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To: European Banking Authority (**EBA**)
One Canada Square (Floor 46)
Canary Wharf
London E14 5AA| UK
From: Russell Investments
Re: Response to Second Consultation Paper: 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 (the *"Consultation"*)[1]

Dear Sir or Madam,

Thank you for the opportunity to provide input in response to the Consultation. The Consultation describes many timely and important themes and raises highly relevant questions. Due to the deadline for comments and considering responses already submitted by other organizations, we are limiting our letter to foreign exchange ("FX"). Notwithstanding the limited nature of our response, Russell would be glad to provide further feedback on any other topics where we can be a resource.

Russell Investments (*"Russell"*) is a leading multi-asset investment management firm managing USD 272.6 billion, at 31 March 2015, for institutional and retail clients in the UK, continental Europe, North America and Asia. A key Russell service offering is foreign exchange currency hedging where we seek to reduce or eliminate the currency risk associated with international exposures within commingled funds we manage and for clients including pension funds, insurers, provincial and governmental entities, and other investors. In all of these instances, Russell always acts as an agent for its clients, rather than a principal.

Russell is extremely concerned that the draft Regulatory Technical Standards that are the subject of the Consultation (*"RTS"*) are unduly burdensome and onerous on EU pension funds and other institutional investors who undertake currency hedging. The burdens are so great, in fact, that we believe they will discourage certain investors from undertaking this prudent risk management activity. There are ways, however, that EBA can dampen that impact and promote prudent, cost-effective risk mitigation practices. We suggest one such potential solution below.

Currency hedging by pension funds is almost universally undertaken with a portfolio of foreign exchange forwards and foreign exchange swaps (as referred to in Article 5 GEN (a) and (b)). Unlike futures contracts these instruments offer pension funds the ability to tailor contract

[1] https://www.eba.europa.eu/documents/10180/1106136/JC-CP-2015-002+JC+CP+on+Risk+Management+Techniques+for+OTC+derivatives+.pdf

maturities to meet their own liquidity schedules. . Furthermore, these instruments allow for well-established risk mitigation techniques (including diversification by counterparty) to reduce pre-settlement risk, master agreements with netting clauses to minimize pre-settlement risk in the event of default, and the use of Continuous Linked Settlement effectively to eliminate settlement risk.

Specifically, it is the combination of the following factors that makes the RTS excessively burdensome:

1. the inclusion of pension funds within the definition of "financial counterparties" (Article 1 GEN 1);

2. an exemption for collecting initial margin on foreign exchange forwards and foreign exchange swaps (Article 5 GEN (a) and (b)) *but no equivalent exemption for variation margin*;

3. the maximum threshold for parties to agree not to collect variation margin (the "minimum transfer amount") being set at EUR 500,000 (Article 4 GEN 1) which is unlikely to provide any relief for pension funds since a currency hedging portfolio of EUR 100 million would be modest in the context of EU-wide pension funds, and a daily currency move of ½% would not be excessive;

4. the phase-in requirements for variation margin being on a shorter timescale, with no explanation, than that for initial margin such that all counterparties will be required to comply by 1 March 2017 (Article 1 FP 6 (b)); and

5. the minimum aggregate average notional amount of non-centrally cleared derivatives for both parties of EUR 8 billion to require exchange of initial margin even by 1 September 2020 (Article 1 FP 3 (e)) not applying to exchange of variation margin.

For the investor who undertakes a prudent and responsible risk management activity such as this (whether undertaken directly or via a professional asset manager), it is unreasonable to impose on that investor the burden of complying with variation margin requirements particularly where it is on a shorter timeframe than is applied to initial margin requirements and, moreover, where the aggregate notional amount of non-centrally cleared derivatives is likely to be such that the client is entirely exempted from initial margin requirements. That would create a poor outcome. The net effect of these requirements, at best, is that it imposes an unnecessary and costly burden and, at worst, may either lead to heightened levels of investment risk (due to less risk mitigation) or lower returns, or both, due to less use of these cost-effective investing techniques.

Furthermore, this RTS requirement is at odds with international standards. In the United States, foreign exchange forwards and foreign exchange swaps have been exempted from

regulation as "swaps" by the Secretary of the Treasury and therefore are not subject to margin requirements for uncleared swaps. The RTS would therefore require EU banks to exchange variation margin on foreign exchange forwards and foreign exchange swaps with a counterparty in a third country when there is no such requirement imposed on banks established in the United States or elsewhere. This would put EU banks at a competitive disadvantage. If this leads to lower use of EU banks, it will lead to concentration in US banks which heighten overall market and counterparty risk.

Therefore, we suggest the following amendments to the RTS, starting with that which we believe would be the most effective:

1. exempt foreign exchange forwards, foreign exchange swaps and currency swaps from the requirement to collect variation margin as well as initial margin by amending Article 5 GEN; failing which

1.1. exempt pension funds from the RTS.

2. apply the EUR 8 billion minimum aggregate average notional amount of non-centrally cleared derivatives to variation margin as well as initial margin; failing which

2.1. materially increase the EUR 500,000 minimum transfer amount threshold in Article 4 GEN 1 to *e.g.*, EUR 5 million or a percentage of the notional amount of exposure to a single counterparty such as 5%; failing which

2.2. align the implementation timetable for variation margin with that for initial margin, so as not to impose the greater implementation burden on those least likely to benefit.

We kindly request the European Supervisory Authorities to re-consider the proposed requirement for counterparties to exchange variation margin on foreign exchange forwards and foreign exchange swaps entered into by pension funds that are objectively measurable as reducing investment risks directly relating to the financial solvency of these funds.

Sincerely,

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