Hogan Lovells

Investing in derivatives: new requirements for occupational pension schemes (EMIR)

March 2014

Pension briefing

HIGHLIGHTS

It is increasingly common for trustees of pension schemes to enter into derivatives, such as interest rate and inflation swaps. Such arrangements are attractive to trustees as they allow them to hedge risk and manage their portfolios efficiently. Trustees using derivatives should be aware of new clearing, reporting and risk management requirements applicable to some derivative transactions.

- A new European regulation on over-the-counter (OTC) derivatives, commonly known as the European Market Infrastructure Regulation (EMIR), has introduced new requirements including:
  - an obligation to clear trades through a central counterparty;
  - risk mitigation techniques for uncleared trades (see glossary below): and
  - trade reporting (see below) for all OTC derivatives.
- Simultaneously, in the United States, the Dodd-Frank Wall Street Reform and Consumer Protection Act (**Dodd Frank**) deals with similar issues in relation to derivatives markets.
- Both EMIR and Dodd Frank arise from the G20 commitment to increase transparency and reduce risk in derivatives markets, following the financial crisis of 2007/08.

Trustees of occupational pension schemes who have invested in OTC derivatives (see box below) should ensure that they comply with these new requirements. In practice, trustees will usually delegate compliance with the EMIR requirements to their investment managers.

Where trustees are exposed to derivatives through investment in a pooled fund or collective investment scheme, it is the responsibility of the manager of the fund or collective investment scheme to comply with EMIR.

DOES EMIR APPLY TO OCCUPATIONAL PENSION SCHEMES?

EMIR classifies counterparties as either "financial counterparties" or "non-financial counterparties", with financial counterparties subject to more stringent requirements than non-financial counterparties. Occupational pension schemes are classified as financial counterparties and, therefore, are subject to EMIR requirements.

WHAT OBLIGATIONS UNDER EMIR APPLY TO OCCUPATIONAL PENSION SCHEMES?

As financial counterparties, occupational pension schemes are subject to the requirements to *clear and report trades* and put in place risk mitigation techniques for *uncleared trades*.

While trustees are legally responsible for ensuring compliance with these new requirements, in practice they will instruct their investment manager to undertake this on their behalf.

RISK MITIGATION

All uncleared OTC derivative trades are subject to certain risk mitigation techniques (including timely confirmation of trades and having a dispute resolution procedure in place) that largely came into effect on **15 September 2013**. In practice, not all firms that should have complied with these requirements did so in time.

The Financial Conduct Authority (FCA) announced in February 2014 that it expects all affected firms to comply fully with certain aspects of the risk mitigation technique requirements by **30 April 2014**.

TRADE REPORTING

Trustees must also comply with the "**trade reporting obligation**", in force on **12 February 2014**. Under this obligation, trustees must ensure that each derivative contract they have entered into (and any modifications or early terminations of a derivatives contract) is reported to a *trade repository* no later than the next working day. Certain derivative contracts entered into before 12 February 2014 also need to be reported.

Glossary: some derivative-related terms

Central counterparty (CCP): a clearing house authorised or recognised by ESMA, a full list of which is published and regularly updated by ESMA.

Cleared trade: a trade that has been "cleared" or executed via a CCP (see diagram below).

Exchange: a marketplace in which securities, derivatives and other financial instruments are traded. For example, the London Stock Exchange.

Margin: assets posted by one counterparty for the benefit of the other counterparty as a means of absorbing loss in the event of a default.

OTC derivative: Derivatives can either be traded on an exchange or over-the-counter (OTC). OTC trading takes place directly between two parties, without the supervision of an exchange. Common examples of OTC derivatives include inflation rate and interest rate swaps.

Trade: an individual transaction, such as an OTC derivative contract between two parties.

Trade repository: a body recognised or registered by the European Securities and Markets Authority (ESMA). There are currently six registered trade repositories, a full list of which is available on the FCA website.

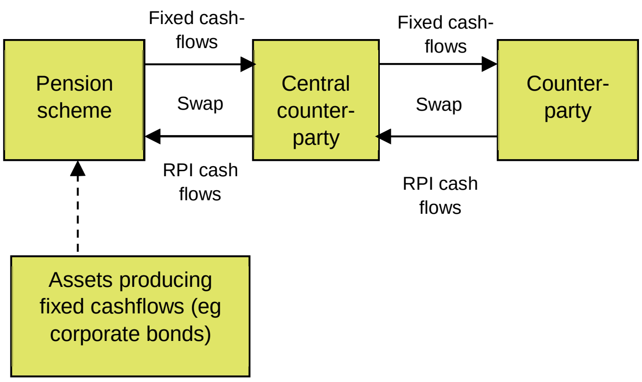
Uncleared trades: a trade that has not been cleared through a CCP, or is exempt from the clearing obligation.

NEW CLEARING OBLIGATIONS

A "clearing obligation" will apply to certain types of OTC derivative contracts entered into between financial counterparties and, subject to certain conditions being met, non-financial counterparties.

All OTC derivatives subject to the clearing obligation must be "cleared" through a *central counterparty* (**CCP**). A CCP acts as an intermediary between the two parties to the trade, so that each party has a separate contract directly with the CCP. By guaranteeing the performance of both parties' obligations, clearing trades through a CCP reduces credit and counterparty risk.

Example: RPI-linked swap



As the clearing obligation is not currently in force (it is not expected to apply until **mid to late 2014**), it is not yet clear which classes of OTC derivatives will be subject to the clearing obligation. However, interest rate swaps are expected to be caught by the legislation.

Why is clearing difficult for occupational pension schemes?

One of the ways in which CCPs reduce counterparty and credit risk is by requiring participants to post highly liquid assets or cash as *margin*. As most pension schemes do not hold large amounts of cash, there were concerns that requiring occupational schemes to clear trades through a CCP would cause trustees to sell assets to generate sufficient cash to allow clearing through a CCP and that this would be detrimental to their long-term aim of providing retirement income.

Temporary exemption for occupational pension schemes

Trustees of occupational pension schemes are exempted from the clearing obligation until **2015**, provided certain conditions are met (see below). The exemption applies only in relation to clearing through a CCP – all other obligations under EMIR applicable to financial counterparties continue to apply to occupational pension schemes.

Under the temporary exemption, occupational pension schemes are exempt from the clearing obligation in relation to OTC derivative contracts that are *"objectively measureable as reducing investment risks directly relating to the financial solvency of pension scheme arrangements"*. In practice, we expect the vast majority of OTC derivatives entered into by occupational pension schemes to fall within the exemption.

The European Commission is due to report by mid-August 2014 on allowing occupational pension schemes to post margin in non-cash form. If satisfactory solutions have not been found, the Commission may extend the temporary exemption for a further three years, up to 2018.

How will clearing apply after the expiry of the temporary exemption?

ESMA has clarified that only new OTC derivative contracts entered into after the expiry of the exemption will have to be cleared. Accordingly, if an occupational pension scheme (and its OTC derivative trade) qualified for the clearing exemption at the time the trade was executed, the trade will remain exempt from clearing until its maturity or termination.

WHAT SHOULD TRUSTEES BE DOING?

Are all your investments made through pooled funds and/or collective investment schemes?

No

In relation to any OTC derivatives that are outside pooled funds/collective investment schemes, you should:

- Seek confirmation from your investment managers that they will comply with the new requirements on your behalf and that they will be compliant by the relevant deadline.
- Consider amending your investment management agreements to delegate expressly the responsibility for complying with EMIR to your investment managers.
- Check whether all your current derivative contracts fall within the temporary exemption to the clearing obligation for occupational pension schemes.
- In due course, take advice from your investment advisers on the likely impact the new clearing requirements could have on your investment strategy.

Yes

Even if your investments include some OTC derivatives, it is the responsibility of the manager of the pooled fund/collective investment scheme to comply with EMIR. Trustees need take no further action.

Reminder – what is a derivative?

A derivative is a financial instrument whose value is derived from some other asset or variable - known as an "underlying". Derivatives contracts can be written by reference to many different types of underlying.

Example of a derivative contract where the underlying is currency

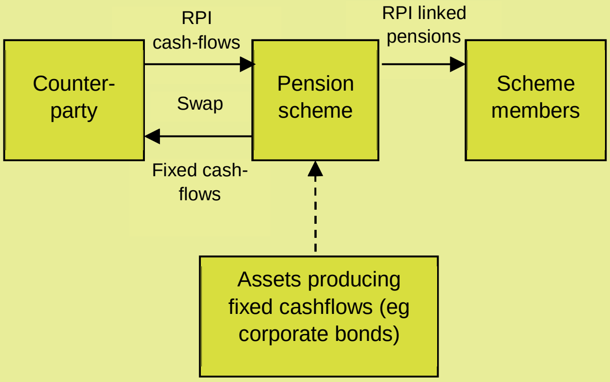
- a UK company agrees to buy manufacturing equipment from a German company in one year's time at a price of €100 million;
- at the time the contract is made, £1 will buy €1.5;
- the UK company wants to protect itself from a strengthening of the euro against the pound over the forthcoming year;
- to do this, the company agrees with a bank to buy euros at today's exchange rate in one year's time;
- in one year's time the euro has strengthened and £1 will only buy €1.2 euros but the UK company can still buy euros at the rate of £1 to €1.5

The value of the *right* to buy the euro (which is the "derivative") is separate from, but related to, the value of the *euro* (which is the "underlying").

Why would trustees use derivatives?

A derivative allows trustees of pension schemes to exchange an existing liability for another liability which they can manage more easily. Perhaps the easiest type of derivative to understand from the perspective of a pension scheme trustee is an “inflation swap”.

Pensions in payment may be required to increase in line with the Retail Price Index ("RPI") (often subject to a cap). This represents a significant risk for the trustees of a pension scheme. It is not possible to be certain of the level of RPI in the future. The conventional way of addressing this risk would be to acquire index linked assets (such as index linked gilts) that match the RPI risk. Alternatively, if trustees have assets that generate fixed returns (such as corporate bonds) then they could "swap" these fixed returns for a cash flow that moves in line with RPI. This is, of course, dependent on finding a party who is prepared to assume the RPI risk in exchange for the certainty of the fixed return.



Such a transaction means that if RPI is low, the trustees may pay to the other party more than they would have paid to pensioners. However, if RPI is high, the trustees will have paid out less than they would otherwise have had to do. In either case, the trustees no longer have the uncertainty.

Many other risks that trustees face can be "swapped" or “hedged” using derivatives. Risks relating to interest rates and currency fluctuations are frequently the subject of swaps. More recently there has been increasing interest in swapping longevity risk.

This note is written as a general guide only. It should not be relied upon as a substitute for specific legal advice.

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