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# In Practice

Authors Sebastian Reger and Cindy Smith

## ISDAs for pension schemes: where one size does not fit all

In this article, the authors consider key provisions in an ISDA Master Agreement which are included to address the particular characteristics of UK defined benefit (or "final salary") pension schemes.

### CONTEXT

Pension schemes are major participants in the derivatives market. Derivatives often form a central part in many pension schemes' strategies for reducing some of the key risks affecting their liabilities – interest rates, inflation and longevity (although the latter – how long members of the pension scheme live – is now mostly managed through insurance).

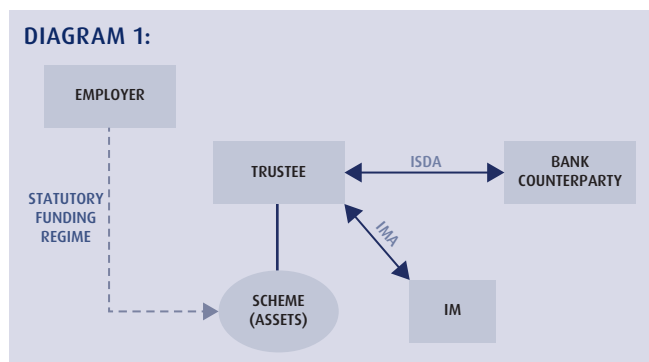
### HOW A PENSION SCHEME ISDA DIFFERS FROM AN ISDA FOR A CORPORATE ENTITY

Over-the-counter (OTC) derivatives transactions are predominantly documented using the International Swaps and Derivatives Association, Inc 2002 or 1992 Master Agreement, schedule and credit support documents (ISDA). UK defined benefit pension schemes tend to be set up as trusts. Whilst corporate entities can contract directly with their ISDA counterparties, a pension scheme itself has no legal personality, so the ISDA is entered into by the trustee of the pension scheme (Trustee) as the legal owner of the scheme's assets. Legally and practically, most Trustees require an investment manager (IM) to manage their derivatives book.

Although Trustees can negotiate bespoke ISDAs, these are generally the preserve of larger pension schemes. More often than not, Trustees will use ISDAs negotiated by their IMs and used by each IM across its entire client book (Agency ISDAs).

An Agency ISDA is an agreement negotiated and agreed between the IM (acting as agent for and on behalf of its various clients) and the counterparty bank, the terms of which govern transactions between the counterparty bank and the IM's clients. Legally, the Trustee will be party to the Agency ISDA as the principal and the IM will act as agent and manage all derivative transactions and administer the terms of the agreement.

The diagram below illustrates the basic structural and contractual relationship between a Trustee, the sponsoring employer of the scheme (whose former and current workforce will be amongst the pension scheme's members), the IM and the bank counterparty to the ISDA.



Even though legally the contract will be between the bank counterparty and the Trustee, the bank counterparty's credit exposure is intended to be to the scheme assets. The assets of the pension scheme are held by the Trustee but segregated from the Trustee's own assets (which are typically of minimal value) and also from the assets of the scheme's sponsoring employer. A bank counterparty wants to be able to have recourse to the scheme assets to meet any claims that it may have against the Trustee under the ISDA. This recourse is achieved under the indemnity which the Trustee is granted from scheme assets to cover expenses which it incurs in its capacity as trustee of the pension scheme. The Trustee's liability to the bank counterparty under the ISDA should fall within the scope of this indemnity, with the result that claims by the bank counterparty under the ISDA should effectively operate as a creditor claim against the scheme assets, ranking in priority to the beneficiaries of the pension scheme.

### PENSION SCHEME ISDAs: KEY TERMS

Whilst the mechanics of the ISDA will generally facilitate the requirements of both ISDA counterparties, there are specific provisions which should be incorporated into ISDAs for pension schemes in order to reflect the particular characteristics of pension schemes.

Some of the key amendments to ISDA schedules for pension schemes concern the following:

#### Insolvency events of default

It is commonly accepted that the standard ISDA bankruptcy events of default (at s 5(a)(vii) (*Bankruptcy*) of the ISDA Master Agreement), which apply to corporate entities, are disapplied in pension scheme ISDAs in respect of the Trustee because it would not be appropriate to apply these provisions to the trustees of pension schemes. This is because the standard ISDA bankruptcy events of default do not reflect how insolvency scenarios play out in the context of a pension scheme.

Instead, pension scheme-specific insolvency events of default should apply. Typical examples include events of default which occur:

- where an order is made for the administration of the scheme pursuant to Rule 64.2(b) of the Civil Procedure Rules or any replacement of that rule, and as a result the Trustee is unable to perform any of its material obligations under the ISDA;
- on the commencement of the winding up, termination or liquidation of the scheme (howsoever described) pursuant to the scheme's trust deed and rules (provided that it shall not constitute an event of default if the scheme is maintained as a closed fund to be administered in accordance with its trust deed and applicable rules (as amended from time to time) or s 38 of the Pensions Act 1995); and
- where the Pensions Regulator orders a winding up of the pension scheme.

## In Practice

### Biog box

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### Other pension-specific events of default

Other default events commonly required by bank counterparties in pension scheme ISDAs may include:

- where the scheme ceases to be a registered pension scheme under s 153 of the Finance Act 2004;
- where the Pensions Regulator appoints a Trustee to the scheme and, as a result, the original Trustee/IM on behalf of the original Trustee is unable to perform any of its material obligations under the ISDA;
- where the Trustee ceases to be the trustee of the scheme and a successor/replacement Trustee has not been appointed within a specified time and the Trustee is unable to perform any of its material obligations under the ISDA as a result;
- where a new Trustee is appointed, but fails to assume the obligations under the ISDA; and
- where the Trustee loses the right to be indemnified out of the assets of the scheme.

### Additional Termination Events (ATEs)

#### *Pension Protection Fund (PPF) ATE*

The PPF is the statutory “lifeboat” for members of relevant defined pension schemes, providing compensation in certain circumstances after the insolvency of sponsoring employers. On 8 March 2010, the PPF issued a guidance note setting out standard termination event language dealing with the situation in which a pension scheme goes into the PPF. One of the PPF’s main drivers for the use of this wording was the preservation of a scheme’s funding and hedging arrangements upon a scheme entering the PPF. The PPF ATE wording also allays any concerns a bank may have that the PPF may exercise its statutory power to terminate contracts entered into on behalf of a scheme or to override any disadvantageous provisions within such contracts.

Pursuant to ss 127 and 132(2) of the Pensions Act 2004, a PPF assessment period (which starts the process of determining whether the scheme will go into the PPF) is triggered by a qualifying insolvency event in respect of the sponsoring employer of the pension scheme, eg where the sponsoring employer is unlikely to continue as a going concern or goes into administration. This is irrespective of the funding position of the scheme. The Trustee’s (and the PPF’s) objective is to avoid a termination trigger in the ISDA which is premature.

#### *“Poison pill” ATE*

Many Agency ISDAs contain a “poison pill” provision whereby, if the IM ceases to be the Trustee’s investment manager, the bank counterparty may be able to close-out transactions under the ISDA, should the trustee replace the IM with an investment manager whom the bank counterparty does not reasonably accept. In addition to the “poison pill” provision, often bank counterparties will seek to include an ATE which is triggered by the occurrence in respect of the IM of any of the events referred to in s 5(a)(vii)(*Bankruptcy*) of the ISDA

Master Agreement, and where a successor investment manager has not been appointed by the Trustee. In practical terms, the parties will need to agree the parameters of any change or replacement of the IM, including the terms and length of the transition from one IM to another, in order to ensure that any live and future transactions under the ISDA are preserved.

### ENFORCEABILITY OF CLOSE-OUT NETTING PROVISIONS IN A PENSION SCHEME ISDA

Trustees of UK pension schemes are one of the counterparty types covered by the English law legal opinion commissioned by ISDA, confirming the validity and enforceability of the ISDA Master Agreement’s close-out netting provisions as against English counterparties (the ISDA netting opinion). The bank counterparty’s netting arrangements will be with the Trustee in its capacity as trustee of the pension scheme, and any enforcement by the bank under the ISDA will be against the assets of the scheme, not any other assets of the Trustee.

### EMIR: CLEARING

Pension schemes fall within the definition of “financial counterparty” given in Art 2(8) and 2(10) of the European Market Infrastructure Regulation (Regulation 648/2012), as amended by Regulation (EU) No 2019/834 (EMIR). Financial counterparties are subject to the requirement to clear certain OTC derivatives transactions pursuant to Art 4 of EMIR.

The long-awaited amendments to EMIR, known as the “EMIR Refit”, came into force on 17 June 2019. These changes included a two-year extension to the exemption for pension schemes from the clearing obligation, and the European Commission has the ability twice further to extend the exemption for a period of one year. Although any consideration of the position of pension schemes in the context of EMIR is outside the scope of this article, it is worth noting that the European Parliament is of the view that this clearing exemption is not intended to be permanent. As such, pensions industry stakeholders are working towards facilitating technical solutions for pension schemes to transfer non-cash collateral with central counterparties as required by the clearing process. Implementing these changes is likely to impact on the cost of these OTC transactions, and although some of the largest pension schemes are already centrally clearing transactions, it is unclear when other pension schemes within the scope of EMIR are likely to follow suit in the immediate future.

### CONCLUSION

There are a number of legal and commercial issues to consider when negotiating a pension scheme ISDA against an evolving regulatory backdrop. Understanding the requirements and concerns of the Trustee and the bank counterparty is vital to achieving a balanced commercial agreement that properly reflects the structure and needs of the scheme. ■