Position Paper on EMIR Refit

Executive Summary

- Central counterparties' (CCPs) currently only permit variation margin (VM) to be posted in cash. Requiring pension funds to post cash collateral would diminish returns for European pensioners and create liquidity risk. Estimates put the potential reduction of returns between €2.3 billion and €4.7 billion annually.
- EMIR provided a temporary exemption for pension funds, in order to find a solution for pension funds to access CCPs with non-cash collateral. The European Commission is now providing impetus to this process through a dedicated stakeholder group and the pension sector is fully committed to finding a solution.
- PensionsEurope believes an open-ended exemption is better suited to provide the regulatory calm for market participants to work on a solution. It would also provide the right incentives for all parties involved.
- The proposals for the revision of the Capital Requirements Regulation, in particular the leverage ratio, should not provide disincentives for banks to accept non-cash collateral in bilateral derivatives transactions.

1. Why pension funds use derivatives

For many pension funds, an integral part of their investment approach is to use over-the-counter (OTC) derivatives to manage their financial solvency risk as their liabilities are often long-dated, one-directional and linked to interest rates and/or inflation. Pension funds use these derivatives to reduce the risk of retirees not receiving pension income. Prudent risk management is encouraged by regulators and reduces the burden on pension funds' corporate (or other) sponsors.

Pension funds also invest in high-quality government bonds to hedge their liabilities. However, the ability to hedge liabilities completely with bonds is limited as the amount of bonds that can be used to match long-dated liabilities is inadequate. Derivatives have the advantage of being available for longer maturities and can also be tailored to more accurately match the dates of pension funds' liabilities, which is not generally possible with bonds. The efficient nature of derivatives also allows pension funds to invest in other European investments such as European infrastructure which also provides important social benefits.

It is important to note that Article 18.1(d) of the IORP Directive (2003/41/EC) stipulates that "investment in derivative instruments shall be possible insofar as they contribute to a reduction of investment risks or facilitate efficient portfolio management". This requirement is carried over into the IORP II Directive, which applies from January 2019.

2. Central clearing and the need to post margin in cash pose serious challenges for pension funds

Central counterparties' (CCPs) current operational models only permit variation margin (VM) to be posted in cash, while non-cleared derivatives transactions with banks traditionally allow pension funds to post high-quality government bonds, with appropriate haircuts, as VM.

Pension funds are asset rich and often do not have an allocation towards cash, but they do typically have a large allocation to high-quality government bonds, usually matching the currency of their liabilities. Pension funds therefore wish to carry on posting margin in high-quality government bonds that form part of their investment portfolio. Holding cash buffers reduces returns return and exposes pension funds to credit risks, as in many cases governments bonds may be safer than cash. Having to post cash instead will have significant implications for pension funds' investment portfolios, and therefore for European pensioners and the economy.

An independent report published by Europe Economics and Bourse Consult in 2014 for the European Commission (hereafter referred to as the "Europe Economics and Bourse Consult report") estimates that if European pension funds were required to post VM in cash, the total cash collateral needed by them to support a 100bp (1%) move in rates would amount to €205 billion to €255 billion, increasing to €420 billion in more stressed scenarios. It further estimates that this would cost European pensioners between €2.3 billion and €4.7 billion annually.[1] This is a significant and disproportionate cost to European pensioners. While the likelihood of this move taking place the same day may be small, the cumulative impact of a significant move in rates over a

[1] Page 10. Baseline report on solutions for the posting of non-cash collateral to central counterparties by pension scheme arrangements: a report for the European Commission prepared by Europe Economics and Bourse Consult. 2014

short time period would likely lead to some forced sales of physical assets in unfavourable market conditions to meet these margin calls affecting the financial solvency of pension schemes. As a result, the cash collateral requirement would create liquidity risk in a situation where the risk of default of a pension fund is virtually non-existent.

For these reasons, policymakers provided a transitional provision within the European Market Infrastructure Regulation (EMIR), giving European pension funds a temporary exemption from the requirement to centrally clear derivatives to provide further time to find an alternative solution which would allow pension funds to use high-quality securities, with appropriate haircuts, when posting VM for cleared derivatives. The temporary exemption for European pension funds remains in place until August 2018 and a further three plus two year extension is proposed by the European Commission.

3. The pension fund sector continues to work with other stakeholders to find a solution

During the last few years the pensions industry has engaged extensively with CCPs, banks and other market participants on this cash VM issue, exploring various solutions. However, a robust solution which allows pension funds to post high-quality government bonds as VM that can be relied upon in stressed market conditions has not been developed.

There are a number of reasons for this. Firstly, technically it is a difficult problem to solve, and we believe a solution requires extensive effort and collaboration from a range of stakeholders including both the industry and policymakers.

Secondly, the delay in the European timetable for mandatory clearing in general has meant that banks and CCPs have been focused on preparing for the important mandatory clearing requirements for the market as a whole, and the extra time that was to be provided to solve the pension fund issue after mandated clearing of the rest of the market did not materialise.

The European Commission has now provided impetus to the process of finding a solution, which we strongly welcome. A coalition of 6 major European pension funds and pension service providers[2] is dedicating serious resource and technical expertise to working with CCPs, clearing members and policy-makers to find a market-based solution. This solution will need to satisfy the interest of all stakeholders, increase the resilience of the financial system by reducing liquidity risks, be reliable in stressed market conditions. Most importantly, it should avoid materially adverse effects on pensioners (both in terms of liquidity risk and costs). As a result of these complexities, this process will take time.

4. The importance of extending the exemption

In order to avoid excessive costs and risk for European pensioners, it is imperative that, at the very least, the temporary exemption is extended. If pension funds would be forced to clear centrally, this would take away the incentive for market participants such as CCPs to work towards a solution for the non-cash VM challenge. As a result, the chance of finding a market-based solution would become more remoted. On the other hand, if the exemption is maintained, CCPs stand to gain this additional business only if they cooperate towards a solution.

However, even another time-limited rolling exemption creates uncertainty for pension funds and other market participants. The EU decision-making process can be slow, so at the moment pension funds are worried that the current exemption will run out before the co-legislators come to an agreement on EMIR Refit. We urge EU policy-makers to consider alternative solutions in case this happens, in order to limit uncertainty for pension funds.

Moreover, to avoid this situation persisting in the future and to provide the right incentives to all market participants, **PensionsEurope believes an open-ended exemption is better suited to provide the regulatory calm for market participants to work on a solution**. In our view, the European Commission would then be empowered to revoke the clearing exemption once it has been established, after thorough consultation of the relevant stakeholders and the right to object by the European Parliament and Council, that the cash VM issue has been solved in a manner that protects returns for beneficiaries, and avoids excessive liquidity risk while safeguarding financial stability more generally. **Therefore, this would not constitute a permanent exemption.** It would also provide better incentives for other market participants to work towards a solution on the cash variation margin issue, as for example CCPs currently may assume that that the exemption will eventually run out regardless of the progress made in the stakeholder group.

It should be noted that a permanent exemption would not solve the issue for pension funds. This is because the Basel III leverage ratio and Net Stable Funding Ratio (NSFR) rules provide preferential treatment for cash VM over high-quality government bond VM. As a result of these bank capital rules, banks are increasingly pressurising pension funds to post only cash as VM even on non-cleared trades, creating the same cash VM issue for pension funds for non-cleared trades as they face for cleared trades.[3]

[2] APG, ATP, PKA, MN, Insight Investment, PGGM

[3] While we recognise that the Commission has proposed amendments that mean that CRR would deviate from the Basel III and we would welcome the proposed amendment (Art 428ag (3a)) that would permit VM in the form of Level 1 assets in the calculation of NSFR derivative assets, we remain concerned that this deviation does not our address our concerns about the calibration of these ratios. For example, the leverage ratio is asymmetric in its treatment of cash and Level 1 assets in the leverage, both ratios are asymmetric treatment of initial margin where bilateral trades are disadvantaged; and both are overly penal in their calibration of repos/reverses and thereby overlook the extent to which these instruments are essential to the collateral transformation that pension funds must increasingly undertake. Furthermore, the exemption from the credit valuation adjustment (CVA) that currently applies to pension funds under Article 382(4)(c) of the capital requirements regulation (CRR) must remain intact for as long as pension funds are exempt from central clearing. Similarly, the exclusion of

This is making the non-cleared markets unworkable for pension funds. We therefore call on the Council and Parliament to calibrate the provisions of the Capital Requirements Regulation so that pension funds can continue to access the bilateral market with non-cash VM. In particular, both cash and Level 1 high-quality securities should receive the same treatment under the leverage ratio.

However, even if such changes would be made, we are concerned that the trend of liquidity moving from the bilateral to the cleared markets will continue and therefore a solution must be found for pension funds to access the cleared markets without the described adverse impacts.

5. The scope of the exemption and pension products provided by insurance undertaking

In our view, the scope of the clearing exemption for so-called pension scheme arrangements is appropriate and has functioned well to protect pension income against the aforementioned adverse effects. The exemption not only includes IORPs, but also entities that are recognised under national law to primarily provide retirement benefits. Moreover, EMIR specifically allows life insurance undertakings to make use of the exemption, provided that all assets and liabilities corresponding to the business are ringfenced, managed and organised separately from the other activities of the insurance undertaking, without any possibility of transfer[4]. PensionsEurope supports the current scope, which provides for a level-playing field between the insurance and pension funds.

6. The exemption for small PSAs is welcome

PensionsEurope welcomes the clearing exemption for small financial counterparties, which will benefit small PSAs. In addition to the very low risk of a pension fund default in general, these funds are very small compared to the overall size of the market. The exemption will therefore shield these funds from the additional costs linked to central clearing. Should a commercially attractive solution with government bonds as collateral be developed, these PSAs could still start clearing voluntarily.

7. The review clause should reflect the purpose of the exemption

PensionsEurope questions why the draft amendment to EMIR Article 85 refers to the assessment of viable technical solutions developed to facilitate the transfer of PSAs of “cash and non-cash” collateral as variation margin. The purpose of the exemption to find a solution for the transfer of non-cash collateral. The drafting would therefore be a significant departure from the current EMIR text which frames the clearing obligation in reference to a suitable technical solution developed by CCPs for the transfer of non-cash collateral.

About PensionsEurope

PensionsEurope represents national associations of pension funds and similar institutions for workplace pensions. Some members operate purely individual pension schemes. PensionsEurope Members are large institutional investors representing the buy-side on the financial markets.

PensionsEurope has 23 member associations in 19 EU Member States and 3 other European countries[5] with significant – in size and relevance – workplace pension systems.

PensionsEurope member organisations cover different types of workplace pensions for over 110 million people. Through its Member Associations PensionsEurope represents more than € 4 trillion of assets managed for future pension payments. In addition, many members of PensionsEurope also cover personal pensions, which are connected with an employment relation.

PensionsEurope also has 25 Corporate and Supporter Members which are various service providers and stakeholders that work with IORPs. PensionsEurope has established a Central & Eastern European Countries Forum (CEEC Forum) to discuss issues common to pension systems in that region.

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pension funds from the MiFIR Article 28 trading obligation must remain intact, since this exclusion is expressly linked to Article 89(1) of EMIR

[4] Article 2(10)c of EMIR.

[5] EU Member States: Austria, Belgium, Bulgaria, Croatia, Estonia, Finland, France, Germany, Hungary, Ireland, Italy, Lithuania, Luxembourg, Netherlands, Portugal, Romania, Spain, Sweden, UK. Non-EU Member States: Iceland, Norway, Switzerland.

PensionsEurope has established a Multinational Advisory Group (MAG) which delivers advice on pension issues to PensionsEurope. It provides a collective voice and information sharing for the expertise and opinions of multinationals. What

PensionsEurope stands for

- A regulatory environment encouraging workplace pension membership;
- Ensure that more and more Europeans can benefit from an adequate income in retirement;
- Policies which will enable sufficient contributions and good returns;

Workplace pensions offer

- Economies of scale in governance, administration and asset management;
- Risk pooling and often intergenerational risk-sharing;
- Often “not-for-profit” and some/all of the costs are borne by the employer;
- Members of workplace pension schemes often benefit from a contribution paid by the employer;
- Wide-scale coverage due to mandatory participation, sector-wide participation based on collective agreements and soft-compulsion elements such as auto-enrolment;
- Good governance and alignment of interest due to participation of the main stakeholders.

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