Brussels 25th of November 2016

Subject: Welcoming Delegated Regulation extending transitional periods related to pension scheme arrangements under EMIR

Dear Vice President Dombrovskis,

We write on behalf of European pension funds. Together we represent more than €1 trillion of assets managed on behalf of these funds and we are responsible for paying retirement income to millions of European pensioners.

As large European investment managers, pension stakeholders and service providers, we have actively supported the initiatives undertaken by European policymakers to increase the safety and stability of the financial markets. During the past years we have, individually and jointly as a group, responded to several consultations initiated by the Commission as well as the ambitious and challenging Call for Evidence, and we are very grateful that such opportunities were given to enhance transparency and contribute to the legislative process.

EU regulation No 648/2012 on OTC derivatives, central counterparties and trade repositories (EMIR) leads to many concerns regarding the possible impact on retirement incomes. The temporary exemption for European pension schemes arrangements from the requirement to centrally clear derivatives was granted to provide further time for CCPs to develop an alternative solution which would allow pension funds to use securities (such as high quality government bonds) when posting Variation Margin (VM) for cleared trades. Unfortunately, at present there is still no central clearing model that allows pension funds to post non-cash collateral as VM. As such the temporary exemption for European pension funds previously was extended until August 2017.

Given the lack of clearing solution that exists to date for pension funds, we very much welcome the Delegated Act granting one extra year extension of the transitional period related to pension scheme arrangements under EMIR until August 2018. We find it encouraging that policymakers take into consideration the high impact on pension funds, as also outlined by a report for the European Commission prepared by Europe Economics and Bourse Consult dated 25 July 2014.

Nonetheless we would like to remind all those involved that an extension does not bring a viable solution to the table on its own. A coordinated solution is needed with bank capital rules to ensure the integrity of the pension exemption is maintained as set out in our Call for Evidence letter set out in the Annex.

Finally, we remain fully committed to finding a long-term solution for pension funds and we believe it is important that the exemption does not expire until a viable clearing solution is developed. We look forward to engaging with the European Commission in the coming months to discuss options for long-term solutions for pension funds.

APG
MN
Insight Investment
PKA
PGGM

Annex Input Call for Evidence on the EU regulatory framework for financial services dated 29 January 2016

Allied Domecq First Pension Trust Limited	The Trustees of the Elementis Group Pension Scheme	Marks and Spencer Pension Trust Limited
Aon Retirement Plan	E.ON UK Group of the Electricity Supply Pension Scheme	Merchant Navy Ratings Pension Fund Trustees Limited
Associated British Foods Pension Trustees Limited	Goodyear Dunlop Tyres UK Limited Pension Plan	National Grid Electricity Group Trustee Limited
AstraZeneca Pensions Trustee Limited	HBOS Final Salary Trust Limited	Nationwide Pension Fund Trustee Limited
The Trustees of the Atkins Pension Plan	Hewlett-Packard Limited Retirement Benefits Plan	Pilkington Brothers Superannuation Trustee Limited
BOC Pensions Limited	HIPS (Trustees) Limited as Trustee of the Hanson Industrial Pension Scheme	Rentokil Initial Pension Trustee Limited
The Church of England Pensions Board	ICL Pension Trust Limited	The Group Trustees of the RWE npower Group of the Electricity Supply Pension Scheme
Dairy Crest Pension Trustees Limited	Irish Airlines Pensions Limited the Trustee of Irish Airlines (General Employees) Superannuation Scheme	Serco Pension Trustee Limited
DMGT Pension Trustees Limited	J Sainsbury Pension Scheme Trustees Limited	Stanhope Pension Trust Limited
Diageo Pension Trust Limited	Kingfisher Pension Trustee Limited	Tate & Lyle Pension Trust Limited
EDS Trustee Limited	The Kodak Pension Plan (No. 2)	Taylor Wimpey Pension Trustees Limited as Trustee of Taylor Wimpey Pension Scheme

29 January 2016

Jonathan Hill, Lord Hill of Oareford
Commissioner
Financial Stability, Financial Services and Capital Markets Union
European Commission
Rue de la Loi / Wetstraat 200
1049 Brussels
Belgium

Dear Commissioner,

Re: Call for evidence on EU regulatory framework for financial services

We write on behalf of European pension funds, and with concerns that may also affect other institutional investors across Europe. Together we represent more than €1 trillion of assets managed on behalf of European pension funds which are responsible for paying retirement income to many European pensioners. As large European investment managers, pension stakeholders and service providers, we have actively supported the initiatives undertaken by European policymakers to increase the safety and stability of the financial markets.

While policymakers have historically taken into consideration the wider impact of these initiatives, we are concerned that new regulatory developments could result in unintended consequences for European pension funds and pensioners. We therefore welcome the European Commission's call for evidence looking at how different regulations will interact and the impact thereof on the wider economy.

In this letter, we provide a joint response that covers our main concerns. We may have also submitted individual responses that provide further evidence where available.

Background
European pension funds play an important role in the economy. They pay retirement benefits to pensioners, and by undertaking prudent investment and asset liability risk management exercises, they help to mitigate risks borne ultimately by corporate sponsors on their commitment to back retirement income for their retired employees. For many pension funds, an integral part of their

investment approach is to use over-the-counter (OTC) derivatives to manage their financial solvency risk.

Policymakers have recognised that pension funds "*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.*"[1]

An independent report published by Europe Economics and Bourse Consult for the European Commission estimates that if European pension funds were required to clear their derivative trades and post cash as variation margin (VM), the total cash collateral needed by them to support a 100bps (1%) move in interest rates would amount to €205 billion to €255 billion, increasing to €420 billion in more stressed scenarios. It further estimates that this would cost European pensioners between €2.3 billion and €4.7 billion annually[2]. This is a significant and disproportionate cost to European pensioners.

A transitional provision was provided within the European Markets Infrastructure Regulation (EMIR), giving European pension funds a temporary exemption from the requirement to centrally clear derivatives. This temporary exemption was granted by policymakers to provide further time to find an alternative solution which would allow pension funds to use securities when posting VM for cleared trades. At present there is no central clearing model which would allow pension funds to post high quality securities as VM and as such the temporary exemption for European pension funds remains in place.

Furthermore, a corresponding exemption was mirrored within the Capital Requirement Regulation (CRR). Under this exemption, banks were not required to apply the Credit Valuation Adjustment (CVA) rules to derivative trades executed with pension funds as long as the EMIR temporary exemption applied. This ensured that the non-cleared derivative markets remained workable for pension funds, meaning pension funds would be able to use non-cleared derivatives and post high-quality non-cash collateral as VM.

Our concerns

We have welcomed the above initiatives, which have enabled European pension funds to continue managing risk effectively, and allowed them to fulfil their obligations to pay retirement benefits to pensioners. However, there are further developments within the regulatory framework which give us cause for concern, and we explain these concerns below.

- **Leverage ratio and net stable funding ratio (NSFR) rules are expected to force pension funds to post VM in cash only, and not permit high quality government bonds, for collateralising non-cleared derivative trades**

  The leverage ratio and NSFR rules only allow cash VM to offset any positive mark-to-market exposures borne by a bank on OTC derivatives positions. Non-cash VM, even high quality government bonds, are not permitted to offset the mark-to-market exposures. As a result, many banks are now restricting OTC derivatives trades to those that are collateralised with cash VM

---

[1] 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 found here:
http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32012R0648&from=EN

[2] Page 10. *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* can be found here: http://ec.europa.eu/finance/financial-markets/docs/derivatives/150203-external-study_en.pdf

only, where previously banks would also accept high quality government bonds as VM. We expect this trend to continue and thereby reduce liquidity within the OTC derivatives market.

This is likely to force European pension funds to either post VM in cash, or be shut out of the derivatives market. This goes against the earlier policy objective reached by European policymakers for EMIR and CRR where it was recognised that pension funds should not be forced to post margin in cash and that the non-cleared markets must remain workable for them.

As set out above, the Europe Economics and Bourse Consult paper estimates that an extra €205 billion to €420 billion of cash collateral would be needed if European pension funds were required to post cash VM, and cost European pensioners €2.3 billion to €4.7 billion annually. While this report focuses on the potential impact of central clearing on pension funds, we would expect the impact to be similar where pension funds are forced to post VM in cash for non-cleared trades as a result of leverage ratio and NSFR rules. This is a significant and disproportionate cost to European pensioners.

These rules would force pension funds to either divest physical assets (such as bonds and equities) to release the required cash, or avoid using derivatives. This would increase the likelihood that pension funds would not be able to manage their financial solvency prudently. We believe this also goes against the policymakers' desire for further investment and growth in the economy.

The leverage ratio and the NSFR rules also create wider market concerns. We believe these rules will significantly increase the demand for cash, especially in times of stress (when large VM calls would be expected). This is likely to significantly increase liquidity risk and exacerbate downward pressure on falling asset prices as market participants sell out of physical assets in order to meet cash VM calls. This would therefore increase pro-cyclicality risk and reduce financial stability.

We would like to highlight that cash is not less risky than high quality government bond collateral. Cash would ultimately be invested on an overnight basis in financial instruments including bank deposits, bank certificates of deposit, and bank floating rate notes. These instruments bear bank credit risk and we believe they are typically less credit-worthy than high quality government bonds.

We request that policymakers consider allowing high quality government bonds, with appropriate haircuts, to offset the market-to-market exposures of OTC derivatives in leverage ratio and NSFR calculations.

- **Negative impact on the high quality government bond repo markets arising from bank capital rules**

The high quality government bond repurchase agreement (repo) market plays a crucial role in the functioning and smooth running of financial markets by providing access to liquidity and allowing market participants to transform securities into cash which can, for example, be used as collateral for posting VM. The importance of this market will grow as demand for cash increases significantly once mandated central clearing is fully implemented in Europe (because clearing houses only accept cash as VM), and as the leverage ratio and NSFR come fully into force.

However, as a result of the bank capital rules, the cost of running a repo business has increased disproportionately for banks and as such banks' appetite to support this important market is shrinking and we expect this trend to continue. A recent report published by the International Capital Market Association (ICMA) estimates that where the historical bid-offer spreads of short-dated liquid instruments were in the region of 5bps (0.05%) or less, the break-even rate to make the repo business profitable for banks following the introduction of leverage ratio rules is likely to range from 40bps (0.40%) up to potentially 75bps (0.75%)[3]. The leverage ratio, NSFR, liquidity coverage ratio and other bank capital rules are expected to have a profound impact on the repo market, resulting in repos becoming unprofitable for banks as a traded product.

At a time when regulation is expected to significantly increase the demand for cash, a shrinking repo market would reduce the supply of cash. We are concerned the combination of the two would reduce financial stability and is likely to cause a liquidity crisis in the future. The consequence of a dysfunctional repo market must not be underestimated. If market participants are unable to transform their high quality securities collateral into cash quickly, cash VM calls on cleared and non-cleared trades may not be met, which could lead to market participants defaulting on their contracts or forced unwinds of positions at a time of market stress which would further exacerbate any crisis.

It must also be noted that any negative impact on the repo market would likely have a corresponding negative impact on physical bond market liquidity and derivatives pricing. This is because repo market liquidity is closely linked to liquidity of the underlying physical bond, and repo market pricing can be an important determinant of pricing many financial market instruments.

We request that policymakers recognise the importance of the high quality government bond repo market and support the smooth functioning of this very important market. We further request that a full analysis is conducted on the impact of bank regulations, including but not limited to, the leverage ratio, NSFR and liquidity coverage ratios on the repo markets.

- **No robust central clearing solution has yet been developed for pension funds that can be relied upon in stressed market conditions**

While we support voluntary clearing for pension funds and have demonstrated this by investing heavily in preparing for clearing, the fundamental issue for pension funds in relation to central clearing remains their inability to post VM in cash. The EMIR temporary pension exemption must remain in place until a robust solution is found for central clearing for pension funds.

We seek a solution that would allow European pension funds to post non-cash VM such as high quality government bonds for cleared trades. This could either be done through a robust collateral transformation service or by direct acceptance of non-cash VM by clearing houses. *It is critical for any solution to 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.*

While some industry initiatives are being worked on, particularly focused on widening repo market participation to transform securities collateral to cash more easily for pension funds, many of them are still at early stages and are only likely to work in normal market conditions. At a time when the repo markets are coming under significant pressure, as explained above, we believe it is unlikely that a solution devised by the industry alone, and based on the repo markets, can be relied upon in stressed market conditions. We would need policymakers' support to ensure that any collateral transformation service can be relied upon in stressed market conditions.

Alternatively, a solution where clearing houses are able to accept non-cash VM directly would provide a solution to this cash VM issue without adding extra pressure to the repo markets. Such clearing models do not currently exist in the market.

We favour the development of a robust solution to the cash VM issue that pension funds can rely upon in all market conditions including stressed market conditions, and without introducing any material adverse effect on pensioners, rather than a permanent exemption for pension funds from

[3] Page 11. *Perspectives from the eye of the storm: The current state and future evolution of the European repo market* published by the International Capital Market Association in November 2015 can be found on the link below: http://www.icmagroup.org/Regulatory-Policy-and-Market-Practice/short-term-markets/Repo-Markets/icma-european-repo-market-reports-and-white-papers/The-current-state-and-future-evolution-of-the-European-repo-market/

central clearing. We recognise the importance of pension funds being able to use cleared derivatives in the new regime post regulatory reform, and therefore we believe it is paramount that a central clearing solution is developed that works for pension funds.

We request the engagement of policymakers and other stakeholders to ensure that any solution that is developed is robust and can be relied upon even in stressed market conditions. Further thoughts on this topic are set out in our industry paper, *European Market Infrastructure Regulation (EMIR): Pension fund exemption on central clearing*, enclosed with this letter.

- **Potential removal of CVA exemption for pension funds**

We understand that regulators have been discussing, and the EBA is currently consulting on, the removal of the CVA exemption provided to banks when trading with pension funds during the period of the EMIR temporary pension exemption. We feel that any removal of this CVA exemption would undermine the temporary exemption provided to pension funds under EMIR and would make the non-cleared OTC derivatives markets unworkable for pension funds by disproportionately increasing the cost of these derivatives. We are concerned that European regulators tasked with implementing the regulation are considering overriding key terms agreed as part of European level 1 policy-making.

We request that the CVA exemption at least remain during the period of the EMIR temporary exemption provided to pension funds.

- **Sovereign issuer concentration rules limit the ability of large pension funds and other institutional investors to manage concentration risks, and disproportionately affect those outside the Eurozone**

The draft EMIR level 2 rules put forward by the European Supervisory Authorities on the margining of non-cleared derivatives introduce sovereign issuer concentration rules. We believe these rules are overly complex, limit the ability of pension funds and other institutional investors to manage credit risk in a crisis, and they further disadvantage those using derivatives denominated in non-euro currencies, effectively forcing them to take more risk. We note that these issuer concentration rules are not included in the international recommendation put forward by the Basel Committee on Banking Supervision (BCBS) and the Board of the International Organisation of Securities Commissions (IOSCO).

At a high level, the proposed sovereign issuer concentration rules require that, for large users of derivatives, the amount of government bond collateral supporting non-cleared OTC derivatives from one sovereign issuer cannot exceed 50%. However, the practical implications of fully implementing the detailed rules are highly complex, and may unnecessarily increase operational risk, particularly in stressed markets.

The rules do not provide users of derivatives with sufficient flexibility to manage credit risk. In a crisis, it may be prudent to hold sovereign bonds of the least risky country rather than diversify across more countries, but the rules would prevent this.

Furthermore, the sovereign concentration rule disadvantages pension funds and other institutional investors using derivatives denominated in non-euro currencies, such as British sterling, the Polish zloty, the Hungarian forint and the Swedish krona, to hedge non-euro denominated liabilities. This is due to the fact that only one main sovereign issuer issues bonds in each of those currencies. Users of these non-euro denominated derivatives would therefore not be able to diversify bond collateral across other sovereign issuers without exposing themselves to currency risk.

This disproportionately affects large pension funds based in countries that are within the European Union but are outside the Eurozone and using derivatives to manage their financial solvency. To provide an example, a UK pension fund with British sterling-denominated liabilities would hold British sterling-denominated bonds, issued by the UK government, and would use those UK government bonds to collateralise British sterling-denominated derivatives used to manage its financial solvency risk. However, the proposed sovereign issuer concentration rules would prevent that and require that at least 50% of the sovereign collateral be in either cash or in non-sterling denominated government bonds (for those large pension funds that would be within the scope of these rules).

This would either force these pension funds to hold more cash (which would go against the EMIR level 1 policy objective which recognised that pension funds should not be forced to hold more cash), or force these pension funds to take additional currency risk (both by posting bonds in different currencies to its derivatives contracts, and by holding bonds in currencies that do not match those of its liabilities).

We therefore request that policymakers revisit the need for this rule, especially given the concentration rules do not exist within the BCBS/IOSCO international standards.

Conclusion

Given the above concerns, we request that policymakers consider the impact on pension funds, and institutional investors more generally, of any proposed rules or amendments. Pension funds and other institutional investors often bear the burden of regulatory reform as banks look to pass on any cost or risk impact to their clients. As such it is particularly important that policymakers consider the indirect impact on these institutions, and in particular on European pensioners, even in situations where these institutions are not party to the rules directly as is the case with the bank capital rules.

We look forward to continuing the dialogue on these issues. If you have any questions or comments on our views, please contact any of the undersigned.

Yours sincerely,

APG Asset Management
Eduard van Gelderen
Chief Executive Officer

Insight Investment
Andrew Giles
Chief Investment Officer - Solutions

MN
Gerald Cartigny
Chief Investment Officer

PGGM
Eloy Lindeijer
Chief Investment Management

PKA
Michael Nelleman Pedersen
Chief Investment Officer