By email only: pensionfundexemption@hmtreasury.gov.uk

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Pension fund clearing exemption
Financial Services
HM Treasury
1 Horse Guards Road
SW1A 2HQ

Dear HM Treasury

SPP response to HM Treasury´s call for evidence Call for evidence: pension fund clearing exemption

We welcome the opportunity to respond to this consultation.

Executive Summary

UK defined benefit pension schemes are broadly in excellent health and their use of derivatives to increase the link between asset and liability values has played a significant role in their progress. The presence of these derivatives within portfolios allows schemes to prudently manage risk and to allocate to return-seeking assets.

Trustees currently have a choice as to whether to centrally clear or use bilateral agreements. This choice is beneficial and allows schemes to make the best choices for their schemes' circumstances.

Therefore, our view is that the exemption for UK pension schemes from clearing should be retained and, ideally, made permanent.

Mandating clearing for all transactions would introduce significant costs and risks for pension schemes and financial stability as a whole with no clear benefits.

Detailed Response

Question 1: How much of your hedging activity involves derivatives? What types of derivatives do you use? Where possible we would appreciate any quantitative information you can provide.

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Our members include a wide range of providers of advice and services to pension schemes, trustees and employers. We observe that corporate defined benefit pension schemes use swaps to hedge liabilities less than previously. Typically, they largely hedge their liabilities using gilts.

Question 2: Do you use the pension fund clearing exemption?

Our understanding is that most UK pension schemes that use derivatives use the exemption.

The need to hold cash collateral against variation margin requirements is a significant burden, as we describe below in our response to Question 13. Also, the benefits of clearing are less significant for pension schemes than for other financial market participants such as hedge funds (which trade much more frequently or have net flat positions) and banks (which typically hold positions with net flat exposure).

Question 3: What proportion of your derivatives activity is cleared? What requirements are there on the type of collateral you need to post as variation margin, and the frequency of variation margin calls, when clearing?

There is significant variation across UK pension schemes, with different investment managers following different approaches to clearing.

For cleared positions, only cash is accepted for variation margin by central counterparties (CCPs), and calls are at least daily. For pension schemes that use clearing, there is therefore a significant need to allocate more of their portfolios to cash, meaning less will be available either to manage risk or to allocate to return-seeking assets.

In contrast, non-cleared derivatives can post gilts as collateral for variation margin. Many schemes hold physical gilts within their portfolios, so posting gilts, rather than cash, is a convenient source of potential collateral and has limited impact on the remaining portfolio.

There is also the potential for some pension schemes using non-cleared derivatives to post corporate bonds as collateral. Having a wider source of potential collateral generally enables a more robust financial system.

Question 4: If you clear derivatives, how much of this activity do you clear voluntarily (i.e. you are not required to do so, either because of the exemption or because you fall below the clearing thresholds)?

Across the pension schemes advised by our membership, we observe that schemes will typically choose to clear derivatives for two reasons.

- **It can be cheaper to unwind cleared derivative transactions:** For pension schemes with positions that may need to be closed before they mature, perhaps because they are looking to conduct an insurance buy-out, the costs of unwinding such transactions can be expected to be lower for cleared relative to non-cleared trades.
- **To remain under the threshold for non-cleared margin rules:** A small portion of larger pension schemes choose to clear some trades to ensure they do not exceed the €8bn threshold under

non-cleared margin rules. This means non-cleared trades can remain elsewhere in their portfolio.

We would note that many UK pension schemes are invested in funds domiciled in Ireland, which do not benefit from the UK clearing exemption. They are required to clear if they exceed clearing thresholds for financial counterparties.

Question 5: What factors influence the relative attractiveness of hedging via gilts vs derivatives?

Many pension schemes allocate to physical gilts without the use of leverage. Where pension schemes are seeking a low-risk portfolio and are well funded it is common for a large allocation to gilts to be made with little or no use of swaps or derivatives.

However, where pension schemes need to target some investment growth, they typically use interest rate swaps or inflation swaps (swaps), and/or gilt total return swaps or gilt repo (gilts).

The choice to hedge using swaps or gilts depends on factors that can change over time, such as relative price, actuarial discount rates, endgame target (e.g. how insurers price a buy-out) and counterparty and roll risks.

Unlike gilts, swaps have no roll risk, can be structured to match liability profiles relatively closely, and can offer some unique features such as the ability to hedge inflation in isolation. However, today, gilts are cheaper and are more extensively used than swaps. This may change in the future as the various influencing factors mentioned above may change.

It is important to highlight that pension schemes also use derivatives beyond their liability-hedging portfolios: they use swaps extensively to hedge interest rate risk for overseas bond allocations. As UK schemes continue to allocate more to fixed income to match future pension payments, we would expect allocations to overseas bonds to also increase, along with associated exposure to swaps.

During the Autumn 2022 LDI crisis, overseas fixed-income assets (especially US corporate bonds) were a liquid and valuable source of collateral whilst UK credit was strained. This enabled some pension schemes to meet cash calls during the crisis and is a good example of why enabling a broad portfolio can be advantageous for risk management.

Question 6: When using uncleared derivatives, how much scope is there to use non-cash collateral to meet variation margin requirements?

Bank counterparties continue to accept non-cash collateral (most commonly gilts) as variation margin on derivative transactions where the manager has negotiated terms. This reflects that non-cleared derivative transactions are based on bilateral agreements between counterparties, reflecting a range of incentives and considerations at play. We would expect that if the pension fund clearing exemption expires, banks' appetite for non-cash collateral for variation margin may diminish, affecting both future and historical transactions.

Question 7: What other costs or benefits do bilateral transactions provide, if any, compared to centrally cleared trades?

Bilateral, non-cleared transactions enable pension schemes to maintain allocations to gilts and return-seeking assets in line with prudent risk-management principles and their ultimate funding objectives. They also avoid the significant costs and structural risks of clearing.

Costs of clearing Doing so avoids the costs of clearing, including fees paid to CCPs and clearing member banks, and the cost of accessing cash via the gilt repo market. It also avoids the need to allocate away from return-seeking assets in order to support variation margin and initial margin requirements. These costs could amount to billions of pounds for the UK DB pension scheme industry as a whole – and crucially, they could increase substantially if the extent of hedging using swaps increases in the future, or in stressed market conditions.

A broader issue is that the implications of central clearing for pension scheme allocations would undermine the government's stated ambitions to encourage more investment in the UK economy and 'productive finance' as outlined in the Mansion House reforms, as we explain in our response to Question 17.

Structural risks of clearing. The clearing process transfers risk to a clearing member bank. This introduces some significant risks, which we outline below.

Concentrated exposure to a low number of clearing member (CM) banks. Many banks have exited this market, meaning counterparty risk is arguably less diversified than for non-cleared trades. For clearing member banks based in the US, proposed changes to Basel rules include bringing clearing into scope for credit valuation charges – making clearing less economically favourable for them. This could lead to even fewer banks offering clearing services.

If a CM bank was to default (or to terminate its services early as explained below), porting of trades is not assured. The ability to port requires a CM bank willing and able to take on the transaction. The ability to port when required, which is likely to be in either stressed periods or during unfavourable market circumstances, is likely to be most problematic for directional portfolios.

Clearing member banks have the right to terminate services, introducing significant uncertainty and the risk of meaningful costs. If a clearing member terminates its clearing services, the positions must either be ported within a set notice period (typically three to six months) or liquidated. If a position is liquidated, a pension scheme would lose its hedge and potentially face significant risk, and initial margin posted by the scheme would likely be used to offset the liquidation cost.

Ultimately, it remains uncertain whether clearing member banks would have the capacity to absorb demand if clearing for pension scheme derivatives was mandatory; the exposures in pension scheme portfolios would likely have a significant impact on the banks' balance sheets.

Question 8: How are changes in the regulation of bilateral transactions, such as Basel reforms, affecting the incentive for counterparties to clear their derivatives?

Basel reforms add to the incentives for banks to prefer cleared derivative transactions. For example, bank capital rules generally favour cleared trades, even for trades when margin is posted daily; and the leverage ratio for non-cleared derivatives does not recognise non-cash assets posted as variation margin.

Separately, rules on credit valuation adjustment (CVA) can penalise non-cleared derivatives. Across the UK and EU, banks have historically benefited from an exemption to this for trades subject to the pension clearing exemption, which has kept non-cleared markets workable for pension schemes. This exemption is being removed in the UK; however, we expect other adjustments for transactions with pension schemes.

Liquidity within the non-cleared markets has reduced, but there is still enough liquidity for pension schemes. The clearing exemption still allows pension schemes to voluntarily participate in the cleared markets when they wish to; see our response to Question 4 which outlines why some pension schemes choose to clear.

Maintaining a proportionate bank capital regime that supports trades that benefit from the pension fund clearing exemption will remain important for maintaining liquidity within the non-cleared markets.

Question 9: To what extent is there appetite among clearing members to provide clearing services to pension funds? What are the key drivers for this?

Clearing member banks have an appetite to provide derivatives clearing services to pension schemes, but as outlined in our response to Question 7, the number of clearing member banks is low and could fall further, and it remains uncertain whether they would have the capacity to absorb demand if clearing for pension scheme derivatives was mandatory. We note that there is apparently very limited appetite among clearing members to support repo clearing.

Question 10: How effectively can gilt repo markets support the ability of pension funds to raise cash for variation margin at short notice?

Repo markets can be relied upon in normal market circumstances but can become fragile in a crisis when demand outstrips supply.

We believe this was illustrated clearly in the March 2020 COVID-induced crisis, when the repo market experienced significant difficulties. As markets fell, many pension schemes sought to access cash from repo markets rather than sell investments at distressed prices.

A Bank of England report stated that liquidity demands of "£34bn within two weeks, outstripped dealers' ability and willingness to further expand intermediation capacity".[1]

The International Capital Market Association (ICMA) noted that "while the demand to access the repo market increased during the height of the crisis, banks' capacity to intermediate that access did not…it would seem that banks struggled to keep pace with client demand…Many report limiting business to top tier clients, with no capacity for new business".[2]

Based on these reports, there is a strong case that the crisis would have been worse if pension schemes had been mandated to clear.

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[1] The role of non-bank financial intermediaries in the 'dash for cash' in sterling markets, June 2021, BoE.

[2] The European repo market and the COVID-19 crisis: An ICMA European Repo and Collateral Council (ERCC) market report (PDF), April 2020, ICMA.

Question 11: Are there any other measures which you think could help pension funds meet CCP variation margin requirements?

The Bank of England has announced the development of a 'crisis toolkit' to provide a collateralised lending facility to pension schemes and insurers in stressed markets. This could help pension schemes when they need to raise cash if the repo market is not functioning.

However, this tool is still to be finalised and the details are yet to be confirmed; it will only be available at high cost and in stressed market conditions; and would not eliminate the issues associated with either variation or initial margin, which we explain in our answer to Question 13.

Pension schemes would still need to allocate more to cash, potentially increasing the risks of a negative outcome for pension savers, and reducing their ability to invest in other return-seeking assets.

Question 12: In your opinion, would the events of the 'LDI crisis' in autumn 2022 have been any different if the clearing exemption had not existed?

Yes. If clearing was mandated for pension schemes, variation margin would have been required in cash, and increased initial margin requirements would also have had an impact. These would have exacerbated the crisis with more schemes being forced out of their hedges more quickly creating more volatility for both pension scheme funding and the wider gilt market.

Question 13: What challenges could pension funds face in managing liquidity in a market stress scenario if there was no clearing exemption? What could help mitigate those challenges?

If the clearing exemption expires, we believe liquidity risk would likely increase for pension schemes. The risk of financial instability would also rise in stressed markets. This is due to variation and initial margin requirements.

Variation margin
For cleared derivatives, only cash is permitted as a variation margin. In stressed market conditions, pension schemes would likely seek to access the repo market to replenish eroded cash buffers, but the sterling repo market is unlikely to have capacity, as outlined in our answer to Question 10. The Bank of England's recently announced 'crisis toolkit' would be helpful, but it does not eliminate the risks meaning the rationale for maintaining the clearing exemption remains valid, as we explain in our answer to Question 11.

It must be noted that although pension schemes currently hedge their liabilities predominantly using gilts, this can change as market dynamics or their endgame target change. For example, for many schemes, the ultimate target is to secure benefits with an insurance policy. The way premiums are set by insurers may change over time which in turn influences how pension schemes invest their assets prior to insuring. While insurers' pricing today is a broadly even blend of swaps and gilts, this has not been constant historically and is subject to change.

As we note in our answer to Question 5, pension schemes also use derivatives extensively to hedge interest rate risk for overseas bond allocations.

Initial margin issue

A spike in initial margin required by CCPs during a crisis could undermine financial stability. In the autumn 2022, our membership observed a sharp increase in initial margin requirements. If pension schemes were mandated to clear, this could have forced them to sell assets or to reduce swap hedges – even more so than occurred in the crisis, which ultimately prompted the Bank of England to intervene.

Question 14: If the exemption expired, what would be the immediate operational impact and costs? What action would be needed to prepare for this scenario and mitigate these costs?

Some investment managers may face costs to become operationally ready to clear.

Trustees will need to review their portfolios and ensure that they have sufficient sources of cash. The greater need for cash will impact on the return potential of the portfolio and is therefore likely to require detailed analysis by their advisors, discussion at trustee meetings and the involvement of the employer and scheme actuary.

It is also possible that some pension schemes may find that they are no longer in a position to use swaps.

Question 15: How would this affect your investment choices, such as your hedging strategy and asset allocations? For example, do you expect that you would increase your cash holdings? Please provide quantitative information where possible, even if this is an estimate.

If clearing becomes mandatory, we would expect pension schemes to increase their allocations to cash to cover potential variation margin calls, and to other assets such as gilts to cover initial margin requirements. The result would be lower allocations to return-seeking investments. This would run counter to the government's stated ambitions to encourage more investment in the UK economy and 'productive finance' as outlined in the Mansion House reforms.

During and since the Autumn 2022 LDI crisis, pension schemes have seen the proportion of their portfolios allocated to illiquid assets increase as a result of LDI strategies calling down more collateral from liquid sources. In stressed markets, it can be difficult and/or very expensive to liquidate some assets (e.g., property) and it is likely that the removal of the exemption will make trustees less inclined to hold illiquid assets.

Question 16: Would you anticipate any impact on your returns and/or clients? Again, any quantitative estimates would be welcome where possible.

Portfolios of cleared derivatives would bear higher costs, and in turn, reflect a negative impact on returns. The impact would be notable in stressed conditions when the costs and risks might be expected to rise sharply, as summarised in our answer to Question 13.

Question 17: If the exemption expired, how would you expect this to interact (if at all) with the government's ambition, as set out at Mansion House, to improve outcomes for savers and increase the availability of funding for high-growth companies?

If clearing becomes mandatory, we would expect pension schemes to allocate less to return-seeking investments, as they would increase their allocations to cash to cover potential variation margin calls, and to other assets such as gilts to cover initial margin requirements.

This would run counter to the government's stated ambitions to encourage more investment in the UK economy and 'productive finance' as outlined in the Mansion House reforms.

Question 18: In an identical market stress scenario (for example a certain percentage change in gilt yields), would you expect variation margin calls to be higher if there was no exemption, as opposed to if the exemption was kept?

No. The size of a variation margin call would be the same for the same percentage change in gilt yields.

However, if clearing was mandatory for pension schemes, , more of the variation margin calls would require cash, and more initial margin would also be required.

Question 19: Are there any lessons the UK can learn from the approach of other jurisdictions to this issue?

UK defined benefit pension schemes have some unique characteristics, which means that a clearing exemption makes sense for this sector. For example:

- Unlike US counterparts, UK defined benefit schemes have longer duration, inflation linkage and the use of swaps is much more extensive; also, the UK corporate bond market is much smaller than the US market.
- Unlike European counterparts, UK defined benefit schemes are much larger in aggregate relative to the sterling repo market, meaning there would be a clear threat to financial stability in a crisis scenario; and most UK schemes are small meaning they can benefit from the clearing exemption without being in scope for non-cleared initial margin rules.

Question 20: Do you have any further information or views to share on the future of the pension fund clearing exemption?

Pension schemes have been exempt from clearing derivatives transactions since EMIR was introduced in 2012. Despite significant efforts by the industry to find a solution, CCPs still cannot accept non-cash collateral as a variation margin.

There are a wide range of costs and risks to consider that mandatory clearing would introduce or exacerbate, outweighing any potential benefits. We would therefore argue for the clearing exemption to be permanent for pension schemes.

Response ends.-

Yours faithfully,

Natalie Winterfrost,
Chair, Investment Committee, SPP

Fred Emden
Chief Executive, SPP

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