ALLEN & OVERY

June 2017

A quick guide to asset protection for pension schemes

What protection is available for pension scheme assets in the event of provider failure such as negligence, fraud or insolvency, or the failure of the other parties involved in an investment? This question is particularly important in the DC space, as members bear the risk of any shortfall in the assets. It's also relevant to DB schemes, where a gap in protection for scheme assets in the event of provider failure could create unexpected additional pressure on scheme funding, and potentially increase requirements for deficit contributions from participating employers.

Trustees of all scheme types need to understand the arrangements that are in place to safeguard scheme assets, and make improvements where appropriate. This quick guide sets out an overview of the types of protection available (the exact position will depend on the structure and legal documentation of each scheme's specific investments).

What the Regulator expects, and what trustees should do

The 2016 DC Code sets out the Regulator's expectation that trustee boards will, in relation to DC arrangements, 'assess the extent to which, and in what circumstances, any loss of scheme assets might be covered by indemnity insurance or similar arrangement, or a compensation scheme such as the Financial Services Compensation Scheme'. Trustees are also expected to communicate their overall conclusion about the security of assets to members and employers. The Regulator's 2017 investment guidance extends this expectation by underlining the importance of asset protection for DB scheme investments. However, determining the nature and extent of asset protection can be a complex task, and in providing information to members, trustees should take care to provide appropriate cautions around statements regarding the availability of the Financial Services Compensation Scheme or other protections.

The key issue is that different forms of protection may apply to assets held in different investment structures, so it's crucial for trustees to analyse and understand the structures involved in any existing or proposed new investment or DC option. The exact position regarding where the risk of failure lies will ultimately depend on the nature of the product and how it is structured – for example, the position of a pooled investment fund is very different to that of a unit-linked insurance policy or a segregated managed portfolio arrangement. The risks involved in regulated pooled investment funds (eg in the UK, Ireland or Luxembourg) differ from those of unregulated offshore alternative funds.

DC trustees commonly offer access to investment products via a platform in the form of an insurance policy issued by their chosen provider – but again, protection may vary depending on whether the provider is UK-based and/or UK-regulated (for example, a non-UK insurance platform provider will be subject to different compensation arrangements). DB trustees may also invest in provider-managed funds (for example, pooled fund investments via a life fund); both here and in relation to direct investments, they particularly need to understand how risks in relation to the custodianship of scheme assets (including activities such as stocklending or the use of prime brokers in alternative funds) are managed.

Trustees and their advisers should consider the structure of the arrangements including the underlying investments on a platform and the risks associated with these structures, as well as the legal documentation underpinning the structures. Unravelling the various layers of asset security in these structures and in relation to the multiple counterparties can be difficult. The scheme's investment consultant/fund manager, in conjunction with your legal advisers, should be able to help you establish the facts and identify key risks and the extent of protection available to mitigate those risks. While no investment in the financial markets is risk-free, pension trustees are expected to assess the risks and conclude whether they are acceptable in the context of a particular arrangement.

Asset protection mechanisms

1. Financial Services Compensation Scheme (FSCS)

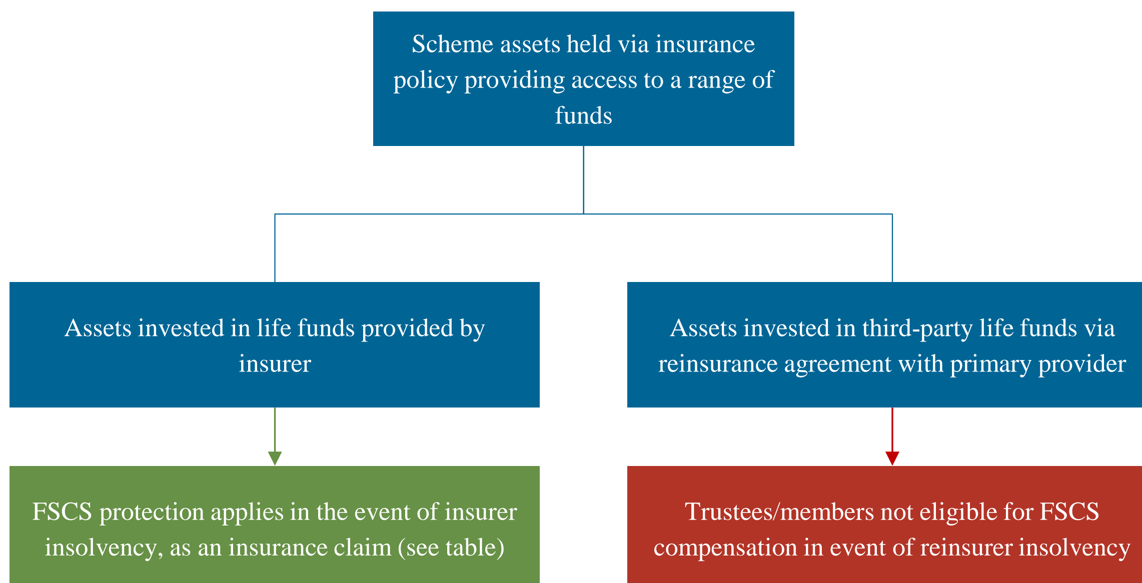
The FSCS is a statutory compensation scheme of last resort for clients of authorised financial services firms who have suffered financial loss where a firm is unable or likely to be unable to pay claims against it. The criteria for FSCS protection are complex, and the availability of, and limits on, protection will depend on the type of claim or investment involved (and, in some cases, on whether the potential claim relates to a DB or DC arrangement).

In relation to occupational DC schemes, the FSCS will look through to individual members and treat them as claimants for the purpose of calculating compensation (even if the trustees actually make the claim). This means that claim limits will apply on a per-member basis. Conversely, in the context of a DB scheme, the FSCS can only provide a meaningful level of protection in the case of the failure of a provider of a unit-linked life policy (with the caveats explained below). The special treatment of unit-linked life policies is a regulatory recognition of particular credit risks involved in those structures – the trustees have no proprietary rights to the underlying assets and depend on the insurer's ability to pay.

Claim	FSCS compensation	Conditions
Insurance claim against insurer under pension fund management policy or life policy	Subject to the FSCS first trying to secure continuity of insurance, there is no upper limit on compensation; but eligibility depends on the existence of a direct relationship with a UK-regulated insurer. There is no restriction on compensation by reference to sponsor size (DB or DC).	Cover applies in relation to claims under a contract of long-term insurance, including annuities and unit-linked life funds, where the insurer becomes insolvent. FSCS compensation is **not** payable where loss is owed to a platform provider rather than directly to the scheme (eg underlying investments are accessed via reinsurance – see diagram below).
Investment claim against UK-regulated adviser or fund manager or, in some circumstances, custodian	In principle, up to GBP50,000 where trustees have a claim against the manager of a failed fund, for example as a holder of fund units. However, eligibility may be rare in practice. FSCS compensation will **not** be payable to trustees where shares/units are held indirectly via an investment platform or pooled fund. DB schemes are **excluded** from coverage if the sponsor is a large employer (there is no such restriction in relation to DC arrangements).	Where compensation is available (eg trustees are direct investors under a segregated managed portfolio), eligibility depends on having a valid civil claim for eg misleading advice or fraudulent conduct by a UK-regulated adviser/fund manager operating in the UK, with loss traceable to a right of action against an FSMA-authorised firm.
Cash deposit compensation	FSCS compensation may be available in some circumstances, for example where the bank is a member of the Deposit Guarantee Scheme, up to GBP85,000. See also the section on cash deposits, below.	Trustee bank accounts are only protected where the scheme sponsor has a turnover of EUR50 million or less.

© Allen & Overy LLP 2017

How might FSCS compensation apply to investments on an insurance platform?



Even where FSCS compensation applies (for the purposes of long-term insurance), there is a risk that under FSCS valuation rules, the FSCS manager will not put the same value on a claim as the trustees or a member. In addition, in some circumstances payment may be reduced, deferred or delayed – this may lead to difficulties where the trustees still remain liable (for example, to pay a transfer value or cash lump sums/drawdown) in the interim. FSCS limits and eligibility criteria change over time, so periodic monitoring is required.

As indicated in the table above, FSCS compensation is unlikely to be useful in the context of investments other than unit-linked insurance policies. However, that doesn't mean that assets are unprotected – for example, typically, trustees would have a proprietary right in respect of the underlying assets or interests in a pooled fund (eg shares in a corporate fund), rather than a payment obligation by an insurer. Credit risk still exists in such structures (and needs to be assessed by the trustees) but at a different level – eg the insolvency of the custodian or broker, or that of the depositary of a pooled fund (see 3 below).

2. Contractual protections

In respect of risks other than insolvency (for example, the provider's failure to discharge its obligations properly, resulting in a loss), trustees have to rely on contractual protections negotiated with the provider. Every provider is likely to limit its liability (either to certain events such as negligence or fraud or, in some cases, to a pre-agreed monetary amount).

Where a provider delegates its duties or uses third party providers, a chain of liability needs to be established – or, as a minimum, a contractual undertaking needs to be obtained to pursue the underlying third-party managers for enforcement, as well as an undertaking to monitor underlying providers on an ongoing basis.

Trustees should check and, if possible, re-negotiate their contractual arrangements to establish whether, and in what circumstances, any such protection (or structural protections – see below) would apply in the event of a provider's failure to discharge its obligations. Trustees should check, for example, whether any liability provision applies only to the platform provider's own-managed funds rather than to funds managed by third parties (as these are managers with whom the trustees have no contractual relationship).

Where funds are held under an insurance arrangement, and investments may be held in third-party life funds structured as reinsurance, FSCS compensation will not apply in the event of the insolvency of the reinsurer – see diagram above. In this scenario, trustees should confirm with the primary insurer what steps it has taken to mitigate the risk of loss in relation to reinsurance arrangements (for example, the creation of a floating charge in favour of the trustees).

Trustees considering a change of provider (or a change between investment and insurance platforms) should ensure that they consider contractual protections as a key part of their due diligence – it may not be appropriate to change providers if there is a material adverse impact on the protection available to the scheme in the event of a provider's failure to discharge its obligations.

Trustee due diligence should include checking the applicability and level of insurance cover held by fund and investment managers, custodians and other providers for errors and omissions, to ensure that it is adequate to cover any potential claim that the trustees may bring against them. Many providers are thinly-capitalised entities and contractual recourse is only as good as the provider's insurance.

3. Structural protections

In some cases, scheme assets may be protected through segregation or ring-fencing – for example:

- Custody arrangements typically provide for segregation of client assets from the custodian's own assets on insolvency. The protection is not absolute (eg trustees would typically bear any unexplained shortfall pro rata) and recoveries on insolvency can take a long time. This structural protection does not apply in some types of arrangement, nor does it apply in respect of cash held by the scheme's custodian (who would typically hold cash as a banker), resulting in a credit risk that needs to be managed through an overnight cash sweep or other method.
- Some investment managers and brokers open a client money account with a bank; funds will be segregated from the investment manager's or broker's own monies. This will normally protect scheme assets if the manager or broker becomes insolvent. However, it does not protect against the insolvency of the bank.
- Pooled fund investments, structured as umbrella vehicles in the UK, Luxembourg or Ireland, protect assets through the protected cell regime. Under this regime, sub-funds are segregated portfolios of assets; the assets of each sub-fund belong solely to that sub-fund individually and cannot be used to discharge the liabilities or claims of any other person, body or sub-fund. However, this only protects against claims of creditors of other sub-funds and does not provide protection against a failure by the fund manager or the fund's depositary.

4. What about cash?

In many cases, 'cash funds' are not in fact held as cash (ie a bank deposit) but as very liquid assets such as treasury notes, commercial paper, etc. Normally, cash will be held during transition periods, for example where DB schemes, or DC members, are switching investments (or as collateral for derivatives transactions, such as liability-driven swaps). It's worth noting that, in the absence of other protection, a DC scheme may be exposed during transition periods because the member is still entitled to the completion of his transfer even if loss occurs – trustees should ensure that member investment switches proceed as smoothly and as swiftly as possible.

FSCS compensation for cash deposits is restricted in a number of ways, including the size of the scheme sponsor and the amount of cash held (see the table above). Where trustees may have an eligible claim under the FSCS, it's worth noting that compensation is also restricted by reference to individual banking licences, and a single licence may cover multiple high street banking brands which belong to the same corporate group. Where relevant, banking arrangements may need to be restructured to optimise FSCS coverage.

Alternatively, trustees could consider not maintaining cash deposits, but converting these into money market funds to diversify risk.

© Allen & Overy LLP 2017

Communicating with members – DC

The Regulator's view is that trustees' assessment of the level of risk, and any measures taken to reduce it, should be communicated to members, and that trustees should be prepared to provide further information if members request it. Changes to the level or availability of protection should also be communicated promptly and these can be integrated with wider communications to members. Trustees should take care to strike a balance in communications to members and employers about asset security, to avoid causing undue alarm.

Where the level of protection varies on a fund-by-fund basis, trustees may wish to consider whether this is sufficiently described in the fund information provided to members as the basis for them to make their investment choices.

There is currently no reporting requirement in relation to asset protection for DB arrangements.

What to do next

The first step is to prepare a checklist of questions to obtain relevant information from providers, fund managers and investment advisers. The aim is to identify what contractual or structural protections are in place in relation to each investment; any limitations on liability; and the applicability of any compensation scheme. We can help you by providing a detailed checklist tailored to your specific investment products and type of scheme. Please contact your usual Allen & Overy adviser for more information.

Armed with this information, trustees then need to obtain a legal review as appropriate and consider whether any risks are acceptable within their overall strategy and the context of a particular investment, or whether they should take action to mitigate risks further. DC trustees should then review the information which is provided to members (both generally and on request).

Finally, trustees should monitor protection levels on an ongoing basis – for example, FSCS compensation thresholds are likely to change in connection with preparations for, or implementation of, the UK's exit from the European Union.

Our pensions and investment experts can help you analyse and improve the security of your scheme's assets. For more information, contact one of our experts:

Neil Bowden
Partner - London

Contact
Tel +44 20 3088 3431
Mob +44 7973 601 609
neil.bowden@allenovery.com

Däna Burstow
Partner - London

Contact
Tel +44 20 3088 3644
Mob +44 788 7754980
dana.burstow@allenovery.com

Andrew Cork
Counsel - London

Contact
Tel +44 20 3088 4623
Mob +447825 384780
andy.cork@allenovery.com

John Goodhall
Partner - London

Contact
Tel +44 20 3088 2506
Mob +44 7775 904 067
john.goodhall@allenovery.com

Jane Higgins
Partner - London

Contact
Tel +44 20 3088 3161
Mob +447825 384786
jane.higgins@allenovery.com

Jessica Kerslake
Counsel - London

Contact
Tel +44 20 3088 4710
Mob +447920713329
jessica.kerslake@allenovery.com

MaameYaa Kwafo-Akoto
Senior Associate - London

Contact
Tel +44 203 088 3516
Mob +44 7785 951 030
maameyaa.kwafo-akoto@allenovery.com

Helen Powell
PSL Counsel - London

Contact
Tel +44 203 088 4827
Mob +44 7920 271 006
helen.powell@allenovery.com

Stephen Richards
Senior Associate - London

Contact
Tel +44 20 3088 2025
Mob +44 773 938 4686
Stephen.Richards@allenovery.com

Paul Sampson
Senior Associate - London

Contact
Tel +44 20 3088 4255
Mob +44 7876 444 907
paul.sampson@allenovery.com

Pavel Shevtsov
Partner - London

Contact
Tel +44 20 3088 4729
Mob +44 7775 904 050
pavel.shevtsov@allenovery.com

Maria Stimpson
Partner - London

Contact
Tel +44 20 3088 3665
Mob +447899 063 396
maria.stimpson@allenovery.com

Allen & Overy means Allen & Overy LLP and/or its affiliated undertakings. The term **partner** is used to refer to a member of Allen & Overy LLP or an employee or consultant with equivalent standing and qualifications or an individual with equivalent status in one of Allen & Overy LLP's affiliated undertakings.

© Allen & Overy LLP 2017 | CO:29961603.1