EXPLANATORY MEMORANDUM TO

THE PENSION FUND CLEARING OBLIGATION EXEMPTION (AMENDMENT) REGULATIONS 2025

2025 No. 670

1. Introduction

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

2. Declaration

2.1 Emma Reynolds, Economic Secretary at HM Treasury confirms that this Explanatory Memorandum meets the required standard.

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

3. Contact

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

Part One: Explanation, and context, of the Instrument

4. Overview of the Instrument

What does the legislation do?

4.1 This instrument relates to the temporary exemption which pension scheme arrangements, or 'pension funds', currently have from the obligation to clear certain derivative contracts through a central counterparty ('CCP'). This obligation is known as the 'clearing obligation'.

4.2 The instrument establishes this exemption on an indefinite basis. It does this by removing the current expiry date of 18 June 2025. It also removes the ability for HM Treasury to extend the exemption by up to two years at a time, as this will no longer be necessary when the exemption has no expiry date.

4.3 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.

Where does the legislation extend to, and apply?

4.4 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.

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

5. Policy Context

What is being done and why?

5.1 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.

5.2 In 2009, G20 countries agreed that 'standardised' over-the-counter (OTC) derivatives contracts should be cleared through CCPs. In the EU this was implemented through Article 4 of EMIR, known as the 'clearing obligation', which states that certain OTC derivative contracts should be cleared through a CCP.

5.3 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 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. The EU clearing obligation was incorporated into UK EMIR.

5.4 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. It is worth noting that the exemption does not prevent pension funds from clearing derivatives if they wish to do so, and some funds do clear some or all of their derivatives voluntarily.

5.5 CCPs generally require 'variation margin' – collateral which covers price movements on contracts – to be provided in cash. 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. These requirements are designed to help derivatives markets operate safely. 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 some other counterparties.

5.6 The UK maintained this exemption when EMIR was incorporated into domestic law and extended it to 18 June 2023 at this time. Most recently, the government laid The Pension Fund Clearing Obligation Exemption and Intragroup Transaction Transitional Clearing and Risk-Management Obligation Exemptions (Extension and Amendment) Regulations 2023, which extended the exemption further to 18 June 2025.

5.7 When making this extension, the government noted that that it would be desirable to put in place a longer-term policy approach and remove the need for future temporary extensions. It noted that it intended to use the time period provided by the two-year extension to consider and implement a longer-term approach.

5.8 HM Treasury has since conducted a review of the exemption, working closely with the relevant financial services regulators (the Bank of England, the Financial Conduct Authority and The Pensions Regulator). The review also sought input from industry stakeholders through a call for evidence than ran from November 2023 to January 2024.

5.9 The review found that requiring pension funds to clear derivatives could bring financial stability benefits, such as reducing counterparty risk, and could enhance

resilience to shocks by increasing cash buffers and placing a greater emphasis on liquidity management. The government continues to strongly support clearing of standardised OTC derivatives at a CCP as a way to reduce systemic risk and improve transparency in derivatives markets.

5.10 On the other hand, the review found that removing the exemption could reduce pension funds' ability to invest in productive assets and generate returns, as it would require them to increase their cash holdings. It found that, at least currently, there is no widely accepted means by which pension funds are able to provide collateral as variation margin when clearing derivatives without having an adverse effect on the retirement benefits of future pensioners. The review also identified concerns from some market participants that removing the exemption could increase pressure on the liquidity management of pension funds, particularly under stressed market conditions, which could then increase financial stability risk.

5.11 Overall, the government concluded that there was clear evidence that removing the exemption would reduce pension funds' ability to invest in productive assets, whilst the extent to which this would be of material benefit to financial stability was more difficult to evaluate.

5.12 On this basis, the government decided that the exemption should be maintained for the longer-term, and that it would take forward secondary legislation to prevent the exemption expiring on 18 June 2025 as currently scheduled.

5.13 The government will, however, keep this policy under review in coordination with the applicable UK regulatory authorities. If there are changes to market dynamics or structure or wider government reforms that have a material impact on the value of mandatory central clearing for pension funds, the government may reassess this issue.

What was the previous policy, how is this different?

5.14 This instrument does not change the current policy position – the exemption is being maintained, with no changes to its scope or operation. The difference is that the exemption will now be in place on an indefinite basis, with no expiry date.

6. Legislative and Legal Context

How has the law changed?

6.1 Under the first sub-paragraph of Article 89(1) of UK EMIR, until 18 June 2025, the clearing obligation does not apply to OTC derivative contracts which UK and EEA pension funds use to hedge risk. HM Treasury has the ability (under the fourth sub-paragraph of Article 89(1)) to 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.

6.2 This instrument revokes the current expiry date of 18 June 2025, thereby removing the time limit on the exemption and establishing it on an indefinite basis. Since this will eliminate the need for the government to use secondary legislation to extend the exemption on a rolling temporary basis, this instrument also removes the ability for HM Treasury to extend the exemption by two years at a time.

Why was this approach taken to change the law?

6.3 Modifying the provisions of the existing instrument represents an efficient and proportionate way to support the policy intent given the exemption is set to expire on 18 June 2025. This instrument needs to be in force before then to avoid a cliff edge and mitigate the risk of disruption that could be caused by the expiry of the exemption. This instrument is made using the powers conferred by sections 3(1) and 84(2) of the Financial Services and Markets Act 2023 to modify retained EU law.

7. Consultation

Summary of consultation outcome and methodology

7.1 A call for evidence was run from November 2023 to January 2024 on this issue, with the information collected used to inform the review of the policy. The government has published a response to the call for evidence, including a summary of the responses and its policy decision, on gov.uk[1].

8. Applicable Guidance

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

Part Two: Impact and the Better Regulation Framework

9. Impact Assessment

9.1 A full Impact Assessment has not been prepared for this instrument because the impact of this SI is small (the cost to businesses is < £10m per year). A de minimis Impact Assessment published alongside the Explanatory Memorandum on the legislation.gov.uk website.

Impact on businesses, charities and voluntary bodies

9.2 There is no, or no significant, impact on business, charities or voluntary bodies because the SI maintains the effect of existing regulatory standards.

9.3 The legislation does not impact small or micro businesses.

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

10. Monitoring and review

What is the approach to monitoring and reviewing this legislation?

10.1 The approach to monitoring this legislation is engagement with industry to understand its impact.

10.2 The instrument does not include a statutory review clause and, in line with the requirements of the Small Business, Enterprise and Employment Act 2015 Emma Reynolds 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."

[1] https://www.gov.uk/government/calls-for-evidence/call-for-evidence-pension-fund-clearing-exemption

Part Three: Statements and Matters of Particular Interest to Parliament

11. Matters of special interest to Parliament

11.1 None.

12. European Convention on Human Rights

12.1 The Economic Secretary to HM Treasury Emma Reynolds has made the following statement regarding Human Rights:

"In my view the provisions of The Pension Fund Clearing Obligation Exemption (Amendment) Regulations 2025 are compatible with the Convention rights."

13. The Relevant European Union Acts

13.1 This instrument is not made under the European Union (Withdrawal) Act 2018, the European Union (Future Relationship) Act 2020 or the Retained EU Law (Revocation and Reform) Act 2023 ("relevant European Union Acts"). It does, however, relate to the withdrawal of the United Kingdom from the European Union because the legislation amends a transitional regime that was established in the UK after EU-exit.