Investment Insight:
How Global Regulation affects UK Pension Fund investments

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Regulatory upheaval has become a constant feature of the pension and investment landscape and the volume, reach and complexity of EU and international regulations continues to increase exponentially. This latest Investment Insight highlights a number of key regulatory changes that UK pension schemes will face and examines how these may alter investor behaviour in the future.

Background

Global crises have always resulted in a plethora of regulatory change. Towards the end of the Second World War, the Bretton Woods Conference saw the creation of the International Monetary Fund (IMF) to regulate the international monetary system. The oil shock and debt crises of the 1970s and 1980s highlighted the need for extra regulation, with the initial focus on internationally active banks (via Basel regulation). Subsequent initiatives added more layers to banking regulation and also widened its scope. Table 1 shows the motivation behind some of the current regulations and highlights the policy initiatives adopted or proposed in Europe and their equivalents in the US. Given the limited scope of this paper, we will highlight how a number of these regulations (notably Basel 3, Financial Transaction Tax (FTT) and the European Market Infrastructure Regulation (EMIR) on derivatives trading) could influence the investment decisions of UK pension schemes.

Table 1.

Regulatory Theme	EU Policy Initiatives	Similar US/Global Policy Initiatives
1. Improve strength of the banks – Capitalisation – Liquidity/leverage	Capital Requirements Directive 4 (CRD 1V)	**Basel 3**
2. Improve resolvability – Structural bank reforms – Orderly recovery and wind-down in event of failure	Liikanen Vickers in UK (Independent Commission Banking)	Volcker Rule
3. Shift in market structure to prevent contagion – Speculative trading activity checks – Shadow banking – Central clearing of derivatives	**Financial Transaction Tax (FTT)** **EMIR** MiFiD Money Market Funds Regulation Bonus Cap UCITS V	Dodd-Frank Reforms

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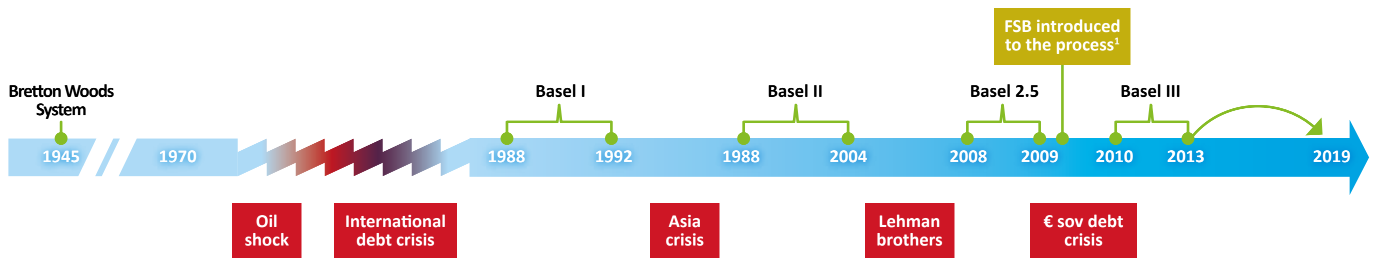
Basel's Evolution



Source: Barclays

> The Basel Committee is the primary global standard-setter for the prudential regulation of banks and provides a forum for co-operation on banking supervisory matters.[2]

1. Basel

Basel 1 in 1988 was aimed at addressing banks' Market Risk (the risk to a bank's earnings or capital) exposure. After the Asian crisis in the 1990s, the Lehman Brothers debacle and the Eurozone Sovereign Debt crisis, subsequent layers of regulation (Basel 2, 2.5 and 3) were added to include Credit Risk (risk of client or counterparty default), Operation Risk (failure of internal processes or systems) and Liquidity Risk (failure to meet financial obligations). The current Basel 3 is intended to increase the quality and quantity of capital that banks are required to hold in general and will have an impact on the cost of over-the-counter (OTC) derivatives. Some aspects of Basel 3, such as the Market Risk rules, have already been introduced but the full suite of regulation will not be in place until 2019.

The impact

Basel 3 is intended to address the perceived short comings in banks' risk management revealed during the financial crisis. Its impact on pension funds and on investment decisions is already palpable and likely to increase over time.

The latest BIS quantitative impact study[3] demonstrates the significance of Basel 3. It shows a total common equity shortfall of €374.1bn against the full Basel 3 rules across the largest global banks. In practice this means that banks will have to devise ways of meeting the shortfall, including issuing new equity, retaining earnings and/or reducing total assets. Although some aspects of Basel 3 will not take effect until 2019, banks have already adjusted their behaviour to meet capital efficiency requirements and the need to hold favourable risk-weighted assets. Pension schemes can expect a series of impacts:

- The cost of capital will increase
- The cost of trading in assets will increase
- Pension funds will be under pressure to fill the breach left by the banks in terms of lending to businesses. This of course could also be seen as an opportunity. We have already seen this happening to a certain extent in the areas of infrastructure and social housing as banks have become very reluctant to hold long term illiquid assets on their balance sheet. Indeed George Osborne has added fuel to the flames by suggesting that UK pension funds should take a key part in supporting the UK economy.[4]

2. Financial Transaction Tax (FTT)

What's the issue?

In February 2013, the European Commission published a proposal for a Financial Transaction Tax (FTT) to be introduced by eleven Member States[5]. The proposed FTT has a broad scope and is intended to apply to both buy and sell transactions in equities, bonds and derivatives (including foreign exchange forwards). The UK has said that it will not participate in the FTT but Financial Institutions[6] which are resident outside the participating EU Member States (ie UK pension funds) could still fall within the scope of this proposed tax. The key concerns can be summarised as follows:

[1] FSB Financial Stability Board coordinates regulation at international level.
[2] Bank of International Settlements (BIS).
[3] BIS September 2012.
[4] Chancellor or the Exchequer, Rt. Hon. George Osborne MP, Budget March 21 2012.

– FTT would apply to a wide range of assets, not just equities. This would also bring into scope stock lending and repurchase (repo) agreements. These two activities help to oil the wheels of asset markets and also provide incremental return (approximately 10 basis points per year) for UK pension funds. Given the cost structure of the proposals, stock lending and repo activity would not be economically viable and would most likely cease under the proposed FTT.

– Most taxes (eg UK stamp duty on equities) are net, but the FTT is gross so (under the current proposal) it will be charged on each leg of a transaction. The cumulative impact on the cost of trading will be significant.

How much?

The rate would be set by each Member State but should be a minimum of 0.1% on equities and bonds and a minimum of 0.01% on derivatives. We asked two of our pension fund members to estimate how much this would cost them per annum in practice – one very large fund estimated an extra cost of £30 million and another an extra £4m per annum. A large portion of the cost would be incurred on foreign exchange (FX) forwards (usually used to hedge FX risk), which typically need rolling (resetting) every three months.

What's the timing?

The European Commission proposed that the FTT would take effect at the beginning of 2014. This now appears unlikely as the 11 participating Member States have been unable to agree on how the tax would actually work. Furthermore, a leaked paper from the Legal Service to the Council of Ministers[7] recently concluded that the FTT could breach EU law in a number of respects.

3. New regulation of over-the-counter derivatives

The issue

EMIR, the Markets in Financial Instruments Directive (MiFID) and the US Dodd-Frank Reforms incorporate a myriad of regulations covering a broad spectrum of topics including governance, proprietary trading and derivative clearing protocol. We will look at the latter, particularly the requirements for greater transparency in the trade in over-the-counter (OTC) derivatives, including mandatory central clearing.

EMIR introduces:

- Reporting obligation for OTC derivatives
- Central clearing obligation for eligible OTC derivatives
- Initial Margin requirements for non-centrally cleared OTC derivatives
- Measures to reduce counterparty credit risk and operational risk for bilaterally cleared OTC derivatives
- Common rules for central counterparties (CCPs) and for trade repositories
- Rules of engagement between CCPs

Central clearing

EMIR was introduced in August 2012 but there is a 3-year exemption from central clearing (but not from new reporting requirements) for pension schemes until 2015; this could be extended until 2018. HM Treasury and the EC are now consulting on the arrangements to be put in place by the time the exemption expires.

Margin requirements

EMIR will require the posting of Initial Margin by the counterparties on either side of derivatives trades that are not centrally cleared. This gives both sides collateral on which they can draw if the other side defaults on the transaction.

Institutions with less than €8bn of OTC derivatives (most UK pension funds) will be exempt, but their fund managers will most likely face extra costs, which will be passed back to end-users – ie pension funds.

In the latest version of the regulation, foreign exchange-based derivatives will be exempt – an improvement on earlier drafts of the proposal. However, there are still major concerns about different treatment for inflation and interest rate-based swaps, about the impact on liquidity and about the sheer cost of the new system. For example, using centrally cleared swaps (exempt from central clearing for pension schemes until 2015 or 2018) will require counterparties to post both initial margin in the form of collateral and variable margin in the form of cash. Traditionally pension funds do not hold large amounts of cash in their portfolios. So there is concern that the cost of hedging for pension schemes will be considerable.

[5] Austria, Belgium, Estonia, France, Germany, Greece, Italy, Portugal, Slovakia, Slovenia and Spain.
[6] Include: investment firms, regulated markets, credit institutions, insurers, pension funds, collective investment funds.
[7] The Council of the European Union - Opinion of the Legal Service on FTT, 6 September 2013.

Summary of the impact of regulation on UK Pension Schemes

1. Cost

Bank capitalisation requirements and the extra cost of dealing in derivatives will result in the cost of trading generally increasing. This extra cost will undoubtedly be distributed across the supply chain resulting in pension schemes paying more to transact.

2. Risk

EMIR's new margin requirements will have an impact on pension schemes using liability driven investment (LDI) strategies. According to KPMG[7], UK funds have around £446bn of hedged liabilities. LDI strategies have grown in popularity over recent years as UK pension schemes look to match their liabilities more closely. Derivatives, in this context, are used for risk reduction purposes. As derivatives become more expensive to transact, pension funds may decide to use less accurate, cheaper hedging tools, thereby increasing the risk of not being able to match future liabilities.

3. Cost of borrowing

The cost of borrowing for corporates may increase as it becomes harder to hedge their issuance. Issuance behaviour may also be affected as a result of the FTT creating an uneven playing field, benefiting certain currencies over others.

4. Investment returns

The higher cost of capital, the higher cost of hedging and the potential loss of incremental return via the repo and stock lending markets are likely to have a negative impact on investment returns. This comes at a time when pension funds are facing the prospect of low investment returns due to historically low interest rates.

What is the NAPF doing about all this?

The NAPF supports greater market transparency and proportionate regulation. It is important that investment markets are well regulated and able to withstand any future financial shocks.

However, the NAPF does not support regulation just for regulation's sake. We view a number of developments highlighted in this paper as a burden on pension schemes. We have voiced our concerns in a number of forums including with HM Treasury, Members of the European Parliament and the Financial Conduct Authority. We are working alongside other trade associations (including PensionsEurope) to mitigate the impact.

Conclusion

New regulation should be aimed at genuinely reducing the risks faced by pension schemes. The NAPF's concern is that too many of the current and proposed regulations increase the cost of pension provision.

We question whether the regulatory pendulum has swung too far in one direction. Once the rules have been adopted and their impacts observed, regulators may adjust to correct unintended consequences, allowing a new equilibrium to emerge. In the meantime, however, we remain concerned about the cost impact of regulation on UK pension schemes.

If you have feedback on this edition of Investment Insight, or would like to speak to us about forthcoming editions, please contact our investment specialist: **Helen.Roberts@napf.co.uk**.

[7] KPMG LDI Survey 2013, notional value of liabilities hedged.