Sackers

Finance & investment briefing

June 2021

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

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Abbreviations

CMA: Competition and Markets Authority

DC: Defined contribution

DWP: Department for Work and Pensions

EMIR: European Market Infrastructure Regulation

ESG: Environmental, social and corporate governance

FCA: Financial Conduct Authority

IBOR: Interbank Offered Rate

IGC: Independent Governance Committee

ISDA: International Swaps and Derivatives Association

LDI: Liability-driven investment

LIBOR: the London Interbank Offered Rate

OTC: over the counter

PPF: Pension Protection Fund

PRA: Prudential Regulation Authority

SONIA: Sterling Overnight Index Average

TPR: The Pension Regulator

UK: United Kingdom

Finance & investment focus

"Welcome to our second finance and investment briefing of 2021, just in time for the summer. The Sackers finance and investment team are ready for some warmer weather and, hopefully, some overseas travel. While I cannot in good conscience recommend this publication as pool-side reading for your holidays, if you are after a concise update on pensions investment hot topics you need look no further.

Our first article explores one of the key issues for trustees considering (or already holding) a longevity transaction: how will that transaction interact with a future move to buy out?

Moving on to LIBOR, on 5 March 2021, the FCA announced the dates on which LIBOR rates would cease to be supported by its panel banks. This announcement has been anticipated for many months and much work has already been done to align affected transactions and investments. For those with work to do, our briefing provides a brief outline of the issue to date together with some practical steps for schemes that have yet to close off this particular workstream.

Finally, our legal update touches on progress on the DWP's adoption of CMA recommendations, a reminder on financial counterparty notifications to the FCA for schemes with non-cleared OTC derivatives, and the DWP's consultation on the "S" in ESG.

Wishing you a sunny and healthy summer."

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Post transaction flexibility for longevity swaps

Trustees are increasingly using longevity swaps to hedge the longevity risk of their schemes. In 2020, the reported transaction volume for longevity swaps was around three quarters of the volume of pensions liabilities covered by buy-ins/buy-outs. While they have traditionally been used by large schemes, some inroads are being made to make a longevity swap market for smaller schemes.

Given that longevity swaps are long-dated transactions, it is important for trustees and scheme sponsors to consider the ways in which the scheme's circumstances might change during the term of the transaction. Below, we explore some of the key points which ought to be considered and how these might be addressed during the negotiation of the longevity swap.

Buy-ins and buy-outs

Strong asset performance (or various other factors affecting scheme liabilities) could cause trustees to be in a better financial position than they would have expected to be at the time of entering into a longevity swap. Trustees that might wish to consider a buy-in or buy-out in the future will be interested to know how feasible it would be to transition from a longevity swap.

How the transition would be structured

It is unlikely to be economical to simply terminate the longevity swap and enter into a buy-in or buy-out transaction. Although longevity swaps often include an optional termination right for the trustees, this will usually trigger an early termination payment, including all future expected fees of the reinsurer from the point of termination to the end of the transaction's scheduled term. To the extent the intermediating insurer is taking credit risk on the insurer, the termination payment is also likely to factor in its intermediation fee for that period. Any premium payable to the insurer in relation to a buy-in or buy-out would also include the insurer's fees for covering longevity risk. As a result, simply terminating the longevity swap would effectively cause the trustees to pay twice for the longevity protection.

The preferred option would be for the longevity swap contracts to be novated by agreement with both the existing parties to the longevity swap and with the UK insurer offering the buy-in/buy-out. The longevity swap between the trustees and the intermediary insurer would be novated to the UK insurer providing the buy-in or buy-out, and the reinsurance agreement between the intermediary insurer and the reinsurer(s) would be novated to create a contract between the UK insurer and the relevant reinsurer(s). Related contracts, such as those relating to collateral, would also need to be novated.

Is a transition to buy-in/buy-out realistic? What can be done to smooth the transition?

UK insurers reinsure substantially all their longevity risk with the reinsurance market and are likely to continue doing so unless there is a material change in the capital regime for insurers under UK Solvency II. A longevity swap includes a ready-made reinsurance arrangement with a particular reinsurer(s) which could be attractive to UK insurers offering buy-ins/buy-outs, and so novation is potentially workable in this way.

Some changes may be required to the terms of the reinsurance and related agreements (such as those relating to collateral) on novation. There is possible complexity here and the terms could potentially have a pricing impact. In addition, it is worth noting that a transaction with a favoured insurer is not guaranteed. The insurer offering the best buy-in/buy-out pricing may have reached its maximum capacity with a particular reinsurer, or may not have an existing relationship with the reinsurer (though in the right circumstances this ought to be surmountable).

That said, transitions of this sort have been done in recent years and the market is becoming more familiar with them. As more transitions happen, it is likely they will become easier to implement.

Post transaction flexibility for longevity swaps cont.

Maximising the chance of novation

In order to increase the chance of novation occurring, trustees would be well advised to negotiate terms with the reinsurer, and intermediary insurer, to contractually limit their ability to block a transition.

As noted above, novation requires agreement by all parties, including the bulk annuity insurer, to make it work. However, having some carefully agreed wording with the reinsurer and intermediary is likely to be extremely helpful.

These terms should take into account the practicalities involved in achieving the proposed transition and the probable objections that the reinsurer (and intermediary insurer) may have. We would caution against these terms being too prescriptive; if they are too inflexible, the terms may make the process more difficult to administer rather than less, but having some clear agreed situations and conditions where parties are unable to block a novation is desirable.

Changes to the trustee or the scheme

It is impossible to foretell what could happen during the life of a longevity swap. Schemes may sectionalise or desectionalise or, as a result of corporate restructuring, schemes may merge or demerge. The terms of the longevity swap should provide for what would happen in such circumstances.

Schemes with individual trustees will almost certainly have to incorporate before entering into a longevity swap. That said, a change in trustees may occur in any event. If a scheme were to go into the PPF, for instance, the corporate trustee may be changed as part of that process. Provisions in the document can help facilitate this.

Liability management

If trustees are considering liability management exercises (for example, pension increase exchange exercises) they will likely want to take this into account in the longevity swap. This may affect reinsurer pricing and provisions should set out how the trustees and reinsurer would work together to agree a solution.

LIBOR transition – implications for schemes

5 March 2021	On 5 March 2021, the FCA finally announced the dates on which the various LIBOR rates would cease to be supported by its panel banks
31 December 2021	LIBOR rates in all currencies other than US dollars will cease on 31 December 2021
30 June 2023	Certain US dollar settings continuing until 30 June 2023

The significance of LIBOR to pension schemes

LIBOR has been one of the main reference rates in financial contracts for many years and will have been, and may still be, a material feature in many schemes' investments. LIBOR is often used to determine interest rates payable in investments such as bonds, loan portfolios, derivatives, insurance contracts, repurchase agreements, stock loans and longevity swaps. LIBOR features in many investment and fiduciary management arrangements as a benchmark or discount rate, and often performance fees are set by reference to LIBOR.

Why LIBOR is phasing out?

LIBOR is intended to reflect the market price at which interbank loans are made in the London market in a given currency, for a given time. However, since the financial crisis, there has been a substantial drop in the amount of interbank lending. As a result, the future of LIBOR as a representative rate has become unsustainable. This was recognised by the FCA and Bank of England a number of years ago and market preparations for the transition have been in progress.

Replacements for GBP LIBOR

A number of public/private working groups have been set up globally to determine the rates that may be used as replacements for GBP LIBOR. The Working Group on Sterling Risk Free Reference Rates was tasked with finding a replacement for LIBOR and supports a transition to rates based on SONIA (the Sterling Overnight Index Average). A spread adjustment would typically be applied to the new SONIA-based term rate with the aim of keeping the transition from GBP LIBOR economically neutral.

What needs to be done to transition from LIBOR?

Efforts to transition from LIBOR to alternative risk-free rates such as SONIA have gone on for a material part of the last six months. The PRA and the FCA have been clear with the banks and investment firms they supervise that they expect them to meet the milestones of the Working Group on Sterling Risk Free Reference Rates including, for example, their requirement to cease producing LIBOR linked investments and to promote a shift to SONIA, so that those institutions are fully prepared for the end of LIBOR by the end of 2021.

LIBOR transition – implications for schemes cont.

Some of a scheme's LIBOR-referencing investments, such as bonds, may already include fallback mechanisms which enable a calculation agent to initiate a move to SONIA. In those cases, while the issuer of the investments and its agents may need to go through a process to change the rate, it would be unlikely that trustees or their managers would have a material involvement in the process.

However, for most investments, active steps will need to be taken by schemes (or their managers) to put adequate fallbacks in place. As a result, the LIBOR phase-out is still a meaningful exercise for schemes. Part of the transition has been made easier for schemes and their managers by the development of market-based solutions. However, there are a number of "tough legacy" contracts where individual attention may be required.

Market action for derivatives

In the derivatives market, significant progress has already been made following the publication of the ISDA 2020 IBOR Fallbacks Protocol. Derivatives transactions are typically traded under an ISDA Master Agreement and incorporate certain ISDA-published definitions, including those to determine LIBOR rates. ISDA prepared an update to those definitions, including fallbacks to SONIA for LIBOR, and they created a Protocol to assist with amending master agreements that use ISDA's definitions booklets.

The Protocol is a multilateral mechanism by which banks and investment firms (and their clients) can use a single adherence letter to amend all derivatives master agreements with their trading counterparties that have adhered. This has helped to avoid a mass repapering of contracts. Many schemes and their managers will have already signed up to the Protocol as part of the LIBOR transition. Trustees may wish to take care to ensure that adherence at scheme level does not cut across a particular manager's decision on whether or not to adhere. Bilateral ISDA agreements can be used to incorporate the Protocol approach for this reason, and as a means of adapting "tough legacy" contracts.

Under the Protocol, the rates for LIBOR will fall back to the SONIA term rate published by Bloomberg upon the rate's cessation on 31 December 2021. They apply an adjustment spread depending on the tenor of the transaction which is published by Bloomberg and are intended to make the transition economically neutral.

Other LIBOR references

An equivalent multi-lateral amendment mechanism has not been developed by other industry bodies. Managers whose portfolios include investments that are affected will likely be doing work to prepare for the transition and it is worth checking in with them. If LIBOR is built into performance benchmarks or performance fee hurdles for portfolios or funds, and trustees have not heard from relevant managers, it is worth contacting them to discuss how to approach this.

Action to be taken by trustees

It is in the best interests of schemes and their sponsors that the LIBOR transition is carried out in an orderly fashion. As a result, trustees might helpfully check in with relevant managers to ask about their plans for LIBOR transition and whether the transition is progressing in line with expectations. If trustees or sponsors have concerns about particular investments which they know reference LIBOR, they may wish to check with their managers what the detailed plans are for the relevant investments.

Legal update

DWP delays response to consultation on trustee oversight of investment consultants and fiduciary managers

CMA Investment Consultancy and Fiduciary Management Market Investigation Order 2019 ("the Order")

The DWP has stated that the publication of its response to the consultation on trustee oversight of investment consultants and fiduciary managers, as well as the final regulations, are delayed. It now expects to publish its response by June 2022. The regulations, which are intended to integrate the Order into pensions law, will:

- require trustees (subject to limited exceptions) to carry out a tender process for fiduciary management services and to set objectives for their investment consultants
- allow TPR to oversee the requirements.

The DWP reminds trustees that, until the new regulations are in force, trustees must continue to comply with the Order (see our Alert).

CMA clarifies compliance report requirements

In addition, the CMA has updated its guidance on the Order to provide new information on submitting compliance reports. When submitting a compliance report under the Order, pension scheme trustees, investment consultants and fiduciary management firms should note that they are responsible for their own compliance. As applicable, all must provide a compliance statement alongside a certificate certifying that the compliance statement has been prepared in accordance with the requirements of the Order, and that the entity has complied in all material respects with the requirements of the Order and reasonably expects to continue to do so.

The guidance notes that compliance reports are required by pension scheme trustees even if a fiduciary management provider has not been used (in this case, the trustee is compliant because it doesn't use fiduciary management).

17 June 2021 deadline

Requirement to refresh Financial Counterparty notifications to the FCA

Following the end of the Brexit transition period, the FCA is requiring pension schemes to refresh applicable regulatory notifications relating to whether or not their non-cleared OTC derivatives activity exceeds the clearing threshold. This must be done by **17 June 2021**.

Pension schemes can choose not to carry out the calculation to determine whether they exceed the clearing thresholds (ie whether or not they are a "**large FC**" or a "**small FC**"). However, if they do not carry out the calculation, they must make a regulatory notification to the FCA and treat themselves as a large FC for the purposes of UK EMIR.

Pension schemes which do run the calculations and determine they are large FCs also need to notify, whereas schemes which determine that they are small FCs do not.

Notifications must be made through the FCA's Connect system.

For further information on ESG, please see our recently published guide

DWP launch call for evidence on the social element of ESG investing

On 24 March 2021, the DWP published a call for evidence seeking views on how pension scheme trustees understand social factors, and how they are included in their ESG policies. The call for evidence aims to help increase policymaker and industry understanding of what is currently being done, and what more could be done, to ensure both the risks and opportunities presented by social factors are adequately considered by pension schemes.

Responses to the call for evidence, which closes on 16 June 2021, will help inform the steps the Government needs to take to ensure trustees are better able to meet their legal ESG obligations. See our Alert for further details.

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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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