HM Treasury

Pension fund clearing exemption

Call for evidence

November 2023

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Chapter 1
Introduction

Central counterparties and the clearing obligation

1.1 Central counterparties (CCPs) are a type of financial market infrastructure (FMI). FMI are institutions that underpin the global financial system, acting as conduits between many other financial services firms. They help maintain stability in the financial services sector, providing critically important functions that make markets safer and more efficient.

1.2 Firms use CCPs to reduce risk when making financial transactions with other parties, such as entering into derivative contracts or buying and selling securities. When a trade is submitted to a CCP, the two parties contract with the CCP rather than directly with each other. This process is known as 'clearing'. By sitting in the middle of each transaction, CCPs reduce what is known as 'counterparty risk' – the risk of the other party becoming unable to meet their obligations under the contract, or 'defaulting'. Firms place assets with the CCP, known as 'collateral', which the CCP can use to mitigate any losses if either party defaults.

1.3 CCPs are also required to have a 'default fund' – a pool of money set aside for the sole purpose of covering any losses that exceed the collateral that has been posted by the party which has defaulted. This, alongside other tools used by the CCP, aims to minimise the impact of the default of an individual firm (or a group of firms) on the wider financial system.

1.4 Given the financial stability benefits, G20 leaders agreed at the Pittsburgh summit in 2009 that all standardised and liquid derivative contracts should be cleared through a CCP. This requirement was implemented in the EU through legislation commonly known as the European Market Infrastructure Regulation (EMIR) and is known as 'the clearing obligation'. Following EU Exit, EMIR was incorporated into UK law by the European Union (Withdrawal) Act 2018. The clearing obligation therefore continues to apply in the UK.

1.5 The obligation has been in force since June 2016, though it was phased in for different categories of firm based on the volume of their derivative contracts. It applies to all firms who enter into derivative contracts in scope of the obligation, subject to certain conditions and exemptions. For example, firms are exempt from the requirement if the overall volume of their derivatives business is below certain thresholds set by the Financial Conduct Authority (FCA).

Clearing exemption for pension funds

1.6 Pension funds can face particular challenges when clearing contracts through a CCP. CCPs typically require 'variation margin' – collateral which covers price movements on contracts – to be provided in cash. They also have the ability to require variation margin to be posted more frequently than is the case for 'bilateral' trades (where two parties manage a trade directly with each other).

1.7 Pension funds do not usually hold large cash reserves – they invest the large majority of their resources in assets such as gilts and corporate bonds to provide returns for pensioners. This means that meeting CCPs' margin requirements can be more difficult for pension funds than for other counterparties. This is particularly the case for defined benefit funds which need to generate sufficient returns to provide their scheme members with guaranteed retirement income.

1.8 In order to raise cash to post to the CCP as collateral, pension funds may have to sell assets such as gilts. This could have a negative impact on the stability of financial markets, particularly in a stressed market where funds need to raise cash quickly to meet increased margin calls.

1.9 To address this issue, an exemption was established in EMIR when the clearing obligation was introduced. Pension scheme arrangements, and firms established to compensate scheme members, are exempt from clearing derivatives contracts used to hedge risks which directly relate to their financial solvency – for example, where they use derivatives to hedge against interest rate and inflation movements to ensure that they can meet their obligations to their members.

1.10 The exemption meant that pension funds could continue to operate these contracts bilaterally if they wished. This situation was intended to be temporary until a solution was found which would enable pension funds to provide cash collateral to CCPs without having an adverse effect on the retirement benefits of pensioners.

1.11 The exemption was extended several times by EU authorities and then maintained (and extended again to June 2023) when EMIR was incorporated into UK law.

Update and purpose of this call for evidence

1.12 In March 2023 the government announced that it intended to extend the exemption by a further two years, to 18 June 2025. Secondary legislation to make this extension came into force in June 2023.

1.13 When making this extension the government noted that it would conduct a review of the exemption ahead of June 2025, and that this review would aim to consider and implement a longer-term policy approach which would not require further temporary extensions to be made. The government noted that the review would be undertaken alongside the UK regulatory authorities and would seek input from industry stakeholders.

1.14 This call for evidence requests input from industry stakeholders on the pension fund clearing exemption. The information collected will be used to inform the government's review and the final policy decision on the future of the exemption.

1.15 Whilst we would appreciate any input stakeholders are able to provide on the questions set out in this call for evidence, we do not expect all questions to be relevant to every stakeholder. For instance some are directly aimed at pension funds, whereas others invite wider opinion. For each section we have noted which questions we anticipate would be relevant to each type of stakeholder.

Chapter 2
Questions

Hedging and use of the exemption

2.1 The first set of questions focus on how pension funds currently hedge their risks and how they make use of the clearing exemption. These questions aim to develop a clearer picture of how funds manage their risks, the extent to which they use derivatives to do so as opposed to other means such as gilts, and the extent to which the clearing exemption is used.

2.2 These questions are specifically aimed at pension funds and their asset managers.

Questions

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.

2. **Do you use the pension fund clearing exemption?**

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?**

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)?**

5. **What factors influence the relative attractiveness of hedging via gilts vs derivatives?**

Bilateral markets

2.3 The next set of questions focus specifically on bilateral, or 'uncleared', markets, particularly how firms currently use these markets and what potential benefits they provide compared to clearing.

2.4 These questions are likely to be relevant to any stakeholders that make use of uncleared markets.

Questions

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

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

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

Facilitating clearing and meeting variation margin requirements

2.5 The next set of questions focus on how pension funds can access clearing, and in particular how they can meet CCP requirements on variation margin.

2.6 These questions are relevant for any stakeholders that clear derivatives, particularly pension funds and their asset managers, and also market participants that facilitate clearing.

Questions

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

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

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

Autumn 2022 'LDI crisis'

2.7 'Liability-driven investment' (LDI) is a type of investment strategy used by defined benefit pension funds to better match the profile of their assets to that of their liabilities. LDI is therefore designed to ensure that funds can meet their obligations to pensioners in the future.

2.8 The issues that pension funds can face in providing cash variation margin at short notice were demonstrated in the 'LDI crisis' in autumn 2022. Rising gilt yields led to higher margin calls, which forced LDI funds to choose between accepting higher leverage, asking investors for more capital, or selling assets to raise cash margin. Some chose the latter, causing gilt yields to increase further and creating a self-reinforcing dynamic of 'fire sales'. Intervention by the Bank of England was required to reduce a material risk to financial stability. Whilst those operations were highly effective, they posed risks, and the Bank of England plans to build new lending tools for non-bank financial institutions to help underpin financial stability during periods of exceptional liquidity stress[1].

2.9 The next question focuses specifically on this event. The government would welcome views on how the exemption did or did not affect the crisis, and how the situation may have developed had the exemption not been in place.

2.10 This question may be relevant for any stakeholders affected by the crisis, especially pension funds operating LDI strategies.

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?**

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?**

Impact of an expiry of the exemption

2.11 The next set of questions focus specifically on how pension funds and their asset managers would be impacted if the exemption were to expire in June 2025. Please note these questions do not pre-empt the policy direction – they seek to understand the impact this outcome could have so that the decision is fully informed.

2.12 These questions are specifically aimed at pension funds and their asset managers.

Questions

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?**

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.

[1] You can read about this in more detail here: https://www.bankofengland.co.uk/-/media/boe/files/speech/2023/september/a-journey-of-1000-miles-begins-with-a-single-step--speech-by-andrew-hauser.pdf

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

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?**

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?**

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

Further views and information

2.13 Finally, the government wishes to provide an opportunity for stakeholders to share any general views they may have on the future of the exemption, or any relevant information which hasn't been covered by the other questions in this call for evidence.

Question

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

Chapter 3

How to respond and next steps

3.1 The call for evidence will remain open until 5 January 2024.

3.2 HM Treasury welcomes responses from all interested stakeholders. This may include:

- Financial services institutions and firms, particularly pension funds and asset managers
- Other businesses impacted by financial services regulation
- Trade associations and representative bodies
- Consumer groups and individuals

3.3 As noted, it is not necessary to provide a response to every question – we would appreciate any input you wish to provide on the questions which are relevant to you or your organisation. We also welcome any general reflections or suggestions you may have outside of the specific questions posed. You are welcome to provide your response in whichever format you prefer.

3.4 To submit a response, please email to pensionfundexemption@hmtreasury.gov.uk or post to:

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

Processing of personal data

3.5 This section sets out how we will use your personal data and explains your relevant rights under the UK General Data Protection Regulation (UK GDPR). For the purposes of the UK GDPR, HM Treasury is the data controller for any personal data you provide in response to this call for evidence.

Data subjects

3.6 The personal data we will collect relates to individuals responding to this call for evidence. These responses will come from a wide group of stakeholders with knowledge of the issue.

The personal data we collect

3.7 The personal data will be collected through email submissions and are likely to include respondents' names, email addresses, their job titles, and employers as well as their opinions.

How we will use the personal data

3.8 This personal data will only be processed for the purpose of obtaining information and opinions about the policy issue.

Processing of this personal data is necessary to help us understand who has responded to this call for evidence and, in some cases, contact certain respondents to discuss their response.

HM Treasury will not include any personal data when publishing its response to this call for evidence.

Lawful basis for processing the personal data

3.9 The lawful basis we are relying on to process the personal data is Article 6(1)(e) of the UK GDPR; the processing is necessary for the performance of a task we are carrying out in the public interest. This task is consulting on the development of departmental policies or proposals to help us to develop good effective policies.

Who will have access to the personal data

3.10 The personal data will only be made available to those with a legitimate need to see it as part of the policy development process.

We sometimes conduct consultations in partnership with other agencies and government departments. For the purpose of this call for evidence, HM Treasury may share responses with the Bank of England, Financial Conduct Authority and The Pensions Regulator. Personal data received in responses will be shared with these partner organisations in order for them to also understand who responded to the call for evidence.

As the personal data is stored on our IT infrastructure, it will be accessible to our IT service providers. They will only process this personal data for our purposes and in fulfilment with the contractual obligations they have with us.

How long we hold the personal data for

3.11 We will retain the personal data until the policy development process has been completed and the policy is implemented. After this, we will only retain personal data if it is embedded in a response, but we will not use it for any unrelated purposes.

Your data protection rights

3.12 You have the right to:

- request information about how we process your personal data and request a copy of it
- object to the processing of your personal data
- request that any inaccuracies in your personal data are rectified without delay
- request that your personal data are erased if there is no longer a justification for them to be processed
- complain to the Information Commissioner's Office if you are unhappy with the way in which we have processed your personal data

How to submit a data subject access request (DSAR)

3.13 To request access to your personal data that HM Treasury holds, contact:

The Information Rights Unit
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

dsar@hmtreasury.gov.uk

Complaints

3.14 If you have concerns about our use of your personal data, please contact the Treasury's Data Protection Officer (DPO) in the first instance at privacy@hmtreasury.gov.uk

If we are unable to address your concerns to your satisfaction, you can make a complaint to the Information Commissioner at casework@ico.org.uk or via this website: https://ico.org.uk/make-a-complaint.

Annex A
List of questions

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.
2. **Do you use the pension fund clearing exemption?**
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5. **What factors influence the relative attractiveness of hedging via gilts vs derivatives?**
6. **When using uncleared derivatives, how much scope is there to use non-cash collateral to meet variation margin requirements?**
7. **What other costs or benefits do bilateral transactions provide, if any, compared to centrally cleared trades?**
8. **How are changes in the regulation of bilateral transactions, such as Basel reforms, affecting the incentive for counterparties to clear their derivatives?**
9. **To what extent is there appetite among clearing members to provide clearing services to pension funds? What are the key drivers for this?**
10. **How effectively can gilt repo markets support the ability of pension funds to raise cash for variation margin at short notice?**
11. **Are there any other measures which you think could help pension funds meet CCP variation margin requirements?**
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?**
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?**

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?**

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.

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

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?**

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?**

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

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

HM Treasury contacts

This document can be downloaded from www.gov.uk

If you require this information in an alternative format or have general enquiries about HM Treasury and its work, contact:

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1 Horse Guards Road
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Tel: 020 7270 5000

Email: public.enquiries@hmtreasury.gov.uk