European Market Infrastructure Regulation (EMIR): Pension fund exemption on central clearing

Finding a solution for cash variation margin remains the main concern

Executive Summary

The fundamental issue for pension funds in relation to central clearing remains their inability to post variation margin (VM) in cash. While we support voluntary clearing for pension funds and have demonstrated this by investing heavily in preparing for clearing, it is critical to find a solution for the cash VM issue that would work (a) in stressed market conditions and (b) without a material adverse effect on pensioners (including disproportionate risk or cost), before mandatory clearing is applied to pension funds.

We agree with the European Commission that Central Counterparties (CCPs) and the relevant market participants need at least two more years to develop and implement solutions for the cash VM issue.

We propose a three step approach to address this issue: First, CCPs and all stakeholders need to find an appropriate solution for the posting of non-cash VM by pension funds for central clearing without introducing any material adverse effect on pensioners. Secondly, if that is not achievable, all stakeholders including policymakers need to identify and develop solutions that address the liquidity and transformation risks that arise in stressed market circumstances as a result of the cash collateral demand imposed on pension funds. One potential solution could be to explore the feasibility of a guaranteed repo facility that pension funds could access under extreme market conditions. Thirdly, if no such solutions are found for the cash VM problem, a permanent exemption needs to be considered.

We prefer options one and two rather than a permanent exemption.

Introduction

We, the pension funds, pension service providers and pension stakeholders, recognise the principles of EMIR. We see the benefits of EMIR, which are increased safety and transparency of the OTC derivatives markets. We understand that an obligation to centrally clear OTC derivatives could be important to reach these goals. However, we can only support central clearing for pension funds if a robust solution is found for our top priority issue: the adverse consequences arising from the CCP requirement to post variation margin (VM) in cash (and not securities) under central clearing.

European pension funds use derivatives to manage the risks related to the financial solvency of pension schemes. They naturally have large, long-dated and one-directional OTC derivatives positions which will be negatively impacted under EMIR. The central clearing of OTC derivative contracts, as currently framed under EMIR, will have 1) a significant adverse effect on pensioners' income and 2) introduce new liquidity risks. The potential adverse impacts of the CCPs' current implementation model for EMIR are therefore twofold.

1) Example of non-cash VM would be high quality securities such as government bonds

We appreciate that the European Commission has studied and subsequently confirmed the disproportionately negative impact on retirement income in the EU of central clearing and the CCP requirement for cash VM.
The European Commission has consequently adopted a Delegated Act in order to facilitate a further two-year exemption of the clearing obligation for pension funds.

We reach out to all relevant stakeholders, such as CCPs and clearing members, but also to legislators and regulators, to create a market infrastructure that adheres to the principles of EMIR but in which the costs to European pensioners are no longer disproportionate. There has not been enough focus on finding a solution that will lead to a robust infrastructure that works for pension funds. It has been an uphill struggle for pension funds to encourage the industry to consider the issue of posting non-cash VM as the stakeholders have been preoccupied with preparing for mandatory clearing, which has still not started due to delayed timelines.

To date, the temporary pension fund exemption has not delivered what was originally intended as pension funds have been exempt from a clearing obligation that still does not exist. Furthermore, it seems the temporary exemption will expire whether or not a robust solution for the underlying problems has been found. In this paper we set out the adverse effects of EMIR for pension funds, explain why the current industry initiatives fail to solve the cash VM issue, and our suggested three-step approach.

Negative impact on pensioners' income

The European Commission published a report prepared by Europe Economics and Bourse Consult on February 3, 2015[2]. This report recommends granting pension funds a further two-year exemption from central clearing. The report, which is based on an extensive study requested by the European Commission, concludes that CCPs need more time to find solutions for pension funds.

The key takeaways from this report are that none of the models assessed stands out as the obvious solution to the issue, further effort is needed by the clearing industry to find a solution for the cash VM issue, and that the negative impact of central clearing on pensioners remains very significant. Estimates show that the costs to pensions funds of mandatory clearing would range from € 2.3 billion to € 4.7[3] billion **annually** and the expected impact could be up to 3.66%[4] over 20 to 40 years on retirement incomes across the EU; It is clear that this is a **disproportionate** impact, which outweighs the potential benefits of mandatory clearing.

On the basis of this report the European Commission concluded overall that *"the necessary effort to develop appropriate technical solutions has not been made at this point in time and that the adverse effect of centrally clearing derivative contracts on the retirement benefits of future pensioners remains unchanged"*[5]. The European Commission therefore extended the existing three-year exemption period by two years through means of a Delegated Act. Moreover, the European Commission does not exclude a further extension of the exemption by another year, depending on market developments. Whether the shortcomings of the existing CCPs' clearing model will be addressed over the next two years will highly influence the next decision by the Commission.

The clearing exemption is due to expire in August 2017 (or August 2018 if extended to the maximum currently allowed within EMIR). In the absence of an extension to the current

2) Baseline report on solutions for the posting of non-cash collateral to central counterparties by pension scheme arrangements: a report for the European Commission prepared by Europe Economics and Bourse Consult (referred to as the Europe Economics and Bourse Consult report in the following footnotes).
http://ec.europa.eu/finance/financial-markets/docs/derivatives/150203-external-study_en.pdf
3) Page 10, Europe Economics and Bourse Consult report.
4) Page 68, Europe Economics and Bourse Consult report.
5) Section 4.4, REPORT FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT AND THE COUNCIL under Article 85(2) of Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade

exemption, we expect that most pension funds would be required to clear from April 2017. The exemption has not therefore delivered a relief from mandatory clearing for three to six years as originally envisaged, as the clearing obligation is still not effective for non-pension fund market participants. We reiterate the importance of the exemption not expiring before a robust solution is found for the cash VM issue that could be relied upon in stressed market conditions without a material adverse effect on pensioners.

New liquidity risk introduced

The total cash collateral demand following from EMIR and the margin policies of CCPs is very significant. The previously mentioned report demonstrates that following a 100bp (1%) movement in interest rates the total cash collateral call would be €205 billion to €255 billion for European pension funds. The report also highlights more stressed scenarios can result in total cash collateral call on pension funds of up to €420 billion[6].

Pension funds are typically fully invested and minimise their allocations to cash to reflect the long-term nature of their pension fund obligations and therefore to generate long-term returns. Mandatory clearing for pension funds would therefore introduce significant new liquidity and transformation risk as they would be forced to meet VM calls by either liquidating existing investments at very short notice (1 day) or attempting to repo their assets. This is a new risk for pension funds as they have previously been able to post VM in the form of high quality government bond securities.

Pension funds would not have the ability to manage this liquidity risk in stressed market conditions. This is exactly when central clearing is meant to provide stability to the financial system. Only central banks can provide the ability to mitigate liquidity risk in these circumstances.

Unlike banks, and to some extent CCPs with the recent developments, pension funds do not have access to central bank liquidity as the liquidity provider of last resort.

This new liquidity risk will potentially have wider market implications. It applies additional stress on a repo market that is already shrinking as a result of bank capital regulations. It potentially exacerbates downward pressure on falling asset prices in stressed market conditions as pension funds sell out of their physical assets (such as bonds and equities) in order to meet the cash VM calls. All this, we believe, conflicts with EMIR policymakers' objective of reducing risk and avoiding pro-cyclicality.

Industry initiatives

The report from Europe Economics and Bourse Consult looked into a variety of options including collateral transformation by clearing members (CMs) or CCPs and the direct acceptance of non-cash VM or a (quad-party) security interest. Although some industry initiatives are being developed to address the cash VM issue, many are still at early stages and not all options suggested by the report are being developed. Our focus has largely been on widening repo market participation to pension funds allowing them to transform securities collateral to cash more easily. However, these industry initiatives are only likely to work under normal market conditions and, in their currently anticipated form, cannot be relied upon as a solution for the cash VM issue in stressed market conditions which is precisely when clearing must work.

While the repo market may offer an effective mechanism for collateral transformation under normal market conditions, repos introduce other risks including counterparty credit risk, liquidity risk and roll (or maturity transformation) risk. Furthermore, the demand from pension funds would significantly exceed current repo market capacity and it would therefore not be prudent for pension funds to rely on it.

repositories, assessing the progress and effort made by CCPs in developing technical solutions for the transfer by pension scheme arrangements of non-cash collateral as variation margins, as well as the need for any measures to facilitate such solution /* COM/2015/039 final */. http://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:52015DC0039&from=EN

6) Page 10, Europe Economics and Bourse Consult report.

"It can be seen that the total VM requirement for [a 100 bps or 1% move in rates] would exceed the apparent daily capacity of the UK gilt repo markets and would likely exceed the relevant parts of the European government bond repo market — i.e. primarily that in German bunds". [7]

The collateral transformation liquidity risk is further exacerbated by the impact on banks of other regulatory reforms as confirmed by the International Capital Market Association (ICMA) December 2014 report[8]. As the Europe Economics and Bourse Consult paper sets out, *"there are serious concerns that the repo market, as presently constructed, could not meet the liquidity demands of the PSAs in times of stress"*[9].

If a robust solution is not found for the material issues that arise for pension funds from mandatory clearing of OTC derivatives, EMIR's effect would be the opposite of what was intended. It would lead to an increase in risk combined with a significant impact on the pension income for many millions of European citizens.

Three steps towards a solution

We are supportive of mandatory clearing for pension funds only if an effective solution can be found for the crucial issue of cash VM.

We recommend the following three step approach under EMIR to address the material issues that the mandatory clearing requirement creates for pension funds:

1. Pension funds should receive appropriate treatment under EMIR for central clearing. For example, pension funds should be allowed to post non-cash VM[10] for central clearing without significantly affecting the pricing or liquidity of the underlying contracts. As EMIR Level 1 text recital 26 sets out "*...a technical solution should take into account the special role of pension scheme arrangements and avoid materially adverse effects on pensioners*"[11]. Until now, no comprehensive solutions have been identified or implemented, as confirmed by the report commissioned by the Commission. Pension funds cannot solve this issue by themselves: it is also the responsibility of the clearing industry and the legislators and we are very active in cooperating with all stakeholders to find a viable solution.

2. If the collective effort of the various stakeholders fails to develop an appropriate solution where securities collateral can be posted as VM, solutions that address the liquidity and transformation risks in case of stressed market situations should be developed with the help of all stakeholders including policymakers. It is important to acknowledge that central banks provide the only reliable source of market liquidity in stressed market conditions. One potential solution could be to explore the feasibility of a guaranteed repo facility that pension funds could access under extreme market conditions, either directly or indirectly from central banks.

7) Pages 66 and 74, Europe Economics and Bourse Consult report.
8) "The reduction in repo activity revealed by the latest survey was widely expected and is seen as reflecting subdued business conditions and the impact of leverage and liquidity regulations aimed at reducing the reliance of banks on short-term wholesale funding". Page 4, International Capital Market Association, European repo market survey, number 28 conducted December 2014, published February 2015. http://www.icmagroup.org/Regulatory-Policy-and-Market-Practice/short-term-markets/Repo-Markets/repo/latest/
9) Page 15, Europe Economics and Bourse Consult report.
10) Example of non-cash VM would be high quality securities such as government bonds.
11) Recital 26. European Market Infrastructure Regulation Level 1 text. 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. http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32012R0648&from=EN

3. A permanent exemption should be considered if neither of the above options are delivered. The non-cleared OTC derivatives market must therefore continue to provide pension funds with an effective mechanism to transact OTC derivatives. To this end, the impact of all applicable regulations to banks and CCPs needs to be assessed in combination and not in isolation. This is particularly relevant with respect to the bank capital regulations CRD IV/CRR. These are expected to incentivise cash VM for non-cleared OTC derivatives transactions (through the leverage ratio and net stable funding ratio rules that are due to be implemented). This would extend the cash VM issue into the non-cleared markets as well. The new banking regulations are also expected to lead to a shrinking repo market. This would reduce the market capacity for transforming securities into cash, while at the same time increasing demand. As the Basel discussions look to overhaul the current credit valuation adjustment (CVA) methodology, we note that the current CVA exemption for transactions by pension funds not subject to mandatory clearing needs to be maintained in order for such an exemption to be effective.

We favour options one and two over a permanent exemption from mandatory clearing of OTC derivatives.

EMIR: state of affairs

The EMIR legislation entered into force on August 16 2012 and has direct legislative force in all EU member states. Over the coming months the various obligations arising from the regulation will be phased in.

Temporary exemption: Pension funds have been granted a three-year exemption from the clearing obligation in article 89 of EMIR (provided the transaction has been entered into to reduce investment risk that directly influences their solvency). This exemption applies as of August 2012. Article 85 of EMIR provides for an extension of this exemption by the EC in consultation with EIOPA and ESMA by two years and subsequently by another year. However, the exempted OTC-derivative transactions are caught by the detailed rules on non-cleared transactions that enter into force on the basis of article 11 of EMIR (and for which the level 2 regulations have been drafted but are not yet finalised). The EC report presented on 3 February 2015 recommends extending it for another two years. This takes form of a delegated act which was presented on 5 June 2015.

Rationale for the temporary exemption as set out in recital (26) of EMIR:
"Entities operating pension scheme arrangements, the primary purpose of which is to provide benefits upon retirement, usually in the form of payments for life, but also as payments made for a temporary period or as a lump sum, typically minimise their allocation to cash in order to maximise the efficiency and the return for their policy holders. Hence, requiring such entities to clear OTC derivative contracts centrally would lead to divesting a significant proportion of their assets for cash in order for them to meet the ongoing margin requirements of CCPs. To avoid a likely negative impact of such a requirement on the retirement income of future pensioners, the clearing obligation should not apply to pension schemes until a suitable technical solution for the transfer of non-cash collateral as variation margins is developed by CCPs to address this problem. Such a technical solution should take into account the special role of pension scheme arrangements and avoid materially adverse effects on pensioners."

The above has no bearing on the detailed rules on non-cleared OTC-derivatives (level 2) as these rules still have to be formulated.

This paper expresses the view of the following pension funds, pension service providers and pension stakeholders:

ABP is the public sector pension fund (NL)
347 billion EUR of assets under management.

APG (NL) EUR 416 billion of assets under management.

Insight Investment (UK) EUR 467 billion of assets under management on behalf of pension fund clients.*

MN (NL) EUR 113 billion of assets under management.

PME is the industry-wide pension fund for the metal and electrical engineering industry (NL)
39,9 billion EUR of assets under management.

PMT is the pension fund for the engineering, mechanical and electric contracting sector (NL) 59,7 billion EUR of assets under management.

PFZW is the healthcare and social welfare fund (NL)
166 billion EUR of assets under management.

PGGM (NL) EUR 187 billion of assets under management.

The Pension Protection Fund (UK) has EUR 31 billion of assets under management.

Rabobank Pensioenfonds (NL) has EUR 22 billion of assets under management.

Syntrus Achmea (NL)
EUR 80 billion of assets under management.

PKA (DK)
EUR 30 billion of assets under management.

ING PF (NL) EUR 25 billion of assets under management.

TKPI (NL) EUR 23 billion of assets under management.

SPF beheer (NL)
18 billion EUR of assets under management.

Timeos Pension Services (NL)
EUR 22 billion of assets under management.

Pensioenfonds Grafische Bedrijven PGB (NL)has
22 EUR billion of assets under management.

In addition to the above, the following pension schemes support this paper:

Allied Domecq First Pension Trust Limited
Aon UK Trustees Limited
Associated British Foods Pension Trustees Limited
AstraZeneca Pensions Trustee Limited
The Church of England Pensions Board
Diageo Pension Trust Limited
EDS Trustee Limited
E.ON Group of the ESPS
HBOS Final Salary Trust Limited
Hewlett-Packard Limited Retirement Benefits Plan
Irish Airlines Superannuation Scheme
J Sainsbury Pension Scheme Trustees Limited
Kingfisher Pension Trustee Limited
National Grid Electricity Group Trustee Limited
Pilkington Brothers Superannuation Trustee Limited
Rentokil Initial Pension Trustee Limited
Serco Pension & Life Assurance Scheme
Tate & Lyle Pension Trustee Limited
Taylor Wimpey Pension Scheme
Whitbread Pension Trustees Limited

* As at 30 June 2015. Assets under management (AUM) are represented by the value of cash securities and other economic exposure managed for clients. Reflects the AUM of the Insight Group (Insight), which includes Insight Investment Management (Global) Limited, Pareto Investment Management Limited, Insight Investment Funds Management Limited, Cutwater Investor Services Corporation and Cutwater Asset Management Corporation (Cutwater Asset Management). Cutwater Asset Management is owned by BNY Mellon and operated by Insight. Base AUM reported in GBP, FX rates as per WM Reuters 4pm Spot Rates.