NAPF Position Paper: Proposed European Regulation on OTC Derivatives, Central Counterparties and Trade Repositories

National Association of Pension Funds

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NAPF Position Paper

Proposed European Regulation on OTC Derivatives,

Central Counterparties and Trade Repositories

1 Summary

- The NAPF strongly supports action to ensure the safety, soundness and efficiency of central counterparty clearing houses and repositories, and welcomes moves to encourage the development of standardised contracts where they are not currently available. But to be acceptable the clearing model must genuinely reduce risks for pension schemes and not increase the cost of pension provision.

- The need to post collateral that is a central feature of the model proposed in the Regulation will reduce pension schemes' investment returns, further increasing the cost for corporate sponsors of providing for their employees' pensions. The proposed Regulation will also reduce pension schemes' opportunities for risk mitigation while introducing new risks, including risks to the safety of scheme assets.

- The NAPF asks for:

  - pension schemes to be allowed access to the 'non-financial counterparty' exemption available to their corporate sponsors. In this context, we support Amendment 9 proposed by the Committee on Legal Affairs in its Draft Opinion of 17 December 2010; this would remove pension funds from the definition of 'financial counterparty'.

  - a fairer division of the costs of central clearing, so that pension schemes are not subsidising more active and less credit-worthy participants.

  - adequate arrangements to ensure the safety of pension scheme assets put up as collateral.

2 About the NAPF

2.1 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 €1,000 billion. Both as major institutional investors and as institutions responsible for the provision of pensions to millions of employees and pensioners, our members support efforts to improve the safety and integrity of financial markets. It is, however, essential that such measures increase the safety and integrity of markets in practice – and that they do so at a cost that does not undermine pension provision.

2.2 An outline of the key characteristics of pensions, in the UK and elsewhere in the European Union, is attached as Annex A.

3 NAPF position on the Derivatives Regulation

3.1 The NAPF strongly supports action to ensure the safety, soundness and efficiency of central counterparty clearing houses and repositories. We believe that pension schemes would welcome the opportunity for improved access to central derivatives clearing. We also welcome moves to encourage the development of standardised derivative contracts where they are not currently available. But to be acceptable the clearing model must genuinely reduce risks for pension schemes and not increase the cost of pension provision.

3.2 We have three main concerns about the impact of the proposed Regulation on pension schemes. These relate to its potential impact on pension schemes' investment returns, and hence on the affordability of pensions; the increased operational risks, including risks to scheme assets put up as collateral, that the proposed Regulation could give rise to; and the likely reduction in opportunities for schemes to access non-standard derivative contracts that more exactly match their long-term pensions liabilities.

- ***Impact on investment returns***. Pension schemes' use of derivatives – like that of corporate end-users – is one-directional, undertaken with the purpose of mitigating risks to the scheme arising from, for example, movements in interest rates or in life expectancy. As the clearing houses' margin requirements are based on net – rather than gross – positions, pension schemes would end up making a disproportionate contribution to the clearing houses' capital requirements, effectively subsidising more active and potentially less creditworthy participants. It has been estimated 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[1]. This would reduce the affordability of pensions, already under strain from increasing longevity and the introduction of legislation and regulation over the years that has turned what were originally intended as discretionary benefits into hard obligations.

- ***Increased operational risks***. Pension schemes are unlikely to be clearing members themselves and would have to access the clearing house through one of its clearing members. They would thus be obliged to accept counterparties that could well be less creditworthy than their current providers of OTC derivative products.

[1] For an estimate of how central clearing would impact schemes pursuing Liability Driven Investment (LDI) strategies, see the Investment Management Association's response to the European Commission's Consultation on Derivatives and Market Infrastructures, July 2010, Annex A (www.investmentfunds.org.uk/policy-and-publications/consultation-responses/responses-and-representations).

Furthermore, it is difficult to see how the collateral that they pass up to the clearing house would remain segregated from the assets of the clearing member and its other clients. This would deprive the scheme of what is usually seen as the most important protection for its assets[2].

- ***Reduced opportunities for risk mitigation***. The proposed Regulation would reduce the ability of investment banks and other financial institutions to provide non-standard derivative contracts tailor-made to meet pension schemes' requirements. Combined with the complexities around collateral management, in its current form the Regulation would complicate rather than help pension schemes' efforts to mitigate the sort of risks that their long-term liabilities for pension provision inevitably give rise to.

3.3 The NAPF is looking for:

- pension schemes to have access to the 'non-financial counterparty' exemption available to their corporate sponsors. We believe that pension schemes are essentially in the same position as their corporate sponsors, whose pensions obligations they are set up to secure.

- a fairer division of the costs of central clearing, so that pension schemes are not subsidising more active and less credit-worthy participants.

- adequate arrangements to ensure the safety of pension scheme assets put up as collateral.

We support Amendment 9 proposed by the Committee on Legal Affairs in its Draft Opinion of 17 December 2010[3] that would remove pension funds (institutions for occupational retirement provision) from the definition of 'financial counterparty' in Article 2 (6).

[2] For a description of the different risks around collateral (written in the context of securities lending), see 'Securities Lending: An introductory guide', Table 1 (pages 4-5) (www.bankofengland.co.uk/markets/gilts/sl_intro_green_9_10.pdf). The particular risks that cash collateral gives rise to are described at the top of page 5 under the heading 'Cash collateral risk'.
[3] European Parliament, Committee on Legal Affairs, 2010/0250(COD).

Annex A: about pension funds

1 Pension schemes were not a cause of the financial crisis[4]. By their nature, they are unlikely to be a source of systemic risk to the rest of the financial system. Because their assets are separate from those of their sponsoring employer[5], they do not pose risks arising from inter-relatedness. Prohibited by law from long-term borrowing[6], neither are they a source of credit risk.

2 In the UK, defined benefit (DB) pension schemes are set up under trust law to provide for employers' promises to pay pensions to their employees. UK pension schemes are subject to their own legislative and regulatory framework[7], separate from banks and other financial institutions. Their assets are separate from the assets of the employer (the scheme sponsor) and are under the control of scheme trustees, rather than the employer. The employer remains responsible for making up any shortfall in the scheme assets. Employers will aim to ensure that the scheme assets are sufficient to meet their pensions obligations by varying employer and employee contribution rates, but they can be required to put in a place a recovery programme if it becomes clear that the assets are inadequate. There is also a guarantee fund (the Pension Protection Fund) that will step in to protect employees and pensioners if the employer becomes bankrupt while there is a deficit in the pension scheme.

3 There are similar security mechanisms in other European Union countries. These were summarised in a survey of technical provisions and security mechanisms published by the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS, since the beginning of this year EIOPA) in March 2008[8].

4 Pension schemes are only allowed to invest in derivatives in so far as their use contributes to reducing investment risk or facilitates portfolio management[9]. They use derivatives to mitigate their interest rate, inflation, solvency and longevity risks. This will frequently involve the use of non-standard derivative contracts that more exactly match their pensions liabilities.

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[4] The De Larosière Report (Report of the High-level Group on Financial Supervision in the EU, Brussels, 25 February 2009: http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf) sets out the causes of the financial crisis in Chapter 1. It makes no reference to pension funds.

[5] Article 8 of the Pensions Directive (IORP Directive, Directive 2003/41/EC) requires legal separation of the sponsoring undertaking and the pension scheme so as to safeguard the assets of the scheme (http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:32003L0041:EN:HTML).

[6] A requirement of the IORP Directive, Article 18 (2).

[7] The Pensions Acts and secondary legislation under the Acts. UK pension schemes have their own regulator, the Pensions Regulator (www.thepensionsregulator.gov.uk). There are further additional statutory requirements on pension schemes, most importantly through social security and tax legislation.

[8] CEIOPS Survey on fully funded, technical provisions and security mechanisms in the European occupational pension sector (CEIOPS-OPSSC-01/08 Final), 31 March 2008, pages 26-28. (https://eiopa.europa.eu/fileadmin/tx_dam/files/publications/submissionstotheec/ReportonFundSecMech.pdf)

[9] The IORP Directive, Article 18 (1) (d) permits 'investment in derivative instruments … insofar as they contribute to a reduction of investment risks or facilitate efficient portfolio management' (Article 18 (1) (d)).