Sackers

Finance & investment briefing

December 2023

Sackers finance and investment experts take a look at current issues of interest to pension scheme investors

Finance & investment briefing

December 2023

In this issue

Troubleshooting – the buy-out issues affecting schemes now 3

Legal update 5

Abbreviations

CDC: Collective DC

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

PLSA: Pensions and Lifetime Savings Association

PRA: Prudential Regulation Authority

TPR: The Pensions Regulator

TSF: Taskforce on Social Factors

WPC: Work and Pensions Select Committee

Finance & investment focus

"Welcome to the final finance & investment briefing of 2023.

The risk transfer market continues to be extremely busy, and this seems likely to be a continuing theme well into 2024. In this briefing, we continue our series of articles examining the process of moving from buy-in to buy-out. On pages 3 – 4 we focus on some of the tricky issues faced at buy-out including how to address illiquid assets, deal with surplus and cover any residual risks.

In the legal update section, we provide an overview of recent developments including the new consultation published by the DWP's Taskforce on Social Factors, the new "Made Simple" guides from the PLSA on buy-ins and buy-outs and the recent TPR speech on delivering investment returns for pension savers.

For those still working through climate risk reports, we touch on the recent TPR activity which serves as a reminder of the importance of checking that those reports can be accessed by members within the required timescales.

We wish you a restful holiday period and look forward to seeing you in 2024."

Stuart O'Brien
Partner

stuart.obrien@sackers.com

Electronic format

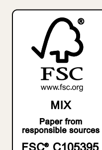
You can access electronic copies of all our publications at:

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



Troubleshooting – the buy-out issues affecting schemes now

Over the last few years, we have seen a rapid move from a risk transfer market dominated by buy-in transactions to one dominated by buy-outs. For trustees, a buy-out will be their final act for members, and it is one they need to get right.

To recap, a buy-in involves securing a portion of scheme liabilities as a matching asset and running the scheme on. A buy-out involves securing all the members' benefits with an insurer and winding the scheme up. In a buy-in scenario, the trustees' role may not change very much; scheme administration, investment activities, the funding cycle, member engagement and the company/trustees funding relationship may be largely unchanged. At buy-out, however, the trustees' focus shifts to the endgame and a number of specific issues can arise.

Here, as part of our series of articles on the journey to buy out, we highlight three current, tricky issues to watch out for.

1 Illiquid assets

Premium

In some cases, insurers have been reluctant to accept schemes' illiquid or alternative asset portfolios as part of the buy-out premium. And although others may be prepared to look at temporary deferral of a portion of the premium to cover such assets, this is by no means guaranteed. Perhaps inevitably, therefore, it is the larger schemes that will be in a stronger bargaining position when it comes to these discussions with an insurer.

Some schemes have found themselves with buy-out pricing at an affordable level much earlier than expected. This can mean that an allocation to illiquid asset classes (private equity or credit, property or other illiquid alternatives) is a problem when it comes to paying the premium. This comes at a time when schemes with LDI portfolios were pushed into a fire-sale of their liquid assets following the LDI crisis caused by the September 2022 mini budget.

Secondary sales

For some schemes, a pre-emptive sale of their illiquid portfolio on the secondary sales market is the answer. This may involve accepting sometimes heavy haircuts on the assets, and assumes that a secondary purchaser can be found. Trustees and sponsors should be aware that secondary sales processes can be slow, and for larger portfolios are material projects in their own right.

Sponsor

Another option is to look to the scheme sponsor to provide liquidity to enable the transaction to go ahead. This can take the form of a loan, though trustees should be aware of the applicable restrictions on borrowing and need to think carefully about the project cycle, the need for balancing premiums, and transaction expenses.

2 Surplus

After so many years of deficits, surpluses have become a reality again. On the face of it, this would seem to be a good thing, but the reality is more complex.

Trustees/sponsors will want to consider:

- the balance of power in the scheme rules: are the trustees required to augment, or is the position more nuanced? In any event, trustees need to go through a proper decision-making process at the right time, including an analysis of the relevant factors
- if a member benefit augmentation is under consideration, how will that be achieved in the context of a buy-in? A relatively small surplus may be difficult to translate into a meaningful up lift, and timing may be an important factor to manage, and
- the tax implications arising on any refund of surplus will be an important consideration.

As ever, prevention is better than cure. If contribution/premium structure can be managed to avoid a surplus arising in the first place, this may be the best outcome for all.

3

Residual risks

There are always risks that do not transfer to the insurer on a buy-in or buy-out.

A buy-in is an insurance policy between the trustees and insurer in which the liabilities are carefully defined. It is not uncommon to talk about an insurer taking on the pension scheme's liabilities, but it would be more accurate to say that the insurer takes on liability for the data and benefit specification set out in the contract. There may be differences between that data and benefit specification, and the members' legal entitlement. The risks associated with any differences do not pass to the insurers, unless it has been specifically agreed that they will (ie "residual risks cover", see below).

Examples include: incorrect final salary information, a discrepancy between administrative practice on pre-1997 increases and the rules, historic issues around document execution formalities, questions around equalisation etc – anyone who's worked in pensions for any length of time could come up with further examples. In addition, there is always the possibility of changes in the law (either through legislation or case law) or complaints about trustee conduct.

For a mature scheme, with a long history of unproblematic member retirements, these risks should be very low. It is, however, difficult or impossible to completely rule out the possibility of a claim. Some schemes will have known "skeletons in the closet" (pension increases and/or sex equalisation are favourites), but clearly trustees and their advisers don't know about the issues they don't know about.

In practice, trustees and their sponsors will be looking at three options for the allocation of these residual risks:

Sponsor indemnity

A broad indemnity from the sponsor at wind-up for the benefit of the trustees. Clearly, the sponsor must be willing, and the trustees will need to take a view on the "covenant" for this purpose.

Run-off cover with a third party general insurer

A policy of insurance for the benefit of the trustees, similar to a corporate "directors' and officer's" policy. This will be capped in amount and for a limited duration (typically not more than 15 years).

Residual risks cover from the buy-out provider

Larger schemes may be able to agree additional cover (eg for data risk), at an additional premium. Not all insurers offer this, and there will be important exceptions to the cover.

It is worth addressing this issue in detail early in the process, and ideally in enough time to negotiate effectively and carry out any additional due diligence that may be desired. If residual risks cover from the insurer is sought, significant additional work will need to be done on the data and benefit specifications, and it may be that the best outcomes will be achieved by front loading that work.

In any event, the trustees' bargaining position with a sponsor may be at its highest point before any transaction is embarked upon.

Legal update

DWP's Taskforce on Social Factors publishes guide for consultation

How to manage social factors

On 19 October 2023, the TSF published a consultation on a draft guide on incorporating social factors into investment and stewardship decision-making. The TSF was launched following the DWP's response to its March 2021 call for evidence on how schemes approach social risks and opportunities, and is intended to help support trustees and the wider pensions industry with managing social factors.

The guide makes recommendations for different stakeholders in the pensions sector, including that pension schemes should "ensure their asset managers consider social factors and integrate them into their investment strategy and stewardship". It also provides example mandate terms and questions to help monitor advisers.

The consultation closes on 1 December 2023.

WPC publishes correspondence with the PRA on DB superfunds

Continued development of DB superfund policy

In a letter published on 18 October 2023, the PRA responded to questions raised by the WPC concerning the PRA's view of DB superfunds. The response notes that the PRA would need to develop an approach to regulation and supervision of any insurance groups which were to operate both an annuity business and DB superfunds, so as to "preserve the level of protection" for insurance policyholders. The PRA has "contributed its expertise" as the Government continues to develop its DB superfunds policy.

PLSA publishes "Made Simple" guide on buy-ins and buy-outs

New guidance for trustees

On 17 October 2023, the PLSA published new guides in its "Made Simple" series, including a guide on buy-ins and buy-outs. The guide explains how trustees should consider and prepare for derisking and includes information on why trustees might consider a buy-in or buy-out, the crucial elements of each transaction, the implications for investment strategies, and tips for communicating with members.

TPR issues first climate change reporting fine

First penalty for failure to publish report

TPR has issued its first fine, of £5,000, against a pension scheme for failing to publish a report on the trustees' management and governance of climate-related risks and opportunities by the relevant deadline. TPR's report into the action taken against the scheme was published on 27 September 2023. Whilst there is a minimum mandatory penalty of at least £2,500 for failure to publish a report, TPR applied an amount above the minimum as the trustee was a corporate body and to "reflect the nature of the breach".

By way of recap, new climate reporting obligations have been phased in over the last couple of years, with larger schemes whose relevant assets are £5 billion or more, CDC schemes and authorised master trusts in scope from 1 October 2021, and schemes with £1 billion or more in relevant assets in scope from 1 October 2022. Trustees of such schemes must put in place appropriate governance arrangements to manage climate-related risks, and produce and publish a report on how they have complied with the requirements within seven months of their scheme year end date. See our Hot Topic for more information.

TPR publishes speech on delivering investment returns for pension savers

Future developments

On 25 October 2023, TPR published a speech on investment and value given by Nausicaa Delfas, the Chief Executive of TPR, to the Mansion House Pensions Summit. The speech discusses value for money, diversification and TPR's regulatory approach, setting out TPR's expectations. It also sets out forthcoming developments, including that TPR will:

- publish new guidance on investing in private markets "by the end of the year"
- update its existing investment guidance for DB and DC schemes "in due course"
- clarify in the new DB funding code that "all schemes can invest in growth assets, with much greater flexibility for open schemes and those further away from their end game"
- launch a new digital and data strategy, and
- work with the industry to develop "safe consolidation solutions".

Sackers

Contact

Sackers is the UK's leading commercial law firm for pension scheme trustees, employers and providers. Over 70 lawyers focus on pensions and its related areas, including Sackers finance and investment group, a team of lawyers who provide cutting-edge advice 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.

Hugh Gittins
Senior counsel
D +44 20 7615 9549
E hugh.gittins@sackers.com

Key areas of expertise include: risk transfer transactions (acting for trustees, sponsors and insurers), LDI, fiduciary duties and corporate projects involving funding, investment and covenant support structures.

Sign up

Stay up to date with all the latest legal developments affecting pension and 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 November 2023