

Is this the end of OTC derivatives

for pension schemes?

Introduction

Over-the-counter (OTC) derivatives, such as interest rate and inflation swaps, have become standard tools for defined benefit pension schemes. These instruments allow pension schemes to reduce risk and manage portfolios more efficiently. However, the financial crisis and subsequent changes in regulation means it is likely that the way pension schemes will use such instruments will change.

Changes in regulation

The financial crisis has brought into question the financial stability and future of the banking industry. Bank counterparties are now perceived to be financially weaker and the perceived risk of them failing has increased.

Regulators have been looking at ways to improve the financial stability and security of the OTC derivative market by introducing 'central counterparty clearing'. The aim of central counterparty clearing is to better manage the systemic, credit, operational and other risks associated with OTC derivatives. In other words, regulators want derivatives to be collateralised with a central counterparty, such as a clearing house, who is perceived to be less risky than bank counterparties due to the central counterparties more focused business activities and risk management framework. (Both the bank and the pension scheme would face a third party rather than each other.) However, not all OTC derivatives will be subject to mandatory central clearing in the short term. For example inflation swaps, swaptions and longevity swaps are not being initially considered for central clearing. For a transitional period, which is expected to last until 31 December 2015, pension schemes are likely to be exempt from central mandatory clearing of OTC derivatives, subject to meeting certain requirements.

Other measures being considered by the UK government to reform the UK banking system are:

- Ring-fencing UK banks' retail banking operations from investment banking operations, splitting 'cheque-book' and 'casino banking'.
- Increasing the amount of capital UK banks are required to hold given the type of business being conducted and risks taken.

The goal of these changes is to reduce the likelihood, impact and cost for the UK taxpayer of dealing with banks that get into trouble. It is being proposed that these UK reforms are implemented by 2019 with legislation finalised by the end of this Parliament in 2015. Some credit rating agencies expect the reforms to have a negative impact on the long-term credit quality of UK banks which has led to some of their credit ratings being downgraded. The rating agencies' view is that financial support from the government is less likely in future. Similar concerns have impacted the credit ratings of some US banks.

How are these changes impacting pension schemes?

We have seen the terms available in the documentation underlying OTC contracts, ISDA (International Swap & Derivative Association) documentation become less attractive. Flexibility over which assets can be used as eligible collateral has also reduced significantly. It appears that counterparty banks are less willing, or able, to accommodate pension schemes. This stems from a reduction in banks' risk appetites and changes in their regulation.

Historically, UK corporate bonds and long-dated UK government bonds were acceptable as eligible collateral. Today, we are seeing banks moving to accept only cash and short- to medium-dated UK government bonds. Over time we expect the list of eligible collateral will move in line with central counterparty clearing arrangements (that is, a preference to only accept cash as collateral). This may require pension schemes to hold large cash allocations to support derivatives positions.

OTC derivatives which will not be subject to mandatory central clearing are likely to require banks to hold more capital than previously has been the case. This will result in higher costs for banks which we would expect to be passed to customers, thus increasing the costs of transacting OTC derivatives that are not centrally cleared.

In addition the UK's Independent Commission on Banking has indicated that the derivative activities of UK banks should largely be in the non-ring fenced part of the bank – that is, the casino.

Some market participants have viewed the move to central counterparty clearing as primarily 'bad' for pension schemes as it may push up some of the costs of using derivatives. In a world of strong banks providing strong derivative documentation we agree these additional costs are unnecessary. However our view is that the weakening of the global banking industry means moving to central counterparty clearing has material benefits compared to facing weaker banks under weaker derivative documentation.

Conclusion

Whilst pension schemes cannot move their interest rate and inflation derivatives to central counterparty clearing today they should understand the impacts changes in regulation are bringing to market practice. Pension schemes should assume that:

- They will move to a 'cash-as-eligible-collateral' world (and maybe short-dated government debt too).
- Bank counterparties credit quality has weakened and could weaken further. This makes it important to take counterparty diversification, a counterparty bank's credit quality and the package of terms a bank will offer into account when assessing who to transact with.
- Either regulation, or economic incentives, will mean that both existing and new interest rate and inflation derivative exposures will eventually be pushed towards central counterparty clearing.

- It will become more common for other instruments to be used to gain leverage – for example equity derivatives.

Markets continue to be volatile, which means that effective risk management, through the use of derivatives, is as important as ever. The operational uncertainty created by market and regulatory changes is not a reason to hold off from managing economic risks, but is an important implementation consideration. We will continue to monitor market developments and help our clients manage these risks within the operational framework that works best for each individual client's circumstances.

Further information

For further information, please contact your Towers Watson consultant, or

Treeve Coomber

+44 1737 284703

treeve.coomber@towerswatson.com

Marcella Murphy

+44 1737 274402

marcella.murphy@towerswatson.com

Towers Watson
21 Tothill Street
Westminster
London
SW1H 9LL

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