



European Federation
for Retirement Provision

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EFRP Response

To the

Joint Discussion Paper

On Draft Regulatory Technical Standards

**On risk mitigation techniques for OTC derivatives not
cleared by a CCP under the Regulation on OTC derivatives,
CCPs and Trade Repositories**

(JC/DP/2012/1)

ABOUT THE EFRP

The **European Federation for Retirement Provision (EFRP)** represents national associations of pension funds and similar institutions for supplementary/occupational pension provision. Its membership covers institutions for work-related (2nd pillar) pension provision. Some of them operate purely individual pension schemes (3rd pillar).

The EFRP has **22 members associations** in most EU-15 Member States and other European countries with significant – in size and relevance – workplace pension systems¹.

In October 2006 the EFRP established the **Central & Eastern European Countries Forum (CEEC Forum)** to discuss issues common to pension systems in that region.

EFRP member organisations cover the workplace pensions of **83 million European citizens**. Through its Member Associations the EFRP represents approximately € **3.5 trillion of assets (2009) managed** for future occupational pension payments.

EFRP Members are large institutional investors representing the **buy-side** on the financial markets. They are specialised institutions solely dedicated to the accumulation and decumulation of assets to provide a supplement to the State pension to avoid old-age poverty.

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INTRODUCTORY REMARKS

Over the Counter (OTC) derivative contracts are a key tool used by Institutions for Occupational Retirement Provision (IORPs) and financial institutions managing assets on their behalf, for risk-mitigation purposes. In practice, OTC derivatives are used to match duration of pension schemes assets with the duration of their liabilities. Derivatives are useful to manage risk and mitigate funded status volatility, in view of the best interest of occupational pension beneficiaries. IORPs need to hedge the risk arising from interest rate and currency, with a view to guarantee their funding and, potentially, their security. In fact, without hedges against these risks, IORPs would be exposed to volatility. This is the only purpose of use of derivatives by IORPs, any speculative use would be forbidden by the IORP Directive.

IORPs are strongly in favour of well-regulated and secure derivative contracts, as they are end-users of these contracts. In particular, IORPs are supportive of greater transparency and better supervision of these products.

Nonetheless, these regulatory changes envisaged to this purpose shall take into account the specificities of different market participants as well the reasons for them to use derivatives. As a consequence, specific arrangements shall be foreseen for some actors, such as IORPs, not to mix derivatives contracts managed by them with contract managed by other actors and thus unexpectedly increase the overall risk. Finally, the cost of these regulatory changes for market participants shall not be excessive. The European Market Infrastructure Regulation (EMIR) effectively addressed these concerns by including a temporarily exemption that is intended to give Central Clearing Counterparties the time and the possibility to establish secured account for derivative contracts managed by IORPs and avoid unexpected risk and cost impacts on pension schemes arrangements. This temporary exemption also allows pension schemes arrangement to continue hedging their risks through derivative contracts and choosing their counterparties carefully. The positive effects, in terms of security, progressive adaptation and legal compliance of such an exemption, should not be partly denied by the imposition of not sufficiently calibrated initial margin (IM) requirements.

The EFRP stresses that the definition of margin requirements, which may have detrimental effects, shall take into account:

- The rational of the exemption from central clearing for pension schemes and related arrangements established in EMIR;

- The need of pension schemes arrangements to mitigate the risks they encounter during the normal course of their business and the use of derivative contracts to this purpose;
- The fact that derivative contracts and their use by pension schemes do not have the potential to create systemic risk;

In this sense, IM should take the credit risk posed by pension schemes arrangements into account and avoid disproportionate administrative and financial burden for IORPs and institutions managing assets on their behalf. Moreover, the Level 2 standards should not jeopardise the outcome of EMIR by imposing disproportionate IM requirements on OTC trades with pension schemes arrangements.

Therefore, L2 measures shall reflect the following.

KEY POINTS

At the moment, IORPs and financial institutions managing assets on their behalf only exchange Variation Margin (VM) with their counterparties, not IM, because they are considered highly creditworthy by their counterparties.

Article 11 EMIR stipulates that pension schemes arrangement, being financial counterparties, are subject to bilateral collateral requirements. Nonetheless, the text of that Article doesn't establish whether and to what extent pension schemes arrangements as defined under Article 2 EMIR should exchange IM with their counterparties. Actually, Article 11 doesn't make any distinction between IM and VM. Therefore, the implementation of that same article shall not be used as an opportunity to introduce high levels of IMs for pension schemes arrangements surreptitiously. Moreover, IMs would have a disproportionate cost impact on pension schemes that would de facto contravene one of the reasons for the exemption established under EMIR.

In fact, mandatory IM requirements would necessitate new and costly incremental funding requirements for pension schemes arrangements. As most pension schemes arrangements do not have expedient and low-cost access to liquidity sources, the outcome of IM calculations would be very high, due to the fact that the derivatives transacted by pension schemes arrangements are typically long-dated and one directional, meaning very little offsetting options exist in the portfolio that would reduce the overall amount.

Given the large one-sided exposure, IORPs are disadvantaged in management of IM in comparison to derivatives dealers: these generally see more trading flow with offsets and have a broader base of counterparties to allow for lower margin requirements. As a consequence, the impact of IM requirement may be disproportionately high for pension schemes arrangements. Mandatory high levels of IM may oblige pension schemes arrangements to put large cash reserves aside, in order to meet margin rules. These capitals would be diverted from productive investments.

Moreover, mandatory IM requirements would increase the costs of OTC derivatives, making it more expensive for pension schemes arrangements to insulate themselves from risk. Paradoxically, risk-hedging products will come at a greater cost. The envisaged IMs would then dissuade IORPs from hedging against risks. This would be clearly against the purposes of regulatory changes in the financial sector in the European Union. Moreover, the extra costs will be borne by current and future pension beneficiaries, who are saving for their retirement and relying on their complementary, occupational pension, in a time when public pensions are progressively shrinking.

IORPs are generally able to fulfil their obligation as:

- They can increase pension contribution;
- They can decide not to index pensions;
- They can cut pension benefits.

Moreover, IORPs are mostly not-for-profit legal entities: they operate as foundations whose activity is based on an agreement between social partners (employer and employees representatives). They are not part of any company nor have they to pay any dividends to shareholder/investors. Therefore, profits, losses and costs only contribute to define the benefits of members. As a consequence, the risk of an IORP not to fulfil its obligations as a counterparty in a derivative contract in the short term is almost inexistent, as a shortage in the short term can be recuperated in the long term.

The EFRP would emphasize the need for IM not to lead to additional risk for non-systemic institutions, such as IORPs. In fact, the posting of IM with more systemically relevant institutions could lead to an increase in risk. Failures in segregating assets in an appropriate way have already led to losses for investors, such as in the MF Global case.

In addition, we advocate a clear regulation of re-use of VM. There are different views among our members about the re-use of collateral. Some are in favour of the practice and see liquidity squeeze and systemic crisis as a consequence of its interdiction; others see re-use of VM as incompatible with the segregation of their assets. In fact, VM is the value of an outstanding contract and in case of a default can be offset against outstanding positions. As the (liquidity) risk of re-use of VM lies completely with the VM receiver, VM re-use shall be allowed. As said before, it is already a current market practice for some IORPs and entities

managing assets on their behalf to re-use VM collateral. VM needs to be re-used in cases when collateral needs to yield a certain return to be paid to the VM provider. Maintaining such a practice would not increase systemic risk, while restricting it would seriously impede on the pool of available collateral for IORPs which re-use VM.

Finally, we would like to recall that, contrary to general financial perception, the one-sided exposure, in particular in relation to interest rates, for IORPs is considered as a reduction of the interest risk of the liabilities.

RESPONSES TO SPECIFIC QUESTIONS

Q1. What would be the effect of the proposals outlined in this discussion paper on the risk management of insurers and institutions for occupational retirement provision (IORPs)?

Q1.

As explained above, VM requirements would have no impact if not required in the form of cash. On the contrary IM requirements would have a disproportionate impact, in terms of risk-hedging strategy and costs. In addition to leading to overall increased risks, the introduction of IM would be against the ratio of the transitional exemption from central clearing set for pension scheme arrangements under EMIR.

Although pension schemes arrangements are required to meet the bilateral collateralisation requirements under EMIR, art. 11 of the same Regulation does not refer to posting of IM. We consider that art. 11 of EMIR should be read in the context of the temporary exemption for pension scheme arrangements: imposition of IM requirements would be against the ration of such an exemption.

Q2. What are your views regarding option 1 (general initial margin requirement)?
Q3. Could PRFCs adequately protect against default without collecting initial margins?
Q4. What are the cost implications of a requirement for PRFC, NPRFC and NFCs+ to post and collect appropriate initial margin? If possible, please provide estimates of opportunity costs of collateral and other incremental compliance cost that may arise from the requirement.

Q2.

The EFRP considers that adequate and well-controlled variation margin should provide sufficient protection against counterparty failure.

Moreover, IORPs and the entities managing assets solely and exclusively in their interest should not be treated the same as banks and broker-dealer. These pension schemes arrangements have a totally different risk profile than other commercial and risk taking market participants and do not create systemic risk.

For IM requirements, a combination of option 1 and 3 (threshold) could be adopted. On this basis, pension schemes arrangements as defined in EMIR should be subject to no IM at all.

The threshold should not be based on the derivative position/exposure, but take the credit risk that pension schemes arrangements pose into considerations.

Q3.

IORPs can adequately protect against default without collecting Initial Margins. Variation margin, combined with normal due diligence and adequate controls (as required by the Derivatives Regulation), is sufficient. Existing capital should be sufficient to cover any residual loss.

We consider that the IM requirements should be clearly linked to the risks of the counterparties. IORPs are creditworthy, conservative, stable, long-term and non-commercial institutions. They are mostly not-for-profit legal entities: they operate as foundations whose activity is based on an agreement between social partners (employer and employees representatives). They are not part of any company nor have they to pay any dividends to shareholder/investors. Therefore, profits, losses and costs only contribute to define the benefits of members.

As a consequence, the risk of an IORP not to fulfil its obligations as a counterparty in a derivative contract in the short term is almost inexistent, as a shortage in the short term can be recuperated in the long term. Therefore, banks do not run counterparty risk when entering into transactions with IORPs.

Pension schemes arrangements could also be protected against default by pledging portfolios of government bonds or similar securities.

Q4.

IORPs currently do not collect nor post IM. The posting of IM based on IORPs' one-sided large derivatives positions/exposure would have a significant cost impact. The Alternative Investment Management Association (AIMA) has estimated that central clearing under current arrangements would reduce investment returns for a fully immunised Liability Driven Investment (LDI) portfolio by 1.1-1.9 percentage points. Cumulated over the years, this decrease of returns would significantly increase the cost for companies of providing adequate occupational pensions for their employees and reduce the resources available for investments and growth.

Q5. What are your views regarding option 2?

Q6. How – in your opinion - would the proposal of limiting the requirement to post initial margin to NPRFCs and NFCs+, impact the market / competition?

Q5.

We are supportive of the idea to consider the perceived systemic relevance of the counterparties and look at the best way to ensure the protection of those deemed most

systemically relevant, so as to ensure protection against the impact of their default on the wider financial system. In this perspective, however, the decision on collection of IM should be based on a rigorous risk analysis of the counterparty, rather than on a classification as PRFC or NPFRC.

Q6.

We don't see any reason for the posting of initial margin. Even less justified would be the obligation for pension schemes to post margin to counterparties whose credit standing might be no better than their own, while not collecting margin in return. Moreover, such a measure could create undesired arbitrage possibilities for market parties, which could choose their counterparties with a view to avoid to fall within the categories obliged to post IM.

Q7. What is the current practice in this respect, e.g.

- If a threshold is currently in place, for which contracts and counterparties is it used?

- Which criteria are currently the bases for the calculation of the threshold?

Q8. For which types of counterparties should a threshold be applicable?

Q9. How should the threshold be calculated? Should it be capped at a fixed amount and/or should it be linked to certain criteria the counterparty should meet?

Q10. How – in your opinion - would a threshold change transactions and business models?

Q7.

As previously stated (Q3), IORPs' counterparties do not run counterparty risk when entering into transactions with them, as IORPs' counterparty risk is very limited or even inexistent. Pension schemes arrangement are no commercial undertakings and bankruptcy risk is very limited or inexistent. They can rebalance shortages through increase of contributions, no indexation of pensions, cut of pension benefits or increase of retirement age.

Q8.

Was a threshold set, it should refer to the credit risk posed by any financial market party.

Q9.

It should be clearly and directly linked to the creditworthiness of the counterparty.

Q10.

Q11. Are there any further options that the ESAs should consider?

Q12. Are there any particular areas where regulatory arbitrage is of concern?

Q13. What impacts on markets, transactions and business models do you expect from the proposals?

Q11.

It is unclear how parties are placed into categories. Also, it is unclear whether the Authorities see pension schemes as Prudentially Regulated or as Non Prudentially Regulated Financial Counterparties. As previously indicated, the categories should be linked to the amount of risk the members of that category pose to the financial system.

Q12. Are there any particular areas where regulatory arbitrage is of concern?

Please refer to our response to Q6.

Q13.

In case of IORPs' market behaviour, the increased cost of derivatives trading could lead to a reduction in risk hedging transactions, paradoxically creating additional risk in the system rather than reducing it. The price of eligible collateral would rise, because of increased demand. Also, the eligible collateral would be locked up for a considerable period of time. The market would become strongly dependent on the repo markets for collateral transformation purposes, with an increased danger of liquidity squeezes.

Procyclicality is another issue to be considered. Depending on the way IM is calculated and prescribed, under certain stressed circumstances, the IM requirements may lead to liquidity being absorbed, which may have an adverse impact on market participants and the financial markets.

Q14. As the valuation of the outstanding contracts is required on a daily basis, should there also be the requirement of a daily exchange of collateral? If not, in which situations should a daily exchange of collateral not be required?

Q14.

A requirement of a daily exchange of collateral would be consistent with the valuation of the outstanding contracts.

Q15. What would be the cost implications of a daily exchange of collateral?

Q15.

We do not see any additional cost implication.

Q16. Do you think that the "Mark-to-market method" and/or the "Standardised Method" as set out in the CRR are reasonable standardised approaches for the calculation of initial margin requirements?

We think that the chances of default of the counterparty should be incorporated in the approach for the calculation of IM requirements. Therefore, these approaches are not appropriate.

- Q17. Are there in your view additional alternatives to specify the manner in which an OTC derivatives counterparty may calculate initial margin requirements?**
- Q18. What are the current practices with respect to the periodic or event-triggered recalculation of the initial margin?**
- Q19. Should the scope of entities that may be allowed to use an internal model be limited to PRFCs?**
- Q20. Do you think that the “Internal Model Method” as set out in the CRR is a reasonable internal approach for the calculation of initial margin requirements?**
- Q21. Do you think that internal models as foreseen under Solvency II could be applied, after adequate adjustment to be defined to the internal model framework, to calculate initial margin? What are the practical difficulties? What are the adjustments of the Solvency II internal models that you see as necessary?**
- Q22. What are the incremental compliance costs (one-off/on-going) of setting up appropriate internal models?**
- Q23. To what extent would the „mark-to-market method“ or the „standardised method“ change market practices?**

Q17.

Please refer to our answer to Q16.

Q18.

Q19.

Q20.

Q21.

Q22.

Q23.

- Q24. Do you see practical problems if there are discrepancies in the calculation of the IM amounts? If so, please explain.**
- Q25. Would it be a feasible option allowing the party authorised to use an internal model to calculate the IM for both counterparties?**
- Q26. Do you see other options for treating such differences?**

Q24.

In case of discrepancies in the calculation of the IM amounts, the cost of maintaining IM would not be distributed fairly between the parties, with reference to the financial risk they pose to the system.

Q25.

No.

Q26.

We would be in favour of a bilateral agreement on the way IM is calculated. This should be fixed in contracts such as ISDA master agreements.

Q27. What kinds of segregation (e.g., in a segregated account, at an independent third party custodian, etc.) should be possible? What are, in your perspective, the advantages and disadvantages of such segregation?

Q28. If segregation was required what could, in your view, be a possible/adequate treatment of cash collateral?

Q29. What are the practical problems with Tri-Party transactions?

Q30. What are current practices regarding the re-use of received collateral?

Q31. What will be the impact if re-use of collateral was no longer possible?

Q27.

Segregation is an essential element in the protection of scheme assets. Assets should be segregated not only from the counterparty's assets but from those of the counterparty's clients. The assets shall be held by a custodian.

With this solution, there would be no danger that the parameters of the portfolio are changed by collateral transformation and the collateral would not be lost when the counterparty defaults. The disadvantage could be the cost of maintaining and monitoring multiple segregated pledged accounts.

We do not see the need to implement segregated pledged accounts for VM collateral. We see a clear distinction between IM and VM and the way it should be treated.

Q28.

We are against use of cash as collateral because IORPs, as long-term investors, are not significant holders of cash and because of the re-investment risks that are inevitably involved in cash collateral. These risks would sum up with practical problems linked to the use of cash collateral (e.g. no control over fees for use of cash collateral, which would lead to more risky and expensive management).

Q29.

More payment and collateral flows, greater time-critical and, as a consequence, more intensive monitoring. Also, the contracts are more difficult and expensive to negotiate.

Q30.

Most VM is re-used. Some IORPs re-use VM as well

Q31.

There are different views among our members about the re-use of collateral. Some are in favour of the practice and see liquidity squeeze and systemic crisis as a consequence of its interdiction; others see re-use of VM as incompatible with the segregation of their assets.

Q32. What are, in your view, the advantages and disadvantages of the two options?
Q33. Should there be a broader range of eligible collateral, including also other assets (including non-financial assets)? If so, which kind of assets should be included? Should a broader range of collateral be restricted to certain types of counterparties?
Q34. What consequences would changing the range of eligible collateral have for market practices?
Q35. What other criteria and factors could be used to determine eligible collateral?

Q.32

A major disadvantage of option 1 is that there will not be sufficient collateral available. An advantage of option 2 is that it creates more flexibility to choose the appropriate collateral to mitigate a specific risk.

Q33.

In theory every asset can function as collateral as long as the appropriate haircuts are applied. The type and range of collateral should for example be linked to the credit quality of the counterparty.

Q34.

A range of eligible collateral too narrowly defined would lead to a reduction of the market availability for these types of collateral: This might be harmful in times of stress, when the demand for this type of collateral would increase jointly with its price, thus engendering the risk that a party at risk of default would have difficulties in obtaining the type of collateral it needs to hedge against the same risk. Therefore, a too narrow definition may actually bring to an increase of the systemic risk it was originally meant to decrease.

Q35.

Liquidity (in stress) and non-correlation of the collateral.

Q36. What is the current practice regarding the frequency of collateral valuation?
Q37. For which types of transactions / counterparties should a daily collateral valuation not be mandatory?
Q38. What are the cost implications of a more frequent valuation of collateral?

Q36.

Daily valuation.

Q37.

In theory, this would apply to less liquid collateral provided appropriate haircuts are applied.

Q38.

Not relevant.

Q39. Do you think that counterparties should be allowed to use own estimates of haircuts, subject to the fulfilment of certain minimum requirements?
Q40. Do you support the use of own estimates of haircuts to be limited to PRFCs?

Q39.

Yes, if models behind these estimates are validated by independent third parties and both parties agree.

Q40.

Again, we feel that the categorisation of PRFCs, NFCs etc. is inappropriate.

Q41. In your view, what criteria and factors should be met to ensure counterparties have a robust operational process for the exchange of collateral?
Q42. What incremental costs do you expect from setting up and maintaining robust operational processes?
Q43. What are your views regarding setting a cap for the minimum threshold amount? How should such cap be set?
Q44. How would setting a cap impact markets, transactions and business models?

Q41.

Counterparties should be able to value, collect and post collateral on a daily basis. They should be able to give full insight in all collateral positions (IM, VM, posted, collected) on a daily basis.

Q42.

This depends on the difference between the current practice and the required practice.

Q43.

We agree to a cap on MTAs. The height of the cap should be dependent on the size of the cash flow in relation to the cost of transferring the collateral.

Q44.

This would depend on the height of the cap. See answer to previous question.

Q45. In your views, what should be considered as a practical or legal impediment to the prompt transfer of own funds or repayment of liabilities between the counterparties?
Q46. What is the current practice regarding the collateralisation of intra-group derivative transactions?

Q45.

Q46.

In some cases IORPs have, for the purposes of professional management, improved risk management and to benefit from economies of scale, outsourced the day-to-day management of their assets to an individual or joint service administration company. These service administration companies are separate organizational entities, although owned/controlled by the IORP and/or are dedicated to operating solely for the benefit of the IORP. Many of these service administration companies facilitate pooling structures for IORPs in order to maximize returns from a purely operational and administrative perspective against the lowest possible costs. Within such a pension pooling structure, both the pension funds and the collective investment vehicles enter into derivatives contracts with so-called treasury entities. These treasury entities are set up for "internal" netting purposes and operational efficiencies. By netting their positions through a treasury entity, pension funds limit their exposure to external counterparties. The treasury entity acts solely and exclusively in the interest of the pension funds. All of these entities fall within the scope of the definition of pension scheme arrangements, but their transactions do not necessarily fall under the definition of intra-group transactions. If the transactions between these entities would be subject to (daily collateral exchange) requirements any benefit of using a pooled vehicle would disappear. Therefore, in order to avoid a disproportionate cost impact the "internal" trades of the pension funds and the collective investments vehicles with the treasury entity should not be made subject to margin requirements.

Q47. What is the impact of the presented options on the capital and collateral requirements of the counterparties affected by the relevant provisions and the span of time necessary to comply with the Regulation?

Q47.

For long-term investors the availability of eligible collateral is crucial. Especially the posting of IM could have a disastrous impact on the performance, as investors must hold large portfolio's of assets with low yields. If the costs of hedging risks increase, the business case for hedging could be reconsidered, possibly leading to less hedging and hence increasing risks in the system.

For pension schemes arrangements, the one-sided exposure in particular in relation to interest rates is considered a reduction of the interest risk of the liabilities. By contrast, the financial markets perceive these interest rate transactions as increasing risk.
