BT Pension Scheme

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Introduction to BT Pension Scheme

By way of background, the BT Pension Scheme (BTPS) is the UK's largest corporate pension scheme, managing assets worth around £38 billion, paying over £2bn in pension payments per year and accountable to some 330,000 beneficiaries under a defined benefit (DB) structure. As a pension scheme in the UK we are limited by law from using derivatives except for the purposes of risk mitigation or facilitating portfolio management.

As we currently only have a limited exposure to derivatives, we have only engaged indirectly in the debate about enhanced derivatives regulation up until recently through our trade body the UK's National Association of Pension Funds (NAPF). As we plan to increase derivatives usage going forward, we are currently carrying out two pieces of quantitative analysis which we will distribute on completion: firstly we plan to model the required size of our expected inflation-hedging programme and estimate our annual derivative usage over the next 10 years; secondly we are working with our potential counterparties to estimate their extra costs of transacting bilateral derivatives outside of central clearing in terms of the additional credit and capital costs that we will need to meet.

General comments
We welcome the temporary (and transitional) exemption for pension schemes for central clearing, this concession for pension schemes needs to be applied consistently across all the current reviews of derivative regulations (including capital requirements such as Basel III and CRD IV). We are concerned that the capital requirements on non-cleared trades will be onerous for the banks, and no doubt passed to the end users, if the current rules are applied to the long maturity transactions without some additional consideration of the strong credit quality of pension schemes. While we are broadly in favour of CCPs and client clearing regulations in as far as that they could reduce systemic risks within the inter-bank market, we retain significant concerns about how the exemption for pensions schemes will work, what the alternative arrangements will be and what happens at the end of the grace period.

Our concerns are twofold:(i) the potential increase in costs arising from transacting outside of clearing (ii) the restrictions around eligible collateral for initial and variation margin.

(i) The potential increase in costs arising from transacting outside of clearing

- We are concerned that non-cleared transactions (i.e. ineligible instruments) or transactions with exempted entities (i.e. pension funds) will be priced more expensively, as a consequence of investment banks passing through any increased capital charges they suffer for non-cleared trades.

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- Overall under the proposed arrangements it could be that pension funds as the ultimate end-users are penalised for mitigating risks.
- As CCPs are generally not set up for all 'standard' OTCs including inflation swaps (and in the future longevity swaps) this will cause bifurcation and reduced netting benefits if we are required to trade 'cleared' interest rate swaps and inflation swaps bilaterally / non-centrally-cleared.

(ii) The restrictions around eligible collateral for initial and variation margin

- We are familiar with mark-to-market collateralisation and have experience of bi-lateral initial margin arrangements and accept that there is a *quid pro quo* for minimising credit risk through collateralisation (i.e. a cost of carry of the collateral)
- Our concerns would be increased if collateralisation was restricted to too short a list of eligible securities or if repo transactions which are used to generate cash collateral became disproportionately expensive.
- To avoid significant investment return drag we would prefer UK index-linked gilts to be recognised as acceptable collateral for initial and variation margin.
- If there is too narrow a class of eligible securities there will be a potential skewing effect for portfolios and a further crowding of the market into already overpriced assets.
- Due to our long-term liabilities we need to utilise long term-instruments which will have potentially larger initial margin requirements. We strongly suggest the length of the investment term and the strong underlying credit quality of pension schemes are considered when calculating margin amounts.
- As pension schemes generally have a directional bias in their portfolios there will be little in the way of netting benefits although eliminating the bifurcation of interest rate and inflation swaps will mitigate this to a limited extent.

<u>Comments on questions</u>

We welcome the sensible approach by IOSCO and BCBS in the consultation document. However we remain concerned about how this approach will interact with plans for CCP's, the exemption for pension schemes and the capital treatment for the banks (typically our counterparties) on non-centrally cleared derivatives. As we expect inflation swaps to be one of our largest exposures we are concerned about which asset class this product fits in Appendix A and would strongly suggest they should not be included under "other".

Q4. Is the proposed key principle and proposed requirement for scope of applicability appropriate? Does it appropriately balance the policy goals of reducing systemic risk, promoting central clearing, and limiting liquidity impact? Are there any specific adjustments that would more appropriately balance these goals? Does the proposal considerations that would make the proposal problematic or unworkable?

The methodology needs to be a simple as possible. It is unclear how a large pension scheme such as the BT Pension Scheme would be categorised? Although we are potentially large users of derivatives we are not systemically important.

Q6. Is it appropriate for initial margin thresholds to differ across entities that are subject to the requirements? If so, what specific triggers would be used to determine if a smaller or zero threshold should apply to certain parties to a non-centrally-cleared derivative? Would the use of thresholds result in an unlevel playing field among market participants? Should the

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systemic risk posed by an entity be considered a primary factor? What other factors should also be considered? Can an entity's systemic risk level be meaningfully measured in a transparent fashion? Can systemic risk be measured or proxied by an entity's status in certain regulatory schemes, eg G-SIFIs, or by the level of an entity's non-centrally-cleared derivatives activities? Could data on an entity's derivative activities (eg notional amounts outstanding) be used to effectively determine an entity's systemic risk level?

We would be interested in how exactly the credit strength of a pension scheme would be evaluated such that we are not unduly impacted by a low initial margin thresholds.

Q14. Should the model-based initial margin calculations restrict diversification benefits to be operative within broad asset classes and not across such classes as discussed above? If not, what mitigants can be used to effectively deal with the concerns that have been raised?

We will have a significant increase in collateral requirements if we are able to assume some non-zero netting benefits between UK inflation swaps and UK interest rates swaps. It is unclear from Appendix A what access class inflation swaps will reside in.

Q21. Should concrete diversification requirements, such as concentration limits, be included as a condition of collateral eligibility? If so, what types of specific requirements would be effective? Are the standardised haircuts prescribed in the proposed standardised haircut schedule sufficiently conservative? Are they appropriately risk sensitive? Are they appropriate in light of their potential liquidity impact? Are there additional assets that should be considered in the schedule of standardised haircuts?

We note that the "tenor premium" in Appendix B, between maturity less than a year and greater than 5 years, is significant. As mentioned in our general comments, we intend to use long-term index linked gilts and a 4% haircut which would have significant cost to the pension scheme.

Q24. Should collateral be allowed to be re-hypothecated or re-used by the collecting party? Are there circumstances and conditions, such as requiring the pledgee to segregate the re-hypothecated assets from its proprietary assets and treating the assets as customer assets, and/or ensuring that the insolvency regime provides the pledger with a first priority claim on the assets that are re-hypothecated in the event of a pledgee's bankruptcy, under which re-hypothecation could be permitted without in any way compromising the full integrity and purpose of the key principle? What would be the systemic risk consequences of allowing re-hypothecation or re-use?

We have a strong preference on a restriction on re-hypothecation. We have specific concerns on the replacement risk of specific portfolios of liability tenor-matched index linked gilts.