

FOR ISSUE IN THE UK AND EU.
FOR PROFESSIONAL CLIENTS AND QUALIFIED INVESTORS ONLY.
NOT TO BE REPRODUCED WITHOUT PRIOR WRITTEN APPROVAL.
PLEASE REFER TO ALL RISK DISCLOSURES AT THE BACK OF THIS DOCUMENT.

HMT consultation on “Implementation of the Basel 3.1 standards”

Insight Investment response
January 2023



Introduction

Insight Investment is one of the UK's largest investment managers, managing £654bn in assets, primarily for defined benefit pension funds, as well as other clients such as insurers, sovereign wealth funds and financial institutions¹. The majority of Insight's assets under management are in risk management solutions and fixed income.

We are grateful for the opportunity to respond to this consultation. Please note that due to the tight time frame, we may need to follow up with further information on this issue after the consultation deadline.

Overarching questions

Q3. Do you have any comments on the proposed changes relating to linkages between CVA capital requirements and EMIR?

Many of Insight Investment's pension fund clients value and use the pension fund clearing exemption provided in the EU and UK on-shored EMIR rules. As such, the corresponding credit valuation adjustment (CVA) exemption, from which banks benefit for these clearing-exempt trades, is important to our clients. The CVA exemption has helped to ensure that the non-cleared markets remain workable for pension funds, and ensures that the EMIR clearing exemption is not undermined by bank capital rules.

We note the HM Treasury proposal to remove the current exemption of pension funds from the calculation of capital requirements for CVA risk. We also note that the Prudential Regulation Authority (PRA) proposes some adjustments to exposure calculation to pension funds that should dampen the impact of the CVA exemption being removed.

Specifically, the PRA proposes a targeted reduced risk weight in the CVA risk framework compared to the BCBS Basel 3.1 standards for exposures to pension funds, and a reduced 'alpha factor' of 1 in the standardised approach to counterparty credit risk (SA-CCR) framework for exposures to pension funds. We are also aware that banks will benefit from a reduced maturity factor on their internal models for trades for which CVA risk is accounted for.

We support the above PRA proposals to dampen the negative impact of CVA exemptions being removed for pension funds, and we agree with the PRA that the SA-CCR and CVA BCBS Basel 3.1 frameworks are too conservative with regard to exposures to pension funds. Therefore, we welcome the PRA's proposed adjustments in the UK implementation of the Basel 3.1 frameworks, as an improvement to the BCBS Basel 3.1 frameworks.

However, we remain concerned about the overall impact on banks' trading behaviour for pension funds and we wish to make the following comments on the proposals:

- **Net impact on pension funds should be analysed**

We do not know the net impact of the CVA exemption being removed, with the other changes mentioned above. We remain concerned that there is the potential for UK pension funds (i) to be subject to increases in the cost of derivative transactions for new trades, and (ii) to be pressured to offload legacy positions if there is a net capital increase on those positions for banks.

It is not possible for non-banking market participants to quantify the net impact of these changes to different bank counterparties as we would not have visibility of banks' modelling and exposures across their books. As a result, we would not be able to quantify the impact until after the event, by which point the rules would have been finalised and negative consequences may have already been realised.

¹ As at 31 December 2022. 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.

We therefore urge HMT and PRA to conduct a thorough quantitative analysis on the overall net impact of how these proposals may change banks' behaviours to ensure that they do not have any negative impact for new or legacy transactions with pension funds.

Typically, industry quantitative analysis focuses on the overall risk positions of banks, and not at a transaction level with a particular client type. This can therefore overlook any disproportionate costs that may arise for certain transactions with a specified client type such as pension funds.

- **Adjustments required for output floor**

We note that the reduced risk weights for pension funds do not apply in the standardised calculations under the output floor. This could negate any potential benefits of the PRA 'concessions' provided to pension funds once the output floor is in effect. We believe the risk weight for standardised calculations in the output floor should reflect the lower risk typically provided by pension funds and be adjusted accordingly, similar to the risk weight within the CVA framework.

- **Definition of pension funds**

We would note that the definition of 'pension fund' in the UK prudential regulatory framework is currently unclear and may be too narrow to cover all pension fund types that currently benefit from the CVA exemption. We believe the reduction of alpha factor and recalibration of risk weights in the CVA risk framework apply to all pension funds that would otherwise have benefited from the CVA exemptions, as defined in the UK on-shored EMIR Articles 2(10) and Article 89.

Specifically, this should include:

- UK PSAs²
- EEA PSAs³
- Entities established to provide compensation to members of pension scheme arrangements in case of default⁴

- **Importance of appropriate calibration for trades with pension funds**

If the increase in the capital charge from the CVA exemptions being removed is not offset by the other measures (such as by the suggestions above), it could lead to a significant increase in capital requirements for transactions with pension funds. This could potentially lead to banks wanting to offload legacy pension fund portfolios or inhibit new trades with these entities.

This would likely place UK pension funds, and UK banks trading with EU or UK pension funds, at a competitive disadvantage compared to their EU counterparts. We note that on legacy portfolios, EU banks still benefit from the CVA exemptions with pension funds for the full life of the relevant transactions, whereas UK banks would lose those exemptions with the same client.

Indeed, it must be noted that this could be more significant for the UK than for some EU jurisdictions, as private defined benefit pension funds play a comparatively more important role in UK retirees' financial plans, and state pensions a comparatively less important role.

In the longer term, we would encourage any revision of the Basel Standards to ensure that any client type, such as pension funds, are not disproportionately impacted.

Finally, we may wish to revert with more information on this issue after the deadline of this consultation.

² See UK on-shored EMIR Article 2(10): <https://www.legislation.gov.uk/uksi/2019/1416/regulation/26>

³ See UK on-shored EMIR Article 89(1): <https://www.legislation.gov.uk/uksi/2019/1416/regulation/34>

⁴ See UK on-shored EMIR Article 89(1): <https://www.legislation.gov.uk/uksi/2019/1416/regulation/34>; which also refers to the original EU EMIR text: <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:02012R0648-20220812&from=EN#page=133>

Contact

Main contact	Vanaja Indra
Title	Head of Public Policy
Telephone	+44 20 7321 1110
Email	vanaja.indra@insightinvestment.com
Address	160 Queen Victoria Street London EC4V 4LA

 www.insightinvestment.com

 [@insightinvestim](https://twitter.com/insightinvestim)

 [company/insight-investment](https://www.linkedin.com/company/insight-investment)