THE INVESTMENT ASSOCIATION

Pension Fund Clearing Exemption
Financial Services
HM Treasury
1 Horse Guards Road
London SW1A 2HQ

5th January 2024

By email: pensionfundexemption@hmtreasury.gov.uk

Dear Sir/Madam

RE: Investment Association response to HMT call for evidence on the pension fund clearing exemption

The Investment Association[1] (IA) welcomes the opportunity to respond to HMT's call for evidence on the future of the pension fund clearing exemption. Our members collectively manage £1.9 trillion of corporate UK pension assets, with LDI portfolios accounting for £1.17 trillion worth of liabilities notionally hedged[2]. In managing these portfolios, our members manage derivative exposures on behalf of their pension scheme clients on both a cleared and uncleared basis, making use of the clearing exemption in the latter case.

The move to central clearing of derivative contracts following the adoption of the European Market Infrastructure Regulation (EMIR) at the end of 2012 significantly reduced some of the risks inherent in bilateral OTC derivative contracts revealed during the 2008/09 Global Financial Crisis. Clearing through a central counterparty (CCP) provides the market and regulators with improved transparency and reduced counterparty credit risk and enhanced execution and operational efficiencies.

However, it was recognised at the time of EMIR's adoption that mandatory clearing was not necessarily optimal for all investors, and the IA and its members supported the establishment of the pension fund clearing exemption on the grounds that that there was no viable solution for pension funds to post non-cash variation margin (VM) to a CCP. More than ten years on, there is still no viable solution and, as we discuss below, the additional cash that DB pension funds would have to hold, or source, in order to ensure compliance with the clearing obligation would have a detrimental effect on these schemes' portfolio returns, as well as increasing the liquidity risk they face. This could result in lower funding levels, meaning increased costs for scheme sponsors and reduced security for members.

[1] The Investment Association (IA) champions UK investment management, a world-leading industry which helps millions of households save for the future while supporting businesses and economic growth in the UK and abroad. Our 250 members range from smaller, specialist UK firms to European and global investment managers with a UK base. Collectively, they manage £8.8 trillion for savers and institutions, such as pension schemes and insurance companies, in the UK and beyond. 48% of this is for overseas clients. The UK asset management industry is the largest in Europe and the second largest globally.
[2] Investment Management in the UK 2022-23, The Investment Association, 2023.

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Additionally, mandatory clearing for UK pension funds could increase the aggregate demand for cash within the financial system during bouts of market volatility: the reduction in counterparty risk from mandatory central clearing would effectively be traded off for increased liquidity risk. For reasons we discuss below, we believe this is a greater challenge for the UK's financial system relative to other countries where pension funds similarly engage in repo borrowing and swap and/or bond-based hedging.

Accordingly, we recommend that HMT ends the ongoing uncertainty around the future of the pension fund clearing exemption by making it permanent. This approach would mean that pension funds could still choose to clear centrally where it is beneficial for them to do so, but mitigates the challenges that mandatory clearing would create:

Mandatory clearing will impose unnecessary costs on pension funds

DB pension funds tend to hold low levels of cash for good reason: with a long investment horizon and inflation-linked liabilities, cash is not an asset class that is especially suitable for DB schemes to hold in large amounts. It is normally held only to meet forthcoming benefit payments or for meeting collateral calls associated with the swaps and repo arrangements they use as part of their LDI portfolios; even then, schemes may seek to generate cashflows from their assets (or raise cash via repoing their gilts) rather than holding cash separately. Indeed, the latest data from the PPF[3] indicates that the weighted average proportion of DB assets held in cash and deposits is -5.1%. This negative holding is likely related to schemes' use of swaps and repos.

While pension schemes can and do sometimes trade on a cleared basis[4], requiring them to do so is likely to force them to hold higher levels of cash to cover their VM requirements, given CCPs require the use of cash for VM. Higher cash holdings will create a drag on a scheme's portfolio returns, which in turn could lead to reductions in funding if realised returns do not keep pace with targeted returns in line with a scheme's funding objective. This would represent a cost to the sponsor in terms of needing to find more money to meet DB funding requirements, as well as a reduction in the security of members' benefits. Mandatory clearing for pension funds also increases the liquidity risk they face, given the need to post cash as VM.

Mandatory clearing will reduce the capacity of the DB pensions sector to assist with the Government's Mansion House reform agenda

Elements of the government's Mansion House reform agenda seek to improve the capacity of the UK DB sector to provide risk capital to the UK economy through changes to the surplus rules, such that well-funded schemes are incentivised to take more investment risk. Mandatory clearing would act against this objective: as well as greater cash holdings to cover VM requirements, the requirements of CCPs in respect of Initial Margin (IM) could result in pension schemes having to hold more gilts relative to uncleared trades.

An IM requirement under mandatory clearing (which is generally not needed for bilateral OTC trades) will reduce a pension fund's ability to target return and/or retain high hedging levels, since the leverage capacity is reduced if gilts are being used for IM instead of being held against the Operational/Market Stress Buffer set out under the Bank of England's regulatory requirements for leveraged LDI strategies[5]. This represents a further unnecessary cost to pension funds.

As a result of both IM and VM requirements under mandatory clearing, DB pension funds are incentivised to hold more cash and gilts and less of the growth assets the Government wishes to see under the Mansion House reform agenda.

[3] The Purple Book 2023, Pension Protection Fund.

[4] Reasons for the use of cleared trades by pension funds may include client instructions or investing via pooled funds which do not themselves benefit from the clearing exemption.

[5] FPC assessment of required resilience for systemic risk, Bank of England, 2023.

Mandatory clearing and systemic liquidity demand

As noted earlier, we see that mandatory clearing has the potential to add to the aggregate demand for cash within the financial system during bouts of market volatility:

- In a scenario similar to 2022's gilt market crisis, pension funds' demand for cash would have been higher if they were required to clear trades. Given the limited amount of cash held by pension funds, this increased demand could have resulted in further asset sales to raise cash – leading to further pricing pressure on markets.
- The other way that pension schemes could raise cash would be to access the repo market. Schemes may wish to do this where they do not want to sell assets, particularly at distressed prices. While the gilt repo market could be used by pension schemes to raise cash in normal market conditions, experience suggests that in stressed markets demand for cash can outstrip supply. The 2020 'dash for cash' at the onset of the Covid-19 pandemic provided a demonstration of this[6]. Impairment of repo markets would leave pension schemes with no option other than to sell assets to raise cash.
- CCP requirements on IM and VM have the potential to exacerbate market volatility. CCP VAR Look Back models for IM mechanistically increase IM at or shortly after the point of stress. The Bank of England's Financial Policy Committee (FPC) confirms this as they note, "IM requirements tend to rise in periods of stress, reflecting increases in expected losses"[7]. This creates a pro-cyclical effect by requiring counterparties who post margin to find additional liquid assets at a point when it is already challenging to do so. Our members reported IM rising significantly during the autumn 2022 gilt market crisis; had pension funds been mandated to clear, they would have had to either post more gilts as IM or cut their LDI hedges to reduce IM requirements, further exacerbating the negative market dynamics.

  With respect to VM, as noted above, CCPs only accept cash, putting further pressure on pension funds to either hold more cash on an ongoing basis (leading to cash drag on portfolio returns) or raise cash via the repo market or asset sales.

A comparison with other major pensions markets suggests the UK is sufficiently different to justify making the clearing exemption permanent

The two major DB pension systems that are comparable with the UK are the US and the Netherlands, both being large, sophisticated, and mature DB systems. While DB funds in those other countries also implement liability matching strategies, there are some important differences:

- In the US, liabilities are shorter duration than in the UK (due to a lack of inflation linkage) and discounted by corporate bond yields. Accordingly, US DB plans generally use corporate bonds to hedge rather than swaps. This is facilitated by a large, diversified domestic corporate bond market, which offers bonds that provide good matching characteristics for plan liabilities. Given the low usage of swaps in the US, their DB plans do not need the clearing exemption. In contrast, the UK DB sector is much more reliant on gilts, repos, and swaps for hedging activity.
- In the Netherlands, swaps are employed for liability hedging purposes, but the Dutch DB pension sector is smaller relative to the Euro-denominated government bond and repo markets than the UK DB sector is relative to the UK gilt and gilt repo markets. This means that the concentration risks in the UK DB sector that gave rise to the financial stability concerns in autumn 2022 are less likely to be realised in the Dutch pension sector as a result of hedging activity by Dutch pension schemes.

These differences suggest there are good reasons for the UK to take a different approach to the clearing exemption, one which better suits the features of the UK pensions market and the needs of UK pension schemes.

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[6] The role of non-bank financial intermediaries in the 'dash for cash' in sterling markets, Bank of England, 2021.

[7] Financial Stability Report, August 2020, FPC, Bank of England.

Solutions: making the clearing exemption permanent and broader reforms on VM requirements

In our view, the reasons set out above provide a compelling rationale for the UK pension fund clearing exemption to be made permanent. Doing so will provide certainty to UK pension schemes, their investment managers, and their capital market counterparties. The exemption was originally introduced in recognition of the fact that pension schemes had prudent risk and return reasons to not hold much cash, a reality that has not changed. Furthermore, given that no technical solution to address the issue of non-cash variation margin has arisen in the years since the introduction of EMIR, we see no benefit to further extensions of the exemption.

We note that under the EU's current reform proposals for EMIR ("EMIR 3.0") there is a provision under which there would be an exemption from the clearing obligation where a counterparty enters into a transaction with a pension scheme established in a third country which is exempted from the clearing obligation under its national law. If HMT were to make the UK exemption permanent, this would enable UK pension schemes to trade otherwise mandatorily clearable OTC derivatives with EU dealers on an uncleared basis.

Of course, making the exemption permanent would not stop pension funds from clearing trades centrally if they wanted to. As we have noted above, some UK pension funds already trade on a cleared basis, either directly or through pooled funds that do not benefit from the current clearing exemption.

In the longer term, one way of encouraging pension schemes to move towards greater use of centrally cleared trades would be for CCPs to accept non-cash assets (including pooled fund units, for example of Money Market Funds) as collateral for Variation Margin. This would better suit the asset allocation of pension schemes and reduce the demand for cash by pension schemes during bouts of market volatility.

I hope this response is helpful and I would be delighted to discuss it further.

Yours faithfully,

Imran Razvi
Senior Policy Adviser, Pensions & Institutional Market

(by email)