HM Treasury

Pension fund clearing exemption

Call for evidence response

January 2025

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Executive summary

In November 2023, the government ran a call for evidence on the exemption that pension funds currently have from the obligation to clear certain derivative contracts at a central counterparty (CCP). It noted that information collected would be used to inform its review of the exemption and the final policy decision on its longer-term future.

The government is grateful for the twenty-six responses received to the call for evidence. These came from pension schemes, asset managers, market infrastructure firms, trade associations and consultancy/advisory firms.

The responses suggested that:

- Pension schemes generally use gilts more than derivatives for hedging purposes at present, but respondents implied that this could change in the future.
- Most firms that can use the exemption to trade their derivatives bilaterally do so, and CCP margin requirements are the key reason most schemes prefer to trade bilaterally.
- Mandatory clearing would require pension schemes and asset managers to increase their cash holdings, reducing their ability to invest in higher growth assets.
- Removing the exemption could make market stress events worse by increasing liquidity pressures, which in turn could increase the likelihood of financial instability.
- There are key differences in market structure between the UK and comparable jurisdictions which do not have similar exemptions.

The majority of respondents supported the exemption and advocated for it to be made permanent.

Having analysed the responses to the call for evidence and having engaged with the applicable UK regulatory authorities on the issue, the government has decided that the exemption should be maintained for the longer-term.

On this basis, the government will now take forward secondary legislation to ensure that the exemption does not expire on 18 June 2025 as currently scheduled and to remove any further time limit on the exemption. The government will, however, keep this policy under review in coordination with the UK regulatory authorities. If there are changes to market dynamics or structure or wider government reforms that have a material impact on the value of mandatory central clearing for pension schemes, the government may reassess this issue.

Chapter 1
Introduction

1.1 In November 2023, the government published the "Pension fund clearing exemption: Call for evidence" seeking input from industry stakeholders on the exemption pension funds currently have from clearing certain derivative contracts at a CCP.

1.2 This exemption was first established in the EU through EMIR in 2012. Pension scheme arrangements, and firms established to compensate scheme members, were exempted from clearing derivatives contracts used to hedge risks which relate to their financial solvency. This meant that pension funds could continue to enter into these contracts on a bilateral basis if they wished.

1.3 As set out in EMIR, this exemption was intended to provide time for a solution to be found which would enable pension funds to provide cash collateral to CCPs without having an adverse effect on the retirement benefits of pensioners. This is particularly relevant for defined benefit funds which need to generate sufficient returns to provide their scheme members with guaranteed retirement income.

1.4 The exemption was extended several times by EU authorities and then maintained (and extended again to June 2023) when EMIR became a part of EU assimilated law in the UK post-EU exit. The government then laid secondary legislation in April 2023 to extend the exemption by a further two years, to 18 June 2025.

1.5 When making this extension the UK government noted that it would conduct a review of the exemption, aiming to consider and implement a longer-term policy approach which would not require further temporary extensions to be made. The government published the call for evidence as part of that review.

1.6 The government received twenty-six responses. These came from pension schemes, asset managers, market infrastructure firms, trade associations and consultancy/advisory firms.

1.7 This paper summarises the responses received and the government's policy response. Chapter 2 draws out the key themes from the responses and sets out the government's policy approach and next steps. Chapter 3 provides a more detailed breakdown of the responses to each section of the call for evidence.

Chapter 2

Summary of responses and policy outcome

2.1 The call for evidence sought information from industry stakeholders across five main areas:

- How pension funds hedge their risks and the extent to which they use the exemption.
- How pension funds use bilateral markets and the potential benefits of this compared to clearing
- How pension funds can access clearing and meet CCP requirements on variation margin
- Whether the Autumn 2022 Liability Driven Investment (LDI) Crisis would have developed differently if the clearing exemption had not existed at that time
- How pension funds and their asset managers would be impacted if the exemption were to expire in June 2025

2.2 The section below summarises the key themes identified from the responses to these topics.

Key themes

Pension schemes generally use gilts more than derivatives for hedging purposes at present, but respondents implied that this could change in the future.

2.3 Most respondents reported that gilts, supported by gilt repo, made up a larger proportion of pension schemes' hedging strategies than derivatives - this is mainly driven by the greater yields provided by gilts at present. The responses indicated that derivatives usage was lower than historical norms and could increase again in future. The large majority of schemes do still use derivatives for hedging, particularly interest rate swaps and inflation swaps as part of LDI strategies.

Most firms that can use the exemption to trade their derivatives bilaterally do so.

2.4 The majority of pension schemes and asset managers that use derivatives which would otherwise be subject to the clearing obligation make use of the exemption. However, some participants do clear some (or occasionally all) of their derivatives voluntarily. They noted that clearing can provide benefits including reducing bilateral exposures to avoid being caught by uncleared margin rules, reducing counterparty risk and benefiting from stronger governance and transparency on their derivative contracts.

CCP margin requirements are the key reason most schemes prefer to trade bilaterally.

2.5 Every respondent who commented on the issue noted that CCPs have a strict requirement to post cash as variation margin. Variation margin calls happen daily and can sometimes take place intraday. Respondents also noted that CCPs require initial margin to be posted, which is not usually the case for bilateral trades. Meeting these margin requirements can be difficult for pension schemes as they do not hold large cash reserves. Instead they invest the large majority of their resources in assets such as gilts and corporate bonds to provide returns for pensioners.

2.6 In contrast, respondents noted that when using bilateral markets, they have the flexibility to use non-cash collateral such as gilts to post as variation margin. Respondents commented that the requirement to post cash as variation margin when clearing, as well as the requirement to post initial margin, were the key reasons most schemes preferred to trade bilaterally.

Pension schemes and asset managers expect that mandatory clearing would require them to increase their cash holdings, reducing their ability to invest in higher growth assets.

2.7 Most respondents noted that pension schemes would need to increase their cash holdings if the exemption was no longer available, to prepare for potential cash variation margin calls. Respondents agreed that this was likely to impact returns for their clients as it would reduce their allocation of more illiquid, higher-growth assets in the investment portfolio – though several respondents noted that this effect was difficult to quantify.

2.8 Most respondents believed that this outcome would not be compatible with the government's reforms in this area. They argued that an increase in cash holdings, and a consequent reduction in holdings of higher-growth assets, would undermine the potential for the government's reforms to increase investment by pension funds in higher-growth assets to improve outcomes for savers and increase funding for high-growth companies.

Removing the exemption could make market stress events worse by increasing liquidity pressures.

2.9 Most respondents thought that mandatory clearing for pension funds would place more pressure on their liquidity management, particularly during market stress. The need to post cash as variation margin would require them to have cash readily available, otherwise they would have to raise cash quickly to meet increased variation margin calls.

2.10 Most respondents felt that gilt repo markets were effective as a method of raising cash margin under normal market conditions but that they may not function as well during periods of stress. Respondents pointed to the March 2020 'dash for cash' as an example of when the repo market had shown signs of dysfunction. Several respondents also noted that the requirement to post initial margin at CCPs would have a procyclical effect, as initial margin tends to spike in a market stress.

Key differences were highlighted between the UK and comparable jurisdictions which do not have similar exemptions.

2.11 Those that commented on this point noted that the UK market is structured differently to other jurisdictions which have a comparable number of defined benefit pension funds, such as the US and the European Union. In the US for example, there is a larger and more diverse corporate bond market which can be used for hedging, which means that derivatives are used less than in the UK. These differences were used by respondents to explain the need for a different approach towards the exemption in the UK.

Almost all respondents supported the exemption being maintained, and most advocated for the exemption to be made permanent.

2.12 Out of the twenty-six responses received to the call for evidence, seventeen advocated for a permanent exemption to be put in place. Four supported a continuation of the exemption without necessarily advocating for a permanent exemption. Three were either neutral or did not give a view, while two advocated for the exemption to expire.

2.13 The main reasons put forward in support of a permanent exemption were the lack of progress in addressing the difficulties pension schemes face in meeting CCP cash margin requirements, the increase in cash holdings and reduced investment returns that would likely result from an expiry of the exemption and the increased liquidity pressures that would be placed on schemes. Several respondents noted that a permanent exemption would provide long-term certainty to firms on this issue.

Policy outcome and next steps

2.14 The government would like to thank respondents for taking the time to engage with this call for evidence, which has been valuable in developing the government's approach to this issue. **Having analysed**

the responses to the call for evidence and having worked closely with the UK regulatory authorities on the issue, the government has decided that the exemption should be maintained for the longer-term.

2.15 The government strongly supports the programme of legislative and regulatory reform that has taken place since the G20 Pittsburgh summit in 2009 to reform over-the counter (OTC) derivatives markets in response to the global financial crisis. A key pillar of these reforms was to mandate the clearing of standardised OTC derivatives at a CCP to reduce systemic risk and improve transparency in derivatives markets. The government continues to support this. Requiring pension schemes to clear derivatives may, therefore, bring financial stability benefits such as reducing counterparty risk. It may also enhance resilience to shocks by increasing cash buffers and placing a greater emphasis on liquidity management.

2.16 On the other hand, the review found that removing the exemption could reduce pension funds' ability to invest in productive assets and generate returns. It found that, at least currently, there is no widely accepted means by which pension schemes are able to provide collateral as variation margin when clearing derivatives without having an adverse effect on the retirement benefits of future pensioners. The review also identified concerns from some market participants that removing the exemption could increase pressure on the liquidity management of pension schemes, particularly under stressed market conditions, which could then increase financial stability risk.

2.17 Overall, the government concluded that there was clear evidence that removing the exemption would reduce pension schemes' ability to invest in productive assets, whilst the extent to which this would be of material benefit to financial stability was more difficult to evaluate. On this basis, the government will now take forward secondary legislation to ensure that the exemption does not expire on 18 June 2025 as currently scheduled and to remove any further time limit on the exemption. The government will, however, keep this policy under review in coordination with the applicable UK regulatory authorities. If there are changes to market dynamics or structure or wider government reforms that have a material impact on the value of mandatory central clearing for pension schemes, the government may reassess this issue.

Chapter 3

Responses by section

3.1 The call for evidence covered twenty questions grouped into six different sections. This chapter summarises stakeholders' responses to each section.

Hedging and use of the exemption

3.2 The first set of questions focused on how pension funds currently hedge their risks and how they make use of the clearing exemption. These questions aimed 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.

3.3 These questions were specifically aimed at pension funds and their asset managers.

1. **How much of your hedging activity involves derivatives? What types of derivatives do you use?**
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?**

3.4 Most respondents reported that gilts, often supported by gilt repo, made up a larger proportion of pension schemes' hedging strategies than derivatives. According to the responses this is mainly driven by the better yields that gilts can provide at present – several respondents noted that use of derivatives vs gilts is lower than has been the case historically and could increase again in future depending on yields. Respondents noted several other factors that can also influence the attractiveness of gilts vs derivatives, including the maturity and investment strategy of the scheme, liquidity and availability of the

assets, financing costs and ability to roll over repo contracts, and the discount rate used to value liabilities.

3.5 While gilts are more widely held at present, the large majority of pension schemes and their asset managers noted that they do still use derivatives for hedging purposes. The main derivative classes noted by schemes were inflation and interest rate swaps, mostly used to manage inflation and interest rate risk as part of LDI strategies. Other derivatives classes mentioned included futures, FX forwards and total return swaps.

3.6 According to the responses, the majority of pension schemes and asset managers that use derivatives which would otherwise be subject to the clearing obligation make use of the exemption. All respondents who commented on the point agreed that, when clearing derivatives, there is a strict requirement to post cash as variation margin. Variation margin calls happen daily and can sometimes take place intraday. Respondents also noted that CCPs require initial margin to be posted, which is not the case for bilateral trades unless positions exceed the threshold to trigger uncleared margin rules.

3.7 A few asset managers and pension schemes noted that they voluntarily clear some or all their derivatives. These respondents noted that clearing can provide benefits including reducing bilateral exposures to avoid being caught by uncleared margin rules (which would require them to post initial margin); reducing transactions costs, which can be beneficial when looking to exit a position before maturity; reducing counterparty risk and benefiting from stronger governance and transparency on their derivative contracts.

Bilateral markets

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

3.9 These questions were likely to be relevant to any stakeholders who make use of uncleared markets.

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?**

3.10 The large majority of respondents reported that they could use non-cash collateral to meet variation margin requirements when using uncleared derivatives. Gilts were highlighted as the most used form of non-cash collateral. While some respondents indicated that they had

scope to use other forms of non-cash collateral, they reported that it often presented poorer value, reduced transparency and an increase in costs.

3.11 Respondents who commented on the issue stated that the requirement to post cash as variation margin when clearing, as well as the requirement to post IM, were the key reasons most schemes preferred to trade bilaterally. Some also noted that bilateral trades benefited from lower fees compared to clearing.

3.12 There were a variety of responses to question 8 on wider reforms to the regulation of uncleared derivatives trading. Some noted that uncleared margin rules and adjustments to the CVA rules have provided an incentive to clear rather than use bilateral markets, while others thought these changes would not have a large impact and that bilateral trades would remain preferable for pension schemes. Half of the respondents did not answer this question.

Facilitating clearing and meeting variation margin requirements

3.13 The next set of questions focused on how pension funds can access clearing, and how they can meet CCP requirements on variation margin.

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

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?**

3.15 Respondents generally agreed that there is appetite among clearing members to provide clearing services to pension funds. However, several respondents noted that the number of clearing members offering clearing services to pension schemes was low and that this could create concentration risk. Some doubts were also expressed about the capacity for these clearing members to absorb the increased demand if pension schemes became subject to mandatory clearing. A few respondents also noted that clearing members may charge higher service fees for pension schemes than for other clients – reasons given included the fact that pension schemes generally have directional long-term portfolios and trade infrequently, and that clearing members may have started charging higher fees since the autumn 2022 LDI crisis.

3.16 There was a strong view amongst respondents that gilt repo markets were effective under normal market conditions but may not function as well as a method of raising cash margin under stress. The March 2020 'dash for cash' episode was highlighted as an example of a scenario where gilt repo markets showed signs of dysfunction. There was a more mixed response from respondents about the performance of the gilt repo market during the September 2022 Crisis.

3.17 In answer to question 11, several respondents suggested allowing a wider range of assets to be used as collateral when clearing – though it was noted that this had been explored previously without success. One respondent suggested that existing sponsored clearing models could be useful in enabling pension schemes to access clearing services.

3.18 Respondents generally welcomed the Bank of England's proposal for a new liquidity tool for non-bank financial institutions (NBFI), known as the Contingent NBFI Repo Facility, noting that this could potentially help pension funds meet CCP variation margin requirements in extreme scenarios. This facility will be activated at the Bank's discretion at times when severe dysfunction in the gilt market threatens UK financial stability, and not available in stresses outside those parameters. At the time of the call for evidence respondents had some outstanding questions about how this facility would be designed, and no respondent viewed this as a complete solution to the issues raised by requiring mandatory clearing.

Autumn 2022 'LDI crisis'

3.19 The next section focused specifically on the autumn 2022 'LDI crisis'. The government asked for views on how the exemption did or did not affect the crisis, and how the situation might have developed had the exemption not been in place.

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

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?

3.21 The majority of respondents thought that the crisis could have been worse without the clearing exemption. They noted that there would have been more pressure on gilt repo markets as demand for cash would have been higher because of the requirement to post variation margin in cash. Pension funds may have needed to liquidate more assets, such as gilts, putting greater downward pressure on an already stressed market. One respondent offered an alternative point of view, suggesting that the lack of a clearing exemption would have

required pension funds to focus on having sufficient liquidity buffers, and that the transparency offered by clearing could have helped identify issues in the market earlier.

3.22 Respondents generally reiterated that the main challenge facing pension funds in managing liquidity in a market stress scenario without a clearing exemption would be the inability to use gilts as variation margin. This would result in funds needing to sell assets at a discount to raise cash quickly. Respondents noted that the proposed Bank Contingent NBFI Repo facility help in these situations in future, though this would only be available at times when severe dysfunction in the gilt market threatens UK financial stability.

Impact of an expiry of the exemption

3.23 The next set of questions focused specifically on how pension funds and their asset managers would have been impacted if the government had decided to let the exemption expire in June 2025.

3.24 These questions were specifically aimed at pension funds and their asset managers.

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?**

16. **Would you anticipate any impact on your returns and/or clients?**

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 were kept?**

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

3.25 While some respondents noted that they are already operationally ready to clear derivatives (even if they do not choose to), most believed that they would need sufficient time to prepare for this scenario and that there would be operational and legal costs involved in setting themselves up to clear.

3.26 Most respondents agreed that pension schemes would need to increase their cash holdings if they became subject to mandatory

clearing, to prepare for potential cash variation margin calls. Respondents overwhelmingly agreed that this was likely to impact returns for their clients as it would reduce their allocation of more illiquid, higher-growth assets in the investment portfolio – though several respondents noted that this effect was difficult to quantify. A few respondents noted that in this scenario pension schemes would face a choice between accepting lower returns or taking on increased risk through increasing leverage, investing in higher-risk assets or cutting the level of hedging.

3.27 Respondents who commented on this point believed that this outcome would not be consistent with other government objectives in this area. The government's ambition is to increase investment by pension funds in higher-growth assets to improve outcomes for savers and increase funding for high-growth companies. Respondents generally agreed that an increase in cash holdings, and a consequent reduction in holdings of higher-growth assets, among pension schemes due to the exemption expiring would undermine the potential for the government's reforms to have the desired impact. Some respondents did note that the 2023 Mansion House reforms were focused on defined contribution schemes, whereas the exemption is more beneficial for defined benefit schemes - but those that pointed this out noted that the same principle would apply.

3.28 Respondents who commented on question 19 noted that the UK market was structurally different to other jurisdictions which have a comparable number of defined benefit pension funds, such as the US and the European Union. Respondents noted that US pension schemes tend to be of shorter duration. Respondents suggested that the Netherlands is the only country with a comparably sized defined benefit pension market in the EU and that this can be more easily supported by the size of the euro government bond repo market. By comparison the UK DB market is larger relative to the size of the sterling repo market, so it would be more difficult for the gilt repo market to support an end to the exemption.

Further views and information

3.29 Finally, the call for evidence provided an opportunity for stakeholders to share any general views on the future of the exemption, or any relevant information not covered by the other questions in the call for evidence.

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

3.30 Most respondents that answered this question used this opportunity to reiterate their belief that the exemption should be made permanent, as outlined in chapter 2, and that the costs and risks of mandatory clearing for pension schemes would outweigh the benefits.

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