ALLEN & OVERY

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# Using derivatives:

## *the outlook for pension schemes in 2013*

## Key points

- Higher collateral requirements, increased transactional and compliance costs for pension schemes using derivatives, and reduced overall investment returns and hedging efficiency, are among the likely impacts of new derivatives trading rules in Europe, the U.S. and the Asia-Pacific region.

- Pension schemes have a three-year exemption from the main central clearing requirement under the European rules, but in some cases it may not apply – and, even where it does, there is a possibility that schemes might find it cheaper not to use it. The exemption does not apply to the reporting obligation or the obligation to collateralise non-centrally cleared trades.

- More details on collateral requirements under EMIR for non-centrally cleared trades, and on the potential cost impact, are expected in early 2013. Schemes should be ready to review and amend structures and documentation as appropriate.

- Whether you use derivatives to hedge pension scheme liability risks or as part of efficient management of your investment portfolio, you will be affected by the changes. Are you prepared?

# New European rules on derivatives trading

In Europe, the new requirements on derivatives trading are embodied by EMIR (the European Market Infrastructure Regulation), which requires over-the-counter derivative contracts (OTCs) to be reported and, when entered into by 'financial counterparties' (including pension schemes), to be centrally cleared. There is a three-year transitional exemption for pension schemes from the obligation to clear certain OTC derivative positions through a central clearing house, and this may be extended after a review. Non-financial counterparties will also have clearing obligations where specified thresholds are exceeded. For both financial and non-financial counterparties, the clearing obligation applies where both counterparties to the contract are required to clear.

# Does the exemption apply?

Article 89 of EMIR exempts from the clearing requirement 'OTC derivative contracts that are objectively measurable as reducing investment risks directly relating to the financial solvency of pension scheme arrangements'. This implies that the exemption should attach to the type of contract as defined by the type of risk being addressed by the contract, not merely the party signing the agreement (whether investment manager or pension scheme) and may not therefore apply to some types of derivatives used by pension schemes and their managers (for example, those used for efficient portfolio management). However, the detail of how this will be implemented hasn't yet been finalised.

In the UK, derivatives are used by defined benefit schemes to hedge long-term liability risk (so-called liability-driven investments or LDIs) as well as for normal investment hedging and efficient portfolio management by both defined benefit and money purchase schemes. Many pension schemes will have exposure to derivatives via a pooled fund or collective investment scheme, in which case it is the fund, rather than the pension scheme itself, which is the contracting party for the derivative.

Some LDI swaps for a particular pension scheme may be entered into via a bespoke sub-fund of a collective vehicle such as an Irish qualifying investment fund (QIF), in which case it is the sub-fund, rather than the pension scheme itself, which is the contracting party for the OTC derivative (even though the swap is materially the same as if entered into by the pension scheme directly). In theory (and depending on how the exemption is implemented), the exemption should still apply to such arrangements, assuming that:

- it is invoked by the type of risk being hedged rather than the contracting party; and
- the only risks being covered are pension scheme risks.

The potential problem here is that if any other type of investor risk is covered under the swap then the exemption might not apply. Nor would it apply to most non-LDI funds which may have multiple types of institutional investor within the overall collective investment vehicle or any of its sub-funds.

# What if the exemption doesn't apply?

You need to analyse the impact for your scheme: if a contract is not exempt (which is likely to be the case with many non-LDI derivatives), what would the cost of central clearing be? What additional documentation or changes to existing documentation would be required? Who would be responsible for putting that in place – the trustees, or the manager? What is the impact on margin requirements? Calculations by the Investment Managers' Association have estimated that central clearing could reduce returns for a typical liability-driven investment mandate with assets of EUR1 billion and interest rate and inflation swap overlays of EUR700 million and EUR800 million respectively by imposing a yield drag of 1.1 to 1.9% on investment performance.

To avoid central clearing for some of your derivatives, you may need to consider with your investment managers whether there is scope to restructure your current arrangements to ensure those contracts retain the benefit of the three-year exemption. A review of the possible impact of central clearing requirements on your investment structures and current documentation is a key first step.

# And that's not all: impact of EMIR on non-centrally cleared derivatives

Even if the three-year exemption applies to some derivatives such as LDIs, EMIR is likely to increase costs and make it less efficient for schemes to use non-centrally cleared derivatives such as inflation or interest rate swaps for risk reduction. This is because it imposes other requirements, including the provision of initial and variation margin (collateral) for non-centrally cleared derivatives, with no exemption for pension schemes.

We are still waiting for a consultation on the specifics of the collateral requirements for non-centrally cleared OTC derivatives – this is not now expected before the end of 2012, but appears likely to include the following controversial elements:

- Initial margin requirements will be imposed on pension schemes for non-centrally cleared derivatives. At the moment, schemes only post variation margin, not initial margin, because they are considered to be a highly creditworthy counterparty. The imposition of initial margin requirements could have a significant impact, particularly in respect of LDI swaps since they tend to be long-dated and one-directional: schemes can't net off against other transactions. High levels of mandatory initial margin may require pension schemes to tie up large reserves, potentially reducing overall returns and the effectiveness of hedging.
- Variation margin will be posted in cash only, which could affect investment strategies and potentially result in lower returns to schemes and members. UK trade bodies have argued that high-quality corporate or sovereign bonds should be appropriate for both initial and variation margin, with the addition of some cash for variation margin purposes.

There is a possibility, depending on the exact margin requirements proposed, that it might be cheaper for pension schemes to use central clearing rather than relying on EMIR's three-year exemption. Whether or not that proves to be the case, the price of eligible collateral is likely to rise because of increased demand.

# What about reporting requirements?

Regulatory technical standards will also set out more detail around the reporting requirements on contracting pension schemes, increasing administrative burdens and costs. The European Securities and Markets Association (ESMA) recently published draft technical standards which include details of the proposed reporting requirements. All counterparties will be required to report any derivative contracts to a registered or recognised trade repository no later than the working day following the conclusion, modification or termination of the contract.

The start date for the reporting obligations will vary depending on the class of asset underlying the derivative contract (see box on reporting timeframes) and, in fact, the registration/recognition of trade repositories has not yet begun. Schemes can delegate their reporting obligation to a third party agent and, broadly, we would expect investment managers and financial counterparties to take on those obligations, rather than pension schemes actively having to report. However, schemes will need to check the position and amend contracts to ensure that reporting responsibilities are allocated appropriately.

It's worth noting that reporting obligations will apply on a retrospective basis to contracts which were outstanding on, or entered into on or after, 16 August 2012 and which have terminated or run-off before the start date for reporting. Schemes may meet more resistance from investment managers/counterparties to taking on the obligation to make these historic reports unless they can agree specific terms for doing this.

Documentation requirements are currently being analysed at industry level and pension schemes should be aware that they may be approached by their financial counterparties over the next 3-6 months to discuss documentation changes.

### What information needs to be reported?

Data about each counterparty – this includes:

– their counterparty ID, name, address etc. and the nature of their activities;

– the value and currency of the contract and the valuation date; and

– details of the collateral posted including its currency and value and whether it is posted on a portfolio or per trade basis.

Data about the transaction itself – this includes:

– the contract's product ID, transaction reference number and venue of execution;

– the price per derivative excluding, where applicable, commission and accrued interest;

– the notional amount of the contract, the number of units represented by a contract and the number of contracts in the report; how the contract is to be settled (physically or in cash) and the amount of any up front payment the reporting counterparty made or received;

– the effective date and maturity date of the contract and whether central clearing applies; and

– some specific requirements for different derivative types.

## Reporting timeframes

The timeframes set out below assume that a trade repository is authorised by 1 April 2013 for interest rate swaps and credit default swaps and by 1 October 2013 for the other types of transactions. If this is not the case, the reporting start date (RSD) will be 90 days after the authorisation of a relevant trade repository. Based on the draft regulatory technical standards, commencement dates are likely to be:

**Credit derivative and interest rate derivative contracts**

| Start date | Outstanding at RSD? | Report required: |
|---|---|---|
| On or after 16 August 2012 | Yes | 1 July 2013 |
| Before 16 August 2012 | Yes | 1 October 2013 |
| Outstandng on, or entered into on or after, 16 August 2012 | No | 1 July 2016 |

From July 2013, all derivative contracts in this category that are concluded, modified or terminated must be reported on the following working day.

**All other derivatives contracts**

| Start date | Outstanding at RSD? | Report required: |
|---|---|---|
| On or after 16 August 2012 | Yes | 1 January 2014 |
| Before 16 August 2012 | Yes | 1 April 2014 |
| Outstandng on, or entered into on or after, 16 August 2012 | No | 1 January 2017 |

From October 2013 all derivative contracts in this category that are concluded, modified or terminated must be reported on the following working day.

### Other requirements

Other risk mitigation obligations will also apply to parties entering into OTC derivative contracts, including:

- **Timely confirmation**: all counterparties that enter into a non-centrally cleared OTC derivative contract are to provide timely confirmation, electronically where available, of the terms of the relevant contract. Counterparties will be expected to comply from around January 2013 with the confirmation obligation, with the deadlines for confirmation becoming gradually more onerous until compliance has been fully phased in. The time for registration commences when the transaction is concluded.

- **Portfolio reconciliation and compression**: all counterparties that enter into a non-centrally cleared OTC derivative contract are to have appropriate formalised processes to reconcile their portfolios. The obligation is likely to come into force in January 2013, with compliance postponed until July 2013. Counterparties would be required to analyse the possibility of compressing portfolios.

- **Dispute resolution**: parties to non-centrally cleared transactions must develop formalised processes for the early identification and resolution of disputes between themselves. This obligation is expected to come into force in January 2013, with compliance postponed until July 2013.

- **Mark-to-market valuation**: some counterparties will be required to value outstanding contracts mark-to-market on a daily basis (with mark-to-model where this is not available).

Again, we expect financial counterparties to take the lead on many of these points and documentation requirements are currently being analysed at industry level. However, schemes should begin to consider internal processes for how they will report (whether directly or by delegation) and how they will meet reconciliation and confirmation requirements within the timeframes set.

# The U.S.

The U.S. position is similar to EMIR in that it imposes clearing and reporting on a broadly-defined class of OTC derivatives. There is no exemption in the U.S. for pension schemes. Like Europe, the U.S. will impose collateral requirements on non-centrally cleared derivatives. Unlike Europe, the U.S. regime requires the execution of OTC derivatives subject to the clearing obligation on a swap execution facility or designated contract market (if such a facility or market makes the swap available to trade), real time post-trade transparency for cleared derivatives trades, and position limits.

The U.S. regime is expected to be in force in advance of the corresponding EU rules. The key impact for UK pension schemes is likely to be an increase in the cost of collateral for derivatives with U.S. counterparties. UK pension schemes may also need to apply for a 'legal entity identifier' in order to trade with U.S. swap dealers.

# Asia-Pacific

The Asia-Pacific region has no central regulatory body for derivatives trades, so derivatives regulation is being developed on a national basis. Japan, China, Korea, Hong Kong, Australia, Singapore and India are all in the process of developing legislation. Clearly there's an opportunity for individual jurisdictions to offer better conditions to attract business, though regulators are trying to avoid a race to the bottom. Reporting requirements are likely to differ from country to country, both in the need to report at all, and in the detail of reporting requirements. The level and quality of collateral required is also likely to vary, as will the basis and territorial extent of requirements for local clearing.

# Next steps and action points

Pension schemes will want to assess over the coming months:

– whether they benefit from the three-year exemption under EMIR and, if not, whether to restructure their investments to benefit from the exemption;

– the relative cost of centrally cleared derivatives versus non-centrally cleared derivatives;

– revising investment management agreements to impose reporting and compliance obligations on investment managers;

– whether investment parameters need to be revised – for example, schemes may wish to change parameters for derivatives in the light of central clearing (in some cases) and non-central clearing (in others); and

– protections that might be appropriate for centrally cleared derivatives such as segregation of margin held by the clearing member and clearing house.

Click **here** for our EMIR implementation timeline (based on estimates in mid-September 2012). ESMA's draft regulatory technical standards, which include details on reporting and risk mitigation obligations other than collateral requirements, are attached **here**.

# How we can help

Allen & Overy brings together expertise in financial services regulation, derivatives and structured finance and pensions law from our offices around the world to bring you the global overview and local detail you need in rapidly changing times.

Our specialist asset management team works for pension schemes, including UK, Dutch, U.S. and Canadian pension funds, as well as government authorities, international organisations, central banks and insurance companies. Our expertise covers all aspects of investment arrangements – from the appointment of fund managers and custodians to advising on investment in a range of alternative funds and co-investment structures, including the financial services and pensions law implications. Our investment team is recognised in the market and works closely with our pre-eminent derivatives group to put in place liability-driven swaps and other derivatives products for pension trustee clients.

Our Derivatives and Structured Finance team is one of the largest and most integrated in the industry, renowned in the market for being innovative and commercially aware of the latest market developments. As counsel to the International Swaps and Derivatives Association, Inc (ISDA) on many matters, we are at the forefront of the latest legal, regulatory and documentary developments and innovations in the marketplace. Our team has been involved with the developments on OTC clearing, advising on the relevant rules and procedures and on the impact the Dodd-Frank Act and EMIR could have on clearing procedures.

Our Global Pensions Practice brings together lawyers with pensions expertise from our offices around the world. At local level, we advise clients – including companies, pension plan fiduciaries and national governments – on pensions issues relating to plan design, compliance, cost management, funding, investment and tax as well as the consequences of restructurings, terminations and corporate transactions.

# Key contacts

If you require advice on any of the matters raised in this document, please contact any of our partners or your usual contact at Allen & Overy.

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