**APG Asset Management**

**APG Asset Management N.V. Response**

**to the Second Consultation Paper on Draft regulatory technical standards on risk-mitigation techniques for OTC-derivative contracts not cleared by a CCP under Article 11(15) of Regulation (EU) No 648/2012**

**10 July 2015**

**Introduction**

APG Asset Management N.V. (“APG AM”) recognizes the principles of the European Markets Infrastructure Regulation) (**EMIR)** of reducing risks in the OTC derivatives market and increasing the transparency on the OTC derivatives market. From a theoretical point of view, we understand that mandatory clearing of OTC derivatives is seen as an important means to reach these goals. However, any mandatory clearing system should be robust, protect the interests of all market participants and actually decrease risks on markets. The same goes for regulation of the non-cleared OTC derivatives markets. As currently framed, EMIR will not reach these goals.

This paper sets out the issues we have with the collateral requirements under EMIR. It describes the potential negative impact of EMIR’s collateral requirements on pension funds and the difficulties that pension funds may face in finding sufficient eligible collateral to meet regulatory requirements under stressed market conditions.

**Key problems with EMIR and potential solutions**

European pension funds are liability driven investors that need to manage the interest rate risk and currency risk in their investment portfolio. They, naturally, have large and one-directional OTC derivatives positions and are *the* end-users within the clearing system. However, central clearing of OTC derivative contracts, as currently framed under EMIR, will have an adverse effect on pensioners’ income and on financial stability.

EMIR’s potential adverse impact is therefore twofold:

*Negative impact on pensioner’s income*

* An important element of mandatory clearing is the posting of (cash) collateral for OTC derivative contracts. The issue for pension funds is primarily, but not only, related to cash variation margin (cash VM) that they are required to post within the clearing system. Pension funds currently post non-cash VM and not cash VM, but Central Counterparties (**CCPs**) require VM to be in cash. Pension funds are not allowed to post securities as VM.
* Pension funds are fully invested and do not have large volumes of cash available. Keeping a large pool of cash pool of cash collateral available, would also be extremely costly and be to the detriments of pensioners. The cash VM requirements would result in a very significant opportunity loss for pension funds, having a disproportionate negative impact on pension investments and pension income. According to the report for the European Commission of Europe Economic and Bourse Consult, the aggregate VM call for a 100 basis point interest rate shock would be a 204-255 billion euro for the EU pension sector. [[1]](#footnote-1) The costs of cash VM could amount to a reduction in pension income of up to 3.1 percent in the Netherlands and 2.3 percent in the United Kingdom based over a period of 40 year. The total expected impact on retirement incomes across the EU over 20-40 years would be up to 3.66%, which is directly attributable to the reduction in investment returns.
* It is clear that this is a disproportionate impact, which outweighs the potential benefits of mandatory clearing.

*Financial stability at risk*

* EMIR will mandate pension funds to collateralize both their cleared and non-cleared OTC derivatives transactions. The total collateral demand following from EMIR and the margin policies of CCPs is very significant. This will expose pension funds to serious liquidity risks, to an extent where pension funds run the risk of not being able to meet the collateral demands under stressed markets conditions. Financial stability may consequently be at risk.
* In the current bilateral non-cleared system the risk of exchanging non-cash collateral for cash collateral lies with banks that have access to central bank liquidity. Under EMIR this transformation risk has been shifted to pension funds that do not have access to central bank liquidity or a lender of last resort. Although some initiatives are being developed to solve the cash VM issue, all potential solutions only work under normal market conditions; they do not work under stressed market conditions. The report of Europe Economics and Bourse Consult highlights that this also applies to the current 'solutions'. The (shrinking) repo market may be helpful under normal markets conditions, but it will be too small in stressed markets. It cannot be relied upon to function in stressed market condition.
* Since the entry into force of EMIR, we have been negotiating with CCPs and clearing members (**CMs**) to prepare for future clearing as this seems unavoidable. It has become clear to us that the margin policies of CCPs and CMs are not risk-based and do not in any way reflect the low risk characteristic of pension funds. These policies will even penalise pension funds. Our main concern is that they will substantially increase costs and liquidity risks for pension funds. Given that pension funds typically use long-dated and one-directional OTC derivatives, the margin policies of CCPs and CMs will not only force pension to post cash as VM to a disproportionate extent, but also impose concentration limits and IM multipliers to their large directional positions. The effect of those policies may be extremely worrying for pension funds. CCPs will not only continue to exclusively accept cash as VM, they also use concentration limits which means that pension funds can, all of a sudden, be required to replace collateral by other collateral. Combined with the cash VM, the IM (multipliers) for large directional positions, this will substantially increase the collateral demand from pension funds, substantially affecting their returns and equally (if not more) importantly increasing liquidity risk.
* We note that the implicit assumption under article 85 EMIR is risk based margin policies that do not have any pro cyclical effects. We do not think that a system that is based on the size of the OTC derivatives book is such a risk based approach. The proposed RTS will further increase the negative effects of margin requirements for pension funds and would have the adverse effect of creating no additional safety (for pension funds), at the expense of even more higher costs and risks. In addition, the RTS will increase operational complexity.
* We note that it should be investigated how other regulatory initiatives and in particular the Capital Requirements Regulation (CRR) interlink with EMIR.
* At present we see the CRR is increasing liquidity risk even more because the imposed capital charges on credit institutions lead to a shrinking repo market. The CRR also incentivises cash variation margin for uncleared OTC derivatives which imposes a significant liquidity risk combined with the obligation to post cash VM obligation for cleared transactions which was the reason to exempt pension funds from mandatory clearing in the first place.
* The leverage ratio calculation in CRR creates serious issues regarding the access to central clearing. If mandatory clearing is imposed on market participants it is not only essential to have direct access to the CCP but also that end users have sufficient clearing limits allocated to them. Furthermore it should be noted that if clearing members have contractual rights to refuse clearing (f.e. the standard ISDA/FOA Addendum makes it very clear that a clearing member has no clearing obligation) or to decrease limits upon notice there is no assurance whatsoever that there is access to central clearing in times of stress.
* We would like to note that while the aggregate collateral demand at macro level may seem manageable, individual markets participants such as pension funds may not be able to meet these demands in periods of market stress. For these reasons, we urge the ESAs to consider the total effect of the (regulatory) collateral demand imposed on pension funds. In doing so, the conclusions of the report of Europe Economic and Bourse Consult should be considered.
* Even though pension funds may be considered important market participants due to their size and scale of their derivatives transactions, they do not pose counterparty credit risk. Pension funds are not leveraged (and are not allowed to be) and are subject to an extensive set of rules regarding their solvency and liability coverage ratios. They are subject to recovery mechanisms and can rebalance 'bad times' by, for instance, the funding and/or backing from sponsor companies, other available tools such as benefit reductions/premium increase mechanism. The theoretical risk of a pension fund is therefore very limited, particularly in mandatory pension systems. The creditworthiness of pension funds should thus be taken into account, particularly as EMIR allows such a risk based approach (which is also reflected in the proposed IM thresholds which are basically de facto exemptions for certain market participant). Based on the proportionality principle, pension fund should be exempted from the IM requirement not only to reflect their low credit risk but also to reflect the inherent intent under EMIR to avoid a disproportionate impact on pension funds. This should not be ignored by the ESAs.
* Furthermore, in the process of determining the exact impact of the margin requirements for non-cleared derivatives, with potentially far-reaching detrimental effects on pension funds, pension funds should be granted an exemption from the IM requirement. Alternatively, it could be considered to give pension funds a higher IM threshold, in which their hedging transactions are excluded.

**Specific remarks regarding proposed RTS**

A number of areas raise concerns from our perspective.

We recommend:

**Question 3**

The current RTS envisages the Standardised Method as well as approved internal initial margin models.

* Implementation issues and timelines. We expect broker-dealers to have a preference for using their internal models. By applying more favourable pricing they may effectively push end users towards using these internal models. This may lead to a wide variety of initial margin models in the market. Counterparties will have to agree bilaterally on the use of initial margin models. In the absence of adequate market standards this will make the implementation process burdensome and costly. It will be difficult for counterparties to implement a variety of initial margin models in their systems. With respect to EMIR reporting we have seen that the absence of market standards (f.e. on the generation of unique trade identifiers (UTIs)), caused significant delays and additional costs. We foresee similar problems when negotiating initial margin models. We therefore urge ESMA to incentivise the use of market standard models.
* Accuracy check, public disclosure and disputes. End users need to be able to check the accurateness of margin calls and also have to be able to dispute (incorrect) margin calls. We acknowledge that Article 1(4) MRM includes an obligation to explain the initial margin model ‘in a way that a knowledgeable third party would be able to replicate the calculation’. We would like to see this clarified so that, like the standardised model, there is full and public disclosure of the approved initial margin model including a calculation tool in a standardised format.

**Question 4**

Concentration limits for collateral should not apply to certain instruments widely used by pension funds, such as corporate and government bonds, for which liquidity is lower in distressed market conditions. We are concerned about the pro cyclical effects of these concentration limits and believe it is an unnecessary requirement, also given the extremely low default risk of pension funds. The proposed threshold does not appreciate the fact that this risk applies to bigger pension funds as well.

Where the collateral pool is small (which is likely to be the case) achieving the prescribed diversification is impractical and unnecessary. Therefore, the proposed prescriptive concentration limits would cause operational issues with no added value.

**Question 6**

We are pleased to see that ESMA recognises the effect that obtaining legal opinions may lead to an excessively burdensome process. We also recognize the fact that there needs to be sufficient legal assurance regarding the effectiveness and enforceability of the segregation structures. The only way to truly tackle the abovementioned items is to use standardised documentation and to have generic legal opinions published with respect to the relevant countries and custodians/(I)CSDs. In practice most custodians/(I)CSDs provide standard (triparty) documentation. It would be beneficial for the market if these custodians/(I)CSDs publish standardised opinions regarding their documentation. On top of that industry bodies could publish additional opinions with respect to the various countries.

**Question 7**

We do not agree with the approach taken on rehypothecation. Although we understand the underlying reasons, we see it as an important liquidity tool, particularly now the collateral demand on pension funds has increased substantially. As such, we consider it as a much needed instrument, particularly where multiple pension funds use a dedicated treasury center for netting benefits and we believe that rehypothecation should be allowed for transactions between pension scheme arrangements as defined under EMIR. When properly managed and controlled it can offer benefits to the financial system, now the collateral demand in aggregate is so substantially increased.

The rehypothecation provisions should only apply if opted for by the client after being informed about the rehypothecation, which is also the approach under the proposed Regulation on securities financing transactions.

We hope that our response is of assistance. Should you require clarification(s) or additional information, please do not hesitate to contact me.

With kind regards,

Zöhre Tali

Head of Regulatory Strategy

1. Baseline report on solutions for the posting of non-cash collateral to central counterparties by pension scheme arrangements, a report for the European Commission by Europe Economics and Bourse Consult, 25 July 2014. [↑](#footnote-ref-1)