Sackers

Finance & investment briefing

March 2024

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

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Abbreviations

BPA: Bulk purchase annuity

CDC: Collective Defined Contribution

DB: Defined Benefit

DC: Defined Contribution

DWP: Department for Work and Pensions

ESOG: Effective system of governance

ESG: Environmental, social and corporate governance

FCA: Financial Conduct Authority

IGC: Independent Governance Committee

LDI: Liability-driven investment

OTC: Over the counter

PLSA: Pensions and Lifetime Savings Association

SIP: Statement of Investment Principles

The Code: TPR's general code of practice

TPR: The Pensions Regulator

Finance & investment focus

"Welcome to our first finance & investment briefing of 2024. We hope the new year has got off to a good start for you.

In this issue, we share our risk transfer highlights of 2023. We advised on risk transfer transactions totalling £22.39 billion and were involved in some of the largest and most significant transactions in the market during the year. We continue to be extremely active in all areas of the market and all types and sizes of transaction, advising trustees and employers. We anticipate that 2024 will again be a busy year in this area.

Also on the risk transfer theme, we look at a potential middle ground for vendor due diligence in buy-in transactions. We believe that thinking about this area at an early stage and deciding your objectives for due diligence will help to develop the most proportionate approach to due diligence and an appropriate strategy for approaching residual risks.

The Sackers investment team will be at the PLSA investment conference in Edinburgh in February. If you are attending, we would be delighted to see you at our stand."

Paul Phillips
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Approaching insurers for residual risk cover

A buy-in is an insurance policy in the form of a bulk purchase annuity ("BPA") contract with an insurer. The terms of the BPA carefully define the liabilities and require the insurer to pay an income stream to the trustees of the insured scheme. The insurer agrees to make such payments calculated by reference to the scheme data provided to it and the benefit specification set out in the contract.

As we discussed in our December 2023 briefing, there is a risk that differences will arise between a member's legal entitlement and what is set out in the BPA, meaning there are risks that do not transfer to the insurer on a buy-in. Where any discrepancies arise, the liability for the difference between the BPA and the legal entitlement will remain with the scheme as a residual risk, unless the trustees have managed to negotiate additional cover for that risk.

Assessing the issue of residual risk early in the process can be extremely beneficial, with trustees' bargaining position probably at its highest before they enter into exclusivity terms with their chosen insurer.

The benefit specification

A potential area that may give rise to residual risks is that of mismatches between a member's legal entitlement to benefits under the scheme and the benefits insured by reference to the benefit specification included in the policy. The preparation of the benefit specification will be based on the review of an agreed set of documentation relating to the scheme (eg governing deeds). There are numerous approaches to the legal work on the benefit specification, from a "lighter-touch" review of the most recent consolidation documents that reflect the benefit structure to a more comprehensive approach that includes reviewing all available deeds and historical documentation (not to mention a full range of approaches in between).

In many cases, there may be a balance to be struck between thoroughness and pragmatism. For example, a scheme may have a number of benefit sections which derive from predecessor schemes transferred to it many years ago. The most thorough approach would be to review the governing documentation of these predecessor schemes. However, in practice, that sort of documentation may no longer be available and, even if it were, it might now apply to only a small number of the current scheme's members. In this case, it may not be cost effective to carry out such a review. It must also be borne in mind that, as with any due diligence exercise, if any issues are identified they may lead to obligatory investigation, additional expense and delay, or indeed there may not be a full resolution available.

It is for these reasons that trustees approaching the insurance market are increasingly asking themselves how far they really need to go in their own vendor due diligence? Does everything need to be checked or can the scope of their enquiries be limited?

Is there a middle ground for vendor due diligence?

The principal question trustees must ask themselves is what their objective is in carrying out a due diligence exercise? Are they intending that their report be presented to insurers as a comprehensive review of the scheme or is it just intended to be a common starting point for insurers to be able to provide realistic indicative quotes for residual risks cover? In some cases, trustees may simply be carrying out their own diligence exercise to form a view on whether seeking residual risks cover is worthwhile. In other cases, it may be to ensure that trustees are well-armed with relevant key information before the insurer carries out its own diligence exercise.

It is important to develop an understanding of the nature of the scheme in question. Is it a large scheme with a long history and multiple benefit sections and complexities, or is the benefit structure likely to be more straightforward and with limited historical changes? Whilst a comprehensive review of all documentation may be the ideal, it may not be possible, or practical, in all cases. For the right scheme, it may make more sense to set a more limited scope of review for a due diligence exercise. This might focus only on key risk areas, without reviewing all aspects of every scheme document (eg in relation to benefit categories with only a small number of members).

Once the purpose and scope of a review has been agreed, trustees will need to consider their approach to insurers. The starting point will typically be that where documents have not been reviewed or disclosed as part of a transaction, an insurer would usually expect to exclude any issues arising from them from the scope of any residual risks cover offered. However, where the trustees' rationale for limiting the review's scope can be made clear, it may be possible for a more nuanced deal to be struck. This might mean further due diligence, or it might be that the parties can agree to some form of cover without further due diligence if the issue or member population in question is proportionately small.

> As with most things, the key is for trustees to present a clear picture to insurers with sufficient information and comfort regarding the details and history of the scheme. But it won't always be the case that delving into the full depths of the scheme is necessary where a more proportionate and balanced approach is possible.

Legal update

TPR's new general code of practice

On 10 January 2024, TPR published its long-awaited new general code of practice and consultation response. The Code, which is expected to come into force on 27 March 2024, brings together 10 of TPR's 16 current codes of practice into new "modules". It is intended to be clearer and more accessible than the existing codes, as well as including some additional detail and new expectations.

Importantly, the Code sets out how trustees should meet the requirement to establish and operate an ESOG. Schemes with 100 or more members which are required to operate an ESOG should also carry out and document an own risk assessment.

The Code includes a section setting out TPR's specific investment-related expectations of trustees. Among other things, the Code states that an ESOG should include consideration of ESG matters relating to scheme investments. Specifically, trustees should identify their rights (including voting rights) attached to investments and consider their approach to voting and engagement on relevant matters. Trustees should also take steps to assess the risks and opportunities associated with climate change and talk to their advisers and asset managers about how short and long-term climate change risks and opportunities are taken into account. The Code also prescribes that governing bodies must invest mainly in regulated markets and clearly identify any investments not traded on a regulated market, documenting why such investments are being used and how they fit in with the agreed investment objectives.

See our Alert for further detail.

Reminder on updated TPR guidance for DC schemes on illiquid assets disclosures

On 24 August 2023, TPR updated its guidance on DC investment governance and communicating and reporting for DC schemes, to reflect regulations and statutory guidance intended to broaden DC investment opportunities in illiquid assets (see our Alert for details). Updates were also made to TPR's quick guide to the chair's statement and technical appendix, and the notes to the web version of the DC code of practice.

The regulations require most occupational schemes providing DC benefits to:

- disclose and explain their policies on illiquid investments in the default SIP (or the main SIP for CDC schemes) from the first time it is revised after 1 October 2023, or by 1 October 2024 at the latest, and
- publicly disclose and explain in the chair's statement the percentage of assets in the default fund(s) that are allocated to certain asset classes (or the scheme as a whole for CDC schemes) from the first scheme year which ends after 1 October 2023.

The web version of the DC code states that TPR "will be closely monitoring the impact of these changes and the approach trustees are taking to investment to deliver the best retirement outcomes for savers".

TPR issues guidance on private market investments

On 24 January 2024, TPR published new guidance for occupational pension scheme trustees who are considering investing in private markets such as private equity, private debt, private real estate, infrastructure and natural resources. This guidance follows the Mansion House reforms, which, among other aims, are intended "to enable the financial services sector to unlock capital for UK industries and increase returns for savers while supporting growth across the wider economy".

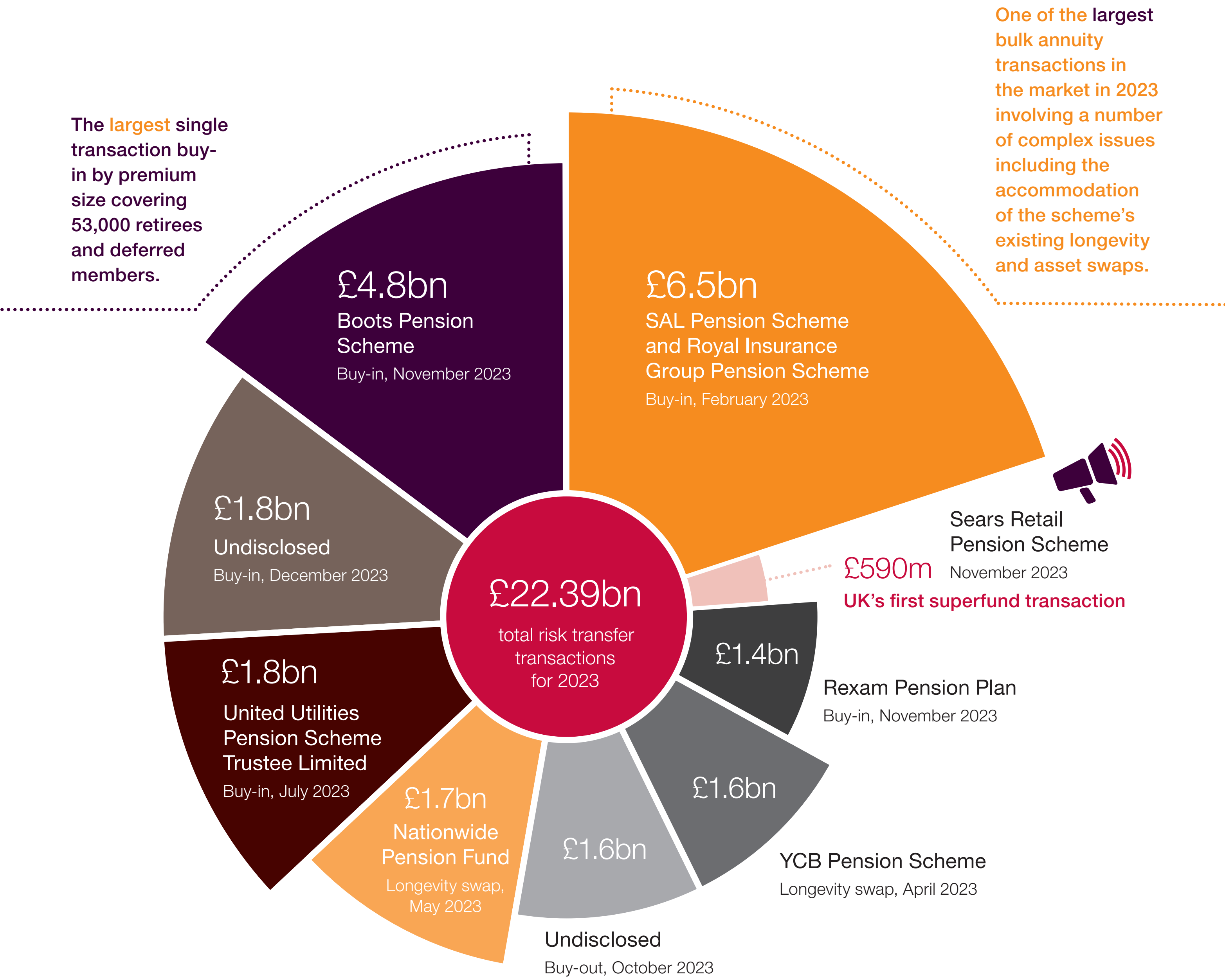
The guidance covers what private market assets are, opportunities and risks, legal duties, key considerations, and specific DB and DC matters to consider. It also includes links to additional resources and refers to the PLSA's case studies on investment in illiquid assets. We will discuss the guidance further in future publications.

FCA sets out rules on Sustainability Disclosure Requirements

On 28 November 2023, the FCA published its final rules and guidance on Sustainability Disclosure Requirements and investment labels. The measures being introduced aim to ensure that the use of sustainability-related terms in relation to investment products is accurate. They include naming and marketing rules for certain investment products which will apply from 31 July 2024. The rules will not initially apply to pension products, but the FCA will consider extending the regime to include such products in the "medium term", working with the DWP and TPR.

An "anti-greenwashing" rule will apply to all FCA-authorised firms from 31 May 2024 to "reinforce that sustainability-related claims must be fair, clear and not misleading". The consultation on supporting guidance closed on 26 January 2024.

Risk transfer highlights 2023



Key highlights of 2023

We had the biggest market share of risk transfer transactions for trustees of any law firm

We act for 36 of the top 200 pension funds in the UK

We advised on 8 transactions over £1.4bn

As at January 2024, we are advising trustees on over 40 risk transfer transactions, with at least 9 transactions anticipated to be over £1bn

In September 2023, we advised the trustee of Northern Bank Pension Scheme on a £286m bulk annuity transaction with M&G subsidiary Prudential Assurance Company. This was a significant transaction that marked the re-entry of Prudential into the bulk annuity market after an absence of 6 years.

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.

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

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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.

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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.

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