NAPF
Securing the future of pensions

NAPF Response
European Commission Public Consultation
Derivatives and Market Infrastructures

1 About the NAPF

The National Association of Pension Funds (NAPF) is the leading voice of workplace pensions in the UK. We speak for 1,200 pension schemes with some 15 million members and assets of around £800 billion. NAPF members also include over 400 businesses providing essential services to the pensions sector. As major institutional investors dedicated to the provision of occupational pensions for millions of employees and pensioners, our pension scheme members are particularly concerned about the efficiency, integrity and safety of financial markets and their infrastructures.

2 Summary

The NAPF:

- strongly supports action to ensure the safety, soundness and efficiency of CCP clearing houses and repositories;
- welcomes the Commission's decision not to attempt to force all derivative contracts through CCP clearing houses;
- insists that the non-financial counterparty exemption should be available to pension schemes; and
- welcomes moves to encourage the development of standardised contracts where they are currently not available.

In our response, we raise concerns about:

- the reduction in pension schemes' options for risk mitigation if all derivative contracts had to be centrally cleared;
- the apportionment of the capital requirements for central clearing under the current arrangements, which would result in pension schemes effectively subsidising more risky participants; and
- the potential impact on of the cost of pension provision.

3 General Considerations

3.1 While we strongly support action to ensure the safety, soundness and efficiency of CCP clearing houses and repositories, we welcome the Commission's decision not to attempt to force all derivative contracts through CCP clearing houses. We believe that the infrastructure for central clearing for the end-user clients such as pension schemes requires further development before pension schemes could be comfortable in moving to the centrally cleared model. As the Commission itself suggests, for example in the introductory comments to Section 1 on page 3, mandatory central clearing, unless properly devised, could increase – rather than reduce – risk in the financial system.

3.2 We therefore welcome the Commission's proposal to require only standardised 'clearing eligible' contracts to be cleared through a CCP clearing house, and to provide a non-financial counterparty exemption for positions not exceeding a certain threshold. Like corporate end-users of derivatives, pension schemes use derivatives primarily for risk mitigation. Contracts tend to be non-standard contracts tailor-made to meet their requirements – in particular, to mitigate their interest rate, inflation, solvency and longevity risks. Mandatory central clearing would limit the ability of their counterparties to provide the tailor-made contracts that pension schemes need to hedge their liabilities, thus reducing schemes' options for risk mitigation.

3.3 It is essential that pension schemes, which – like corporate end-users – are clients of financial services firms for their risk mitigation needs, should be allowed to benefit from the non-financial counterparty exemption and not be excluded from the exemption by an incorrect definition of 'financial counterparty'. Although major institutional investors, they are not financial services firms. Pension schemes are set up with the sole purpose of providing for the pensions obligations of their sponsoring employer or employers. They do not provide financial services or products and are subject to a different legislative and regulatory regime from financial services companies. They typically delegate the management of their investments to external investment managers. Thus, like their corporate sponsors, pension schemes are clients of the financial sector, rather than financial services firms themselves.

3.4 Again like corporate end-users of derivatives, pension schemes' positions tend to be one-directional. This limits the benefits that they would derive from multi-lateral net settlement, whose provision is one of the main ways that CCP clearing houses reduce risk for their participants. It also means that pension schemes would make a disproportionate contribution to the clearing houses'

capital requirements, as the initial margin requirements that provide the clearing houses' capital buffers are based on participants' net positions. It has been suggested that with mandatory central clearing, pension schemes could end up providing half the clearing houses' capital and have 10 per cent or more of their assets tied up in margin, representing a significant drag on investment performance. This would reduce the affordability of pensions, already under strain from increasing longevity and introduction of legislation and regulation over the years that has turned what were originally intended as discretionary benefits into hard obligations.

3.5 Obliging pension schemes to provide a large part of the clearing houses' capital requirements would be particularly unjustified as they pose little systemic risk to markets or the financial system:

- prohibited from long term borrowing, pension schemes are not a source of credit risk;
- with their assets clearly separated from those of their sponsoring employer, UK pension schemes do not pose risks arising from inter-relatedness; and
- pension schemes' gross derivative positions are relatively small.

3.6 We nevertheless believe that pension schemes would welcome the opportunity for improved access to central derivatives clearing. They would also welcome moves to encourage the development of standardised derivative contracts where they are not currently available. To be acceptable the clearing model must:

- genuinely reduce pension schemes' risks to their counterparties and to the system as whole;
- provide a fair apportionment of the costs of the systems, so that pension schemes do not subsidise less creditworthy participants;
- provide sufficient product flexibility to meet pension schemes' risk mitigation requirements; and
- not materially impact the cost of pension provision.

4 Answers to specific questions

Section I: Clearing and risk mitigation of OTC derivatives

Q1 **[Page 5] What are stakeholders' views on the clearing obligation, the process to determine the eligibility of OTC derivate contracts for mandatory clearing, and its application? Do stakeholders agree that access from trading venues to CCPs clearing eligible contracts should be guaranteed?**

1 Clearing obligation

We explain elsewhere in our response, and in more detail in our answer to your final question (Q 11) on definitions, why pension schemes should be excluded from the definition of 'financial counterparty'.

2 Eligibility for the clearing obligation

We fully support the need for a clearly defined procedure to determine the eligibility of contracts for a clearing obligation. We support the proposed requirement for consultation by ESMA.

Q2 **[Page 5] Do stakeholders share the general approach set out above on the application of the clearing obligation to non-financial counterparties that meet certain thresholds?**

We agree with the general approach set out in section I, paragraph 4.

The consultation document's comments on the need for 'an appropriate legislative approach for the (corporate) end-users of OTC-derivatives' and for 'a sensible system that reflects the economic and financial hedging needs of corporate end-users' applies equally to pension schemes, whose use of derivatives for risk mitigation purposes are similar to corporates'. They should therefore, like corporates, have access to the 'non-financial counterparty' exemption.

The level of the threshold for the 'non-financial counterparty' exemption should take into account the risk that the counterparty poses to the system. There should be a high threshold for pension schemes, which are not geared and do not have systemic linkages.

Q3 **[Page 6] Do stakeholders share the principle and requirements set out above on the risk mitigation techniques for bilateral OTC derivative contracts?**

We agree with the principle and requirements set out in section I, paragraph 5.

Section II: Requirements for Central Counterparties

Q4 **[Page 10] Do stakeholders share the general approach set out above on organisational requirements for CCPs? In particular comments are sought on the role and function of the Risk Committee; whether the governance arrangements and the specific requirements are sufficient to prevent and manage potential conflicts of interest; stringent outsourcing requirements; and participation and transparency requirements?**

Do stakeholders consider that possible conflicts of interests would justify specific rules on the ownership of CCPs? If so, which kind of rules?

We query whether the internal organisational and administrative arrangements described on page 8 would be adequate to handle conflicts of interest between the different participants in the clearing house. For the reasons set out in our answer to Question 6 (on Prudential Requirements), current arrangements for providing for the clearing houses' default fund would represent a large and unacceptable subsidy from low risk counterparties with one-directional exposures, like pension schemes, to higher risk counterparties with large gross positions. Stronger measures, possibly including regulatory controls over charging, are required to protect the interests of participants like corporates and pension schemes that are clients of the clearing houses' more active participants.

Q5 **[Page 11] Do stakeholders share the approach set out above on segregation and portability?**

We believe that the approach should go further to protect investors. As drafted the principles are intended to require better choice and better record keeping, and they acknowledge the desirability of contract portability. This is not enough.

We believe that legislation should require full segregation of all client monies, assets and positions from the house account of the clearing member; and that segregation must be offered at both the clearing house and at the clearing member level. This should not be a matter of choice or negotiation, either for the clearing member, clearing house or indeed financial firm handling the client money or client relationship. Although there is a cost attached to segregation, this should reduce, on a per unit basis, when segregation is universally embraced for the client side of the market.

Q6 **[Page 15] Do stakeholders share the general approach set out above on prudential requirements for CCPs? In particular: what should be the adequate**

level of initial capital? Are exposures of CCPs appropriately measured and managed? Should the default fund be mandatory and what risks should it cover? Should the rank of the different lines of defence of a CCP be specified? Will the collateral requirements and investment policy ensure that CCPs will not be exposed to external risks? Will the provisions ensure the correct management of a default situation? Are the provisions above sufficient to ensure access to central bank liquidity without compromising central banks' independence?

Clearing house margin requirements, based on net positions, discriminate against counterparties with one-directional exposures. Pension schemes, which typically use derivatives to mitigate risks relating to their long-term pension liabilities – for example interest rate, inflation, solvency and longevity risks. We understand that LCH SwapClear, the largest interest rate swap CCP clearing house, has estimated initial margin requirements of 7-9 per cent on swaps maturing in less than 30 years and 12-15 per cent for those maturing in 50 years. Stress simulations have given rise to even higher requirements; indeed, we have heard that it is not unusual in test portfolios for 20 per cent of notional value to be demanded as margin. We have heard that, with such a model for funding the CCP clearing houses' default risk, European pension schemes could end up providing half the clearing houses' default fund. This is particularly unjustified as pension schemes – as ungeared institutions with limited external linkages – pose little systemic risk themselves. Pension schemes would thus effectively be funding a central clearing process designed to reduce systemic risk caused by other market participants. Fairness requires that the costs of supporting the system should be borne predominantly by those representing the greatest systemic risk.

A fair proportioning of costs is important from a wider social perspective. Even if pension schemes had sufficient acceptable collateral readily available at all times, the charges imposed on the assets advanced as collateral would represent a considerable drag on pension schemes' performance, reducing the returns available to pay pensions. Compounded over a number of years, even a relatively small reduction in returns would have a significant impact on the affordability of any given level of pensions. Where acceptable collateral is not readily available, and pension schemes have to switch out of higher earning assets to meet the clearing house's requirements, the drag on investment performance will be even higher.

In more detail:

- One of the main potential drawbacks for pension funds of centrally-cleared contracts is the charges applied on assets posted to meet margin calls, whether this be a charge to hold gilts or a return given by the clearer on cash which is below a fair market rate. The Commission

should consider whether there is a need for requirements on CCP clearing houses for explicit charging limits, so as to keep these charges to a minimum (preferably zero) – particularly in view of the fact that the clearing house might be in an essentially monopolistic position for certain types of contract for which central clearing is required.

- At present, under typical OTC collateralisation arrangements (ISDA/CSA contracts) cash posted to a counterparty attracts interest at SONIA and there is no holding charge imposed by the receiving counterparty at all for physical bonds posted as collateral. By contrast, gilts posted as initial margin for exchange-traded futures do incur a holding cost and the return on cash is below SONIA. Pension schemes could find themselves as substantial contributors to the total margin posted to clearing houses and therefore substantial bearers of these costs. This would represent the pension industry funding a central clearing process designed to reduce systemic risk caused by other market participants. Fairness requires that cost of support CCP clearing houses should be provided by those institutions representing the greatest systemic risk.

- Another key concern for pension schemes of central clearing is the much increased, and more restrictive, margining requirements compared to the collateralisation processes currently existing for OTC transactions. The amount of the initial margin is a principal source of concern since this would represent a one-off addition to the amount of collateral assets required to back a derivative position.

- The use of a simple Value-at-Risk measure to set the initial margin, as suggested in paragraph C(a), takes no account of the credit risk posed by the counterparty entering into the trade. There needs to be a mechanism to reflect the substantially lower credit risk attaching to most pension funds, which should result in a substantially lower initial margin requirement.

- Margin requirements are not static. Initial margin can, for example, be increased in periods of heightened market volatility. This makes it very difficult for pension schemes to plan their collateral asset requirements and is an unnecessary uncertainty given that initial margin need not in practice be posted by pension funds at all in most cases. This argues either for any initial margin for pension schemes to be kept static or for there to be a clearly-defined and publicly available formula for the determination of any initial margin on all centrally cleared contracts.

- UK gilts should be acceptable as variation margin, not just initial margin.

- '*Default Waterfall*' (paragraph F, on page 13): we seek confirmation that segregated client margin accounts will not used to cover losses.

We believe there are a number of amendments to the proposals that would be in keeping with the intent of reform but would not overly penalise end-users who pose no systemic threat:

- ensure a proper balance between default fund and initial margin – Central Counterparties (CCPs) and their clearing members should contribute a far greater amount into the default fund in order to reduce the margin requirements of end-users to a fairer level;

- recognise that conservative investors are lower risk – stable structured investments with low turnover such as pension funds adopting LDI strategies should have reduced collateral requirements for centrally cleared trades; and

- broaden the range of permissible collateral – non-cash collateral should be permissible to cover variation margin as well as initial margin.

Without these amendments European pensioners and taxpayers will be forced to shoulder a high percentage of the financial burden, while higher risk investors like hedge funds and bank trading desks escape relatively unscathed. One of our key concerns is that the reduction of risk in one area (e.g. counterparty credit risk) leads to a series of other unintended risks. As we have already commented, the Commission itself has referred, in the introductory comments to Section 1 on page 3, to the danger that risk will be increased – rather than decreased – if the arrangements are not properly devised.

Q7 **Question on recognition of third country CCPs (page 16).**

N/A

Section III: Interoperability

Q8 **[Page 18] Stakeholders' views are welcomed on the general approach set out above on interoperability and the principles and requirements on managing risks and approval.**

Fragmentation (Interoperability – Introductory Comments, page 16). Under current bilateral arrangements pension funds are able to gain some netting benefits from counterparties by offsetting risks between, for example, their interest rate and inflation swap portfolios. This same effect could only be achieved under central clearing where the clearing house covers the full range of asset classes. Since not all of the transactions used for hedging mandates are suitable for central clearing and CCP product ranges are likely to be fragmented for some time, the scope for a pension fund to net exposures could in fact be reduced by a requirement to clear 'clearing eligible' contracts centrally.

Section IV: Reporting obligation and requirements for trade repositories

Q9 **[Page 20] What are stakeholders' preferred options on the reporting obligation and on how to ensure regulators' access to information with trade repositories? Please explain.**

We prefer Option A. Option B would involve an unnecessary administrative burden on non-financial counterparties. We also believe that, because of the risk of double reporting, it would provide regulators with less accurate information.

As with central clearing, pension schemes – as clients of financial services firms rather than financial services firms themselves – should be defined as non-financial counterparties. We explain elsewhere in our response, and in more detail in our reply to your final question on definitions, why pension schemes should be excluded from the definition of 'financial counterparty'.

Q10 **Question on requirements for trade repositories (page 21).**

N/A.

Section V: Technical reference glossary of definitions

Q11 **[Page 25] Do stakeholders agree with the definitions set out above?**

The definitions of 'financial counterparty' and 'non-financial counterparty' are incorrect. Pension schemes must be excluded from the definition of 'financial counterparty'. Although major institutional investors, pension schemes are not financial services firms. Pension schemes:

- are set up with the sole purpose of providing for the pensions obligations of their sponsoring employer or employers.

- do not provide financial services or products, nor are they involved in any financial intermediation process except to the extent they invest in financial assets from which their members' pensions will be paid.

- are subject to a separate legislative and regulatory regime from financial services companies – in the UK, the Pensions Acts (rather than the Financial Services and Markets Act), with their own regulator, the Pensions Regulator.

- typically delegate, at least in the UK, the management of their investments to external investment managers or, in the case of the largest schemes, to 'in-house' investment managers authorised by the Financial Services Authority to manage the scheme's investments.

Thus, like their corporate sponsors, pension schemes are clients of the financial sector, rather than financial services firms themselves.

As we have argued elsewhere in our response, the definitions of 'financial counterparty' and 'non-financial counterparty' have wide-ranging implications for how pension schemes would be affected by the proposals both for clearing and reporting set out in the Commission's consultation document. Inclusion of pension schemes within the definition of 'financial counterparty' would have a damaging impact on pension schemes and their ability to provide good quality pensions to millions of employees and pensioners, without any benefit in terms of reducing their risks.

July 2010