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

By email: pensionfundexemption@hmtreasury.gov.uk

5 January 2023

Dear Pension fund clearing exemption team

Call for evidence: Pension fund clearing exemption – USS response

The Universities Superannuation Scheme (USS) welcomes the opportunity to respond to the *Call for evidence: Pension fund clearing exemption.*

About USS

By way of introduction, Universities Superannuation Scheme (USS) was established in 1974 as the principal pension scheme for universities and higher education institutions in the UK. We work with around 330 employers to help build a secure financial future for 528,000 members and their families. We are one of the largest pension schemes in the UK, with total assets of around £75.5bn (at 31 March 2023).

Our response

We have provided responses to the individual questions from the consultation on the following pages. We would also make three initial wider points:

- **We are strongly supportive of the exemption from the obligation to centrally clear being made permanent for pension funds**. It reduces costs and risks to occupational pension schemes, including USS, thereby reducing the burden on sponsoring employers and members. Those risks would arise both from limiting the ability to effectively hedge risks and from the need to generate cash to meet collateral calls. In addition, we believe that removing the exemption would be contrary to the aims of the Mansion House proposals, namely for increased pension funds investment in productive assets.

- **Ending the exemption would increase risks to wider financial stability.** The 'gilts crisis' in September 2022 was primarily driven by smaller pension schemes using pooled funds. Larger schemes such as USS with bespoke hedging arrangements and in-house teams were able to react more promptly and effectively manage collateral calls (albeit USS' asset allocation meant a lower impact from the events, in that we had relatively less in hedging

"USS" and the USS logo are both trade marks of Universities Superannuation Scheme Limited. All rights reserved.
Head Office: Royal Liver Building, Liverpool L3 1PY Tel: +44 (0)151 227 4711 Local: 0845 068 1110 Fax: +44 (0)151 236 3173 Website: www.uss.co.uk
Registered in England & Wales No. 1167127 Registered Office: Royal Liver Building, Liverpool L3 1PY Regulated by The Pensions Regulator

and more in growth than a typical scheme due to our open status). The ability to offer collateral other than in cash and having a direct relationship with the counterparty were particularly important in mitigating the challenges of the crisis. USS's ability to use the pension scheme exemption and so actively manage the balance between cleared derivatives (requiring cash variation margin) and bilateral derivatives (allowing gilt collateral) was key to being well prepared for the LDI crisis.

- **Lack of effective market competition in UK clearing houses.** LCH is the dominant CCP for centrally cleared derivative transactions in the UK. Ending the exemption would force pension funds to likely trade through LCH. Given the dominant market position of LCH, the ability of LCH to set the basis for OTC transactions (both initial margins and fees) with limited commercial tension is a matter of concern. Should the Government choose to end the exemption we would encourage them to refer the market for clearing derivatives to the CMA with a focus on regulation, initial margin requirements and fees.

In respect of the specific questions raised in the Call for Evidence we provide the responses below.

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.

   We run a portfolio approach to our hedging activity. This means we look at leverage and collateral across all our assets. If we just used derivatives alone for our hedging activity, over 50% of our activity would involve derivatives. The volumes will therefore vary over time but, for example, we currently have approximately £8billion in equity delta 1 derivatives in a combination of Forwards, Futures and Total Return Swaps. We have interest rate and inflation swaps in Sterling, Euros and USD at LCH with current initial margin requirements of £750 million, and our FX hedging book has a gross notional of a little over £30billion GBP equivalent. Our current repo book across USD Euro and GBP is roughly £4billion.

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

   Yes. As a major pension fund, we use the exemption both for 'vanilla' hedging activity and more complex bespoke activity.

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?**

   The proportion of derivatives that we clear varies by type and changes over time. For rates and inflation, we would normally clear around 90%, but for equities less than 20%. For FX the norm is that all of our derivatives are OTC. This wasn't really affected by the LDI crisis in September 2022, but we do actively manage this to optimise collateral and initial margin requirements

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)?**

   All of our clearing is currently voluntary given that we benefit from the pension scheme exemption.

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

   There are a number of factors that influence the relative attractiveness. There is a trade-off between roll risk of Repo / TRS and the yield differential between gilts and swaps. There are

also the associated costs of clearing in terms of LCH fees (where the effective monopoly position has led to what we regard as excessive fees with their having an ability currently to uplift charges as they see fit). There is an unpredictability of increases in the initial margin requirements by LCH and the margin offset when trading Euro/USD vs GBP.

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

   All of our OTC derivatives are traded so that we can post non-cash collateral. This is imperative for us to allow us to manage cash variation requirements. This enables us to minimise cash drag and invest in higher return seeking assets – not being able to do so would inherently result in additional costs that would ultimately be borne by our employers and members.

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

   Bilateral trades are cheaper than centrally cleared (given no fees are payable to the single available clearing house, LCH). They also reduce initial margin drag, giving better flexibility.

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

   UMR has incentivised banks to do more OTC. They now have the ability to post non-cash collateral off-balance sheet to meet UMR initial margin.

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 experience is that given our scale and profile we have a lot of pricing power. We ran a successful RFP to appoint two additional clearing members to support us in 2021/ 2022, and there was no shortage of banks willing to provide these services.

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

    Gilt repo markets function very well. However, we generally fund in USD / EURO as this is cheaper and more liquid. In 2022 we funded 80% of our requirements in USD and funded below SONIA. Consequentially we probably aren't the most reliant on the Gilt repo market. We believe the BoE initiative to allow greater access to the Bank to trade repo in extreme circumstances will be a useful additional safety valve.

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

    Better visibility on changes to initial margin requirements would assist. Greater clarity on CCP fees without the ability to arbitrarily increase fees would also assist. As noted above, if clearing is mandatory, closer regulation and capping of LCH fees would be appropriate.

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?**

    Yes. As noted above, events would have been worse, likely materially so. If the clearing exemption had not existed, more pension schemes would have cleared swaps. Therefore, more schemes would have been required to post cash as collateral. This would have meant

even more pressure on the repo market. There were reports of schemes which had to generate cash to meet collateral calls being unable to access the repo market and therefore having to 'fire sale' assets to generate cash; that would likely have been much wider without the exemption.

Given our scale and in-house team we were able to use the exemption effectively. We very actively manage the split between cleared and bilateral derivatives. This means we had much more flexibility in the collateral that we could post and therefore less need to generate cash.

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?**

    Given the dominant position of LCH, the absence of a clearing exemption would concentrate more risk with LCH and hence create a single point of failure, with schemes more reliant on the whims of LCH in terms of initial margin and fees.

    All variation margin having to be in cash would mean we would need to hold more cash (and assets that might be turned into cash easily). These are less productive assets which is counter to the stated Government policy intention to increase pension fund asset allocation to private market and other growth assets. It would harm both our members and also the wider UK economy.

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?**

    Subject to the comments above about LCH initial margin requirements and fees, we would expect a limited initial impact.

    We would expect costs to rise over time, both as a function of the lack of choice in CCP and, more significantly, we would need over time to sell private market assets and to replace them with more liquid ones (with costs arising both from undertaking these transactions and the frictional drag on investment performance).

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

    Yes. We would need to change our assets allocation to hold more cash and liquid assets that can be turned into cash.

    We review our investment strategy following each valuation and the process following our 2023 valuation is currently underway. We would respond to the implications of the exemption not being extended beyond June 2025 as part of that process. It is therefore more complex than a simple quantitative estimate of the increase in our cash holding and likely drag on returns (though it would impact multiple £billions of our investments); this would ultimately feed through to the wide risk/reward/liquidity decisions set at a scheme level. The ultimate likelihood would be more expensive pensions for members and less productive finance for the UK economy.

16. **Would you anticipate any impact on your returns and/or clients?** Again, any quantitative estimates would be welcome where possible.

    As per the response above, yes, but it is difficult to quantify at this point.

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?**

    As noted above, there would be a significant divergence and contradiction in policy between the Government's stated Mansion House aims and any ending of the exemption. There would be a long-term impact on defined benefit pension schemes, in terms of reducing their ability to invest as per the Government's ambitions, and a material reduction in our ability to provide productive finance to the UK economy.

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?**

    Yes.

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

    Our understanding is that Dutch pension schemes are worse off from the loss of the exemption within the EU. We would therefore suggest the UK not follow that route.

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

    As noted above, we would welcome further discussions with Pension Fund Clearing Exemption team as helpful. Officials would be very welcome to visit us to understand our current practice and approach in more detail, along with the negative implications of ending the exemption for us and our members.

We would be very happy to discuss this further and look forward to further developments.

Sincerely yours

Simon Pilcher
Chief Executive, USSIM