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Horizon

Welcome to the latest edition of our pensions briefing for clients. It highlights recent developments in pensions law and suggests in practical terms what schemes should be doing to deal with them. If you have any comments on this publication, just e-mail us at pensions@cms-cmck.com.

INVESTMENT AND DERISKING – CURRENT ISSUES FOR TRUSTEES

In recent years there has been a trend in DB schemes towards more and more complex investment products as trustees seek to find investments that match or offset some of the risks that the scheme is exposed to.

This issue of Horizon looks at some topical issues that trustees should be aware of in relation to complex investment products and recent developments in relation to what can happen where investments do not perform as expected.

Derivatives and EMIR

Derivative products can provide a useful tool for trustees by allowing them to protect against various funding risks, including rises in inflation and interest rates. However, they are sophisticated products and trustees need to ensure that they understand the nature of the investments that they are entering into and the risks that they might pose to the scheme. The 2005 Investment Regulations provide that "*investment in derivative instruments may be made only in so far as they- (a) contribute to a reduction of risks; or (b) facilitate efficient portfolio management…and any such investment must be made and managed so as to avoid excessive risk exposure to a single counterparty and to other derivative operations*".

Trustees also need to be aware that there are regulatory requirements governing some derivative products which may directly affect them.

The European Market Infrastructure Regulation (EMIR) applies to over-the-counter (OTC) derivative transactions – that is those not traded on an exchange but negotiated directly between the parties. This is likely to be most derivative transactions that pension schemes enter into.

EMIR requires OTC derivatives to go through a central clearing process with conditions applied to that clearing, including specified arrangements for posting collateral.

There is a temporary exemption from the clearing requirements for pension schemes which currently lasts until 2017. However, the exemption only applies to derivatives which are "*objectively measurable as reducing investment risks directly relating to the financial solvency of pension scheme arrangements…*" There is some uncertainty as to the exact scope of that exemption, particularly as it appears to be drafted more narrowly than the provision of the Investment Regulations quoted above.

As the provisions of EMIR gradually come into force, it is becoming more important for trustees to identify whether or not any derivatives they hold come within the scope of the pensions exemption. In particular, counterparty banks need to know the answer because it has an impact on their credit valuation adjustment risk and whether they need to apply a capital charge (known as the "CVA capital charge").

It is also important to remember that the pensions exemption does not cover most of the risk mitigation requirements under EMIR, including the requirements relating to margin which come into force from 1 September 2016 albeit on a phased in basis. Trustees should speak to their fund manager to confirm that they are ready to comply with these requirements and confirm that all derivatives which the manager is permitted to invest in come within the pensions exemption.

You can find more information on how EMIR relates to pension schemes and relevant considerations for trustees here.

Longevity

The last few years have seen a significant growth in longevity hedging transactions. These are transactions where the pension scheme agrees to pay a fixed amount over a period of time, based on the cost of benefits if members live to a particular age, plus an amount representing fees. In return, the provider pays the cost of the benefits that actually fall due. This means that trustees have certainty over the cost of longevity and the risk of a significant increase in costs as a result of members living longer than anticipated is passed to the provider.

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Other things to be aware of...

The PPF has published its draft levy determination and accompanying documents for 2016/17. The structure of the levy remains largely the same but there are some points to note:

- Where schemes have wrongly identified themselves as last-man standing schemes in previous years, the PPF may now re-invoice them for past years.
- The PPF may take a more rigorous compliance approach to ABC certification this year as it is no longer a new thing. However, the re-certification process means less work may be required in many cases this time around.
- There are some changes in relation to mortgage exclusions and not all mortgages will need to be recertified for the new levy year.
- The main submission deadline will be mid-night on 31 March 2016.

The Regulator has published its first Section 89 Report on scheme funding in relation to the DLR Scheme. In this case the trustees and sole statutory employer could not reach agreement on the recovery plan and schedule of contributions following the Scheme's actuarial valuation for 1 April 2009. There was also confusion over what the contribution rule in the scheme allowed the trustees to do. Eventually the parties reached a settlement under which the whole of the deficit will be repaid by 2018.

The Regulator says in its comments that where it is involved in the valuation process its "*focus will be to help the trustees of a scheme…reach an appropriate outcome as soon as possible.*" In addition: "*Where the trustees and employers have options available to them which are capable of addressing the funding issues…(such as the exercise of powers under a scheme's governing documentation), the*

Initially longevity hedging was only available to the largest schemes. However, 2015 has seen the emergence of products aimed at smaller schemes. As a result, increasing numbers of trustees may find that employers are encouraging them to consider this kind of arrangement.

Whilst longevity swaps are often driven by the employer, it is important for trustees to remember that the ultimate power to invest the scheme assets is theirs and this is an investment like any other. They therefore need to ensure that they comply with their investment duties when entering into such an arrangement, fully understand it and are not driven to a product selected by the employer without adequately considering where the needs of the scheme might differ from those of the employer.

Trustees need to understand the protections available to them if the other party to the swap defaults or becomes insolvent. Different types of contracts (for example with a bank or an insurer) are governed by different regulatory regimes and have different protections against insolvency. The Pensions Regulator is increasingly keen that trustees understand such issues and the exact level of risk to which the fund is exposed.

Another issue we have recently encountered is the problems posed for individual trustees entering into such arrangements. These contracts will typically last for many years and individual trustees will come and go during the period. The problem is the extent to which the contract will bind trustees who were not party to it. Remaining trustees may need to ensure that new trustees assume the responsibility to carry out the contract. This is something that trustees will need to consider when entering into a longevity hedge and when new trustees are appointed.

What happens if things go wrong?

The general trust law rule in the UK is that trustees cannot be held responsible for investment underperformance unless there is negligence, fraud or breach of trust. There have been few cases looking at this question. Perhaps the most notable was *Nestle v National Westminster Bank plc* in 1992 where the Court of Appeal held that "*trustees' performance must not be judged with hindsight: after the event even a fool is wise*".

US courts have looked more closely at liability for underperformance. In 1996, the US Court of Appeals held in *Mienhardt v Unisys* that investment decisions should be judged by "*a fiduciary's conduct in arriving at an investment decision, not on its results, and [by] asking whether a fiduciary employed the appropriate methods to investigate and determine the merits of a particular investment".* The US Supreme Court revisited the investment duties of a pension scheme fiduciary earlier this year in the case of *Tibble v Edison International*. The court did not come to any startling conclusions and held in that case that: "*Under trust law, a trustee has a continuing duty to monitor trust investments and remove imprudent ones. This continuing duty exists separate and apart from the trustee's duty to exercise prudence in selecting investments at the outset*".

Although these cases are not based on UK law, similar principles are likely to apply here. Investment is not a one off process and trustees have continuing obligations to review their investments. The Regulator's Scope document setting out the detail of the knowledge and understanding that trustees should have says they should have knowledge and understanding of "*the mechanisms for monitoring investment*". This applies to the operation of complex products just as much as it applies to more straightforward investment funds.

Trustee rights of action

Generally, if investments do not perform as expected, trustees do not have a right to claim against a fund manager or the investment provider. Risk is an inherent part of investment and investments do go down as well as up. However, sometimes, an investment will fall in value, not because or market forces but because of possible wrongdoing. The most recent example would be the fall in Volkswagen's share price as a result of the alleged fixing of emissions data.

Taking legal action in such circumstances is expensive, but recent years have seen a growth in class action type claims with many UK pension funds participating in US class actions.

Claims in the US are easier than those in the UK because claimants can be included automatically in a class and the litigation can be conducted on a no-win-no-fee basis, without having to bear the other side's costs if unsuccessful. In the UK, someone has to co-ordinate the group litigation and fees can be high. Trustees are often unwilling to expose their schemes to the risk of high litigation costs and an unsuccessful outcome. They are also often concerned about pursuing a claim with other parties that may not have the same objectives as the trustees.

However, a change in the law due to come into force on 1 October may make some class action claims easier to pursue. The Consumer Rights Act 2015 will allow opt-out type class actions to be brought before the Competition Appeals Tribunal in relation to infringements of competition law.

This may not at first glance appear to be particularly relevant to pension scheme trustees. However, it is possible that claims in relation to the fixing of LIBOR and foreign exchange rates by UK banks could be structured as competition claims and fall within this new provision and many schemes may have suffered losses which could fall within such claims.

If claims are set up on this basis, trustees will need to give careful thought about whether they want to remain part of such litigation and any risks that might be associated with it.

regulator will generally expect these options to have been pursued before the regulator will consider exercising its powers. This underlines the importance for trustees to pay close attention to the terms of contribution powers available under the governing documentation of a given scheme."