ASSOCIATION OF CONSULTING ACTUARIES

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Pension fund clearing exemption
Financial Services
HM Treasury
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To whom it may concern

Pension fund clearing exemption: Call for evidence

I am writing on behalf of the **Association of Consulting Actuaries** in response to the above call for evidence. The Association is the representative body for UK consulting actuaries. Our members are all qualified actuaries – mainly Fellows of the Institute and Faculty of Actuaries. Members provide advice to thousands of employers and pension schemes with assets exceeding £1 trillion, including most of the country's largest schemes – and increasingly consulting actuaries are now involved in a wide range of additional areas.

Our responses to your specific questions are set out in the appendix to this letter. Our response focusses on derivatives used for liability hedging purposes only. In summary our view is that the pension fund exemption should not be allowed to expire, and that very careful consideration would need to be made if the exemption is to be removed.

If it was to expire then it is likely to create operational burdens and bottlenecks to implement and we believe on balance it will bring more costs than benefits. In particular, it is likely to lead on average to pension schemes needing to hold more instantly available cash. The consequence of which could be for some schemes increased liability risk or a requirement to target lower returns, both of which could be negative for members and in particular sponsors who will see the volatility of contributions increased and/or the pound amount of contributions increased.

We hope that you find the contents of this letter of assistance. We would be happy to discuss them further if that is helpful. In that event, please contact me at Vanessa.hodge@mercer.com

Yours faithfully

Vanessa Hodge
Chair of the ACA Investment Committee
On behalf of the Association of Consulting Actuaries Limited

APPENDIX

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

As an organisation, we have many members who advise pension schemes that make extensive use of derivatives. The level of derivative usage varies based on client circumstances and Trustee/advisor preferences (for example, the requirement for leverage and the choice of hedging instrument).

The majority of liability hedging is executed via Gilt TRS or Repo arrangements.

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

The vast majority of our members' clients make use of the exemption and will be driven by the investment manager's preferred implementation approach.

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 do not have detailed information on the proportions as this will be client specific.

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)?

This will be driven by the investment manager's preferred implementation approach though we expect the majority of interest rate and inflation swap exposures are not voluntarily cleared.

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

There are several factors that feed into the assessment, such as the requirement for leverage, counterparty risk, transaction costs, match to a certain liability measure (e.g. ongoing Technical Provisions or solvency), as well as pricing of hedging instruments.

In general, pension schemes that are targeting higher levels of return will make greater use of derivatives for liability hedging as this allows them to hold more in growth assets such as equities whilst not also running significant liability risk. It tends to be the case that pension schemes with lower return targets or close to fully funded on a Solvency basis will make more use of physical gilts.

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

Across the clients that our members work with, most UK LDI mandates will limit eligible collateral to GBP cash and gilts.

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

The principal benefit of bilateral trades is that initial margin is not required and variation margin can be posted in the form of cash and gilts (centrally cleared trades currently only accept cash). There are naturally risks with bilateral trades, with probably the largest one being counterparty risk however the industry has well adapted over many years to managing this, via processes such as indepth counterparty reviews (usually carried out by the LDI manager) and daily collateralisation. In reality, there are typically around 10 – 12 counterparties used across our client base and therefore managing counterparty risk is an important and well documented process for many clients and investment managers.

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

We do not have any comments on this 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?

Our understanding is that there is an appetite for counterparty banks to provide clearing services to pension schemes. Many of the large asset managers that our clients work with have the master clearing documentation in place in order to clear trades if required. We are sceptical however that if all pension schemes were required to clear and therefore have agreements in place to implement this that it could be done quickly given the number of pension schemes who make use of liability hedging.

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

Our belief from talking to managers and our members' experience with clients is that the repo market would likely be of limited use for the purpose of raising variation margin at short notice. This is due to the frequency of variation margin calls and the speed at which repo can be executed within a day. For example, if a sudden market move occurred, an industry demand for cash will impact supply and pricing of gilt repo which can make it challenging to raise sufficient cash to cover the collateral calls. In addition, if this was considered the standard relief valve then it is likely that funding could dry up for a short period of time as many pension funds would be trying to access the same market at the same time.

Overall, it is our view that it is not a good idea to assume that this escape valve would always fully function if considerable pressure was put on it through many pension schemes needing to raise cash at the same time. We do note that the gilt repo market did function well during the gilt market crisis in September 2022 and encourage our client base to diversify their counterparty risk and gilt repo maturity dates (minimise 'roll risk').

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

CCP variation requirements are generally meant for large institutional investors who are not set up like pension schemes (which are focussed on hedging long term liabilities). We believe one option could be to give some more leeway in terms of timescales in delivering margin to pension schemes (i.e. longer than T+0 settlement). However, this could then add credit risk to the clearing houses, and overall may not result in less systemic risk.

The ability for CCPs to deliver gilts as opposed to cash would also solve many of the issues that could occur with mandatory clearing however we note it would be challenging to put this structure in place quickly given the industry has known about this issue for many years and a solution has not arisen.

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?

Our view is that the events of "LDI Crisis" would have been worse if derivatives used by pension schemes had been centrally cleared. This is because it is unlikely pension schemes would have been able to realise the cash reserves in time. This could have led to either even higher hedge level cuts than actually occurred (which in that volatile market could have had even more severe effects on funding levels) or potentially some pension schemes defaulting to the clearing houses (even though they were balance sheet solvent) due to liquidity issues.

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?

The most obvious challenge is in raising sufficient cash to meet variation margin requirements, given the requirement for on-the-day settlement. Pension schemes could choose to hold significantly higher cash buffers or cut liability hedge levels. However, this could end up creating risks elsewhere in the strategy or mean lower returns can be targeted.

As noted in question 11, greater time being offered to pension schemes to deliver the collateral would also be beneficial but that naturally could create more counterparty risks for the clearing houses.

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?

If it expired quickly, it could cause issues with trading of cleared derivatives as investment managers will need to line up documentation and make arrangements for all their clients, which is not a simple process. From speaking to investment managers, this could take 12 – 18 months to complete across a large client base.

In addition to this, pension schemes using cleared derivatives would likely need to hold more cash collateral which could lead to changes in their wider investment strategy and potentially a drag on returns if more operational cash needs to be held by the scheme.

The actions that would be needed to prepare for this would be for all pension schemes to continue to carry out collateral sufficiency reviews alongside investment strategy reviews to understand if the scheme can continue to target the same level of expected investment return whilst maintaining the level of liability hedging if the operational implementation requirements change.

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?

See question 14.

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

For clients with lower return targets, it would likely have a limited impact, although we may see some marginal flows out of assets like corporate bonds for these clients as they may need to raise cash. For clients who need higher returns, they will either need to accept lower returns (due to the need to have access to a larger proportion of cash in order to maintain the same level of liability hedging), opt for more risky asset classes or cut the level of hedging. All of these options are either going to lead to an increase in risk (and therefore an increase in the risk of increased contributions from the sponsor) or in the case of the lower return target, higher contributions today.

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?

All else being equal it would likely increase investment risk for DB pension schemes (although you can argue that it reduces counterparty risk). It is hard to say whether this would increase funding in high-growth companies as the marginal money for this is more likely to come from DC rather than DB schemes.

We can envisage two main scenarios (acknowledging there are a wide range of options open to pension schemes) in the event of the exemption expiring, for schemes targeting higher return levels and who will need to access a greater proportion of cash if they want to maintain liability hedging levels with cleared swaps:

a. Schemes choose to reduce investment risk, or

b. Schemes create a barbell-type strategy with a small number of higher return/risk assets.

For schemes that choose the first of these, this is likely to make it harder for them to invest in line with the aspirations of the Mansion House reforms, whilst for the second set could use this risk budget to invest in high growth companies but the assets allocated to this may be more limited given the requirement to set aside more assets for hedging.

On balance, we suspect that the pension fund exemption expiring will reduce the ability and inclination for UK DB pension funds to invest consistently with the Mansion House reforms.

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?

We do not have any comments on this question.

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

We do not have any comments on this question.

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

In general, we don't believe that this will reduce risk in the Defined Benefit pension market. It may potentially reduce counterparty risk but in reality, the vast majority of bilateral trades are done with 10 – 12 counterparties which are regulated. The marginal decrease in risk is likely to be quite small. It could however increase risk from a liquidity, operational and investment perspective and on that basis, we feel that very careful consideration needs to be made if this exemption was removed.

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