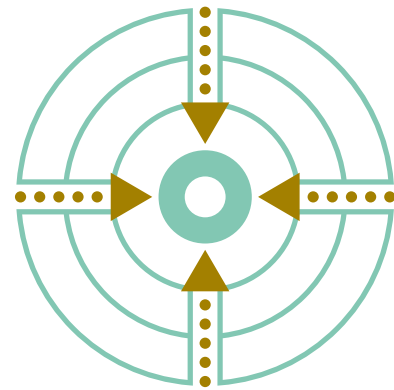


# Investment Insights for Pension Funds

APRIL 2020



This inaugural edition of Investment Insights for Pension Funds is devoted to the current economic crisis caused by COVID-19. Experts from across the firm share their insights on how companies are being affected, the actions they are taking, and the implications for investors.

We cover:

- Companies in distress: a view from the front line – what are our restructuring and insolvency experts seeing?
- Issues for specific individual asset classes: Real Estate, Infrastructure, Loans, Bonds, Structured Credit and Private Equity.
- Tax: what will proposed rescue arrangements mean from a tax perspective for individual asset classes?
- Synthetic investments: issues for derivative contracts.
- Funds and their response: as problems with individual assets feed into funds, what does this mean for funds, and how will funds react?
- How are regulators responding to the current crisis?
- Specific issues for trustees to consider.

## Speed Read

- The key focus for companies is to manage cashflows to trade through the current crisis. Often this needs to happen against the backdrop, and within the confines, of existing debt. However, as payments get deferred, companies need to be confident that they will be able to meet these obligations in the future.
- Difficulties at company level: commercial tenants unable to pay their rent and charges; infrastructure projects which need to be managed with decreased access and restrictions on movements; borrowers who need to defer debt payments and agree restructurings with their lenders; and boards having to reduce or suspend dividends.
- Managers of open-ended fund structures are having to ward off the immediate danger of investors looking to redeem their interests in the fund in a bid to raise cash, whilst managers of closed-ended fund structures could run into problems if they lack confidence in their investor base being able to fund their "just-in-time" drawdown structures.
- Regulators both here in the UK and in the EU are starting to recognise the pressures being put on firms in times of such market volatility and are working to alleviate some of these by considering delays in implementation and the issuance of guidance. The Pensions Regulator has provided some guidance to Trustees of DB and DC schemes.

## Actions for trustees

The full consequences of the current economic upheaval for investment portfolios will materialise over time as it becomes clear how the crisis for individual companies affects their profitability, cashflows and ability to meet obligations to stakeholders. We think the following are issues for trustees to consider and monitor.

### 1 Assess impact on investments

Identify the risks from individual asset classes. Could the trustees be expected to get involved in the restructuring of specific assets?

### 4 Strategic investment advice

How will COVID-19 affect different geographies, sectors and companies? Will defaults and insolvencies arise indiscriminately across the economy or will some areas be more affected? Do portfolios need to be adjusted in response? Should index-tracking funds be replaced with actively managed funds?

### 2 Liquidity

Trustees need to be prepared for cashflow failures in their investments and, at the same time, greater liquidity demands to fund existing commitments and margin calls on derivatives. At the same time, trustees might be asked to agree deferral of contributions to the scheme, and there might be increased outflows as members who have lost employment income seek to replace it with pension benefits, including transfers to other pension arrangements that give them more flexibility.

### 5 Credit triggers in portfolios

If trustees have restrictions on credit holdings by reference to credit ratings, should these be reviewed in anticipation of potential widespread downgrades?

### 6 Governance

Although trustees may wish to act quickly, there are legal and governance processes that must be followed and committees and individuals should act only within the scope of their delegated authorities. This is relevant, for example when reviewing a SIP, investing in or out of funds, or changing a fund manager's mandate.

### 3 Macro-economic and political issues

Trustees need to consider the long-term effects on the economy (and therefore returns to investors) of increased government borrowing and, potentially, more quantitative easing, and the potential effects that the COVID-19 experience will have on tax, health and social security policies.

### 7 Scheme valuations

Many schemes have 31 March year-end dates. Valuing illiquid assets could be more of a challenge than usual. An actuarial valuation based on market values on that date might paint a misleading picture.

# Companies in distress: Restructuring & Insolvency – a view from the frontline

For many businesses, the key question has become: "How can I put my business into hibernation"? The second question is: "How do I prepare my cashflows when we can't tell how long this will last"?

The answer to the first question depends on the business, its creditors, its cash and its stakeholders. The answer to the second question is that nobody knows; but our conversations with companies suggest that many are currently modelling cashflows with between three to five months' fully impacted by the crisis and a tapered exit back towards "normality". Of course, views are changing constantly.

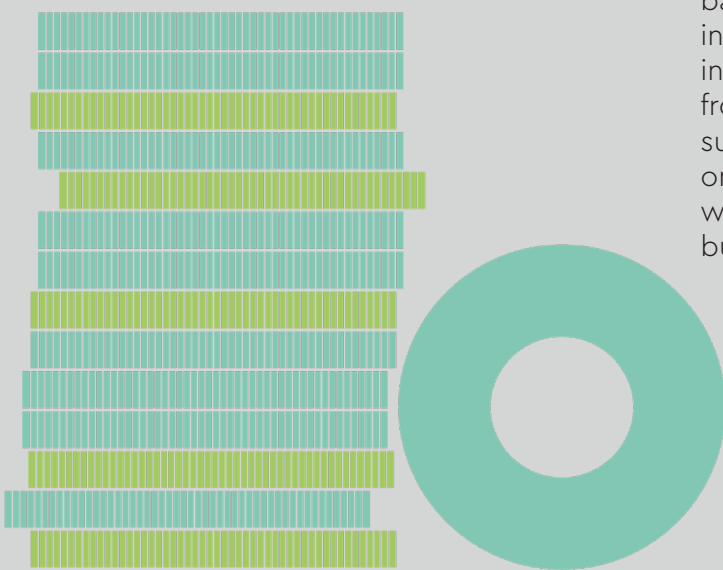
Front-line decision-makers – in particular the directors of companies needing to formulate a response to the consequences of COVID-19 – are having to make critical choices in real time, while the basic rules underpinning those choices are being rewritten by the Government on a daily basis.

## Cash is king

As always, cash is king, with the key question for all businesses being the extent to which their available cash can be made to cover the anticipated period of shutdown. Businesses are urgently looking to reduce their cost bases and are engaging with their suppliers and other creditors to reschedule payment terms.

The initial government financial support scheme left many businesses unable to access funds. It is now being modified. Governmental support for the temporary "furloughing" of employees is a help but there are timing issues on the availability of the relief and each business needs to strike its own arrangements with its staff as necessary. Similarly, governmental intervention has sought to assist businesses who would otherwise face the threat of being ejected from their leased premises because of failure to pay rent; but the assistance is only partial and there are still potential ways in which landlords can apply damaging pressure to businesses. There is help on some taxes, but it is only a deferral not a waiver. Businesses will have to think about what happens when things get back to a new normal – will they actually be able to settle all these deferred liabilities?

Inevitably, close attention must be paid to bank relationships. Many facilities risk being in default as a result of a dramatic reduction in turnover. Although there is broad guidance from the government that lenders should support businesses, this is not a "silver bullet"; on the ground, there are difficult conversations with lenders around continuing support to businesses that are struggling.



## Issues for individual asset classes

### Real Estate

Commercial tenants with leases on FRI terms will be under obligations to pay rents, service, and other charges.

Many tenants, particularly in the retail and leisure sectors (with the notable exception of supermarkets) are currently unable or unwilling to operate from their premises and are requesting temporary rent holidays, rent reductions, monthly (as opposed to quarterly) rent payment schedules, and declining to pay some or all of their service charges. Some are seeking longer term variations of their leases or considering whether they can exit their leases altogether. Some tenants will be close to insolvency if they cannot reduce their liabilities.

Tenants are already approaching landlords with these requests, and landlords are typically agreeing to at least some of them, provided that this does not put them in breach of any of their own lease and/or finance arrangements, and some with a condition that tenants investigate whether their insurance will cover the shortfalls first.

However, unless a landlord is looking to recover the property (e.g. for redevelopment), then forfeiture is not usually an appealing remedy in the circumstances, and in any case, some expect that legislation will be enacted imminently to restrict or prevent forfeiture for the next one or two quarters to give tenants a chance to recover. Replacing tenants in the current climate is likely to be very challenging and even if a replacement can be found, general economic uncertainty is likely to make pricing very difficult. Negotiations with current tenants and mutual agreements to restructure or waive outgoings are likely to become the norm.

### Infrastructure

Restrictions on movement and access can affect real operating assets. Perhaps inevitably attention has therefore focused on the impact of force majeure provisions.

Investors in existing infrastructure assets often outsource the operation of the physical assets under operation and maintenance agreements (O&Ms). In general, the O&Ms usually have a force majeure clause excluding the operator's liability if it is unable to perform its services in accordance with the O&M as a result of an event beyond the reasonable control of the operator.

Whilst a pandemic (such as the COVID-19 outbreak) is often not listed as a specific example of a force majeure event, it is quite clear that such an event is beyond the control of an operator.

However, force majeure clauses tend to be triggered only if the operator's ability to perform its obligations is affected. This is going to be fact specific (and in part depend upon the governmental restrictions in place at the location of the asset).

While force majeure provisions may excuse performance in the short term, what are the potential long-term effects? Usually parties will be entitled to terminate the O&M if the ability to perform the contract is affected for a prolonged period (often 60-180 days). However, if the asset/project is debt financed, a force majeure under the O&M may also result in an event of default under the related debt facility. Investors will therefore monitor the situation carefully to assess how any prolonged restrictions on movement could affect their asset.



## Credit and credit products

### Bilateral and syndicated loans

Unsurprisingly, lenders are carefully monitoring their loan books. As the restrictions on movements hit the cashflows and balance sheets of borrowers, lenders are taking a close look at potential breaches of financial covenants over the coming weeks and months.

Monitoring is increasing and borrowers are being asked to provide more frequent updates and forecasts. Lenders are also evaluating their options. Can commitments be cancelled? Should additional security be taken? Are increased margins appropriate? Which events of default are likely to be triggered? What are the enforcement options? Lenders have also started to assess their priority vis-à-vis other creditors.

Non-bank lenders are carefully assessing the strength of their own funding sources.

Lenders in syndicates are concerned about the behaviour of other members. This is perhaps even more the case if a syndicate is made up of a selection of both bank and non-bank lenders.

Borrowers are engaging with lenders to find ways to bridge the anticipated period of disruption. Both lenders and borrowers are assessing the communications from the UK banking authorities and regulators who have asked lenders to take into account the current circumstances when assessing breaches of covenants in banking documents.

### Bonds

Issuers of corporate debt are tracking payments dates and monitoring cashflows closely. A concern for issuers needing to defer payments or restructure their obligations is that their debt can be held by a wide range of investors across different jurisdictions. A diverse investor base with different objectives can complicate restructurings.

Formal notification, amendment and waiver processes can further complicate rescue and stand-still arrangements.

Fund lenders are assessing the obligation which they owe to their own investors and how to manage their liquidity requirements with the demands of issuers of corporate debt.

### Structured credit

Issuers of structured credit (e.g. CLOs, RMBS and CMBS) will, in time, be affected by developments in the real estate sector and the corporate loan and bond market.

The response will often be driven by the impact of pre-agreed triggers and actions, which in turn tend to be based on credit rating agency requirements.

## Private Equity

Private Equity sponsors are pro-actively assisting their portfolio assets in a number of ways.

These include working with the portfolio companies to help them:

- 1** preserve cash resources (e.g. liaising with commercial landlords, HMRC and other significant creditors to reduce the burden on businesses which in some cases means not paying these creditors at all and making the most of available financial facilities by drawing down on these monies where possible);
- 2** managing employment related costs by making the most of the Government support measures or otherwise reducing cost by putting in place part time working, remuneration reduction measures and, in certain cases, redundancies; and
- 3** making the most of government initiatives to support business – this landscape changes almost daily, although, at the moment, the financial support measures are not, in practice, readily available to many PE backed businesses.

At the fund level, there is considerable interest in raising capital by way of NAV borrowing or the issuance of preferred equity – giving the fund a war chest to deploy in supporting its businesses in circumstances where the fund is not willing or not able to leverage the underlying portfolio assets further. We are also seeing funds seek out new investment opportunities, particularly those funds that are able to invest private capital into undervalued public companies.



## Tax implications of rescue arrangements

The actions and measures that can be taken in relation to the various asset classes will inevitably have tax consequences, and companies need to consider how best to structure any actions, and whether there are useful reliefs or measures that could be utilised.

For example, as part of its response to the current situation, the Government has announced that all businesses in the UK are able to defer their VAT payments for the rest of this quarter (applicable from 20 March 2020 to 30 June 2020) until the end of the 20/21 tax year. No application will be required, and any businesses wishing to defer do not need to tell HMRC prior to doing so.

All retail, hospitality and leisure businesses in England will benefit from a 12-month business rates relief for 2020/2021. It will apply to the next council bill in April 2020 and requires no action on the part of the businesses concerned.

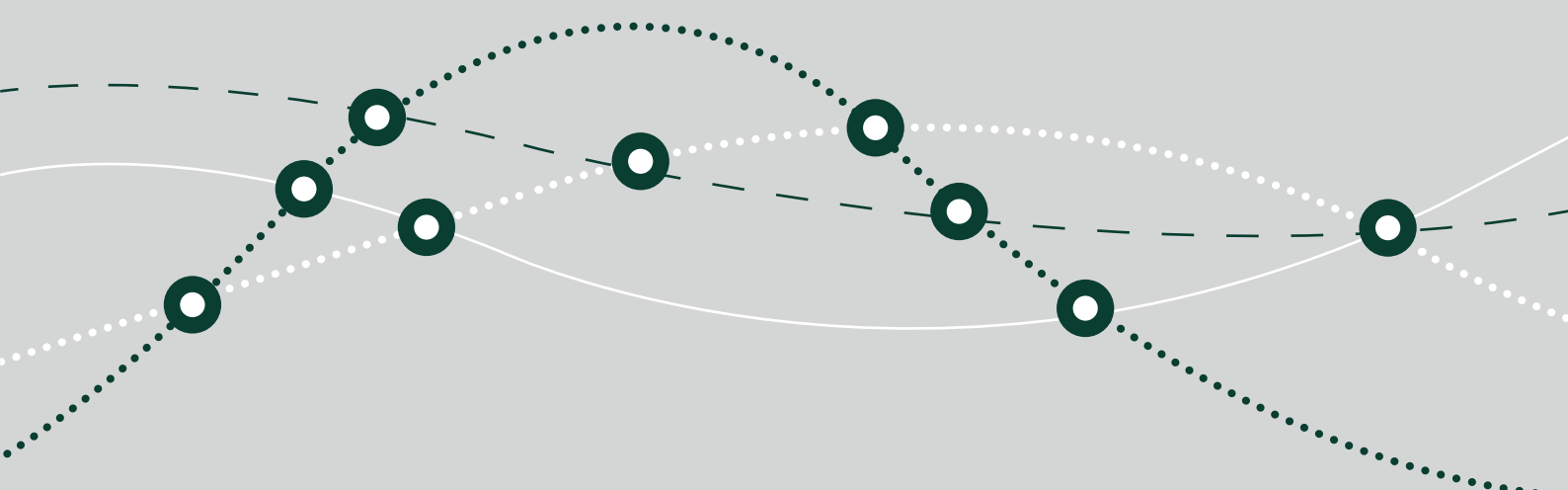
The Government has also confirmed that all businesses in financial distress, and with outstanding tax liabilities, will be able to receive tailored support from HMRC through the "Time To Pay" service. Such arrangements are agreed on a case-by-case basis but can include instalment arrangements to pay tax.

There are other tax reliefs that tax practitioners are already familiar with, and which may be used more prevalently in times of economic difficulty.

If a creditor acquires shares in a company in exchange for reducing the debt burden on the business, this can be done without resulting in a tax charge for the debtor company (provided it is properly drafted and the beartraps avoided).

Another example is VAT bad debt relief, whereby a supplier can reclaim VAT that it has previously paid to HMRC in circumstances where that supplier does not ultimately receive payment (in whole or in part) from its customer for the supply in question.

Managing cashflows, and that includes tax payments, will be crucial to the survival of individual businesses.



## Synthetic investments – derivative based strategies

Often synthetic investments require the exchange of collateral, and in some cases, on terms mandated by law. Frequent and large fluctuations in either the value of the underlying exposure or the collateral can result in regular margin calls (in some cases more than once per day), putting liquidity strains on counterparties.

Synthetic investments are based on contracts, and just as with every other commercial contract, much attention has been paid to force majeure clauses over the last few weeks – especially given that some market standard terms contain force majeure provisions.

However, as financial services businesses across the UK have successfully implemented business continuity measures, counterparties have generally been able to continue to perform. As a result the concerns over force majeure provisions have receded.

## Investment Funds

All fund managers, and their investors, will be facing significant challenges in the current environment. The exact nature of those challenges will vary depending on the structure of the funds and the underlying assets in which those funds are investing.

### Open-ended vs. closed-ended

From a structural viewpoint, a distinction can most easily be drawn between those managers running open-ended funds (i.e. those containing periodic redemption rights for investors) and those which are closed-ended (i.e. those with no unilateral liquidity options for investors prior to the end of the life of the fund).

For managers running open-ended structures, the immediate danger is that investors will wish to redeem their interests in the fund to raise cash. For managers in very liquid asset classes, such as listed equities, this may be manageable.

Even if underlying liquidity is partially restricted, the manager may well be able to use gating provisions (i.e. restricting the proportion of the fund which can be redeemed at any single redemption date) to ensure that redemptions are maintained at a manageable level.

Far harder is the situation where the fund is invested in assets where it may be impossible to determine valuations due to the current conditions; given the manager's obligation to redeem interests at prevailing net asset value, if there is no route to price discovery at the underlying level, the manager may have no choice but to suspend the fund altogether and allow no redemptions (or subscriptions) for a period of time. Such a route is likely to be unpopular with investors and might dent confidence in the manager's investment programme.

For managers running closed-ended structures (which tends to be the starting point for illiquid asset classes like private equity, credit, infrastructure and some segments of the real estate market), the position might appear easier – investors cannot redeem their positions. However, challenges remain: funds of this type will typically be running "just-in-time" drawdown structures and so a manager will need to be confident that their investor base will fund when drawdowns are issued.



# The regulatory response

## Financial services

There have been various announcements by both UK and Continental European regulators which have impacted institutional investors either directly (where they are licensed in the UK or Europe) or indirectly (e.g. where that institution invests through a fund or account managed by a UK or European investment manager).

Where regulators have intervened, it has generally been to protect consumers and market integrity, and to mitigate impacts for the real economy.

These measures affect a number of different segments of the market and overlay existing requirements, some of which are triggered or become particularly relevant in times of market downturn or disruption (e.g. 10% depreciation notifications under MiFID client reporting rules).

Institutions who actively pursue or invest in strategies that utilise short selling have seen additional complexity with additional bans imposed by individual EU Member States (and although the FCA has stated that it does not as yet plan to introduce its own specific ban in respect of UK securities, it has supported action taken by other European regulators) and a lowering (by the European Securities and Markets Authority) of the private, regulatory reporting notification under the EU Short Selling Regulation to 0.1%.

Additionally, the UK banking authorities and regulators have acted to strongly encourage lenders (which we think includes bank and non-bank lenders) to take into account the current circumstances when assessing breaches of covenants in banking documents.

This could be relevant for institutions who actively invest in, and those who manage or advise on, credit investments.

We are also starting to see regulators both in the UK and at EU level recognising the pressures on firms (and themselves) and working to alleviate them. For example, there have been delays to the implementation of the first reporting wave under EU Securities Financing Transaction Regulation (note that there has not been a corresponding delay for UK and EU alternative investment fund managers who are due to start reporting in-scope securities financing transactions later this year) the next stages in the implementation of initial margin requirements under the European Market Infrastructure Regulation.

However, regulatory initiatives relating to the replacement of LIBOR and the EU prudential regime for investment firms have not been delayed.



## Pensions regulator

In the pensions sector specifically, the Pensions Regulator (TPR) has also issued (and is regularly updating) guidance to trustees, both of DB and DC arrangements.

### DB

For defined benefit (DB) arrangements and their sponsoring employers, TPR has issued a suite of guidance statements covering a variety of issues. In relation to DB scheme investments, TPR observes that falls in investment markets and decreases in yields will have affected funding levels for many schemes, with the most significant effects for DB schemes with low levels of hedging and significant allocations to risk assets. There may also be opportunities emerging in certain markets or asset classes to enhance or preserve value. The pricing of risk transfer through buy-ins or buy-outs has also been affected by the turmoil in the bond markets and widening credit spreads.

TPR has also announced a series of regulatory easements, including around DB scheme funding and employer contribution arrangements, provisionally lasting until 30 June 2020.

In relation to downside investment considerations, TPR has stated that while DB schemes with longer-term investment horizons may be able to 'trade through' some of the current market volatility, trustees should consider with their advisers what actions should be taken in relation to significant risks (short, medium or long-term), or where the scheme's sponsoring employer may be facing challenges, and keep this under constant review.

Matters for trustee review include: expected scheme cashflows and how these might vary (e.g. as a result of changing member activity); whether investment strategies and rebalancing arrangements are suitable in the current environment; assessing diversification (or concentration) of investment risks within portfolios; appropriateness of derivative and collateral management arrangements; and the timing and appropriateness of any planned or pre-agreed asset transitions. More mature schemes are likely to need to pay particular attention to these issues.

### DC

For defined contribution (DC) arrangements, TPR's guidance aims to help trustees address some of the investment risks in the short, medium and potentially long-term for DC schemes and members.

Although many members of DC schemes will be able to endure short-term volatility in the market due to their long investment horizons, TPR is recommending that trustees take a number of steps to help address members' concerns. Communicating what the current market volatility might mean for members retiring at different stages in the future, considering getting investment advice before switching funds (in order to avoid crystallising losses) and the dangers of scamming in the current environment are all points that trustees are encouraged to highlight to members.

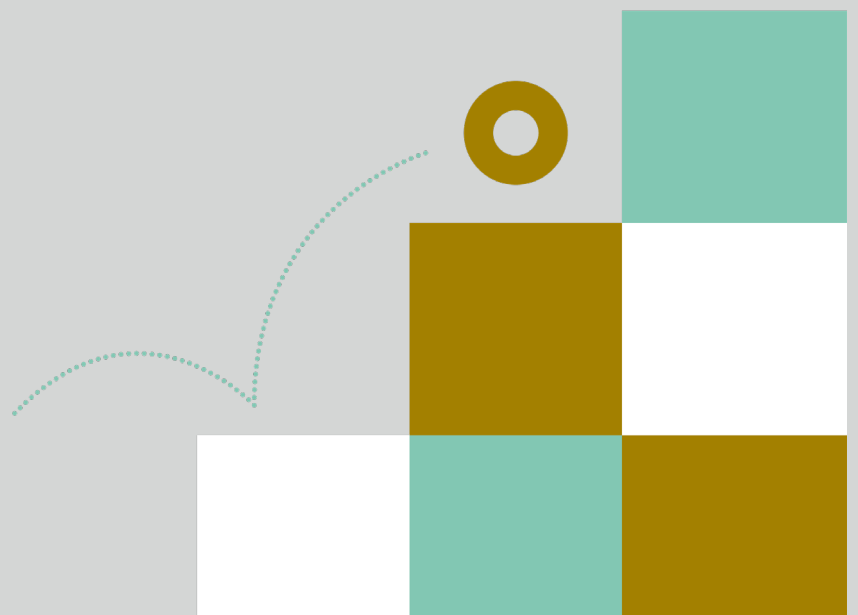
Trustees should also be drawing their own attention to default investment strategies and the timings of fund switches or asset transitions, currently in place (and whether it would be appropriate to suspend or refine these arrangements), and the extent of any concentrations of risk or exposures to certain counterparties in their portfolios.

Trustees might also consider whether the scheme gives members facing immediate financial difficulties the full range of options to draw on their DC pots.

## Pensions investment at Travers Smith

Pension scheme trustees and sponsors are taking an increasingly sophisticated approach to investment. We have market-leading specialists in financial services, capital markets, derivatives, structured products, and investment funds. They have a deep understanding of the particular concerns and perspectives of pension scheme trustees and they advise on the full range of pension investment arrangements, including:

- Liability driven investment (LDI) and cashflow driven investment (CDI) mandates.
- Investment management agreements (IMAs), transition management agreements.
- Fiduciary management.
- Custody arrangements.
- Investment funds, including: regulated and unregulated, long-only, private equity and venture capital, insurance-wrapped funds, infrastructure, debt, real estate, structured finance, hedge funds and listed funds.
- Investment aspects of scheme covenant/funding arrangements.
- Derivatives and repo, including: negotiation of ISDAs, GMRAs and GMSLAs, longevity, interest rate, inflation, FX and other risk hedging.
- Clearing and collateral management.
- Asset transition exercises, including in relation to scheme mergers and bulk annuity transactions.
- Investment in structured finance products.
- Regulation including EMIR, MiFID and SFTR.
- Tax structuring of investment arrangements.



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