting a handful of stocks may make little difference to the overall portfolio. So, the "financial" rationale for the exclusion could look rather thin.

It may well be the case that issues that start out as non-financial, such as public censure in relation to a particular company, may quickly become financial, where this translates into reputational damage or reduced customer demand. Consequently, a financial investment case for divestment may often be found to mirror a non-financial issue.

Exclusion on broader financial grounds?

Taking coal as a specific example of a sector which trustees might have decided to exclude on financial risk/return grounds (see above), there may also be a broader way of looking at the financial rationale. Rather than make a decision to divest specifically from a particular sector, trustees could decide, on a macro level, that their investment strategy should, for example, prefer industries aligned with the transition to a low carbon economy. The trustees may have a strong conviction in the financial merits of such an approach. After all, companies that are not well aligned with that transition may run a higher financial risk in the long term as national governments legislate to seek to meet targets under the 2015 Paris Agreement. Taking this in the round, it is not too much of a stretch for trustees to identify that there may be some companies that can, by definition, have no place in such an approach. Thermal coal is excluded not for its own sake, or even in isolation as a financial decision, but as a natural consequence of a broader financial approach.

This may sound like it is splitting hairs, but it has particular force when allied with a similarly motivated engagement policy. If the trustees believe in a strong engagement policy aimed at applying asset owner pressure on companies to align with Paris goals, they might reasonably take the view that a divestment threat will be a useful "stick" to beat such companies with. And, taken to its logical conclusion, some businesses may simply be beyond the pale. So, if the trustees have a financially motivated belief in engagement and engaging could only ever be fruitless in some areas, there is a consequential divestment.

Navigating investment exclusions cont.

Non-directed exclusion

This may, in practice, be the most common exclusion framework adopted by trustees since it is potentially achieved without an express trustee decision. Trustees may have selected a particular manager or fund which has attractive, financially based ESG credentials. The trustees may select such a fund based on a financially motivated conviction in the manager's overall approach. But, on closer inspection, the manager may be found to be operating an exclusion policy of their own.

Provided the decision to appoint that manager was properly taken (ie for financial reasons in the round, rather than on the basis of the manager's exclusion policy), it can mean exclusion by the back door. While this isn't really the positive application of an exclusion by trustees, and does not allow trustees to have any input on specific exclusions, it might, in practice, create a legal basis for exclusion without trustees having to make difficult decisions of their own.

Establishing the legal basis

In practice, when positively considering an exclusion policy, trustees will need to:

- engage with their investment consultants and managers to see what is being done from an engagement/stewardship perspective. Trustees should seek to understand how investment managers are engaging in relation to relevant issues and consider whether this is aligned with the trustees' policies. Is exclusion the correct approach?
- recognise that a financially motivated divestment or exclusion policy will usually be easier to implement than a non-financially motivated one, although the financial basis will still need to be carefully considered and articulated. In either case, investment and legal advice will need to be taken
- consider whether, in practice, exclusions might already be being applied by their fund managers
- address practical implications – any exposures within pooled funds and passive mandates may not be easily capable of exclusion without exiting the particular fund or adopting a different index. Trustees should speak with the relevant managers to understand what is practically achievable and may need to draw a distinction between existing and future investments.

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

Legal update

TPR sets out expectations for trustees in respect of the Ukraine conflict

TPR has published a statement on the conflict in Ukraine. It expects trustees to talk to their advisers about any action which they may need to take, depending on their scheme's investments, risk management or employer covenant exposures.

Given the "potential heightened risk" of cyber attacks and financial crime in the current environment, TPR also expects trustees to consider whether their cyber safety procedures and other related processes remain adequate or need to be revised.

TPR publishes further climate-related guidance

TPR published an Appendix to its climate change guidance on 23 February 2022, which is intended to illustrate the types of steps that trustees could consider taking in respect of their climate-related governance and reporting duties (see our Alert).

The Appendix seeks to address areas where specific requests for more information and examples were received by TPR from the pensions industry during its consultation on its guidance on governance and reporting of climate-related risks and opportunities.

The example set out in the Appendix aims to help develop trustees' understanding of how they might approach implementing the climate change reporting requirements at a practical level. However, TPR makes clear that it is not intended to be used as a checklist. It expects trustees to take appropriate advice and ensure that the approach they adopt to meeting the requirements of the climate change regulations is suitable for their scheme.

High Court approves investment policies aligned to the Paris Agreement

On 29 April 2022, the High Court approved the investment policies of both the Ashden Trust and the Mark Leonard Trust that had chosen to identify the investments that their charities should invest in based on whether they are aligned with the Paris Agreement (the principal goal of which is to limit global warming to well below 2°C above pre-industrial levels).

Reinterpreting previous case law from 1992, Mr Justice Green found that the trustees could legitimately pursue investment strategies with a specific aim of not conflicting with the charitable purposes of the charities in question, which included "environmental protection and improvement" among their objects. The Charities Commission is in the process of updating its guidance for trustees.

Whilst not directly applicable to pension trustees, the case contains some helpful clarification of trustee duties generally.

DWP consultation on Facilitating Investment in Illiquid Assets

On 30 March 2022 the DWP published a consultation which, among other matters, seeks views on proposals and draft regulations to improve the accessibility of illiquid assets for DC pension scheme investment.

The DWP proposes to:

- amend the SIP requirements to ensure that DC schemes, and the DC section of hybrid schemes, disclose and explain their policies on illiquid investments
- require trustees of DC and hybrid schemes with over £100m in total assets to publicly disclose and explain their default asset class allocation in their annual Chair's Statement
- amend the current restrictions on employer-related investment for master trusts with 500 or more active participating employers.

The consultation, which closed on 11 May 2022, also includes the Government's responses to its:

- consultation on "Enabling Investment in Productive Finance"
- call for evidence on the "Future of the defined contribution pension market: the case for greater consolidation".

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.

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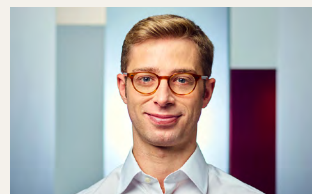

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