EXPLANATORY MEMORANDUM TO

THE PENSION FUND CLEARING OBLIGATION EXEMPTION AND INTRAGROUP TRANSACTION TRANSITIONAL CLEARING AND RISK-MANAGEMENT OBLIGATION EXEMPTIONS (EXTENSION AND AMENDMENT) REGULATIONS 2023

2023 No. 472

1. Introduction

1.1 This explanatory memorandum has been prepared by HM Treasury and is laid before Parliament by Command of His Majesty.

2. Purpose of the instrument

2.1 This instrument relates to the temporary exemption for pension funds from the obligation to clear certain derivative contracts through a central counterparty ('CCP'). This obligation is known as the 'clearing obligation'. The instrument extends the current expiry date of the exemption from 18 June 2023 to 18 June 2025.

2.2 This means that pension funds based in the UK and the European Economic Area (EEA) will continue to be exempt from the UK clearing obligation.

2.3 The instrument also extends exemptions from the clearing obligation and certain risk mitigation requirements for derivatives contracts held between counterparties in the same corporate group ('intragroup transactions'). Collectively these exemptions are known as the temporary intragroup exemption regime ('TIGER'). The instrument extends TIGER by three years by amending the relevant expiry dates for the exemptions from 31 December 2023 to 31 December 2026.

2.4 This means that relevant intragroup transactions made between a UK and non-UK counterparty will continue to be exempt from the clearing obligation and certain risk mitigation requirements.

3. Matters of special interest to Parliament

Matters of special interest to the Joint Committee on Statutory Instruments.

3.1 None.

4. Extent and Territorial Application

4.1 The extent of this instrument (that is, the jurisdictions which the instrument forms part of the law of) is England and Wales, Scotland and Northern Ireland.

4.2 The territorial application of this instrument (that is, where the instrument produces a practical effect) is England and Wales, Scotland and Northern Ireland.

5. European Convention on Human Rights

5.1 As the instrument is subject to negative resolution procedure and does not amend primary legislation, no statement is required.

6. Legislative Context

Pension fund clearing exemption

6.1 The UK's regulatory framework for CCPs is set out primarily in Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories (more commonly known as the European Market Infrastructure Regulation or 'EMIR'), as retained in domestic UK law by virtue of the European Union (Withdrawal) Act 2018 and amended by regulations made under section 8 of that Act. This legislation, as amended and forming part of retained EU law, is referred to in this explanatory memorandum as 'UK EMIR'. UK EMIR lays down rules on over-the-counter ('OTC') derivatives and trade repositories, as well as CCPs.

6.2 The first sub-paragraph of Article 89(1) of UK EMIR states that, on a temporary basis, the clearing obligation does not apply to OTC derivative contracts which UK and EEA pension funds use to hedge risk.

6.3 The Over the Counter Derivatives, Central Counterparties and Trade Repositories (Amendment, etc., and Transitional Provision) (EU Exit) (No. 2) Regulations 2019 (SI 2019/1416) amended Article 89 so that this exemption expires on 18 June 2023 – extending this date by two years from 18 June 2021. It also amended Article 89(1) to provide that HM Treasury may make regulations extending the exemption by up to two years at a time where it concludes that no appropriate technical solution has been developed for the transfer of collateral to CCPs by pension funds, and that requiring them to centrally clear their derivative contracts would have an adverse effect on the retirement benefits of future pensioners.

6.4 HM Treasury has concluded that no solution has yet been developed to this issue and that the adverse effect on future pensioners remains. This instrument uses this power to extend the exemption by two years, to 18 June 2025. This is the first time that HM Treasury has exercised this power.

Temporary intragroup exemption regime (TIGER)

6.5 When the UK was an EU Member State, EMIR made provision for intragroup transactions between UK firms and their overseas entities to be exempted from the clearing obligation and risk mitigation requirements (EMIR Article 11). These exemptions were granted by the FCA on a firm-by-firm basis provided that certain conditions were met such as robust risk management procedures being in place.

6.6 In order to maintain this policy effect and to avoid disruption to firms, Part 5 of the Over the Counter Derivatives, Central Counterparties and Trade Repositories (Amendment, etc., and Transitional Provision) (EU Exit) Regulations 2019 (SI 2019/335, the '2019 Regulations') created what is known as the temporary intragroup exemption regime (TIGER).

6.7 The 2019 Regulations maintained intragroup exemptions obtained before the end of the transition period (i.e. on or before 31 December 2020) for OTC derivative contracts between UK firms and their overseas group entities. Firms can also make applications to the FCA for new intragroup exemptions. As previously, firms must demonstrate that they have satisfied certain criteria, such as having appropriately robust risk management procedures. Currently, exemptions apply from the day they are granted until 3 years after the end of the transition period (31 December 2023), unless an equivalence determination under EMIR Article 13 is made for the relevant third country before then (in which case firms can apply for permanent exemptions).

6.8 Without TIGER, temporary intragroup exemptions would no longer have applied in the UK after the end of the transition period. This would have disproportionately increased costs for UK firms and put them at competitive disadvantage.

6.9 The 2019 Regulations empower HM Treasury to amend the expiry dates for temporary exemptions under TIGER to a later day via a statutory instrument. In this instrument HM Treasury is exercising this power to extend TIGER to 31 December 2026. This is the first time that HM Treasury has exercised this power.

7. Policy background

What is being done and why?

7.1 CCPs are used by firms to reduce certain risks that arise when trading on financial markets, such as derivatives and equities markets. They sit between the buyers and sellers of financial instruments, providing assurance that contractual obligations will be fulfilled. The process of transacting through a CCP is known as 'clearing'. CCPs have played a vital role in making markets safer following the 2008 financial crisis, and they help substantially in managing potential systemic risk arising from global financial transactions.

7.2 In 2009, G20 countries agreed that 'standardised' OTC derivatives contracts should be cleared through CCPs. In the EU this was implemented through EMIR. Article 4 of EMIR is known as the 'clearing obligation', and states that certain OTC derivative contracts should be cleared through a CCP. The clearing obligation was incorporated into UK law on the UK's exit from the EU, by virtue of the European Union (Withdrawal) Act 2018.

7.3 EMIR also contains risk mitigation requirements for trades that are not cleared through a CCP (often known as 'bilateral' trades). These include a requirement for counterparties to have appropriate procedures for exchanging collateral (or 'margin') on derivatives contracts they enter into.

<u>Pension fund exemption</u>

7.4 The exemption from the clearing obligation for pension funds has existed since the introduction of EMIR into EU law in 2012. The exemption was introduced because of the specific challenges that pension funds face in meeting margin requirements when clearing through CCPs.

7.5 CCPs require 'variation margin' – collateral which covers price movements on contracts – to be provided in cash form. They also have the ability to require variation margin to be posted more frequently than is the case for bilateral trades, which may be multiple times a day. Pension funds do not usually hold large cash reserves – they invest the large majority of their resources in assets such as gilts and corporate bonds to provide returns for pension holders. This means that meeting CCPs' margin requirements can be more difficult for them than for other counterparties.

7.6 For pension funds to raise this cash collateral to give to the CCP, they may have to sell assets such as gilts, which could have a negative impact on financial markets. Alternatively, the pension funds could hold larger cash reserves, but this could impact pensioners' returns.

7.7 The UK maintained this exemption when EMIR was incorporated into domestic law, and it is currently set to expire on 18 June 2023.

7.8 This SI extends the exemption by a further two years, to 18 June 2025. This extension will mitigate the risk of disruption that could be caused by the expiry of the exemption.

7.9 The government recognises that it would be desirable to put in place a longer-term policy approach and remove the need for future temporary extensions to this exemption. It therefore intends that the time period provided by this two-year extension will be used to consider and implement a longer-term approach.

7.10 Accordingly, HM Treasury will conduct a review of the pension fund exemption ahead of its new expiry date in 2025. This will be undertaken alongside the UK regulatory authorities and will seek input from industry stakeholders. It will incorporate relevant analysis from work being undertaken by regulators internationally on financial market fragilities and resilience in the non-banking financial sector.

7.11 The review will be concluded in time to provide firms with sufficient notice of the outcome and any potential changes that may be required ahead of the 2025 expiry date.

<u>*TIGER*</u>

7.12 Intragroup transactions are used by global firms to manage risk across their businesses. Exemptions from clearing and margin requirements make these transactions less costly and less burdensome, making them valuable for corporate groups. While the clearing obligation and margin requirements are important to limit systemic risk in financial markets, the EU (and now the UK) have been comfortable granting exemptions for intragroup transactions from them, provided certain conditions are met, as these trades are unlikely to generate additional risks within a group.

7.13 If HM Treasury had not set up the TIGER, UK firms would no longer have benefitted from temporary intragroup exemptions granted prior to the end of the transition period. This would have disproportionately increased costs for UK firms and put them at competitive disadvantage. It would also have affected their ability to manage their risk portfolios across their global groups.

7.14 The UK created the TIGER to replicate the effect of these exemptions for UK firms when the UK left the EU. This regime expires on 31 December 2023, meaning that as it currently stands, the exemptions will expire on that date unless there is an equivalence decision under Article 13 of UK EMIR in place for the country in which the UK firm's counterparty is located.

7.15 This SI extends the TIGER until 31 December 2026. This will ensure that UK firms continue to benefit from these intragroup exemptions regardless of whether an equivalence decision is in place for the country where their counterparty is located, and avoids disruption to firms' business models that could have been caused by the exemptions expiring.

7.16 As with the pension fund exemption, the government recognises that it would be desirable to have an approach in place for intragroup exemptions which would not require temporary extensions to be made in future. The government will, therefore, consider whether this area of legislation could be reformed with the aim of implementing a longer-term approach.

7.17 The three-year extension will provide time for the required policy development and implementation as part of the government's work to repeal and replace retained EU law in financial services.

7.18 This work will be carried out in close cooperation with the UK regulatory authorities and will incorporate feedback from industry stakeholders. Firms will be provided with sufficient notice of the outcomes of this process and any potential changes ahead of the expiry date of the regime.

8. European Union Withdrawal and Future Relationship

8.1 This instrument does not trigger the statement requirements under the European Union (Withdrawal) Act.

9. Consolidation

9.1 There are currently no plans to consolidate the relevant legislation.

10. Consultation outcome

10.1 A public consultation was not undertaken for these amendments as these are technical amendments which make use of the powers in the legislation to extend the length of two transitional regimes.

10.2 HM Treasury has engaged with the Bank of England, the Prudential Regulation Authority and the Financial Conduct Authority on the issues raised in this instrument.

11. Guidance

11.1 HM Treasury does not propose to provide any guidance in relation to this instrument.

12. Impact

12.1 There is no, or no significant, impact on business, charities or voluntary bodies.

12.2 There is no, or no significant, impact on the public sector.

12.3 A full Impact Assessment has not been prepared for this instrument because the impact of this SI is small (the cost to businesses is < £5m per year). A de minimis Impact Assessment is submitted with this memorandum and published alongside the Explanatory Memorandum on the legislation.gov.uk website.

13. Regulating small business

13.1 The legislation does not apply directly to activities that are undertaken by small businesses.

13.2 The amendments made by this instrument are not expected to have an impact on small businesses, and therefore no action is needed to mitigate the impact on them.

14. Monitoring & review

14.1 These provisions are subject to ongoing review as part of HM Treasury's work to reform these exemptions, as outlined above.

14.2 The instrument does not include a statutory review clause, and, in line with the requirements of the Small Business, Enterprise and Employment Act 2015, the Economic Secretary to HM Treasury (Andrew Griffith) has made the following statement:

"It is not proportionate to include a review clause in this instrument because the estimated annual net direct cost to business is less than £5 million and the number of small businesses in scope is very low.".

15. Contact

15.1 Owen Davies at HM Treasury (email: owen.davies@hmtreasury.gov.uk) can be contacted with any queries regarding the instrument.

15.2 Tom Duggan, Deputy Director for Securities and Markets at HM Treasury, can confirm that this Explanatory Memorandum meets the required standard.

15.3 Andrew Griffith, Economic Secretary to HM Treasury, can confirm that this Explanatory Memorandum meets the required standard.