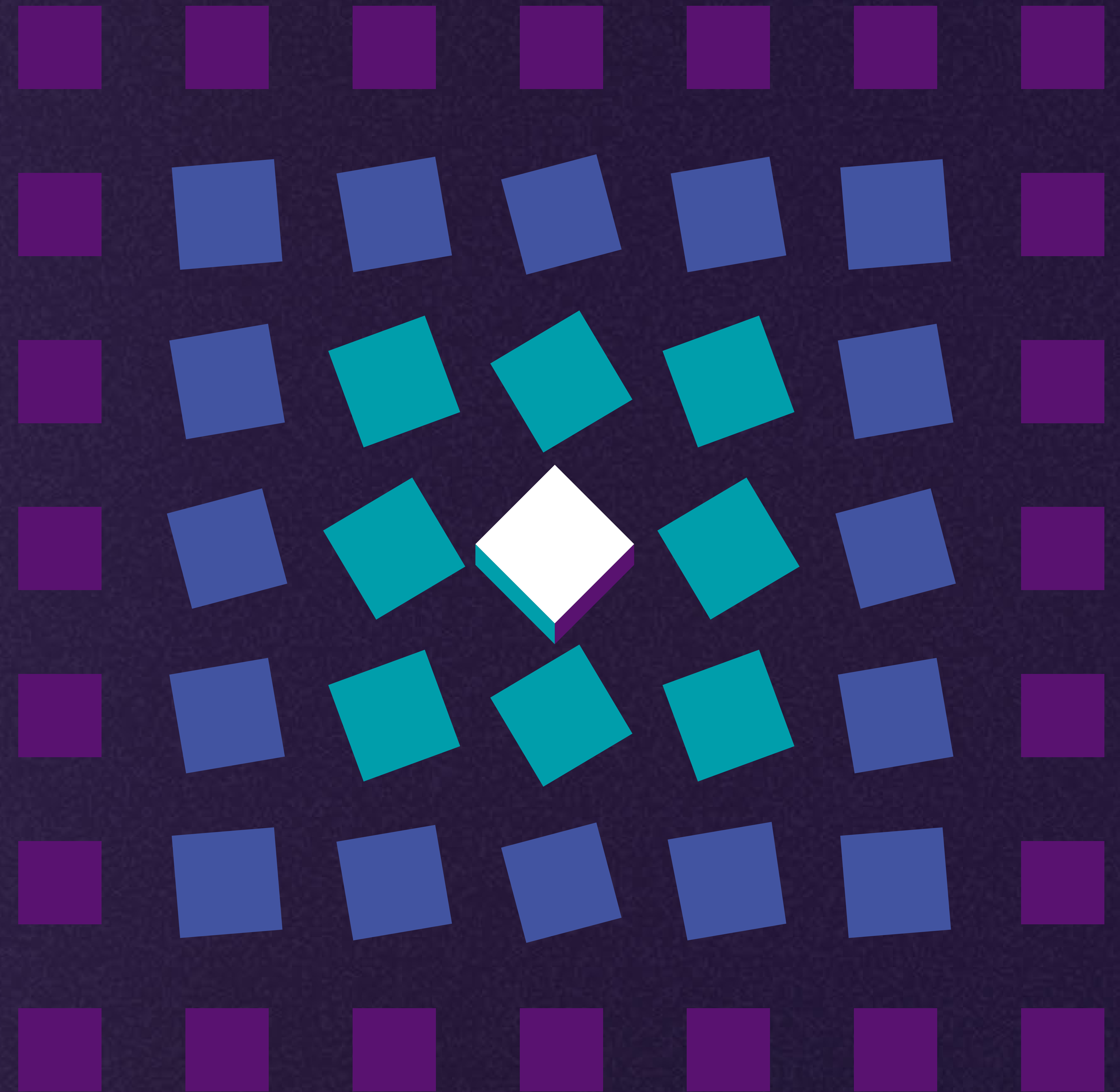
Depositary Insights

Autumn 2020



NatWest Trustee and Depositary Services

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Foreword

Welcome to *Depositary Insights*: a new quarterly regulatory developments publication from NatWest Trustee and Depositary Services (NWTDS).

Our first edition comes at an important point of reflection: in the final quarter of 2020 we are able to look back on what has been a year of unprecedented disruption. But we are also starting to look ahead to 2021, and towards the long-term implications of the challenges and transformations we have all experienced in 2020.

With that in mind, this first edition focuses on a number of themes that have been front of mind for many of our clients:

- **The economist's view;**
- **Operational reflections on Covid-19 and the funds industry;**
- **Liquidity mismatch in open-ended funds;**
- **Trends in sustainable and responsible investment and investor stewardship; and**
- **The impact of Covid-19 on dividends and the long-term implications.**

I hope you find Depositary Insights useful, in providing an overview of some of the key developments facing our industry. Please get in touch if you would like to follow up on any of the topics discussed: we welcome your engagement and feedback.

Craig Bowie
Director, Regulatory & Technical

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by Craig Bowie

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This is an interactive publication.
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The economist's view

Ice Cube tweeted about *what?*

Imagine borrowing £800k every minute of the day...

Well, that's approximately what the UK government racked up in the first five months of the financial year. Over in the US the government is forecast to run a deficit roughly equal to the entire economic output of the UK (in a normal year). Dealing with a pandemic is an expensive business. Economists refreshing their forecasts for government debt to GDP are drawing lots of sharply upward-sloping lines.

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The economist’s view

Despite the recovery remaining firmly in its infancy, some are asking questions over what lies on the other side – what extent do taxes need to rise, and on whom? Where should the burden of budget cuts fall? Familiar questions for those with memories of the financial crisis. Those alarmed over, at that time, multi-decade high deficits won out. Efforts to reduce deficits were enacted.

Even prior to Covid-19 attitudes to government deficits were shifting.

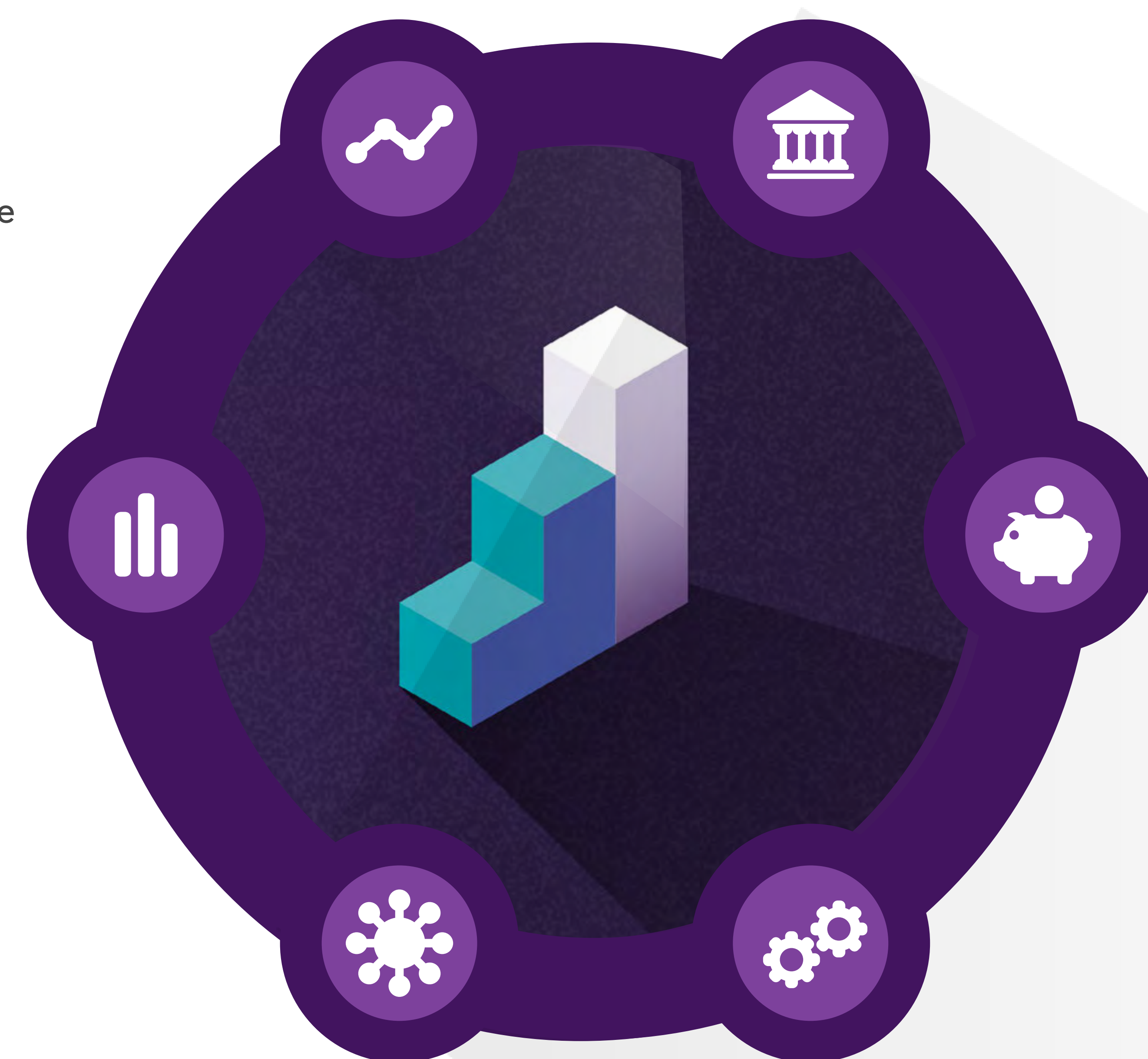
The UK was in the process of pivoting away from austerity, fulfilling the promises made during last year’s election to rebalance economic success. The US had initiated a series of tax cuts, running fiscal deficits to the tune of around 5% of GDP. Germany was the hold out. But it was clear that something needed to change. Its export machine had been repeatedly buffeted by a series of events and a shifting global landscape – China slowdown, Brexit, trade wars etc.

In other words, governments were tentatively beginning to act on the lessons of the past ten years.

Currency-issuing countries with their own central bank can run sustained deficits without any hint of a sovereign crisis.

The Covid-19 crisis has markedly accelerated that shift.

Governments have just demonstrated that the power of the state can be harnessed to forcefully intervene to mitigate economic pain. Whether through European governments replacing earned income or US-style cash disbursements and sizeable increases in unemployment benefits.



They of course are not acting alone. The crutch has been an activist central bank.

Paving the way with low, zero or indeed negative rates and large levels of government debt purchases to pin interest rates and keep debt loads manageable. That has left governments free to spend generously.

Which brings us back to what lies beyond outsized government spending.

What government now is going to revert to austerity in any meaningful sense? Can years of sustained below inflation rises in public sector wages ever be countenanced? Will society tolerate a large proportion of people living on modest unemployment income support?

Moreover, plenty of work remains to engineer a sustained recovery.

What other cajoling might the consumer need in the shape of tax cuts or cash handouts? What additional support might the sectors at the sharp end of the economic fallout (consumer facing services, aviation etc.) need?

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The economist's view

A lot of questions…

Many believe the answers to which lie through modern monetary theory. A dry sounding topic, but a book which recently became a New York Times bestseller, even tweeted by hip-hop star and actor *Ice Cube!* MMT, among other aspects, argues that the financial constraints on governments (or currency issuing governments) are far less than widely believed. Government can run sustained, large deficits, free to focus on the economic and social impacts of policy and relieved of budgetary considerations (aside from inflation risk).

The interplay with other structural trends is obvious.

The transition to a low carbon economy likely requires considerable capital outlay. While there is a growing clamour for governments to mitigate income and wealth inequalities, of which technological change and globalisation are key drivers.

Investors might want to explore the implications of the MMT experiment going well or going wrong, when thinking about the balance of risks in the future. It just might be the key megatrend of the post-pandemic world in the decade to come.

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Covid-19 and the funds industry

Reflections from a depositary

Covid-19 has created operational challenges across the investment ecosystem – from asset managers and asset owners to service providers, including depositaries.

However, the industry as a whole has adapted well amid unprecedented change, and shown considerable resilience in a volatile market. At NWTDS, we have adopted agile working practices and have been able to provide continuity of service thanks to ongoing investment in technology and a thorough review of operational procedures.

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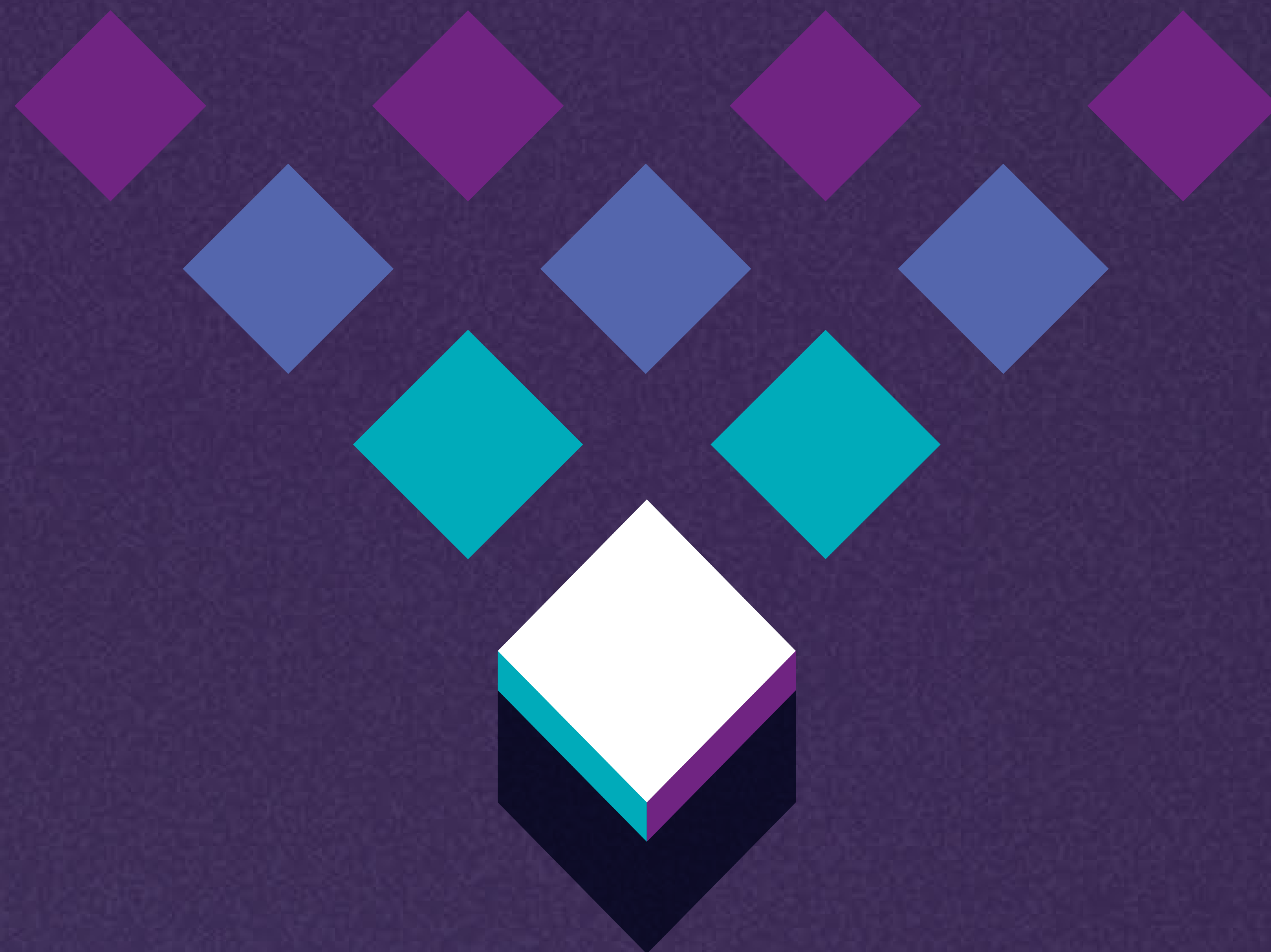
Covid-19 and the funds industry

These have been exceptional circumstances and it is worth taking stock of the scale of disruption that the coronavirus pandemic has caused. The figures are quite remarkable: there were a record £10bn of outflows from funds in March, as well as widespread suspension of daily dealing property funds due to concerns about material uncertainty. We have also seen a significant decline in dividends as companies focus on protecting balance sheets.



Regulatory reaction

Regulators moved fast in the early stages of the lockdown to provide the industry with guidance and support. Deadlines for major consultations such as that on operational resilience were pushed back, and planned surveys – for example on open-ended fund liquidity – were also postponed. Arguably, the priority has been to deliver the tactical steps needed to help firms to manage the impact of the virus before returning focus back towards more strategic set-piece initiatives.

Operational disruption

Firms appear largely to have adapted at pace: the uptake in working from home has arguably been so successful that there are implications for the post-pandemic working environment, in terms of a more permanent adoption of remote working. Some asset managers have announced that their employees will now be able to work from home on a permanent basis if they wish. This does of course create additional regulatory considerations in terms of data security, oversight and conduct, but regulators have reacted to this shift with new guidance. Other aspects of the operating rhythm of the investment industry such as AGMs have also been disrupted: swift changes in rules have been required.

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More positive trends?

Amid the disruption, there have also been a number of more positive trends observed. For example, open-ended funds have performed relatively well throughout the year, and UK savers put £4.7 billion into retail funds in May 2020, building on the positive fund flows that we saw in April. Environment, social and governance matters have gained increasing attention: Covid-19 has driven increased interest in investing in funds, and particularly in those with a focus on societal impact.

Our perspective

We have been focussed on ensuring ongoing support for our clients. Achieving this during office closures has dictated adjustments to our own business; for example, our regular regulatory update briefings and webinars are now delivered virtually. This has in fact proven to have some benefits, as it allows larger numbers of attendees to join irrespective of location. Our depository team has been focussed throughout the crisis on supporting clients providing immediate understanding of the regulatory implications of the courses of action available to them.

Looking forward...

As we look towards the end of 2020 and into 2021, the shared experience of the Covid-19 pandemic raises important questions for the industry on an operational, regulatory, financial and fiduciary level. But in considering the long-term consequences of these events, it is also worth reflecting on the resilience and continuity that has been shown in the face of unprecedented upheaval.

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In June 2019 the suspension of the Woodford Equity Income Fund and subsequent wind up raised important questions about how liquidity is managed in authorised funds, particularly with respect to investment in illiquid assets.

In January 2020 the FCA issued a Dear CEO letter to Authorised Fund Managers (AFMs). The letter outlined the FCA's supervision priorities and reminded firms of the central responsibility to ensure effective liquidity management in funds. The letter also referenced the December 2019 joint Bank of England and FCA work to explore liquidity mismatch in open-ended funds.

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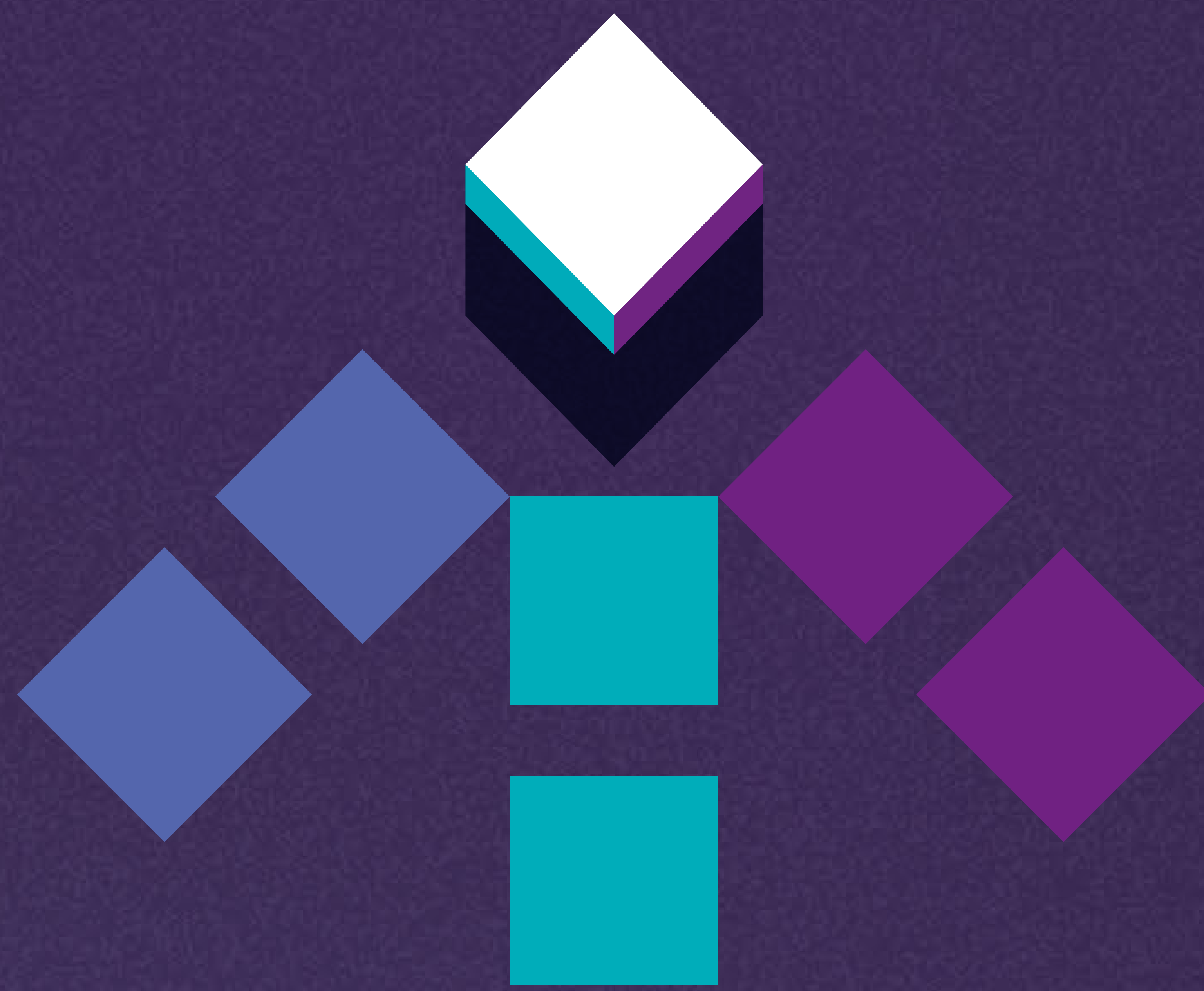
From a regulatory perspective liquidity management and the related issue of fund suspensions has remained high on the industry's agenda for 2020. There is now greater clarity on the new regulatory framework as many of the pieces of the jigsaw are either in place or are under detailed consultation. The exception to this is the joint Bank of England / FCA work where conclusions are now expected to be published in Q1 2021.



New mandatory suspension rules

From 30 September new mandatory suspension and enhanced liquidity monitoring rules and new disclosure rules came into force for funds investing in illiquid assets (FIIAs). The scope of the new rules is restricted to non-UCITS retail funds (NURS) property funds or to NURS funds with indirect exposure to immovables, such as multi-asset funds holding units in property funds, or feeder funds of property alternative investment funds (PAIFs).

Whilst the rules came into force last month, in practice the rules on mandatory fund suspension were adopted by the industry in March as Standing Independent Valuers (SIVs) of property funds met to discuss concerns surrounding the valuation of property, in part caused by the lack of transactional data and consequential material uncertainty about the valuation of those assets. This led to the majority of funds in the property sector suspending on the grounds of material uncertainty.
While fund suspensions have created challenges for some investors, the decisions were taken to protect the interests of all investors in the fund and have been reviewed at least **every 28 days** as part of the formal fund suspension governance process.

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More recently conversations have concerned the resumption of dealing as material uncertainty clauses have been lifted by SIVs.

Of interest is the requirement to resume dealing **'as soon as reasonably practicable'** after:

- **the SIV's material uncertainty assessment applies to less than 20% of the value of the scheme property; and**
- **the scheme's depositary gives its approval for the temporary suspension to be removed.**

The wording 'as soon as reasonably practicable' could be interpreted to mean as soon as material uncertainty falls below 20% of the scheme property. However, the FCA has made clear before lifting a suspension fund managers should ensure there is **sufficient liquidity to meet the expected level of redemptions** on a sustainable basis to reduce the risk of the fund suspending again in the near future.

To date some of the property funds we act for have reopened, some are in the process of reopening and other have changed the basis of fund suspension from material uncertainty to liquidity.

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The introduction of notice periods for daily dealing property funds

The publication of the FCA's consultation paper on liquidity mismatch in authorised open-ended property funds (CP20/15) has proved to be controversial as it could require investors to give notice – potentially of up to 180 days – before their investment is redeemed from an open-ended property fund. Additionally, the proposed rule changes could risk these funds being excluded from ISAs as they may no longer be qualifying investments for a stocks and shares ISA. Self-invested personal pension providers would also be affected as they would face higher capital adequacy requirements if they hold property funds. The proposed notice period may also give rise to some operational challenges for financial advisors wanting to rebalance client portfolios which may make them more reluctant to recommend property funds to their clients. The issue of notice periods has also made reopening some property funds more challenging as the new rules have created uncertainty amongst the investor community and this has made it harder to quantify expected level of redemptions.

These are important questions and where possible solutions need to be found so as to ensure investors can continue to benefit from the diversification advantages of investment in property. At NWTDS we strongly think a notice period is an important tool within the liquidity toolkit.

The Consultation paper is open to 03 November and NWTDS will be submitting a response.

Updated Investment Association Liquidity

We are expecting the Investment Association (IA) to publish an updated liquidity management guidance paper in Q1 2021 to reflect recent developments. Publication is expected after the publication of the Bank of England's Financial Stability Report to ensure it is aligned to the latest standards.

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In conclusion

Despite fears in March that significant outflows due to Covid-19 would lead to a liquidity crisis this did not happen. The overwhelming majority of funds remained open, suggesting that investment funds do not represent a systemic risk to the financial system. The property funds which suspended were generally due to concerns about material uncertainty rather than fund liquidity issues. Many of these funds have now reopened or are in the process of re-opening.

Whilst many of the pieces of the regulatory framework are now in place there are still missing pieces, such as whether the FCA / Bank of England will introduce asset classification for liquidity (liquidity buckets) similar to US SEC rules. This means that liquidity will remain high on the industry's regulatory agenda for some time to come.

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Sustainability and responsible investment (SRI) can no longer be regarded as a narrow issue which applies only to a subset of investment funds at the margin.

SRI is now a force in investing and is fundamental to the asset management industry and its clients. Rather than dampening enthusiasm for SRI, the global pandemic has instead acted as an accelerant. SRI funds have continued to attract high levels of investment over the pandemic period, attracting around a billion pounds of new investment per month over the last three to four months, according to Investment Association (IA) research figures.

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At a time when conventional funds were experiencing material outflows, SRI funds have continued to attract high levels of investment over the pandemic period – attracting around a billion pounds of new investment per month over the last three to four months, according to Investment Association (IA) research figures. Interest and demand is not only from retail investors but also from institutional investors, all of whom want to know how the industry is rising to the challenge of responsible investment. SRI is not confined to traditional authorised funds but is also on the rise in alternative funds, such as private equity, where there has been an increase in the launch of Environmental, Social and Governance (ESG) funds.

The political imperative – The Paris Agreement and the transition to net zero

To tackle climate change and its negative impacts, 197 countries adopted the Paris Agreement at the COP21 in Paris on 12 December 2015. The deal aims to substantially reduce global greenhouse gas emissions and to limit the global temperature increase in this century to 2 degrees Celsius while pursuing means to limit the increase even further to 1.5 degrees. The Paris Agreement marks the beginning of a shift towards a low-carbon world but there is much to do as the world is currently heading towards 3 + degrees.

In 2019 the UK raised its ambition on climate change by setting a legally binding target to cut its greenhouse emissions to 'net-zero' by 2050, becoming the first member of the G7 group of major economies to do so. The UK has also indicated it will at least match the ambition of the objectives of the EU Sustainable Finance Action Plan and the Government will work with the financial services sector to strengthen the UK's status as a global hub for sustainable finance.

Figure 1: The COP21 Paris agreement (2015)

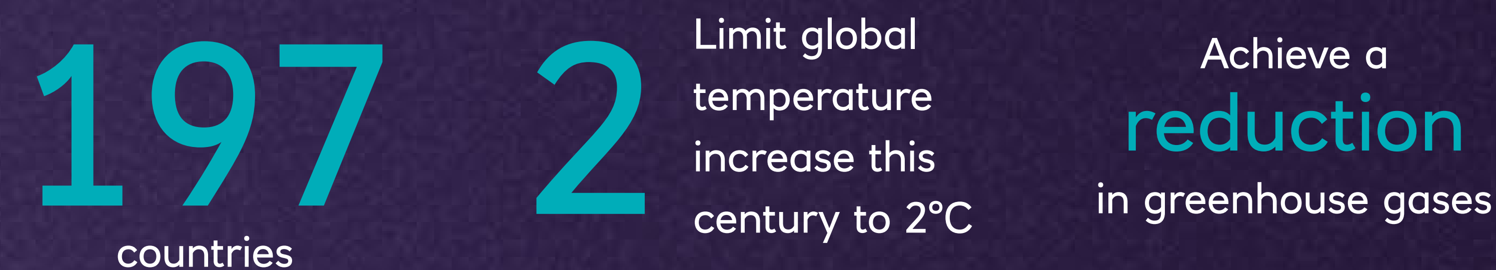

Figure 2: The UK's 'net-zero' target for 2050

> The good news is that many of the UK's biggest firms have got the message and are moving quickly to reduce their emissions. For example, at **NatWest Group we have set out an ambition to be a leading bank in helping to address the climate challenge by making our own operations net carbon zero in 2020 and climate positive by 2025.**

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Regulatory interest in SRI

There have been few other emerging trends that have attracted the same level of regulatory interest as SRI. This has led to a plethora of international standards with no common definition of what a sustainable finance product is. The multitude of frameworks makes it difficult for investors to compare one company's disclosure to another and this creates issues around market integrity and the potential for greenwashing. The International Organization of Securities Commissions (IOSCO) has created a taskforce to bring the standard setters together to try to achieve some global cohesiveness in international standards frameworks and hopes to report back in about 18 months. It is an ambitious timeline given the complexities involved as individual countries try to establish a leadership position in ESG disclosures.

The demand for ESG ratings

ESG ratings are becoming increasingly important in the world of investing. There is growing evidence that firms with high ESG scores will also produce stronger financial results. But unlike credit ratings, ESG scores are poorly correlated with each other. This is perhaps not surprising when many firms do not report on sustainability regularly or consistently, making it difficult for ESG rating firms to arrive at an accurate picture given a lack of information. ESG rating methodologies are also proprietary to firms meaning that rating firms can disagree about companies which are good or bad from an ESG perspective.

The hope is that the demand for ESG ratings and recent consolidation within the sector will bring greater consistency in ratings and make it harder for investee firms to engage in greenwashing, to the ultimate benefit of shareholders and the wider financial community.

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How is the UK asset management industry rising to the challenge?

In November 2019 the IA published its Responsible Investment Framework – an industry-wide common language for responsible investment with clear definitions and a framework for product categorisation. The IA is due to publish before the end of the year a best practice guidance paper on fund level communication of responsible investment. Perhaps the most significant development will be the launch of a UK retail product label for authorised funds. The label will help the UK to compete with other European jurisdictions by showcasing UK expertise and will help simplify investor's choice of SRI funds for the benefit of the investor and the industry. The Association of Real Estate Funds (AREF) is also considering the merits of an ESG label. A position paper on climate change and the role of the industry is also expected.

It is clear SRI is now a core strategic issue for the asset management industry. This gives grounds for optimism but this optimism should be tempered with reality. ESG remains an emerging frontier in finance and the scale of the challenge is profound.

How can NWTDS help?

Before the end of the year NWTDS will hold a client webinar on ESG which will explore some of the issues raised and the impact of SRI on depositary oversight.

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The UK Stewardship Code 2020:

A regulatory *revolution?*

The UK's new Stewardship Code took effect from 1 January 2020. Firms must submit a final Stewardship Report to the Financial Reporting Council ("FRC") by 31 March 2021 if they want to be included in the first list of signatories to the UK Stewardship Code 2020.

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The UK Stewardship Code 2020

The new Stewardship Code reflects some of the key issues of 2020

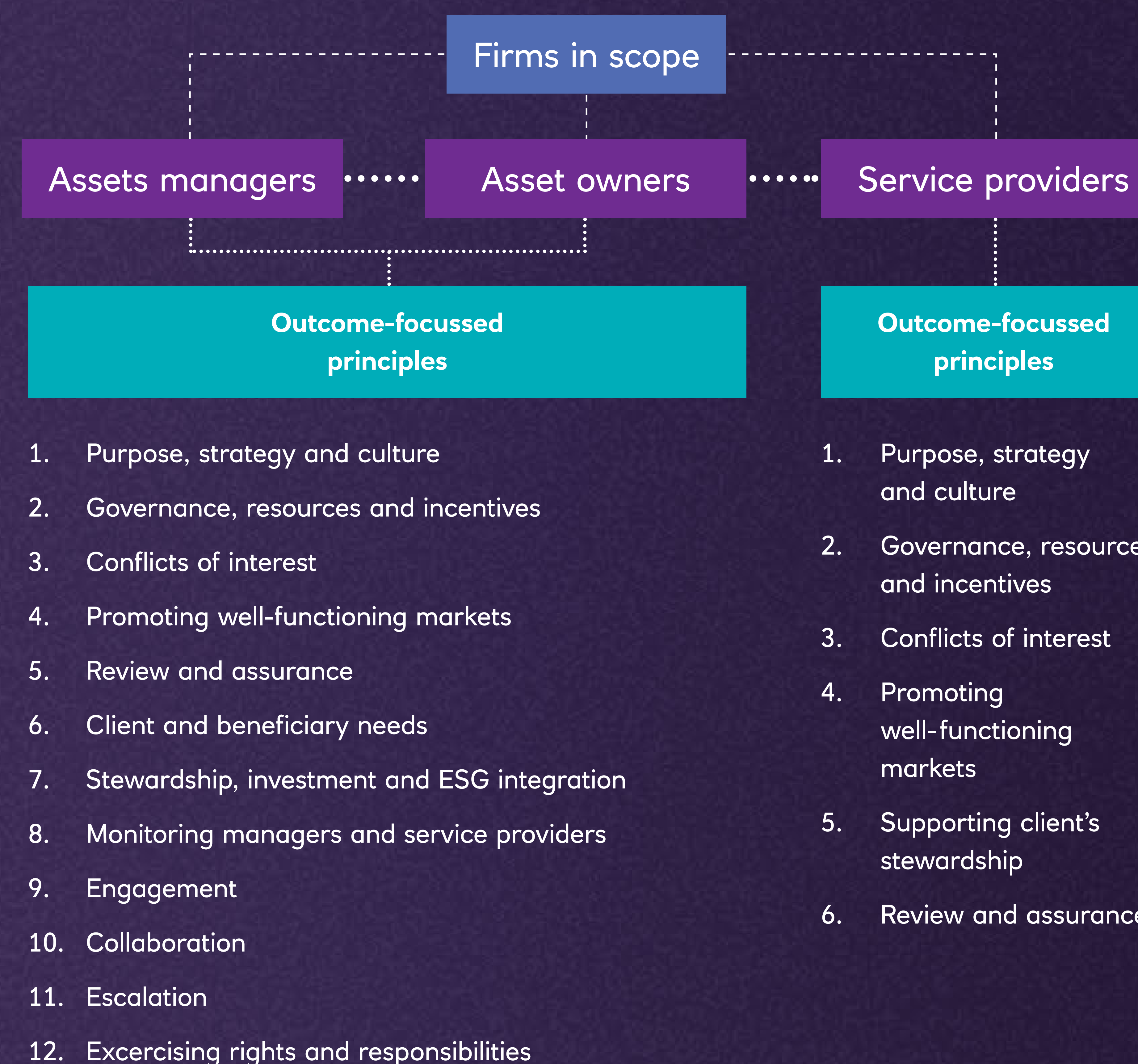
The introduction of the Financial Reporting Council's UK Stewardship Code 2020 has proven fortuitous in its timing.

Many of the new themes that it covers have become increasingly topical: the new Stewardship Code has proved prescient in aligning with the public mood. It is increasingly relevant given increased public focus on **climate change, global protests against racial inequality, and amid the context of Covid-19.** For asset managers, asset owners, and service providers, becoming a signatory to the new Stewardship Code represents an opportunity to demonstrate engagement with some of the key themes driving change in 2020.

It contains ambitious new requirements…

The aspiration of the new code is clear – the definition of stewardship has been boldly redefined as delivering "long-term value for the economy, the environment and wider society." The number of principles for asset managers and asset owners has increased from seven principles under the previous iteration of the code, to twelve in 2020, and, for the first time, environment, social and governance ("ESG") is explicitly included as a principle in scope. Service providers – such as proxy advisors and research firms – are also specified as being covered by the code, with seven of their own distinct principles to report against (see Figure 1).

Figure 1: an overview of the UK Stewardship Code 2020



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The UK Stewardship Code 2020

Apply and explain

There is a far keener focus in the new code on demonstrating outcomes. It is not enough simply to state a policy on the various principles under the Code – signatories will need to demonstrate how they have acted on their policies and made an impact. Similarly, the code operates on an **"apply and explain"** basis, whereas the previous iteration of the code had worked on a "comply or explain" basis. Given all of this, it could be argued that the UK Stewardship Code 2020 is less of an evolution of the 2012 Code, and more of a revolution.

What are the advantages of becoming a signatory?

But it is still voluntary, which raises an important question: given the array of other demands being made on firms in 2020, what are the advantages of becoming a signatory?

The short answer is that, on matters such as ESG, purpose and societal value, the new code closely reflects the public mood and the concerns of stakeholders. Becoming a signatory of the code will arguably provide greater assurance to these same stakeholders that a firm is taking seriously the key issues of 2020 – including responding to Covid-19 (the FRC has noted that it expects signatories to address pandemic risk in their stewardship reporting).

Arguably, 2020 has been a year in which the shift towards "stakeholder capitalism" has been accelerated by events, with increased focus on matters such as corporate purpose, the environment, and corporate governance. In this sense becoming a signatory to the new code is a means of demonstrating an awareness of some of the most pressing challenges facing businesses.

How does a firm become a signatory?

The first thing to note is that we are already comfortably into the first reporting period: the code "went live" on 01 January 2020. The FRC has noted that it will engage with and provide feedback on draft stewardship reporting from would-be signatories up until 30 November 2020, ahead of the deadline for submission of stewardship reporting on 31 March 2021. Asset owners have a slightly later deadline of 30 April 2021. The FRC will then publish the list of signatories in the second half of 2021, before conducting analysis of reporting.

There are a number of governance requirements to bear in mind when seeking to become a signatory. Firms are required to produce a single, succinct and engaging report, which must be approved by its governing body, and signed by the chair, chief executive officer, or chief investment officer. The report should be fair, balanced and understandable, and should cover all assets across all jurisdictions. Notably, the code also calls for reports to be subjected to internal or external assurance. Becoming a signatory is therefore a significant commitment.

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Supporting effective stewardship

The FRC has clearly raised the bar in 2020 with the introduction of the new stewardship code, and would-be signatories will have to work hard to meet its requirements and show how they are achieving outcomes across each of its principles. However, while the expectations are much higher, this is a fair reflection of the heightened expectations of stakeholders more broadly.

The FCA has indicated it will continue to work with the FRC as the UK Stewardship Code 2020 is introduced. An important area of the FCA's focus is the balance between the regulatory baseline for effective stewardship and promoting higher standards through the UK Stewardship Code 2020. It will consider the need for further action as the new Code takes effect, so that the regulatory framework continues to support effective stewardship.

The UK Stewardship Code 2020 is a timely benchmark against which firms can show how they are meeting the challenges of our time.

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The UK Stewardship Code 2020:
a regulatory revolution?

Dividends and Covid-19:
What happens next?

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The collapse of dividends in 2020 has been one of the most intriguing, and notable, investment market consequences of Covid-19.

From listed companies to investment trusts, the dividend landscape is changing in ways not seen since the 2008 financial crisis. Unlike in 2008, however, the restoration of dividends to any kind of 'old normal' does not appear simply to be predicated on economic recovery: an array of political and social factors have been brought into play.

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As autumn progresses, we are certainly not where we expected to be: at the start of 2020, IHS Markit had forecast a 10% growth in dividend payments over the year. In September 2020 the FT reported that the total cut to dividend pay-outs in the UK could in fact reach 50%. Globally, dividend payments in Q2 2020 were at their lowest level since 2009.

Key factors driving change to dividends

Underpinning this is the fundamental of financial resilience, and the need for companies to protect balance sheets; issuing dividends has fallen down the list of priorities for listed firms as they find attentions focussed increasingly on stability and even survival.

There has also been an added political dimension.

In March the Bank of England ordered banks and insurers to suspend dividends and buybacks.

The Investment Association ("IA') has noted that investment managers, who hold a third of the FTSE, have an important role to play in supporting companies through these tumultuous times. That is why in April the IA wrote to every company in the FTSE 350 outlining ways in which the industry would help and offering "honest" advice on its member's views on dividend payments.

There has even been an operational hindrance to paying dividends: the impact of Covid-19 on AGMs has led to some dividend suspensions, because the meetings and the votes themselves could not take place. And so there have been economic, financial, political and operational impediments – creating quite an unprecedented mix.

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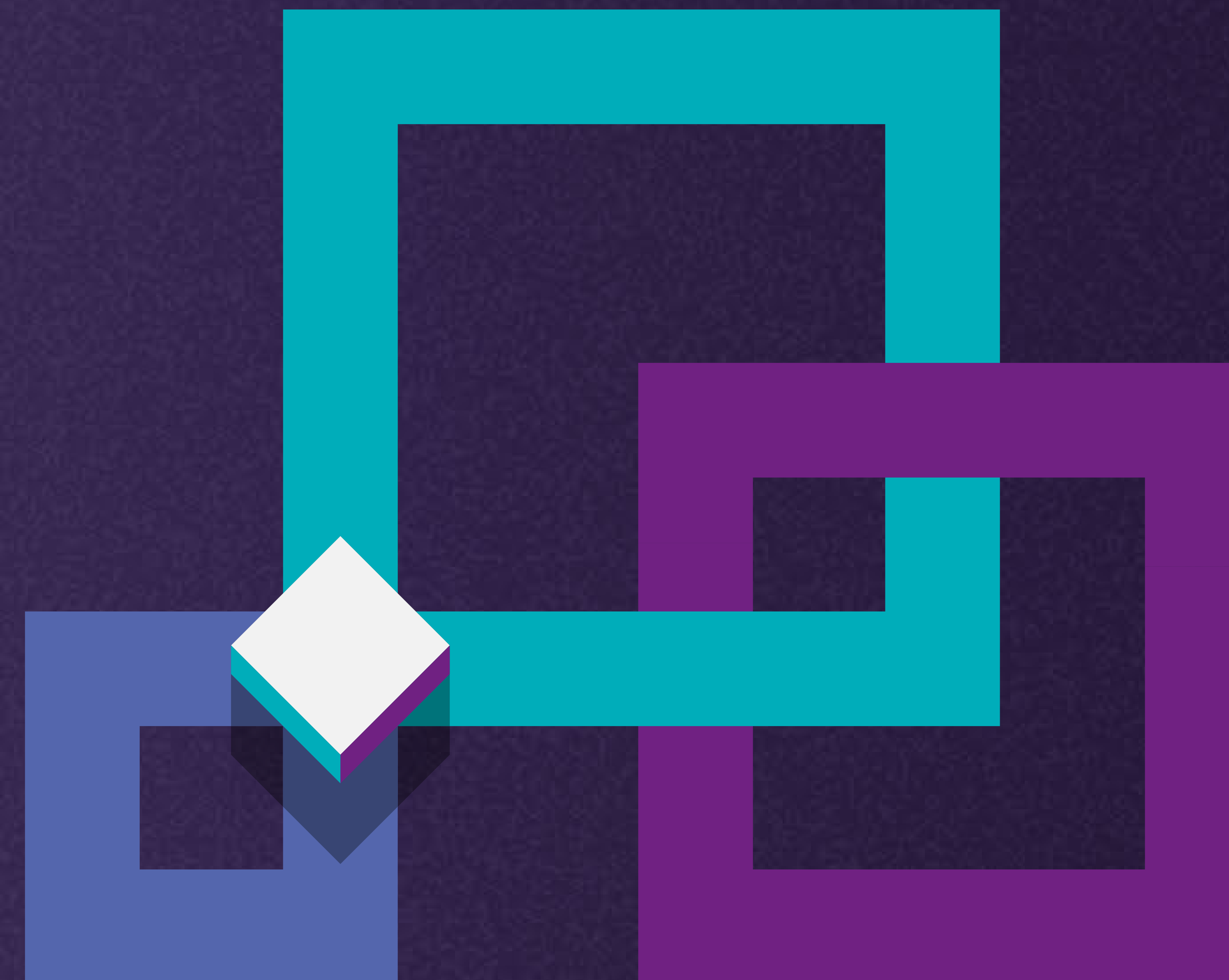
Implications for investment trusts

At times like these, investment trusts have historically had an advantage as they have been able to draw upon revenue reserves, and indeed some trusts have already announced on dividends, such as City of London in July. However, with everything else being disrupted by the pandemic, the impact on so-called “dividend heroes” – trusts which have issued growing dividends year-on-year for more then two decades in a row – is open to speculation. Increasingly, trusts are indeed drawing on their reserves, suggesting that hero status will be more hard-won this year.

Whether the dividend is issued by a listed firm or an investment trust, the disruption to the dividend landscape is not, of course, happening in a bubble: there will be an impact on end investors as a result of this transformation – for example, among pensioners and those who depend on dividends as a source of income.

All of which raises the question of what might happen next?



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Where do we go from here?

This depends on an array of factors, not least of which is how the pandemic pans out in the coming months. The shape of the economic recovery will play a key role: with a “V” shaped recovery we might expect a return to normal, whereas other potential models, such as the “W” or “L” shapes that have been mooted, would encourage far more conservative approaches to dividends. Different sectors of the economy such as leisure and hospitality are of course more exposed and can be expected to apply the breaks on dividends for longer, meaning that return to dividends will not be even across sectors.

Aside from financial and economic factors, we also need to consider the political dimension: at least in the short term many companies may feel under increased expectation to focus on protecting balance sheets and protecting employees, as opposed to rewarding shareholders.

At an even higher and more esoteric level, there has also been some speculation that Covid-19 is moving the market away from shareholder primacy altogether, towards a model of stakeholder capitalism where dividends are much less of a priority. In this regard the pandemic may be accelerating a trend that had been picking up anyway; for example, in 2019 the Business Roundtable – a corporate lobbying group in the United States – published a letter signed by 181 CEOs committing to stakeholder primacy.

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A pivotal moment

If Covid-19 is indeed accelerating an ideological shift like this in the capital markets, then there will be significant strategic and operational implications for the asset management industry.

The market is therefore potentially facing an historic upheaval to one of its most fundamental concepts, with implications for companies, funds, and investors, and the picture is complicated not just by economic factors but by political and societal and even ideological factors.

The IA has made clear the view of its members is that shareholders will expect companies to restart dividends as soon as it is prudent to do so. It remains to be seen whether this will be the case.

Covid-19 has proved to be a disruptor to so much of the economy in 2020; it may prove to be pivotal for dividends, too.

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Depositary Insights

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