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Call for evidence: UK pension fund clearing exemption

Insight Investment response

January 2024

BNY MELLON | INVESTMENT MANAGEMENT

Executive summary

Insight Investment is one of the UK's largest asset managers. We manage c.£400bn of assets for over 450 UK defined benefit (DB) pension funds, of £607bn in total across our global business.[1]

We welcome this opportunity to respond to His Majesty's Treasury's call for evidence on the clearing exemption for UK pension funds. For over a decade, we have engaged with policymakers and the wider industry in support of the pension fund clearing exemption. Insight was a participant in the European Commission's pension fund expert group on this topic, which met from 2017 to 2023.

Pension funds will, and do already, choose to voluntarily clear where there are good reasons to do so. Indeed, Insight clears derivatives for a proportion of UK pension fund clients. **However, we believe the risks and costs associated with mandatory clearing for pension funds remain significant, and it is unlikely these will be resolved. While we are grateful for the numerous extensions that have taken place since 2012, we believe UK pension funds should have greater certainty regarding the long-term treatment of their transactions, and that the clearing exemption should be made permanent.**

Key points we wish to highlight include the following.

- **Mandatory clearing could increase financial stability risk:** If the pension fund clearing exemption expires, we believe financial stability risk could rise in a market-stress scenario due to both the cash variation margin issue and pro-cyclicality risk from central counterparty (CCP) initial margin.

  For cleared derivatives, CCPs will only accept cash as variation margin. Pension funds do not hold much cash, but mandatory clearing would force them to increase cash allocations, and in stressed market conditions the sterling repo market would struggle to absorb demand to meet variation margin requirements. For a 1% yield rise, and assuming 10% to 50% liability hedging with swaps, variation margin calls by UK corporate DB pension funds could amount to c.£17bn to £85bn[2]. According to a Bank of England (BoE) report, dealers struggled to meet demand within the repo market amounting to £34bn within two weeks during the March 2020 crisis.

  While the arguments for the clearing exemption have centred around the cash variation margin issue, it is also important to note the potential risks that could arise from posting initial margin. Initial margin required by CCPs is highly sensitive to pro-cyclicality risks. We saw initial margin doubling during the gilts liquidity crisis in autumn 2022. If pension funds had been mandated to clear this could have forced them to either sell assets or cut hedges to reduce initial margin requirements.

  Finally, we note that the benefits of clearing for netting portfolios are not so apparent in directional pension fund portfolios. Under clearing, pension funds' credit risk exposures to banks are transferred rather than reduced, and the structure of the clearing process creates other issues for the wider financial system.

- **Mandatory clearing would lead to increased risks and costs, and reduced security, for UK DB pension funds:** The need for pension funds to hold more assets against initial and variation margin requirements, rather than to focus purely on their funding objectives, would result in reduced return potential, leading to a negative impact on their financial solvency. In stressed market conditions they would be under greater pressure to sell assets or reduce hedges if these margin requirements spike, leading to a meaningful increase in risk and costs in a crisis scenario.

- **Mandatory clearing would go against the chancellor's ambitions set out in the Mansion House reforms:** Mandatory clearing would likely lead to pension funds investing less in return-seeking assets, for the reasons outlined above. Pension funds would need to hold more assets specifically against initial and variation margin requirements,

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[1] As at 30 September 2023. Assets under management (AUM) are represented by the value of cash securities and other economic exposure managed for clients. Figures shown in GBP. Reflects the AUM of Insight, the corporate brand for certain companies operated by Insight Investment Management Limited (IIML). Insight includes, among others, Insight Investment Management (Global) Limited (IIMG), Insight Investment International Limited (IIIL), Insight Investment Management (Europe) Limited (IIMEL) and Insight North America LLC (INA), each of which provides asset management services.

[2] This is calculated as: size of DB pensions sector liabilities (£1.25trn) x 90% hedge ratio x percentage hedged with swaps (10 to 50%) x 1% rate move x 15-year duration. Convexity is ignored.

meaning they would have less scope to invest in return-seeking assets supporting growth in the UK economy – contrary to the government's objectives outlined in the Mansion House pension reforms.

- **A permanent clearing exemption will provide certainty:** The exemption was originally temporary to allow time for the development of technical solutions to the cash variation margin issue. However, after over 10 years of exploration, it is clear that technical solutions for CCPs accepting non-cash as variation margin will not be developed; there are strong operational reasons for CCPs to require variation margin in cash. Ten years on, pension funds and the financial markets will benefit from the certainty of a long-term solution of a permanent exemption.
- **There are strong reasons for the UK to diverge from other international jurisdictions on the exemption:** The size of the UK DB sector relative to the sterling repo market is much larger than in other jurisdictions and comparable markets, meaning the potential threat to financial stability from this issue is larger for the UK than elsewhere – creating a strong rationale for the UK to maintain the exemption and make it permanent.

Insight clears trades for many UK pension fund clients, and we believe this can support prudent and efficient risk management. However, we believe mandating clearing would be an unambiguous negative for pension funds and the wider markets, for the reasons outlined in this response.

DB pension scheme liabilities need to be managed for decades. We believe it is plausible that their use of swaps could increase over this time, and so any policy decision should reflect this, rather than focus only on current swap usage. We believe a permanent exemption would achieve this.

Insight Investment

January 2024

Questions and answers

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.

The average outstanding notional amount of derivatives that we manage across all mandates for UK pension funds amounts to c.£279bn as at 31 October 2023.

It must be noted that the current use of swaps is lower than what it has been historically. Pension funds currently hedge their liabilities predominantly using gilts (supported by the use of gilt repos); however, this can change as market dynamics change. All else being equal, swaps are the long-term hedging asset of choice for the majority of pension funds, as they have no roll risk and can be tailored to match liability profiles more accurately than gilts.

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

Yes, most of our UK pension fund clients use the exemption.

Clearing works well for market participants with net flat positions (e.g., banks) or those with high turnover of trades (e.g., hedge funds). It works less well for long-dated directional portfolios that may be held to maturity, because the collateral impact is greater and the benefits of clearing and risk reduction from netting are lower.

Mandatory (as opposed to voluntary) clearing could increase liquidity risk to pension funds and disproportionately increase financial stability risk for the system, as further explained in our answers to Questions 7 and 13. It can also negatively impact outcomes for future pensions by increasing costs and risks, and reducing security. Mandated clearing would likely lead to pension funds allocating more assets to cash and low-risk investments, and therefore reducing pension funds' ability to support wider UK growth, a key goal of the Mansion House reforms.

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?

We clear 10%-15% of the outstanding notional amount of derivatives exposure that we manage on behalf of UK pension funds.

CCPs only accept cash as variation margin. The frequency of calls is daily and sometimes intra-day.

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)?

Clearing is not used by a significant proportion of Insight's UK pension fund clients, but when it is used, this is typically due to the following three factors:

- **Clients instruct to clear:** Clients sometimes instruct Insight to clear derivatives transactions. For example, pension fund clients seeking to prepare for an insurance buy-out may prefer cleared transactions as the overall costs of unwinding such trades are likely to be lower than for non-cleared trades (the bid-offer spread is typically narrower for cleared trades).
- **To enable exit from positions prior to maturity:** It may be beneficial to clear positions that are deemed likely to be closed before they mature, as the frictional trading costs for cleared trades can be less than for non-cleared trades (the bid-offer spread is typically narrower for cleared trades).
- **No exemption applies:** Many of our UK pension fund clients are invested via Ireland-domiciled fund structures known as QIAIFs (Qualifying Investor Alternative Investment Funds). These structures do not benefit from the UK pension fund clearing exemption and are therefore mandated to clear if they are above certain clearing thresholds available for financial counterparties.

- **Non-cleared margin rules**: Some large pension funds choose to voluntarily clear a portion of their portfolio so that they remain below the €8bn threshold for the non-cleared margin rules. This allows those pension funds to ensure that non-cleared trades remain workable, if needed elsewhere within their portfolio where they wish to use the pension fund clearing exemption.

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

The choice of hedging instrument (e.g., between swaps and gilts) for managing liability risk is driven by a number of factors and can change over time as market dynamics change. These factors include the price of gilts relative to swaps, the discount rate used for valuing liabilities by actuaries, counterparty risk and roll risk.

All else being equal, swaps are the long-term hedging asset of choice, as they have no roll risk and can be tailored to match liability profiles more accurately than gilts. In some situations swap-based hedges may be structurally preferable; for example, to hedge inflation-only exposure.

Historically, pension funds were predominantly hedged using interest rate and inflation swaps. However, as gilts became materially cheaper, pension funds increased gilt exposure. While gilts are currently the cheaper hedging instrument, this may not persist. It is reasonable to expect that pension funds may increase allocations to swaps for liability-hedging purposes in the future.

It must also be noted that the use of swaps in fixed income portfolios to hedge interest rate risk for overseas bonds, remains high. As they mature, pension funds typically allocate more of their assets to overseas bonds due to the limited size of the sterling corporate bond market at longer maturities.

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

In non-cleared derivative transactions, collateral permitted as variation margin is dependent on the bilateral agreements with the bank counterparties. Insight has broadly maintained the ability to post gilts as variation margin. For non-cleared derivative transactions that we manage on behalf of UK pension funds, we estimate that about 90% of the collateral posted to bank counterparties is in non-cash collateral, the vast majority of which is gilts.

Historically, it was standard practice for swaps to be collateralised with either cash or gilts. However, after the global financial crisis, regulatory reform and the introduction of certain bank capital rules led banks' appetite to decline for non-cash collateral posted as variation margin. For example, because of the leverage ratio rules for banks, banks cannot use non-cash collateral posted as variation margin for non-cleared derivatives to offset their mark-to-market exposure; this can act as a significant disincentive for banks to accept non-cash collateral. At the time, there was significant demand from banks to move to credit support annexes (CSAs) that only recognised cash collateral.

However, Insight has broadly maintained the ability to post gilts as variation margin. Some constraints apply; for example, the contracts often permit the bank counterparty to revisit these arrangements periodically, allowing for the potential that they could withdraw the eligibility of gilts as collateral.

When these contracts are re-negotiated, we understand from our bank counterparties that various factors determine whether the counterparties allow gilts as variation margin. We understand these to include bank capital rules and their balance-sheet impact, but also policymakers' stance on the pension fund clearing exemption gives an indication to banks on where to focus their commitments. If the pension fund clearing exemption was to expire, there may be a risk that banks reduce their commitment to support non-cash variation margin and therefore withdraw the ability to post gilts as variation margin when these agreements are next negotiated.

This would have a detrimental effect not only on future trading but also on historical derivative transactions, as these could be converted to allow only cash to be posted as variation margin. This would significantly increase the liquidity risk associated with cash variation margin (see our response to Question 13) and is another reason to ensure that the pension fund clearing exemption is made permanent.

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

We believe this question can be answered most clearly by outlining the costs associated with clearing and the risks specifically associated with clearing member (CM) banks.

Costs of clearing

In our experience, implementing long-term swap positions on a bilateral basis is currently more cost-effective than implementing them via clearing – once explicit and implicit clearing costs, such as the opportunity cost of raising cash to post as variation margin and gilts to post as initial margin, are taken into account.

The cost of clearing can be attributed into three components.

- **Direct cost:** Clearing fees (CCP and CM fees)
- **Indirect cost – opportunity cost of initial margin held:** The cost of holding gilts to fund initial margin requirements rather than investing in return-seeking investments.
- **Indirect cost – variation margin:** The cost of borrowing cash from the repo market (relative to SONIA) to raise or replenish cash buffers.

For a 1% rise in yields, we estimate the total cost of clearing for UK DB pension funds could amount to £160m to £360m per annum, or £2.4bn to £5.4bn over the life of these funds, assuming the use of swaps accounts for 10% of liability hedging.

If the use of swaps increased to account for 50% of liability hedging, the total estimated cost of clearing could increase to £1.1bn per annum or £15.8bn over the life of UK DB pension funds.

In stressed market conditions, the costs could rise unpredictably and increase to unknown levels.

These calculations, illustrated overleaf, are based on a range of assumptions.

Illustrative calculation estimating the cost of mandatory clearing for UK DB pension funds

	10% hedged with swaps	50% hedged with swaps
Notional hedged with swaps[3]	c.£113bn	c.£563bn
Initial margin[4]	£6bn to £8bn	£28bn to £39bn
Variation margin[5]	£17bn	£84bn
Cost breakdown		
Assumed repo cost (per annum)	15bp to unknown	45bp to unknown
Direct cost: clearing fees (per annum)[6]	c.£23m	c.£113m
Indirect cost: opportunity cost of initial margin[7]	c.£113m to £315m	c.£563m to £1.6bn
Indirect cost: cost of variation margin calls[8]	c.£25m to unknown	c.£380m to unknown
Total costs (£ pa)	**c.£160m to £360m, or unknown**	**c.£1.1bn to unknown**
Total costs over the life of UK DB pension funds[9]	**£2.4bn to £5.4bn, or unknown**	**£15.8bn to unknown**

Assumptions underlying the above calculations

- Private sector DB pension fund liabilities of £1.25trn[10].
- 1% rate move for different usage of swaps (10% and 50%).
- Pension funds hedge 90% of their liabilities.
- Initial margin amounts to 5%-7% of notional exposure of interest rate swaps used.
- Average duration of pension fund of 15 years.
- The direct cost of clearing (CM and CCP fees) assumed to be 2bp per annum on notional exposure hedged with swaps.
- The opportunity cost of raising cash for variation margin to be 15bp-45bp in normal market circumstances, and unknown in stressed conditions. These costs are based on the implied funding cost of repo relative to SONIA as cash may be raised through using repo; the unknown level is to represent the fact that it is not possible to estimate the cost in a crisis situation.
- The opportunity cost of gilts being allocated to CCP initial margin (as opposed to investing in return-seeking investments) we estimated at 2%-4%.
- For simplicity, convexity has been ignored.

Risks associated with exposure to CM banks

It is important to note that for directional portfolios, clearing does not eliminate risk in a manner that is possible to achieve with netting for portfolios with flat positions. Rather, the client's risk is moved from the executing broker bank to the CM bank. This leads to several significant concerns that we outline below.

- **Potentially increased concentration risk to banks for cleared contracts.** The number of banks offering client clearing services is low. Over the last decade many banks have exited this market, leading to a high concentration of

[3] Calculation: liabilities (£1.25trn) multiplied by hedge ratio (90%), multiplied by percentage hedged with swap (10% or 50%).
[4] Calculation: notional exposure hedged with swaps multiplied by 5%-7% range for initial margin.
[5] Calculation: notional exposure hedged with swaps multiplied by 1%, and by 15-year duration. This ignores convexity.
[6] Calculation: clearing fees (2bp per annum) multiplied by notional exposure hedged with swaps.
[7] Calculation: size of initial margin (5%-7%) multiplied by opportunity cost of initial margin (2%-4%).
[8] Calculation: size of variation margin multiplied by cost of raising cash via the repo markets.
[9] Calculation: total costs in £ per annum multiplied by 15 years.
[10] Source: The Purple Book 2023: DB pensions universe risk profile (PDF), 2023, Pension Protection Fund. Figure 4.3, estimated liabilities on a full buy-out basis as at 31 March 2023.

risk across a small number of CM banks. This counterparty risk is arguably less diversified relative to executing broker banks for non-cleared trades.

- **Less negotiation power for pension funds.** The dominance of a few banks providing client clearing leads to limited power for pension funds to negotiate equitable terms.
- **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.
- **Greater risk of contracts being liquidated.** CMs retain the right to terminate their services at their discretion (notice periods are typically three to six months, whereas the underlying positions may have maturities up to 50 years). If a CM terminates its clearing services, and the positions are not successfully ported within the notice period provided by the CM, the transactions would be forced to liquidate. This risk does not exist for non-cleared derivatives as the bank counterparty cannot terminate or novate the agreement without consent from the client. If positions are forced to be liquidated, pension funds would lose their hedge, exposing them to significant risk and costs.
- **Greater amount of capital is at risk.** If a CM was to default or terminate its services, and porting was not secured meaning that the portfolio would enter liquidation, a greater amount of a pension fund's capital is at risk because initial margin posted by the pension fund would likely be used to offset the liquidation cost. This would lead to the pension fund not only losing its hedge, but also paying to liquidate positions against its wishes.
- **Currently many of the CM banks are concentrated in regions outside the UK.** This introduces foreign regulatory risk which pensions funds do not have the ability to manage. For example, many CM banks are currently based in the US, and proposed changes to US Basel rules (widely referred to as the "Basel III endgame") proposes bringing clearing into scope for credit valuation charges. This creates a risk that US-based CM banks exit the market as clearing becomes less economically favourable for them, leaving pension funds exposed to a structural market risk that they cannot manage.
- **Capacity of CM banks remains untested.** If pension funds were mandated to clear, it remains uncertain whether CM banks would have capacity to absorb demand (both in terms of balance-sheet availability and onboarding capability). The directionality of pension fund portfolios is likely to have significant impact on clearing 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 over non-cleared derivative transactions. However, we believe there are still strong reasons for pension funds to trade non-cleared swaps, and we are seeking to encourage these to be reflected when new bank capital rules are devised.

Based on our understanding of the Basel reforms, below are some of the incentives to clearing or challenges we see to non-cleared positions:

- Bank capital rules generally favour cleared over non-cleared trades, even when margin is posted daily.
- The leverage ratio for non-cleared derivatives does not recognise gilts and other non-cash assets posted as variation margin.
- Credit valuation adjustment (CVA) rules can penalise non-cleared derivatives. UK and EU banks have benefited from a CVA exemption, applied to trades subject to the pension fund clearing exemption, which has allowed non-cleared markets to remain workable for pension funds. Going forward, we understand that this exemption will be removed in the UK but other adjustments will be made for transactions with pension funds. At the time we responded to the UK Basel 3.1 consultation to ensure that the definition pension funds aligned with that used in EMIR. We are waiting to see the final rules and understand their impact.

Despite the above factors, while liquidity within the non-cleared markets has reduced over the years, there is still sufficient liquidity for pension funds. The clearing exemption still allows pension funds to voluntarily participate in the

cleared markets when they wish to; for example, for trades which may be closed before they mature, where the increased liquidity is beneficial.

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?

There is appetite among CMs to provide derivatives clearing services to pension funds.

However, as explained in our response to Question 7, we believe the number of banks offering client clearing services is low. Over the last decade a number of banks have exited this market, leading to a high concentration of risk across a small number of CM banks and in certain jurisdictions (for example US). The lack of competition in this market leads to limited power for pension funds to negotiate equitable terms.

There is very limited appetite among CMs and custodians to support repo clearing. Currently we are aware of only one bank providing client clearing services and only two custodians supporting this model. As a result many pension funds will not have access to this service. This service is still very much in its infancy and we hope this will improve with the BoE's focus on repo liquidity facilities for non-bank financial intermediaries.

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 stressed market conditions, when demand can outstrip the supply.

If clearing, pension funds will likely access the repo markets following variation margin calls, at least to replenish any eroded cash buffers.

- For a 1% yield rise, and assuming 10% to 50% hedging with swaps, variation margin calls by UK corporate DB pension funds could amount to c.£17bn to £85bn[11]. Note that 20-year swaps increased by 1.3 percentage points between 21 and 28 September 2022, including intra-day moves, during the crisis in autumn 2022[12].
- Sterling gilt repo markets are unlikely to cope with the demand. The size of the sterling repo market is c.£390bn in outstanding notional exposure, or £120bn in terms of average daily turnover[13].
- The March 2020 COVID crisis showed vulnerabilities in the repo markets (see below).
- Pension funds may be forced sellers of physical holdings (including gilts), which could negatively impact financial market stability.

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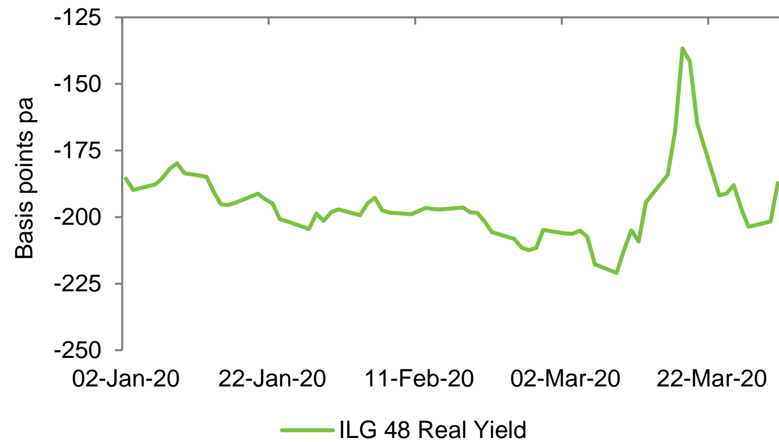
[11] This is calculated as: size of DB pensions sector liabilities (£1.25trn) x 90% hedge ratio x percentage hedged with swaps (10 to 50%) x 1% rate move x 15-year duration. Convexity is ignored.
[12] Source: Insight Investment.
[13] Source: BoE Database, sterling money market data, code YWQZM5T and YWQZM5K respectively. As at 30 September 2023.

Cash variation margin issue: the 'dash for cash' experience (March 2020 COVID crisis)

During the March 2020 COVID market turmoil, the repo market experienced difficulties with smaller increases in demand. According to a BoE report[14], liquidity demands of "£34bn within two weeks, outstripped dealers' ability and willingness to further expand intermediation capacity".

We believe the crisis would have been worse if pension funds had been mandated to clear.

There was substantial increased demand for cash from margin calls as asset classes declined in a correlated manner. Many pension funds preferred to generate cash from repo markets rather than sell physical assets at distressed prices (or with longer settlement periods). The BoE noted that "the repo market has shown signs of strain in recent stress episodes"[15]; this was evidenced by an increase in repo pricing.



More importantly, supply did not meet demand. Indeed, the International Capital Market Association (ICMA) noted that[16]:

- "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."

Liquidity issues in the underlying funding markets put pressure on money market funds to fill the gap, and markets stabilised only once central banks intervened. **If pension funds had been mandated to clear, the dash for cash experience would likely have been worse.**

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

We support the principles outlined in a speech by the BoE's Executive Director for Markets, Andrew Hauser, which explored how the bank can develop a crisis toolkit to provide a collateralised lending facility to pension funds and insurance companies in stressed market conditions. We fully support this development and believe it is an important tool for the bank to help manage financial stability risk.

This could support pension funds in a stressed market when the repo market does not function as expected, but pension funds need to repo their gilts for cash to meet CCP variation margin calls.

While we fully support the development of this tool for managing extreme financial stability risk events, this does not negate the need for the pension fund clearing exemption to be made permanent. We also note that it would not solve other issues, including those related to initial margin (explained in our response to Question 13).

This tool is not yet operational, and it is not clear how it will work or how many pension funds will be able to access it. Once it is up and running, it will be available only in extreme market conditions and at punitive costs, and is not intended for use by pension funds as part of normal business. Pension funds will still need to hold more cash, increasing financial solvency risks and the likelihood of a negative outcome for pensions savers, and reducing pension funds' ability to invest

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[14] The role of non-bank financial intermediaries in the 'dash for cash; in sterling markets, June 2021, BoE.
[15] Source: page 25, Staff Working Paper No. 910: How does the repo market behave under stress? Evidence from the Covid-19 crisis, June 2021, BoE.
[16] The European repo market and the COVID-19 crisis: An ICMA European Repo and Collateral Council (ERCC) market report (PDF), April 2020, ICMA.

into UK growth, equities and higher-risk assets. These points run counter to the government's ambitions set out in Chancellor Hunt's Mansion House speech in July 2023.

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. We believe the events of autumn 2022 would have been worse if pension funds had been mandated to clear, as cleared positions would have required variation margin to be posted as cash, and increased requirements for initial margin would have also had an impact. These are likely to have exacerbated the crisis further.

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 pension fund clearing exemption expires, we believe liquidity risk could increase for pension funds, and financial stability risk in the system would rise in a market-stress scenario. This is due to the cash variation margin issue and pro-cyclicality risk from CCP initial margin.

Cash variation margin issue

For cleared derivatives, although pension funds can post gilts as initial margin, only cash is permitted as variation margin. Pension funds prefer to collateralise swaps with gilts, as they do not hold much cash – holding cash erodes returns and negatively impacts financial solvency, and cash is not risk-less. The industry has explored solutions for cash variation margin for over 10 years, but none have been developed. There are strong operational reasons why CCPs will not accept gilts as variation margin, so the need to post cash as variation margin for cleared trades remains.

If clearing, pension funds will likely access the repo markets following variation margin calls, at least to replenish any eroded cash buffers. The sterling repo markets are unlikely to cope with the demand in stressed market conditions as explained in our answer to Question 10.

We believe the recent announcement by the BoE, that it will create a crisis toolkit to provide a collateralised lending facility to pension funds and insurance companies in stressed market conditions, would be helpful in extreme circumstances. While we fully support this development, we do not believe it negates the need for the pension fund clearing exemption to be made permanent.

This tool is not yet operational and it is not clear how it will work or how many pension funds will be able to access it. Once it is up and running, it will be available only in extreme market conditions and at punitive costs, and is not intended for use by pension funds as part of normal business. Pension funds will still need to hold more cash, increasing financial solvency risks and the likelihood of a negative outcome for pensions savers, and reducing pension funds' ability to invest into UK growth, equities and higher-risk assets. These points run counter to the government's ambitions set out in Chancellor Hunt's Mansion House speech in July 2023.

It must be noted that although pension funds currently hedge their liabilities predominantly using gilts (supported by the use of gilt repos), this can change as market dynamics change. All else being equal, swaps are the long-term hedging asset of choice, as they have no roll risk and can be tailored to match liability profiles more accurately than gilts. It must also be noted that the use of swaps in fixed income portfolios, to hedge interest rate risk for overseas bonds, remains high.

Initial margin issue

While the arguments for the clearing exemption have centred around the cash variation margin issue described above, there are also potential risks that could arise from posting initial margin. Initial margin required by CCPs is highly sensitive to pro-cyclicality risks and spikes in initial margin during a crisis could negatively impact financial stability.

We saw initial margin doubling during the crisis in autumn 2022. If pension funds had been mandated to clear, this could have forced pension funds to either sell assets to support increased initial margin requirements, or to cut swap-based hedges to reduce initial margin requirements. It is already apparent from events of autumn 2022 that even small forced cutting of hedges in stressed situations with limited underlying liquidity could further exacerbate a crisis. This would not

only increase system-wide financial stability risks, but would likely also have a negative outcome in terms of returns and security for pension funds.

It must also be noted that the increased amount of gilts being allocated as initial margin to support clearing would also reduce pension funds' ability to invest into UK growth, equities and higher-risk assets, as highlighted above for the cash variation margin issue.

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?

Insight is operationally ready to clear but others in the market may not be, and so may incur an operational set up cost.

It is possible that some pension funds give up the use of swaps altogether.

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 the pension fund clearing exemption expired, pension funds would need to increase their allocations to cash (to cover for potential variation margin calls) and other lower-risk assets such as gilts (to cover CCP initial margin requirements). As a result, this could reduce pension funds' ability to invest into UK growth, equities and higher-risk assets, running counter to the government's ambitions set out in Chancellor Hunt's Mansion House speech in July 2023.

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

Cleared portfolios would bear increased costs which would likely have a negative impact on returns. This is difficult to quantify as the specific impact would vary depending on the specific circumstances of a pension fund. The reduction in return potential would likely be relatively low in normal market conditions, but could increase sharply in stressed conditions when costs and risk can increase significantly (for example, in conditions where investors are forced to sell out of assets and/or reduce hedges to meet variation margin calls or spikes in initial margin requirements).

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 the pension fund clearing exemption expired, we would expect it to reduce pension funds' ability to invest into UK growth, equities and higher-risk assets. This is because pension funds would increase their allocation to cash (to manage potential variation margin calls), and to gilts (to meet CCP initial margin requirements).

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 actual size of a variation margin call will be the same for the same percentage change in gilt yields. However, if there was no pension fund clearing exemption, there would likely be more clearing, and more of the variation margin calls would require cash as opposed to non-cash assets, 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?

The UK DB sector is different to the DB sectors in other key jurisdictions. We offer comparisons with DB funds in the US and Europe below. There are strong reasons why the UK should diverge from US and Europe in ensuring there is a clearing exemption for UK pension funds.

Comparison with the US

In the US, the structure of the pension market is different in significant ways. US pension funds typically use corporate bonds rather than swaps as their primary asset for managing financial solvency, for several reasons:

- US pension funds have shorter duration than UK funds due to the lack of inflation linkage;
- the US corporate bond market is much larger than that of the UK, has greater diversification at longer maturities, and provides a good match for the fixed liabilities; and
- US pension funds' hedging activity is usually driven by their corporate sponsor to minimise balance-sheet volatility, with the discount rate used to measure US pension fund liabilities on corporate balance sheets, under US GAAP, typically linked to the AA-rated corporate bond yield.

US pension funds do not need an exemption from clearing as the use of swaps is low compared to UK DB pension funds.

Comparison with Europe

In Europe, the Dutch DB pensions market has some similarities to the UK, in terms of both size and the use of swaps for financial solvency management. Some other European countries also have DB pension funds, but the Dutch DB sector – which accounts for 80% of eurozone derivatives usage, and 89% of interest rate swap usage, of all eurozone DB funds – is considered a good proxy for the wider euro area sector for analysing this issue[17]. For this reason, we use the Dutch DB sector as a proxy for the European DB pensions market for our analysis.

The size of the Dutch DB sector relative to the euro government bond repo market is small when compared with the size of the UK DB sector relative to the gilt repo market. This suggests that the UK sterling repo market would be much more likely to struggle, if clearing is mandated, to meet demand from UK DB pension funds for cash to support variation margin requirements – leading to greater potential financial stability concerns in the UK. Therefore we believe there is a greater need for the clearing exemption in the UK than Europe.

There are other differences. The Dutch DB sector is far more consolidated than the UK sector meaning there are a few very large funds. These funds are in-scope for EU initial margin non-cleared rules, which can make the non-cleared markets economical, making the clearing exemption less appealing. In the UK, the funds are typically small and most funds can benefit from the clearing exemption without being in-scope for initial margin non-cleared rules.

Comparison of Netherlands and UK DB pension funds and repo markets

	Netherlands	UK
Size of DB pensions market	€1.5 trillion[18]	£1.4 trillion[19]
Level of consolidation	High	Low
Impacted by non-cleared initial margin rules	Mostly yes	Mostly no
Size of relevant government bond repo markets	€5,325 billion[20]	c.£390 billion[21]

[17] For example, see Derivatives-related liquidity risk facing investment funds, May 2020, ECB.

[18] Source: Occupational pensions statistics, end Q2 2023, European Insurance and Occupational Pensions Authority. Total assets for Dutch DB pension schemes.

[19] Source: The Purple Book 2023: DB pensions universe risk profile (PDF), 2023, Pension Protection Fund. Page 11, Total assets as at 31 March 2023 for UK DB pension schemes.

[20] Insight analysis using International Capital Market Association report: European Repo Market Survey, Number 44 – Conducted December 2022. Note the EUR data presented here may have some double counting (as it includes both repos and reverse repos), however it is likely to not show the full market size as banks are the main provider of data into the ICMA survey which may balance the earlier effect.

[21] Average daily value of sterling gilt repo transactions outstanding over the quarter as at 30 September 2023. Source: Bank of England Database, sterling money market data, code YWQZM5T.

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

Pension funds have been exempt from clearing derivatives transactions since EMIR was introduced in 2012. The 2012 regulation states clearly that the rationale for the exemption was to allow a for a solution to be developed regarding variation margin:

> "Entities operating pension scheme arrangements…typically minimise their allocation to cash in order to maximise the efficiency and the return for their policy holders. Hence, requiring such entities to clear OTC derivative contracts centrally would lead to divesting a significant proportion of their assets for cash in order for them to meet the ongoing margin requirements of CCPs. To avoid a likely negative impact of such a requirement on the retirement income of future pensioners, the clearing obligation should not apply to pension schemes until a suitable technical solution for the transfer of non-cash collateral as variation margins is developed by CCPs to address this problem."[22]

Despite significant efforts by the industry, it is clear there are strong operational reasons why CCPs cannot accept non-cash collateral as variation margin.

Also, while the risks and costs associated with variation margin have been significant, there are other material risks and costs to consider, as we have outlined in this response (see for example our responses to Question 7 and Question 13). **We believe these costs and risks far outweigh the benefits of mandatory clearing.**

Given these risks and costs, which are material both for pension funds and wider financial stability, we believe there is a strong case for the clearing exemption to be permanent for pension funds.

[22] Source: Paragraph 26, Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories (PDF), OJ L 201, 27.7.2012.

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