Depositary Insights

March 2021

NatWest Trustee and Depositary Services

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Foreword

Welcome to the March edition of Depositary Insights, which offers the latest thinking on regulatory and industry developments from NatWest Trustee and Depositary Services.

Now that the Brexit transition period has come to an end and the UK has left the European Union, regulators are focussing their attention on the future. The competitiveness of the UK is becoming increasingly important and the UK Funds Review is the first insight in terms of future direction of travel as regulators continue to address the important strategic issues of Covid-19 recovery, liquidity and ESG.

The articles in this edition are each connected to these themes. The industry has the opportunity to shape its future, working with regulators to come up with solutions that provide investors with the solutions they need whilst also improving investor protection. At NWTDS we are also committed to working with ACDs and fund boards to drive forward governance standards within the industry.

We hope you find the topics contained in this edition to be a helpful guide as we look ahead to the challenges and opportunities of 2021. We welcome your feedback as to how we can improve future editions or on topics for inclusion.

Articles in this edition:

- Review of the UK funds regime: wide-ranging but cohesive
- 2021: a "tipping point" for transparency on Responsible Investing
- Liquidity and the Long Term Asset Fund
- The Dormant Assets Scheme: what to expect next

NatWest Trustee and Depositary Services team

Review of the UK funds regime:

Wide-ranging but cohesive

On 26 January 2021 HM Treasury published its call for input on the future of the UK funds regime. The government has stated that it aims to make the UK a more attractive place for setting up, administering and managing funds.[1]

It covers a series of key questions around how the funds regime can be enhanced, to support UK economic attractiveness and the levelling up of the economy across the UK, as well as questions on the taxation of Real Estate Investment Trusts (REITs) and Property Authorised Investment Funds (PAIFs), and the taxation implications of the Long Term Asset Fund.

Dive deeper →

1 Source: UK Government, Budget 2020, 11 March 2020, Section 2.208, Page 92 (https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/871799/Budget_2020_Web_Accessible_Complete.pdf)

Review of the UK funds regime

Gaps and issues

The call for input asks a number of questions around potential gaps in the current state of the funds market in the UK, and on how it can be adapted to better enable investors to meet their goals. One area of focus is around speed to market and the extent to which the current system facilitates an efficient process for the establishment of new funds. Linked to this is the authorisation process: the paper seeks an international perspective, asking respondents how the FCA's processes compare to those found in other jurisdictions. On the matter of operational efficiency, the Treasury also notes the ongoing work on the Direct2Fund model.

Aside from the operational and procedural structures underpinning the funds regime, the Treasury also probes the attractiveness and effectiveness of a number of different fund types, including Qualified Investor Schemes (QISs), Exchange Traded Funds (ETFs), Investment Trusts, and Alternative Investment Funds (AIFs). The paper asks open questions around what could be done to make AIFs and QISs more attractive; for example, it raises the option of removing requirements for distribution of income and allowing QISs to distribute capital and carry over income.

The call for input asks respondents why they think there are so few ETFs domiciled in the UK, and what could be done to address this. Acknowledging that re-domiciling ETFs could prove expensive and technically challenging, the government asks what could be done to encourage new ETFs to be set up in the UK.

The government is also interested in why asset managers choose to set up funds as either closed-ended or open-ended funds, and whether they should be required to justify why they have chosen to set up a fund as one or the other. Views are also being sought as to whether there are barriers to investing in long-term assets, and whether the investment trust structure is a more appropriate fund type for these than, for example, Non-UCITS Retail Schemes (NURSs), which have been the focus on attention from the FCA in CP20/15 (liquidity mismatch in open-ended investment funds).

Review of the UK funds regime

The HM Treasury paper noted that

20%

of asset management jobs in the UK are based in Scotland[2]

Levelling up

A key area of focus in the call for input is how the jobs and growth of the asset management and fund administration industries can be spread across the country.

Respondents are asked for thoughts on how specific UK locations could better foster growth in funds-related employment, and how the government can support in ensuring that the right expertise exists in the workforce. This aligns with the government's "levelling up" agenda, in seeking to spread the benefits of the industry across the UK and in ensuring that the workforce is well-placed to facilitate this growth.

Next steps

This call for input represents an important step as the government looks to the future of the funds industry, now that the UK has left the European Union. It is wide-ranging in its scope – covering (among many other things) taxation, operational effectiveness, fund structures, efficiency of bringing funds to market, and the distribution of jobs across the UK. However, in so doing, it effectively ties together a number of 2021's key regulatory themes. The deadline for responses is 20 April 2021.

NWTDS view

The call for input is significant in tying together a number of key strands in government policy – from "levelling up" to UK attractiveness and international competitiveness. Its questions encourage deep thinking as to why some fund types are more popular and successful than others, and this represents an opportunity for the regime to "build back better".

We will engage with clients' and industry bodies such as the IA and DATA on the themes and issues that the government has raised and will build this into our response to this call for input.

2 Source: Review of the UK funds regime: call for input, 26 January 2021, Section 4.5, Page 22 (https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/955542/REVIEW_OF_THE_UK_FUNDS_REGIME_-_CALL_FOR_INPUT.pdf)

2021: a "tipping point" for transparency on Responsible Investing

2021 is set to be a "tipping point" year for Responsible Investing in the investment industry: this was the consensus at Natwest Trustee and Depositary Services' ESG-focussed webinar held at the turn of the year.

It is easy to see why: 2021 is set to be punctuated with significant milestones as governments and investors continue to drive towards "greening finance" and "financing green". All the while, expectations of end investors continue to grow, and there is increased interest in the substance and credibility of claims made for sustainability.

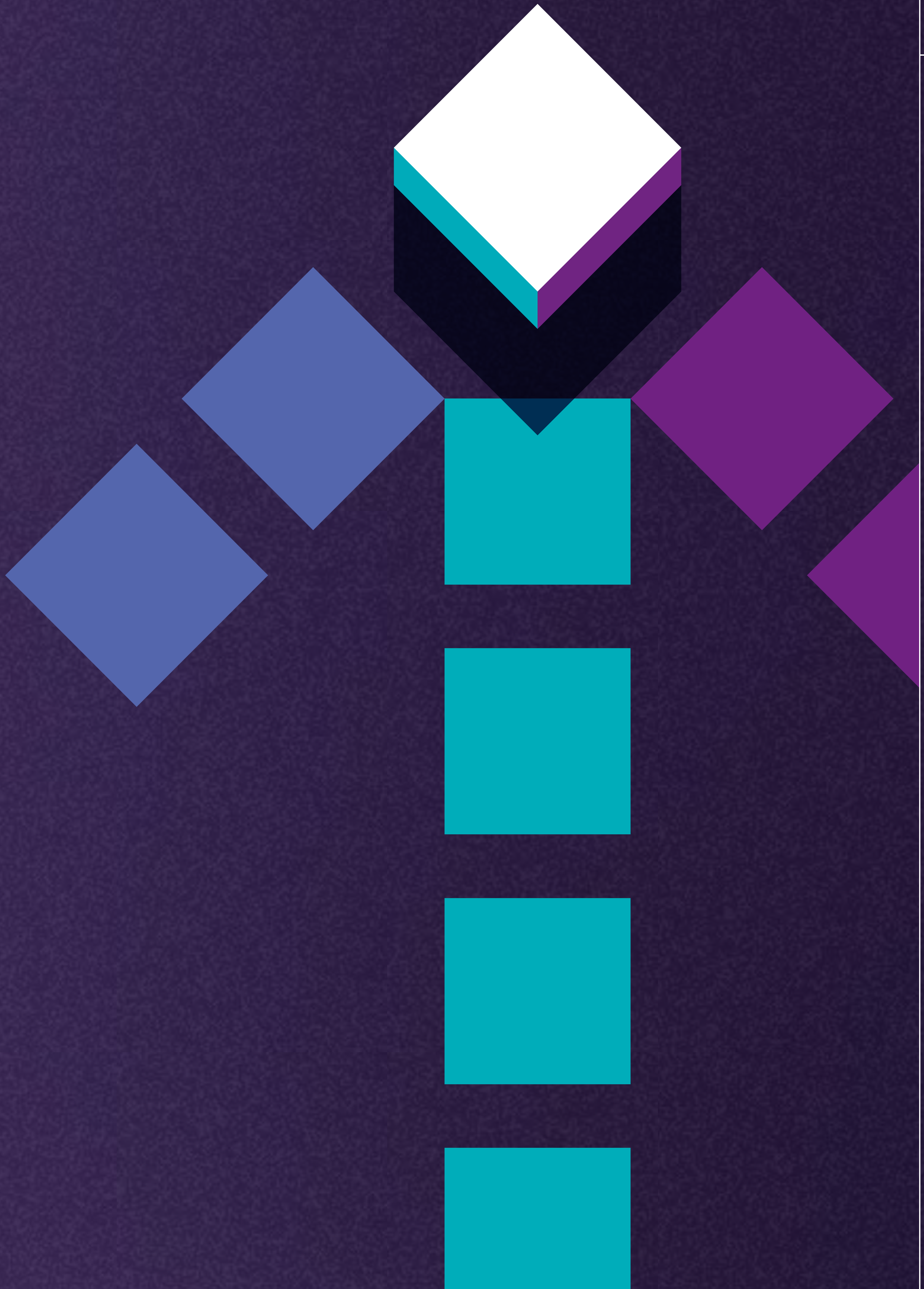
Dive deeper →

2021: a "tipping point" for transparency on Responsible Investing

A green recovery and a race to net zero

The concept of "greening" the financial sector was memorably coined in the UK Government's 2019 Green Finance Strategy, which set bold targets for greenhouse gas reduction and emphasised the role that financial services have to play in pushing the UK economy as a whole to "Net Zero" by 2050. Since the strategy was published, the UK Government has made further commitments with implications for financial services firms. They are expected to play a key role in the COP26 climate change conference in Glasgow later this year.

On 09 November 2020, the Chancellor of the Exchequer delivered a speech highlighting the government's aim to lead the world on green finance, and to achieve a green recovery from the Covid-19 pandemic. This was echoed in the Prime Minister's "Ten Point Plan for a Green Industrial Revolution" on 18 November 2020, in which the government outlined its aim to "harness the international reputation of the UK's world-leading financial sector to encourage private investment into supporting innovation and manage climate financial risk." These have set the tone for 2021, and the focus is now on meeting these aspirations.



2021: a “tipping point” for transparency on Responsible Investing

Raising the bar for disclosures

As the government raises expectations for firms, it is also raising standards for accountability and transparency. From a fund regulatory perspective, this translates into two particular policy developments, both of which were trailed in the Chancellor’s speech. These are the introduction of mandatory reporting aligned to the Taskforce for Climate Related Financial Disclosures (TCFD), and the introduction of the UK’s Green Taxonomy.

Many investment firms are already engaged with standards and codes which seek to evidence outcomes and guard against “greenwashing” - these include TCFD as well as the UN Principles for Responsible Investment and the UK’s Stewardship Code – but the government’s intention for TCFD to become mandatory for firms is a significant step up. The government has published a roadmap setting out its proposed timeline.

Of course, some firms will want to report to TCFD standards ahead of their allotted time, in order to demonstrate proactive engagement and meet governmental and public expectations. The competitive landscape on ESG is growing as end investors increasingly seek out credible sustainable investments, meaning that a proactive approach can be a differentiator in an increasingly crowded market.

Early in the year there should be scope for firms to shape the policy itself and to act as thought leaders on the issue, as the government is expected to consult on TCFD alignment for asset managers in the first half of 2021.

TCFD roadmap for 2021 to 2024/5

2021

Banks, building societies, insurance companies, occupational pension schemes with AuM of over £5 billion, and premium listed companies.

2022

Occupational pension schemes with AuM of over £1 billion, the largest asset managers (with assets under management in excess of £50 billion), life insurers and FCA-regulated pension companies, listed companies, and UK registered companies.

2023

Other UK-authorised asset managers, life insurers and FCA-regulated pension providers.

2024/5

Other occupational pension schemes and other companies subject to review.

2021: a "tipping point" for transparency on Responsible Investing

Consistent definitions for sustainability

The rise in popularity of ESG has simultaneously led to greater risk of its terminology being misused in boilerplate language or as a marketing exercise. To address this, the UK government is set to introduce a green taxonomy, which will set out accepted terms and definitions, to ensure transparency and consistency in terminology used on prospectuses, reporting and marketing materials. The UK green taxonomy will be based on the EU green taxonomy, but there is scope for divergence. Combined with the Investment Association's drive for an ESG retail label, the focus this year will be on establishing a shared understanding of norms, terms and principles, increasing accountability and ultimately benefitting the end investor.

Pressure from end investors as well as government

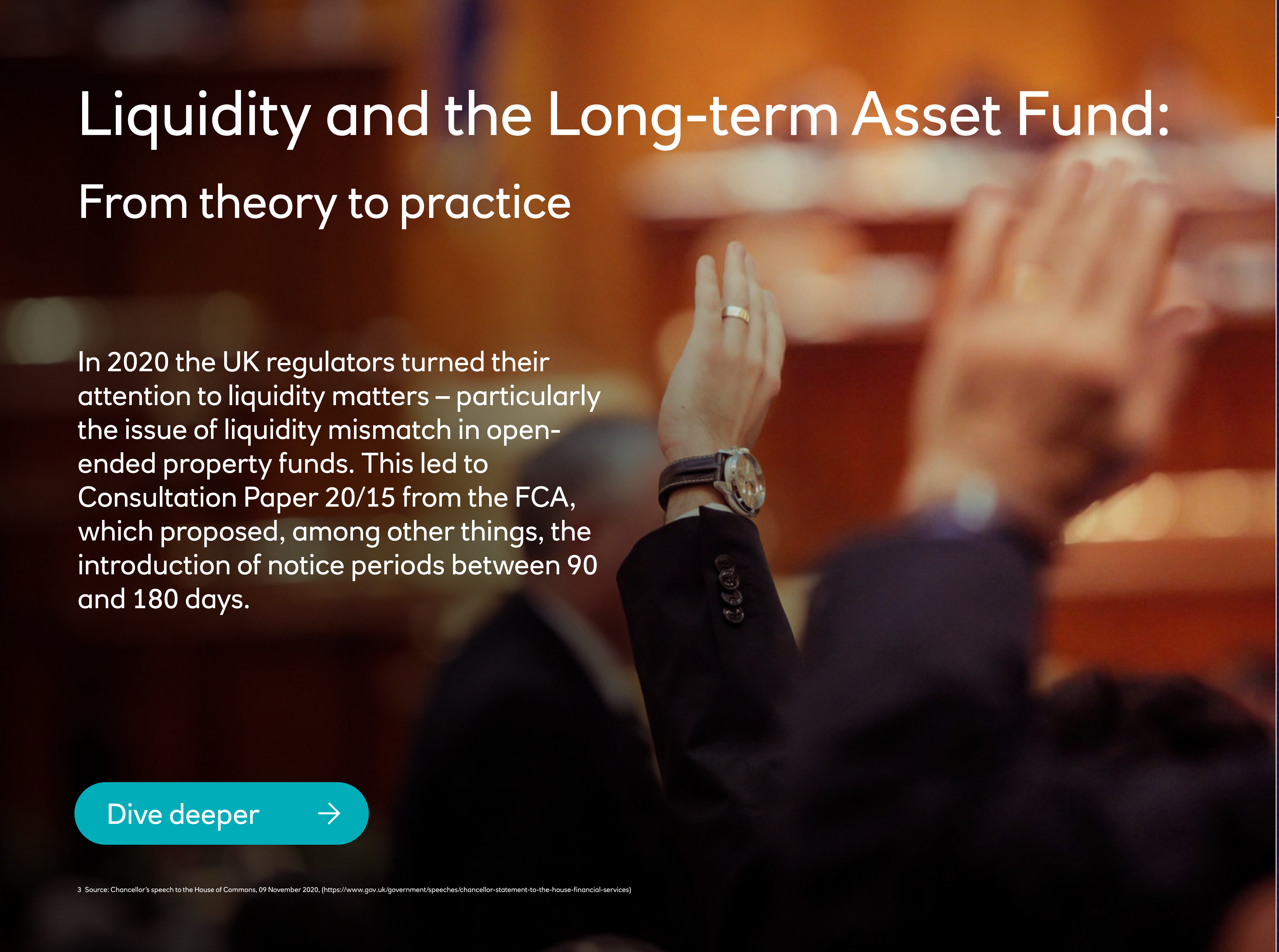
2021 will also likely be a year of increased activism from end investors. Campaigns such as "Make my Money Matter" have increased public awareness of the impact that investments can have in achieving societal outcomes. Growing public interest in investing means that it is likely that there will be further examples of activist interest from end investors not just in the composition of funds but in the exercise of voting rights. As a result, firms will face increased scrutiny on ESG not just from government and regulators, but from the public and from end investors.

In a tipping point year for ESG, firms should be prepared for further focus on transparency, consistency and accountability. Incoming regulatory reform will help firms to avoid the growing reputational risks associated with accusations of "greenwashing," and this will allow them to become more credible and competitive in an increasingly popular market, by providing benchmarked "decision-useful" reporting data. Expectations from government and end investors have grown, but the means of meeting them have also become much clearer.

2021: a "tipping point" for transparency on Responsible Investing

NWTDS view

- We are developing tools to assist clients with ESG data analytics and reporting, and to produce granular and traceable ESG insights as part of our "Odyssey" programme. We are actively considering how we can shape depositary oversight standards for ESG funds. Please contact us to find out more.
- Regulatory developments on ESG are an opportunity for firms: engaging with these developments can help enhance credibility and transparency – differentiators in a crowded market.
- We have seen clients increasingly engage with standards such as TCFD, UNPRI and the Stewardship Code, in line with the increasing expectations. There is increasing demand for outcome-focussed reporting – in other words, setting out how a policy or investment strategy enhances environmental, social or governance measures.
- Market metrics appear more advanced in terms of the "E" of ESG. However, there is increasing public and regulatory attention turning to the social and governance categories.
- The FCA's five principles for ESG, set out in a speech in November 2020, indicate that there will be closer investigation of the composition of funds, to kick the tyres on the extent to which they truly are "ESG" funds.
- At a Group level, NatWest is a principal sponsor of the COP26 climate change conference in November 2021.



Liquidity and the Long-term Asset Fund:

From theory to practice

In 2020 the UK regulators turned their attention to liquidity matters – particularly the issue of liquidity mismatch in open-ended property funds. This led to Consultation Paper 20/15 from the FCA, which proposed, among other things, the introduction of notice periods between 90 and 180 days.

Dive deeper →

3 Source: Chancellor's speech to the House of Commons, 09 November 2020, (https://www.gov.uk/government/speeches/chancellor-statement-to-the-house-financial-services)

Liquidity and the Long-term Asset Fund

We await the result of this activity: the Bank of England's financial stability report in March should give an indication of direction of travel, followed by subsequent policy statements and potential handbook changes from the FCA. HMRC also issued a consultation on the impact of notice periods on ISAs, and the results of this process are expected in the first half of this year as well.

In the interim, the government has proposed a new type of fund – the Long Term Asset Fund (LTAF). This is aimed not only at addressing the challenges of liquidity mismatch but also at supporting economic recovery from Covid-19.

On 09 November 2020 the Chancellor of the Exchequer confirmed the UK Government's support for LTAF in a speech before the House of Commons:

> "To encourage UK pension funds to direct more of their half a trillion pounds of capital towards our economic recovery I'm committing to the UK's first Long-Term Asset Fund being up and running within a year."

With this announcement, the work of delivering the fund has now begun in earnest.

Opportunities and questions

The LTAF brings new opportunities, but there are also plenty of questions to be considered as well. The concept of the LTAF was first proposed in June 2019 by the Investment Association's Funds Regime Working Group. At the time, the proposal sought to address the challenges of low dividends, low bond yields, and property fund suspensions, while providing more choice to retail investors: the LTAF is intended to broaden access to investment opportunities in infrastructure, housing, small and medium enterprises, private equity, and Patient Capital.

While providing greater choice to retail investors, the LTAF concept also aligns with key policy themes such as economic recovery from Covid-19 and improving the competitiveness and attractiveness of the UK funds landscape post-Brexit. By potentially facilitating greater investment in infrastructure, the fund could help to "build back better" and to "level up" – both key governmental priorities.

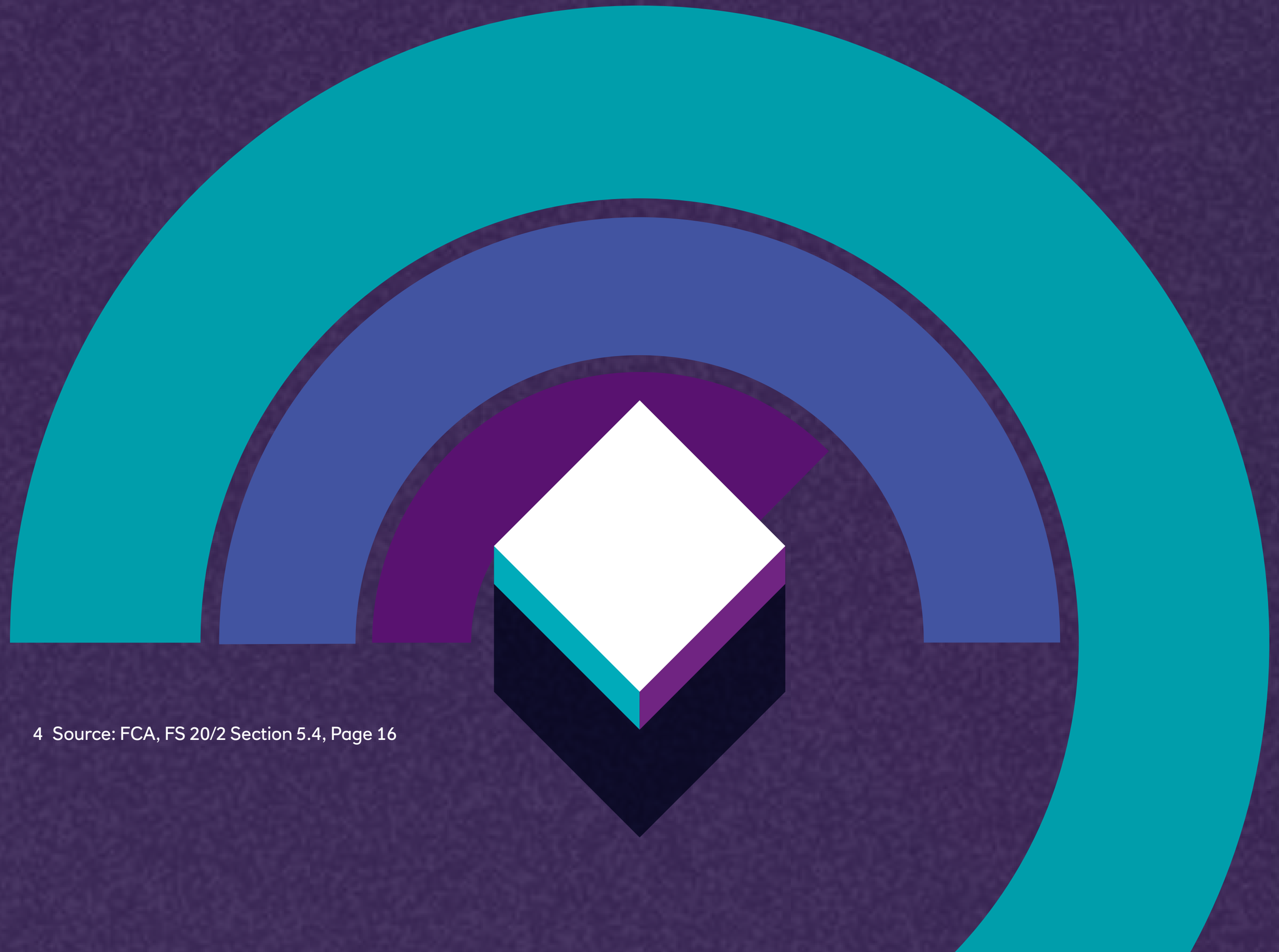
The Long Term Asset fund is also intended to address the challenge of liquidity mismatch. By introducing controlled dealing periods, the risk associated with the illiquid nature of the underlying assets and the redemption needs of the retail fund holder are addressed. These issues have been highlighted in recent years through fund suspensions as a result of events such as Brexit and the market volatility caused by Covid-19. The FCA and Bank of England are expected to expand further on this theme when the conclusions of the joint FCA / Bank of England review on liquidity mismatch are published in March or April.

3 Source: Chancellor's speech to the House of Commons, 09 November 2020, (https://www.gov.uk/government/speeches/chancellor-statement-to-the-house-financial-services)

Liquidity and the Long-term Asset Fund

Thinking through the details

The specifics, including the operational details of these proposals, will need to be carefully thought through in advance of the proposed launch of this product type later in the year. The FCA is expected to consult on the LTAF in Q1, and the tax treatment of the fund has already been included in HM Treasury's Call for Input on the future of the UK Funds Regime, which closes on 20 April 2021. The FCA, Bank of England and HM Treasury are also convening a "Productive Finance Working Group" to consider technical aspects of the proposal such as potential barriers to investment, and the roadmap for implementation.



Some of the key questions to emerge so far relate to the structure fund: should it be a Non UCITS Retail Scheme (NURS), as the IA has suggested, or would a Qualified Investor Scheme, as the FCA has suggested, be more appropriate?

And is the LTAF significantly differentiated from other product types that are currently available? In its Feedback Statement (FS 20/2) to the consultation on patient capital and authorised funds, the FCA noted that while respondents had argued that NURSs and UCITS currently had limited scope to invest in long-term assets, they did not in fact identify any infrastructure assets in which authorised retail funds could not currently invest.

There is also the question of the similarly-named Long Term Investment Fund (LTIF), and the European Long Term Investment Fund (ELTIF). These were established in 2015 as closed-ended investment companies (with limited exceptions) but have not proved particularly popular: there are 28 in total across the EEA with an asset base of €2bn, and no firms have sought authorisation from the FCA to open such a scheme in the UK.[4]

4 Source: FCA, FS 20/2 Section 5.4, Page 16

Liquidity and the Long-term Asset Fund

Looking ahead

As the working group begins to focus on the technical details of how LTAF will work, and as respondents reflect on the contents of the upcoming consultation, a key consideration will be around how the LTAF can advance the interests of the end investor, especially given the proposed dealing periods. HMRC has called out the potential introduction of notice periods for property funds as meriting further investigation, in terms of whether these are in the best interests of investors who own units in such funds through stocks and shares ISAs[5]. The success of the LTAF will depend on being able to demonstrate that it is of benefit to investors and an attractive proposition.

The funds industry has a role to play in directing resources towards economic recovery, in addressing liquidity mismatch, and in enabling greater investment in assets with a focus on long-term value. The LTAF is a concept which can trace its roots partly to the Patient Capital Review, and it has seen its relevance and potential grow as a result of Brexit and Covid-19. After the Chancellor's speech in November, it is now at the crucial point of transitioning from theory to reality.

NWTDS view

- Some firms are already offering products to clients that meet many of the objectives of the LTAF, while for others it represents an opportunity to introduce a new product type. Engaging with the consultation paper when it is issued will provide an opportunity to shape the policy and act as a thought leader.
- A key concern will be the attractiveness of the LTAF as a new product type, and avoiding the issues that resulted in low uptake of the LTIF and ELTIF models.
- We recognise therefore that while the LTAF may bring new revenue into authorised funds in the form of pensions investments, there are also some questions to be addressed related to having LTAF within an open ended structure. The proposed fund structure will be key.
- NWTDS is engaged with industry discussions on this issue and will work closely with clients to support their product development plans.

The Dormant Assets Scheme:

What to expect next

On 09 January 2021 the UK Government published its response to the four-year review of the Dormant Assets Scheme, announcing that its scope will be extended from retail banks and building societies to insurers, pensions, and investment and wealth managers. This is a significant evolution with implications in terms of new costs and requirements, but it has been welcomed by the industry.

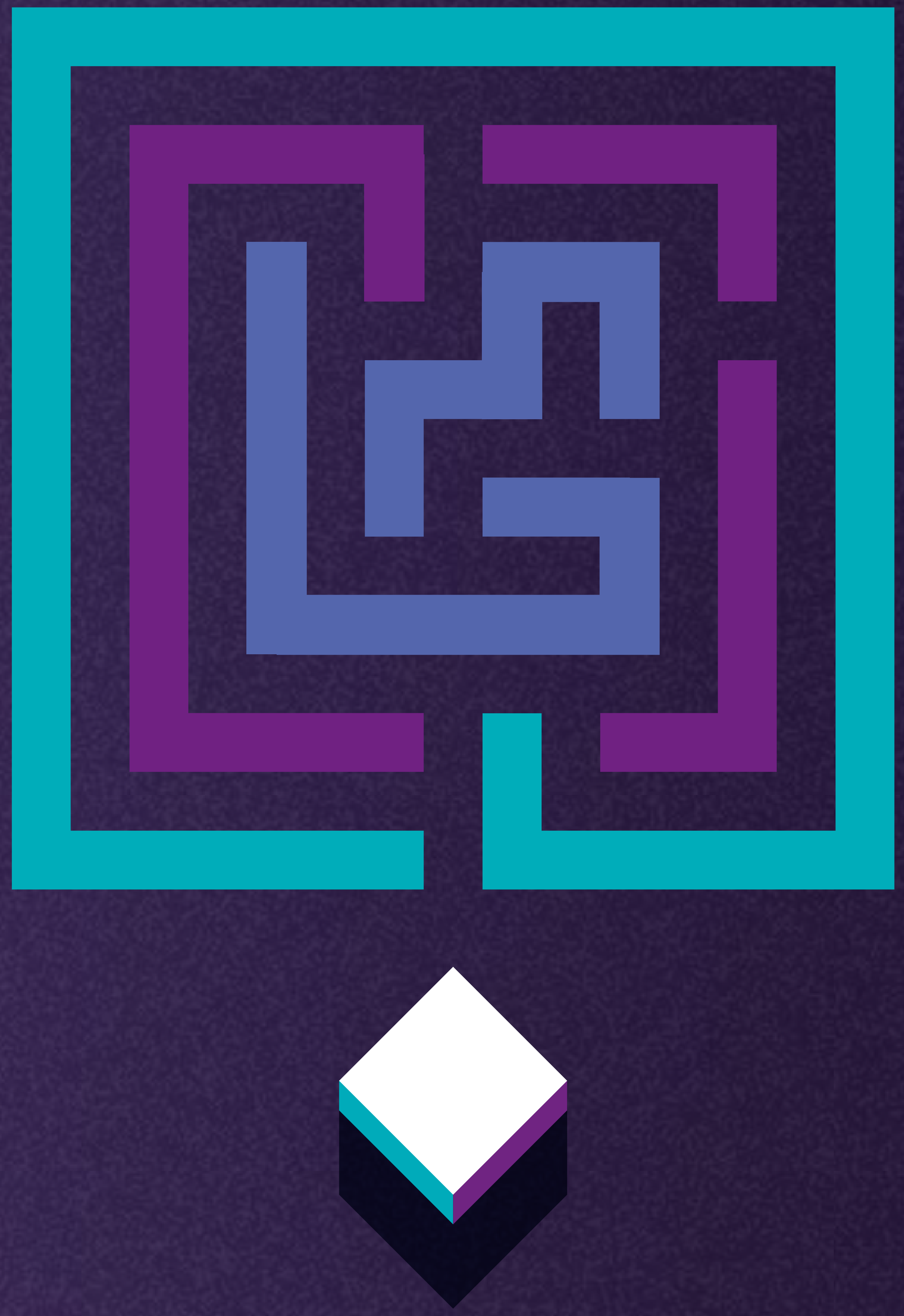
Dive deeper

The Dormant Assets Scheme

The Dormant Assets Scheme has the primary aim of reuniting ‘gone away’ customers with assets that have been forgotten about or lost for a number of years.

Under the scheme, firms are expected to use best efforts to reconnect with customers, for example, whose deposits have been untouched for fifteen years or more. If this is not possible, these assets are transferred to a government fund (Reclaim Fund Ltd) which uses the money for social investment. As the country as a whole focuses on recovery from the Covid-19 pandemic, the increased funding that the expanded scheme could make available will be particularly important: the government estimates that more than £880 million will be made available as a result.[6]

A key feature of the scheme is unchanged: it remains voluntary. However, uptake is expected to be high: more than 30 firms participate in the current scheme as it stands, encompassing most high street banks and building societies.[7]



6 Source: UK Government, Government Response to the consultation on expending the Dormant Assets scheme, 09 January 2021, Ministerial Foreword, Page 2 (https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/951269/Government_response_to_the_consultation_on_expanding_the_Dormant_Assets_Scheme.pdf)

7 Source: Reclaim Fund Ltd, Dormant Assets: Information Guide, August 2020, Page 8 (https://www.reclaimfund.co.uk/wp-content/uploads/2020/09/Dormant-Assets-Information-Guide.pdf)

The Dormant Assets Scheme

Impact on funds

The roll-out to investment and wealth management (IWM) will require firms to make a judgment in terms of their participation, but there will also be operational considerations around how to engage with the scheme effectively. Much of IWM is in scope: assets that will be covered include UCITS and NURSs. A dormant asset will be defined as one associated with a customer who has “gone away” for at least twelve years[8]. Following up with end investors who have not touched their funds for many years will therefore require firms to increase their monitoring activities, and to track down assets that fall into the “dormant” category.

The funds industry, in responding to the government’s consultation, noted that there were technical details to be worked through in terms of how the scheme will tie in to the FCA’s COLL and CASS rules[9]. For its part, the government has noted that these issues will need to be addressed by the regulator itself as the government does not currently plan to legislate on this aspect of the scheme.

The government’s response also notes that there will be costs associated with joining the scheme. These will include set-up costs, including potential rewording of terms and conditions and prospectuses, and establishing new administration systems. There will be ongoing costs associated with the tracing of customers. However, the government notes that the costs of retaining dormant assets can also be significant, and this, coupled with the reputational benefits of engaging with the scheme, will likely offset any costs associated with joining.[10]

Considerations for firms

When considering whether to participate when it is introduced, there are a number of factors that will influence firms’ decisions. Aside from the cost-benefit analysis, there are broader societal benefits that will be of interest to firms as the government seeks to marshal the industry behind its efforts towards recovery from the pandemic. It estimates that the IWM sector’s share of the £880m total will amount to £238m: this represents a significant societal contribution on behalf of the industry[11]. Firms will also look to the uptake of the scheme as it currently stands: it will be noted that most of the banks and building societies in scope for the existing scheme have signed up. It can be expected that uptake among IWMs will therefore be similarly high, especially given the support firms have expressed for the proposals so far. Finally, it is in the interests of the end investor for firms to seek them out and reunite them with their lost or forgotten assets: the government estimates that some £2 billion of dormant insurance, pensions, IWM and securities sector assets could be reunited with owners through enhanced tracing efforts[12]. Considering the societal impact, the likely uptake among competitors, and the benefits to end investors, it is likely that many firms will indeed support the expanded scheme when it is introduced.

8 Source: UK Government, Government Response to the consultation on expending the Dormant Assets scheme, 09 January 2021, Page 21 (https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/951269/Government_response_to_the_consultation_on_expanding_the_Dormant_Assets_Scheme.pdf)

9 Source: UK Government, Government Response to the consultation on expending the Dormant Assets scheme, 09 January 2021, Page 9 (https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/951269/Government_response_to_the_consultation_on_expanding_the_Dormant_Assets_Scheme.pdf)

10 Source: UK Government, Government Response to the consultation on expending the Dormant Assets scheme, 09 January 2021, Page 25 (https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/951269/Government_response_to_the_consultation_on_expanding_the_Dormant_Assets_Scheme.pdf)

11 Source: UK Government, Government Response to the consultation on expending the Dormant Assets scheme, 09 January 2021, Page 20 (https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/951269/Government_response_to_the_consultation_on_expanding_the_Dormant_Assets_Scheme.pdf)

12 Source: UK Government, Government Response to the consultation on expending the Dormant Assets scheme, 09 January 2021, Page 4 (https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/951269/Government_response_to_the_consultation_on_expanding_the_Dormant_Assets_Scheme.pdf)

The Dormant Assets Scheme

Next steps

The next steps for the expansion of the Dormant Assets Scheme have not yet been set out in detail, although the government has noted in its response that it will seek to legislate on this when parliamentary time allows. Any changes from a Handbook, COLL and CASS perspective can be expected to follow after this.

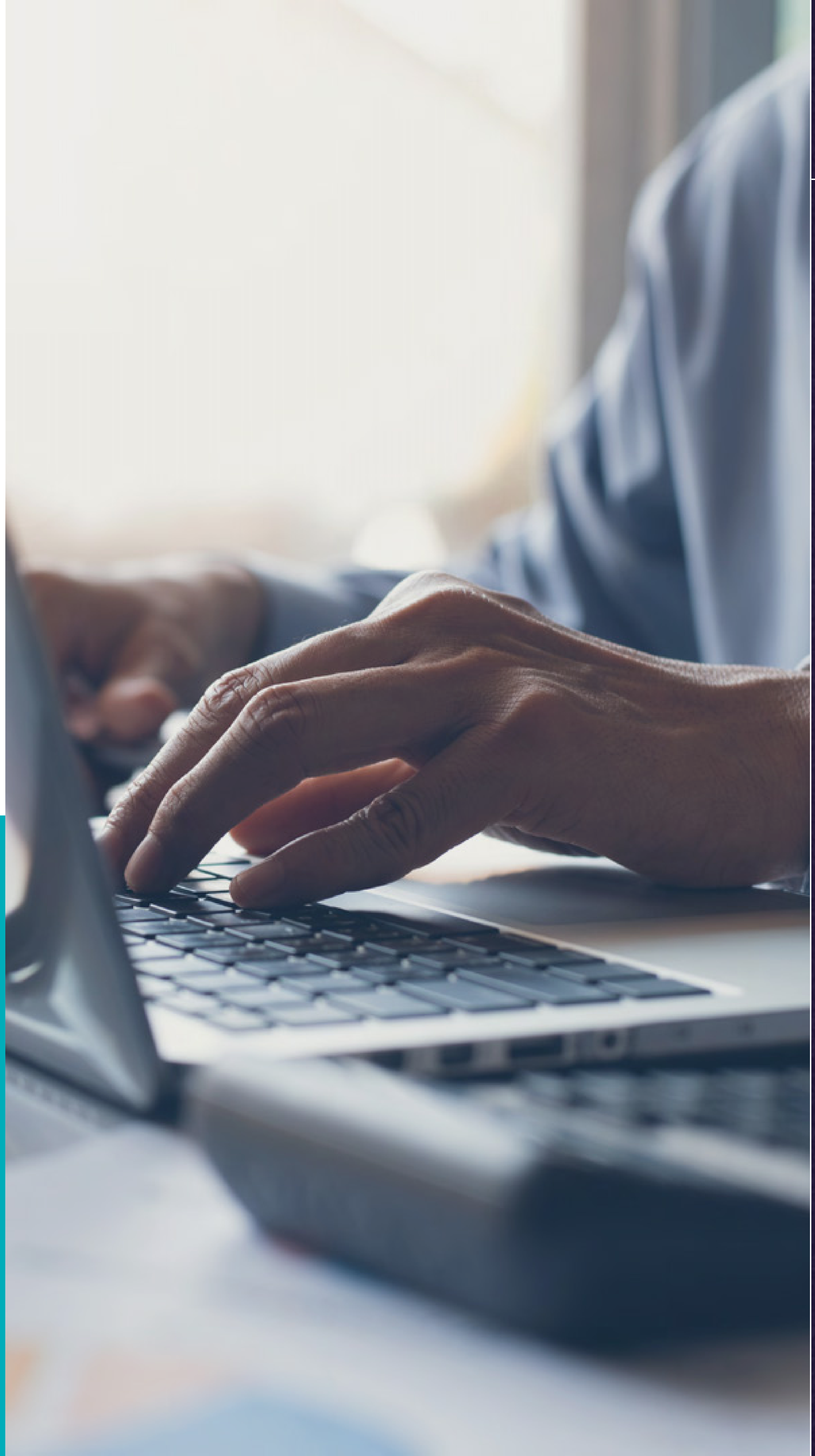
Since the scheme was first established, it has distributed £745 million to social causes throughout the UK[13]. The expansion to cover UCITS and NURSs offers the investment and wealth management industry the opportunity not only to build on the scheme's successes, but to play an important part in supporting the economic recovery from Covid-19.

NWTDS view

It is worth remembering that the Dormant Assets Scheme will remain a voluntary initiative, and it does not preclude tracing outside of the scheme. A number of firms are already actively tracing "gone-aways" and reuniting them with their assets, citing many of the benefits listed in the article above. There is therefore the possibility of firms proactively and independently repatriating assets. Ultimately firms can decide whether or no to sign up to the formal scheme when further details are made available by the government.

Initial principles have been published, but the more technical elements such as timeframe, regulatory interactions, and implications in terms of COLL and CASS are still to be set out. Ultimately these specifics, rather than the overarching principles, will likely determine the level of uptake and interest from firms.

13 Source: Reclaim Fund Ltd, Dormant Assets: Information Guide, August 2020, Page 8 (https://www.reclaimfund.co.uk/wp-content/uploads/2020/09/Dormant-Assets-Information-Guide.pdf)



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