NAPF Response

Joint Committee of European Supervisory Authorities
Discussion Paper: Draft Regulatory Technical Standards
on risk mitigation techniques for OTC derivatives not cleared by a CCP

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 €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 Scope of response

2.1 Our response focuses on the Joint Supervisory Authorities' proposal that parties to bilateral derivative contracts should put up initial margin. It is unclear whether the Authorities envisage that pension schemes will exchange initial margin with their bank counterparties, or whether they will put up but not collect initial margin. Either way, the proposal goes well beyond what was agreed by the Council of Ministers and the European Parliament and undermines the purpose of the temporary exemption from the clearing obligation provided by the Regulation. Adequate and properly controlled variation margin is more than sufficient to provide protection against the risks to individual institutions and to systemic stability about which the Authorities are rightly concerned.

2.2 The reason for the temporary exemption for pension schemes from the clearing obligation is to allow clearing houses time to work out collateral arrangements to meet pension schemes' needs, in relation both to cost and to the safety of their assets. The Investment Management Association has estimated that central clearing under current arrangements would reduce investment returns for a fully immunised Liability Driven Investment (LDI) portfolio by 1.1-1.9 percentage points[1]. Compounded year after year, this drag on performance would hugely increase the cost for companies of providing adequate pensions for their employees and reduce the resources for investment and growth. Most of the additional cost results from the lower return on the margin put up as collateral, particularly the initial margin that would have been required for the sort of long-term derivative transactions that pension schemes enter into for the purposes of risk mitigation. By

[1] Investment Management Association: 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).

mandating the provision of initial margin the Authorities would undermine the intention of the European Parliament and the Council of Ministers in allowing pension schemes a temporary exemption from the clearing obligation.

3 Response to individual questions

Q1 *What effect would the proposals outlined in this discussion paper have on the risk management of insurers and institutions for occupational retirement provision (IORPs)?*

Requiring counterparties to provide initial margin would undermine the effect of the temporary exemption for pension schemes (IORPs) from the clearing obligation provided by the Derivatives Regulation. As explained above (paragraph 2) this would greatly increase the cost for employers of providing adequate pensions for their employees and reduce their resources for investment and growth.

Adequate and well-controlled variation margin should provide sufficient protection against counterparty failure. Existing capital requirements should be sufficient to absorb any residual loss.

It is unclear from the Discussion Paper whether the Authorities see pension schemes as Prudentially Regulated or as Non Prudentially Regulated Financial Counterparties. In the UK pension schemes are subject to statutory funding requirements under the Pensions Act and have their own regulator (the Pensions Regulator) that has oversight over recovery programmes. By their nature they are unlikely to be a source of systemic risk. Because their assets are separate from those of their sponsoring employer, they do not pose risks from inter-relatedness. Prohibited by law from long-term borrowing and from the use of derivatives except for the purposes of risk mitigation or facilitating portfolio management (in line with the requirements of the IORP Directive), neither are they a source of credit risk.

Q2 *What are your views regarding option 1 (general initial margin requirement)?*

The provision of initial margin is unnecessary and runs counter to the intention of the Derivatives Regulation. It would greatly increase the cost for companies of providing adequate pensions for their employees and reduce their resources for investment in growth and employment (see paragraph 2 and our response to Question 1).

Q3 *Could PRFCs adequately protect against default without collecting initial margins?*

Variation margin, combined with normal due diligence and adequate controls (as required by the Derivatives Regulation), is sufficient. Existing capital should be sufficient to cover any residual loss.

Q4 *What are the cost implications of a requirement for PRFC, NPRFC and NFCs+ to post and collect appropriate initial margin? If possible, please provide estimates of opportunity costs of collateral and other incremental compliance cost that may arise from the requirement.*

The Investment Management Association has estimated that central clearing under current arrangements would reduce investment returns for a fully immunised Liability Driven Investment (LDI) portfolio by 1.1-1.9 percentage points (see paragraph 2). Compounded year after year, this drag on performance would hugely increase the cost for companies of providing adequate pensions for their employees and reduce the resources for investment and growth.

Q5 *What are your views regarding option 2?*

Q6 *How – in your opinion - would the proposal of limiting the requirement to post initial margin to NPRFCs and NFCs+, impact the market / competition?*

It is unclear whether the Authorities see pension schemes as Prudentially Regulated or as Non Prudentially Regulated Financial Counterparties. We see no reason for the posting of initial margin. We see even less justification for pension schemes posting margin to counterparties whose credit standing might be no better than their own while not collecting margin in return.

Q27 *What kinds of segregation (e.g., in a segregated account, at an independent third party custodian, etc.) should be possible? What are, in your perspective, the advantages and disadvantages of such segregation?*

Segregation is an essential element in the protection of scheme assets. Assets should be segregated not only from the counterparty's assets but from those of the counterparty's clients. We would usually expect the assets to be held by a custodian.

Q28 *If segregation was required what could, in your view, be a possible/adequate treatment of cash collateral?*

UK pension schemes are conservative in their approach to collateral, insisting on good quality collateral. They are in general opposed to cash collateral both because, as long-term investors, they are not significant holders of cash and because of the re-investment risks that are inevitably involved in cash collateral. We know of no UK scheme that lost out from securities lending at the time of the Lehman Brothers collapse; we understand that the situation was different in the United States, where cash collateral is more common and where some schemes incurred significant losses.

Where cash is provided as collateral, pension schemes may well have no say on the reinvestment criteria or guidelines and will therefore be exposed to both investment and counterparty risks that they would want to avoid. Furthermore, the fees taken for cash collateral management may well be outside their control. Mandatory cash collateral requirements would thus result in pension scheme assets being managed in a more risky and expensive way than pension schemes would accept were it not for the requirements.

Q31 *What will be the impact if re-use of collateral was no longer possible?*

There are different views among our pension scheme members about the re-use of collateral. Some are relaxed about the practice but others see it as incompatible with the segregation of their assets.