PENSIONS AND LIFETIME SAVINGS ASSOCIATION

21 December 2023

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

PENSION FUND CLEARING EXEMPTION: CALL FOR EVIDENCE

The Pensions and Lifetime Savings Association (PLSA) is the voice of workplace pensions and savings. We represent pension schemes that together provide a retirement income to more than 30 million savers in the UK and invest more than £1.3 trillion in the UK and abroad. Our members also include asset managers, consultants, law firms, fintechs, and others who play an influential role in people's financial futures. We aim to help everyone achieve a better income in retirement.

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Earlier this year, we were heavily involved in engaging with the government to extend the temporary pension fund clearing exemption to 18 June 2025. We noted at the time the HMT commitment to conducting a full review into the long-term approach and are pleased to have the opportunity to respond to this call for evidence which seeks input to shape that approach. In our response, we have not responded to all the questions and have taken the approach of grouping questions by key themes. Where we have done so, we've set out which questions we have grouped together. The key messages within our response are as follows:

1. We support the clearing process and acknowledge its benefits.
2. We recognise however that clearing is challenging for many of our members and therefore, our position is to advocate for a permanent pension fund clearing exemption.
3. Despite holding up during last September's LDI crisis, we do still have concerns about the capacity of the gilt repo market.
4. We have significant concerns that the removal of the clearing exemption would run in direct contradiction to Government policy announced via the Mansion House reforms and the UK Pensions and Growth agenda. These issues cannot be considered in isolation.

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The benefits of clearing for our members (Q2)

At the PLSA, we encourage our members and their trustees to consider clearing because we recognise that the process is fundamentally about creating a safer financial system. We know that the exemption is used by a number of our members. Through engagement with our membership (including pension funds, investment consultants and asset managers), the benefits of clearing are widely acknowledged. It helps to reduce biliteral counterparty credit risk, it can increase market transparency and it can help to protect members' benefits by reducing wider systemic risk.

PLSA position on the Pension Fund Clearing Exemption (Q20)

Whilst we acknowledge the benefits of clearing, it is also evident that for many pension funds, clearing can be incredibly challenging. Pension funds do not typically hold large cash reserves and so the fundamental challenge they face when clearing is the ability to raise cash quickly to be used as variation margin for central counterparties in the transaction. In addition, it is often the case that the level of margin required to be posted under central clearing can change at short notice without the ability to negotiate. This uncertainty poses a significant risk to pension schemes being able to maintain their positions.

As we have outlined above, some of our members will voluntarily clear where they are able, and it makes sense for them to do so. However for others, clearing will often require the selling of assets, such as gilts, to free up cash for variation margin. The clear view of our members is that a permanent pension fund clearing exemption is the solution to this problem and we think it is the best approach for 2 main reasons:

1. It ensures those who find clearing challenging are not mandated to go through the process.
2. It allows those who wish to voluntarily clear and have found ways of managing the requirements for cash, to do so. An exemption would in no way prevent them.

If the approach taken is for the continuation of the exemption, we are clear there is no value in announcing further temporary extensions, it must be permanent. The uncertainty caused by further temporary exemptions poses challenges to our members from a reporting perspective. We know that clearing leads to operational reporting of trades. Having an exemption in place is therefore cost-efficient, particularly for smaller schemes, because there are fewer administrative and governance costs. A temporary exemption leaves pension schemes unclear on how to manage resourcing for reporting which increases costs. In addition, any measures that could come into effect to make the clearing process smoother for pension funds could still be used with a permanent exemption in place.

We have also heard concerns over how a permanent exemption could cause challenges in that it establishes a different approach between UK and the EU and where funds operate across both jurisdictions, it may place them in a difficult position. We are clear however that we think there is a stronger case for the exemption in the UK compared to the EU. The EU DB pensions market is more consolidated and there is a more sizeable EU government bond repo market than in the UK.

Challenges facing the gilt repo market and what might help pension funds manage in a market stress scenario (Q10/11/13)

Last September's LDI crisis was one of the biggest the sector has faced. It was positive that the gilt repo market stood up to the challenges, but we still have concerns over the capacity of the gilt repo market. Whilst it could be argued that schemes are now in a much stronger collateral position, the gilt repo market is still largely untested under significant market stress and was heavily reliant on significant Bank of England underpinning in September 2022. The removal of the pension fund clearing exemption would lead to a significant increase in demand for the services in the gilt repo market. Were pension schemes required to have cleared during the LDI crisis last year, it is very likely that it would have been significantly more challenging for the market to cope as there would have been significant additional demand. As part of this call for evidence, we would be interested in understanding further from the gilt repo sector whether:

- It deems itself well equipped to deal with an increased demand for their services.
- It thinks it can manage increased demand under market stress like the LDI crisis.
- More needs to be done to support the sector (and if so, what).

Andrew Hauser at the Bank of England announced proposals for the establishment of a bank run liquidity facility. We acknowledge that this could be part of the solution and may well have benefits in terms of addressing the cash variation margin issues that pension schemes face. However, we do have some concerns which we would urge HMT to consider:

- These proposals could support pensions schemes, but the establishment of such a facility does not, in our view, negate the need for a permanent exemption. It is likely to be challenging to establish and we anticipate would only be available for extreme scenarios at high cost.

- The availability of such a facility would not have solved last year's LDI crisis and cannot be relied upon as a guarantee against scenarios of future market stress.

- Our members are concerned about how a BofE liquidity facility could infringe on the regulatory perimeter. If such a facility is to be considered as part of the solution, HMT must engage and be clear on the implications for pension schemes.

How does a clearing exemption support the Government's Mansion House ambitions? (Q17)

A key concern for us is ensuring that Government policy in relation to the pension fund clearing exemption clearly aligns with the main government priority in the pensions industry at present – to encourage UK pension investment into UK growth assets. We believe that removal of the exemption would run in direct contradiction to the Government's ambition for investment in illiquid assets.

At the PLSA, the Pensions and Growth agenda has been a key priority for us. We have been working hard with our members to support the Government in removing barriers preventing schemes investing in growth orientated assets. Investment in private markets has been identified as a vital way to generate this growth. We support the Mansion House

Compact committing the eleven signatories to allocating at least 5% of their assets to unlisted equities by 2030 and in continuing to consider what more can be done, have called on the Government to:

- Ensure there is a stream of high-quality investment assets.
- Amend DB Regulations to allow for greater flexibility over investments.
- Introduce fiscal incentives, like dividend tax relief, to make UK investment more attractive.
- Adopt primary legislation to establish a regime for the growth of DB superfunds.
- Reform the AE DC market so there is less focus on cost and more on performance.
- Increase AE pensions contributions from 8-12% to increase the flow of assets into pensions.

The clearing exemption policy cannot be considered in isolation to this work. We have significant concerns that if the exemption is removed, pension schemes will need to increase their allocation in assets that are more easily and quickly convertible to cash. Whilst investment in illiquid assets can be good for growth, the issue is that they are very much long-term investments that cannot easily be cashed in. That is why we believe the removal of the exemption would be in direct contradiction to the Government's ambition. We urge cross Government consideration of this to ensure that objectives are aligned.

Impact of removing the pension fund clearing exemption – our concerns (Q14/15/16)

Throughout our response, we have focused on some of the concerns we have with the removal of the exemption, but there are some further specific issues that we want to raise. It has been challenging to quantify from a financial perspective the impact that removing the exemption will have, particularly because impacts will vary from scheme to scheme. We are continuing our engagement with members to develop a better understanding of the costs.

- As we have already outlined, there are operational reporting costs that arise because of the clearance process. That comes in the form of reporting itself as well as managing the uncertainty that comes from not having clarity over whether the exemption will remain temporary or be made permanent. For our members, certainty is vital.
- As we have alluded to above, the removal of the exemption would impact investment choices. We would expect that it will lead to an increase in pensions schemes holding more cash to clear which may therefore reduce the capital available for growth assets, including UK growth assets.

With regards to the impact on member returns, we recognise that the process of clearing is beneficial, it is vital in creating a safer financial system. However, for many schemes, the act of clearing is challenging because of the need to raise cash. If there is no exemption in place, it will lead to more being held in cash by pension schemes. This is something that pensions schemes look to avoid in order to maximise the returns for their members. A requirement to clear would mean that certain decisions have to be taken to raise additional cash through the sale of assets. The act of which is likely to affect returns for members. We would therefore argue that clearing should be a decision taken by individual schemes where it is appropriate for them to do so.

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We thank HMT for the opportunity to respond to this call for evidence and we hope that our response is utilised to shape the long-term approach to the pension fund clearing exemption. We would be happy to respond to any queries or provide further information.

Kind regards,

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