BlackRock

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

Submitted via email to: pensionfundexemption@hmtreasury.gov.uk

RE: Pension fund clearing exemption call for evidence

BlackRock[1] is pleased to have the opportunity to respond to the Pension fund clearing exemption call for evidence, issued by HM Treasury.

BlackRock supports a regulatory regime that increases transparency, protects investors, and facilitates responsible growth of capital markets while preserving consumer choice and assessing benefits versus implementation costs.

We welcome the opportunity to comment on the issues raised by this call for evidence and will continue to contribute to the thinking of HMT on any issues that may assist in the final outcome.

We welcome further discussion on any of the points that we have raised.

Yours faithfully,

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[1] BlackRock is one of the world's leading asset management firms. We manage assets on behalf of institutional and individual clients worldwide, across equity, fixed income, liquidity, real estate, alternatives, and multi-asset strategies. Our client base includes pension plans, endowments, foundations, charities, official institutions, insurers and other financial institutions, as well as individuals around the world.

Executive summary

The move to central clearing for derivative contracts following the implementation of the European Market Infrastructure Regulation (EMIR) in 2016 significantly reduced some of the risks revealed in the Global Financial Crisis (GFC) with bilateral OTC derivative contracts.

Clearing OTC derivative contracts through a central counterparty (CCP) provides the market and regulators with improved transparency and reduced counterparty credit risk and increases execution and operational efficiencies. Many market participants, who are not subject to clearing mandates, including end-investors, tend to decide to clear voluntarily indicating that the economic and risk reduction rationale to clear trades centrally often outweighs the operational costs incurred by market participants to comply with clearing mandates.

However, it is important to recognize that risk is not completely eliminated through central clearing, as demonstrated during the COVID-19 pandemic which saw an increase in market volatility in 2020. This demonstrated that markets are interconnected, with CCPs playing a central role in the market ecosystem.

Further to the above, clearing requires i) the ability to manage operational processes which can result in significant financial outlay; and ii) sufficient liquidity (typically cash) to meet variation margin (VM), on a daily basis.

The latter point, as noted by HM Treasury in this call for evidence, was the reason for the original exemption of pension funds from the clearing obligation: given DB pension funds do not have large cash reserves and would struggle to meet VM requirements, the exemption was granted to give pension funds and other relevant market participants sufficient time to differentiate sources of liquidity to cover VM needs and to develop operational capacity to handle clearing of large OTC derivative portfolios.

At present, there has been little progress towards a robust solution that would allow pension funds to generate short-term liquidity to meet cash VM requirements, or an alternative means of meeting VM requirements through non-cash collateral.

In the absence of further progress on solutions for pension schemes to generate short-term liquidity from their existing portfolios, greater use of clearing is likely to generate opportunity costs in terms of pension funds' asset allocation decisions, the capital available for other investment opportunities, and investment returns for end-investors.

Indeed, the issues raised by this call for evidence are a microcosm of those in financial markets more broadly, where we see a tension post-GFC between reforms to the financial sector: namely, a simultaneous move to full collateralisation of trades and increased cash margin requirements from central clearing, alongside the banking sectors' ability to provide liquidity and move cash being constrained.

End-investors (asset owners) must manage liquidity risk – including the need to meet margin calls – within the market structure they are given. This can be done by holding cash buffers, selling assets, or using alternative sources of short-term liquidity – i.e., repo. The feasibility of each option is influenced by the costs to end-investors, regulatory constraints, and market structure issues.

End-investors' decisions on the size of cash buffers to hold is shaped by judgements about the range of market scenarios they may face, by their investment objectives, and

(in part) by regulation. The risk management benefits of holding cash buffers must be balanced against the costs of forgone investment opportunities. The size of investors' cash holdings also has implications for the wider economy in terms of foregone productive investment.

Selling assets is a legitimate way for end-investors to meet collateral calls, but may not be optimal for their overall portfolio, and sales will inevitably impact overall market dynamics. The extent of this impact is influenced by intermediaries' (e.g., banks') willingness to intermediate markets – which has been impacted by post-GFC regulation.

Another option is to use repo as a source of liquidity, given it is the main method used by UK pension schemes to generate cash to cover their margin collateral requirements. The use of repo can allow market participants time to meet margin/ collateral calls, while re-structuring their portfolios in a way that may be more optimal. However, as we have seen, banks' capacity to offer repo is circumscribed by post-GFC regulation. Thus, during bouts of volatility market participants need to locate high-quality collateral to offset their increased counterparty credit risk and so rely on market liquidity. At the same time banks are disincentivised from providing liquidity via repo, as transactions collateralised by High-Quality Liquid Assets (HQLA) incur an additional capital charge relative to direct holdings of these assets, despite presenting effectively the same risk. These factors increase the risk of banks being unwilling to intermediate repo transactions during periods of market stress when investors may be most reliant upon the use of repo to raise cash for cleared swap margin posting. This tension places possible constraints on how end-investors choose to manage their portfolios but also has the potential to generate liquidity pressures throughout the system as in the absence of being able to raise liquidity through repo, investors may resort to selling assets they otherwise may have held to maturity at short notice and potentially into volatile market conditions.

In sum, there are many benefits to clearing, and at an aggregate level the shift to clearing post-GFC has significantly improved transparency and efficiency for many investors while mitigating counterparty risk. However, the reduction in counterparty risk has been traded off against for increased liquidity risk. As noted above, there are trade-offs inherent in how market participants manage their liquidity risk, which we would encourage HM Treasury to consider in more depth.

Alongside this, the options available to end-investors to manage liquidity demands could be enhanced through changes to market structure, which HM Treasury may also wish to consider in more detail. For example, the supply of liquidity available to end-investors through repo markets could be augmented by re-visiting the weighting of these transactions for banks' capital requirements, consistent with international standards. Demand for cash could also be mitigated by exploring expanded collateral eligibility for VM; for example by making cash-equivalent securities such as money market or exchange-traded funds eligible as collateral.

Responses to questions

Hedging and use of the exemption

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.**

The most widely used means of hedging is Gilt repo (see question 5). However, our clients use a range of derivatives for hedging, including interest rate swaps, inflation swaps, equity futures and total return swaps (TRS), credit default swaps (CDS) and foreign exchange derivatives are also reasonably common.

Whilst not a derivative, Gilt repos are one of the most common forms of leverage used by UK pension schemes, as gilt repos allow leveraged exposure to Gilts and it is often this exposure that pension schemes aim to hedge given liability discount rates, at generally the lowest cost of leverage.

2. Do you use the pension fund clearing exemption?

Our clients make use of the clearing exemption but may still choose to clear contracts voluntarily and / or trade bilaterally depending on what will best suit the circumstances of the client's portfolio.

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?

BlackRock takes a pragmatic approach as to whether derivative contracts on mandates we manage are actively cleared via a CCP or traded OTC (bilateral). Any decision is based on client circumstances with the aim of achieving the most efficient overall outcome. In normal market conditions, VM must be posted daily and must, as per CCP requirements, be cash.

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)?

BlackRock is provided with discretion to choose to voluntarily clear OTC derivatives on behalf of clients for several reasons, such as:

- A shorter expected holding period and greater ease of closing out the OTC derivative contract;
- Circumstances where clients only hold bilateral positions, and cleared positions would add diversification when looking to close out positions;
- Views on any basis between cleared and bilateral swaps for example in inflation swaps, where there is a material difference in execution price between cleared and bilateral swaps.

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

Many schemes choose to hedge using a combination of Gilts and leveraged Gilts, with exposure gained through the repo markets or via bilateral TRS. This better matches the liability discount rate, but can introduce other risks, for example by creating a reliance on the ability to roll (renew positions in) Gilt repos/TRS, which typically have terms of 1yr or less, whereas the average hedging instrument they fund has a maturity of 20-30 years or more. If a scheme were more than fully funded, then arguably a fully Gilt based hedge could be purchased, and this would offer the best match to the typical discount rate of UK pension schemes.

Alternatively, schemes can choose to hold a combination of cash and swaps, but this creates risks, for example:

- Earning Sterling Overnight Index Amount (SONIA) on cash holdings, net of fees, meaning that if a cash fund were to underperform it is not guaranteed that the scheme would be able to generate SONIA after total costs are calculated and relevant deductions made.
- Counterparty risk to bank and dealers on swaps, if traded bilaterally;
- Initial margin (IM) requirements, if swaps are cleared;
- Lower yield than the schemes' Gilt-discounted liabilities (at most maturities).

Bilateral Markets

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

It remains standard practice for bilateral derivatives used by pension schemes to be collateralised by both cash and Gilts, subject to a haircut. This model offers a material benefit to schemes that have a large quantity of Gilts but little natural cash holdings, as Gilts can be directly transferred as collateral rather than relying on the repo market to convert them to cash.

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

A benefit to trading bilaterally is not having to post IM or incur any associated charges. For example, it is typical for clearing members to impose a capital utilisation charge on IM posted to them, which can be substantial.

If such trades are centrally cleared, IM can typically be posted as Gilts, however this uses up scheme collateral that could otherwise be used as VM. By way of illustration, on a 30yr rate swap, approximately 12% of the notional value would be posted as IM, not including other associated clearing charges.

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

In recent years we have seen some banks exit the bilateral market-making business, citing low returns on capital.

As an asset management firm, it is difficult for BlackRock to determine how changes to capital requirements under the Basel reforms (regulatory requirements for the banking sector) will impact our counterparties' market making businesses versus their clearing businesses, as both incur capital costs. Potentially, clearing could mitigate some capital requirements on the market-making side, but increase capital requirements for the clearing business. In order to fully ascertain the impact changes in regulations such as the Basel reforms will have on banks incentives to clear derivatives, we recommend discussing with the banking sector directly.

Facilitating clearing and meeting variation margin requirements

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

There is a limited number of banks and dealers offering clearing services for their clients. Since the 2022 Gilt crisis we have observed credit risk teams at banks tightening their risk appetite for new pension fund business given the directional, long-dated nature of their portfolios. Clearing members are also more likely to charge higher fees to compensate for this risk or allocate lower limits for clearing.

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

Under normal market conditions, the Gilt repo market can be one of several effective ways for pension schemes to raise cash. Bank intermediation capacity is key for the functioning of the repo market, however, and post–GFC capital and liquidity requirements placed on banks have reduced their ability, or willingness, to provide short-term liquidity and/or to immediate markets. To function effectively, the repo market requires stable balances and access to bank-issued credit lines, which if not used consistently can lapse. The propensity for instability in the repo market has been demonstrated during stress events, or at quarter/year end, when the demand for cash can outstrip supply, as there is not enough capacity in the market to support the additional requirements.

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

As noted above, investors can meet VM requirements by either holding cash reserves, selling assets, or generating short-term liquidity through e.g., the repo market.

There are trade-offs inherent in how market participants manage this liquidity risk, and the feasibility of each option is influenced by the costs to end-investors, regulatory constraints, asset allocation decisions, and market structure issues. Holding larger cash buffers generates opportunity costs with respect to other investment options. Selling assets is a legitimate way for end-investors to meet collateral calls, but may not be optimal for their overall portfolio. If HM Treasury wishes to encourage take-up of clearing while avoiding recourse to either larger cash balances or selling assets, market structure issues need to be addressed. This could include:

- Expanding the scope of eligible collateral for VM to include non-cash instruments, including the potential for digital (tokenised) collateral solutions.

- Revising capital treatment of repo transactions: banks are disincentivised from providing liquidity via repo, where transactions collateralised by HQLAs incur an additional capital charge relative to direct holdings of these assets, despite presenting effectively the same risk.

Autumn 2022 'LDI Crisis'

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?

We do not believe that the issues in the Gilt market in the autumn of 2022 were because of VM requirements or the ability to turn Gilts into cash via repo. We did not observe material issues in the Gilt repo market during this period. The events of this period were predominately due to extremely rapid price/interest rate movements which resulted in investors requiring more Gilts to cover their exposure.

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?

See questions 9 – 11.

Impact of an expiry of the exemption

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?

An end to the clearing exemption would require a significant build out of operational capability for market participants that do not currently have the infrastructure in place to clear derivative trades.

Participants that do not have the infrastructure in place for clearing would have to undergo a repapering exercise with their clearing broker, as each fund requires a legal agreement. This means every client would need to be onboarded with the clearing broker, which would entail internal and external operational structuring to facilitate trading and margin movements (internally), and their connectivity with clearing brokers, CPPs and other middleware platforms (externally). Whilst BlackRock has the business-as-usual functions in place to support our clients, if such a scenario were to occur, the above considerations must be factored into any future timelines. This is in order to provide firms that are not currently set-up for clearing with an adequate amount of time to get the necessary legal and operational functions set-up.

For pension funds who already have the infrastructure in place (i.e., are set-up for clearing) this would be less resource and cost intensive, as these firms would already have agreements in place with the relevant clearing members and the operational infrastructure would also be in place.

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.

As previously noted, the majority of our pension fund clients use OTC derivatives in some form. Primarily leverage is gained in Liability Driven Investment (LDI) mandates through Gilt repo, as this gives pension schemes the Gilt exposure that best matches the liability discount rate, and presently offers the highest yield.

If the pension fund exemption were to expire, new swap-based strategies would be less compelling, given the accompanying cash VM and IM requirements. However, in the short-term, it would be unlikely to alter much, given existing swap hedges could remain bilateral for some time dependent on the maturity of the contract. In terms of operational issues, we do not envisage an issue given the majority of our clients are signed up for clearing.

It is, however, harder to ascertain the longer term impact any termination of the pension fund exemption could have, as the end of the exemption would only impact new swap trades and it could take some time to realise the impact this could have on investment strategies and markets.

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?

Answering questions 16 and 17 together.

We anticipate the impact for both us and our clients to be very limited. Potentially, it could increase the requirement for IM which might further constrain access to leverage and reduce the ability to invest in broader assets – as more assets have to be directed/held to manage the hedge. However, as noted above, the way in which schemes choose to manage the liquidity risk from margin calls – cash buffers, asset sales, or repo – have wider implications in terms of asset allocation decisions and investment returns.

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?

Regardless of whether the pension fund exemption ceases to exist or not, we believe that VM would remain as it is today for both cleared and uncleared swaps, as VM is calculated through a contract's daily mark-to-market value, which can be estimated via standard liquidity risk management models. A larger potential impact is on IM: Firstly, unless the pension scheme is in-scope under UK EMIR most bilateral trades do not require regulatory IM, and in a volatility spike IM requirements for cleared trades often increase. Secondly, IM for cleared swaps is purely directed by the CCP's margin model and is likely to increase substantially in stressed market conditions, resulting in the pension fund having to hold more cash and reducing the amount they could invest for the end client.

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

We did not observe a significant impact resulting from the end to the clearing exemption in the EU, however, we caution against drawing firm conclusions from the experience of other jurisdictions, given major differences in the approaches to portfolio construction by pension scheme investors. For example, in the US, DB pension fund liabilities are shorter in duration than in the UK (due to a lack of inflation linkage) and discounted by corporate bond yields. Accordingly, US DB plans generally use corporate bonds to hedge rather than swaps. This is facilitated by a large, diversified domestic corporate bond market, which offers bonds that provide good matching characteristics for plan liabilities. As a result, given the low usage of swaps in the US DB pension schemes there has never been a need for a clearing exemption. Whereas the UK DB sector is much more reliant on Gilts, repos, and swaps for hedging activity.

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

No comments.

Conclusion

We appreciate the opportunity to address and comment on the issues raised by this call for evidence and will continue to work with HM Treasury on any specific issues which may assist in the ongoing review of the pension fund clearing exemption.