



PensionsEurope response to BCBS's targeted consultation on CVA Risk

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PensionsEurope welcomes the opportunity to comment on the Basel Committee on Banking Supervisions (BCBS)'s targeted consultation on Credit Valuation Adjustment (CVA) risk.

PensionsEurope endorses the efforts of the Basel Committee on Banking Supervision (BCBS) aiming at strengthening the credit valuation adjustment risk framework. Indeed, PensionsEurope acknowledges the importance of ensuring that banks' potential mark-to-market losses due to a deterioration in the creditworthiness of any counterparty are adequately covered and prudently mitigated by the capital risk framework, and recognises the need for alignment with the more recently adopted market risk framework.

PensionsEurope would like to share its views on further additional adjustments of the CVA risk framework that would be needed to mitigate the cost impacts which would be passed on to end-user, more specifically EU pension funds.

1. Although we recognise the need for higher alignment in CVA risk weighted assets (RWAs) calculation methods across jurisdictions, some flexibility in the transposition of the standards under local rules would ensure an appropriate calibration of the framework that takes account of relevant local specificities.
 - The structural differences between the US and the EU pension markets explain that, unlike US pension funds, EU¹ pension funds use OTC derivatives to effectively manage their solvency risk.
 - It is important to ensure that the calibration of the CVA risk framework does not discourage EU pension funds from prudently managing their risks.
2. The CVA risk framework applies a "one-size-fits-all" treatment to all financial entities and does not differentiate the risk weights that will be assigned to different types of financial counterparties with very different creditworthiness profile.
 - EU pension funds post high-quality government bonds as variation margin unlike other counterparties and demonstrate higher creditworthiness than other financial institutions. They are typically conservative investors, neither allowed to be leveraged nor to use derivatives for speculative purposes, employ strict investment policy, and hold high-quality assets including a significant proportion of high-quality government bonds.
 - For these reasons, the treatment applied to pension funds in BA-CVA should be differentiated from the one applied to other financial institutions. Risk weights should be reviewed downwards.
 - Additional credit quality buckets with lower risk weights for highly rated counterparties should be included in BA-CVA.
3. In several jurisdictions, specific counterparties are exempted from any clearing obligation under local rules since the efficiency of their risk management strategy is conditioned upon a guaranteed access to OTC derivative markets.
 - CVA exemptions should be aligned with the exemptions provided by clearing local rules and at least include non-financial counterparties and EU pension funds.

¹ All references to the European Union also apply to the United Kingdom

1. Higher consistency is needed in banks' calculation methods of capital requirements for CVA risk but local markets have relevant specificities that should be recognised in the framework.

PensionsEurope supports the objective of the final revisions of the Basel III reform that consists in reducing the variability in banks' risk-weighted assets (RWAs). Indeed, it is important to increase the homogeneity of RWAs in order to ensure that capital requirements accurately reflect the inherent risks of exposures and to allow a higher comparability of capital ratios both across jurisdictions and across banks. A higher consistency in banks' RWA calculation methods would foster confidence in capital regulation and therefore in the financial markets. For all these reasons, we recognise the need for higher alignment in banks' calculation methods of capital requirements for CVA risk across jurisdictions.

Notwithstanding this, local markets show relevant specificities that should be recognised in the CVA risk framework. In the case of pension funds, it is noteworthy that the structure of the US pension market is significantly different from the EU pension market. These structural differences explain that, unlike US pension funds, EU pension funds use OTC derivatives to effectively manage their solvency risk. It is important to ensure that the calibration of the CVA risk framework does not discourage EU pension funds from prudently managing their risks.

We would therefore recommend the BCBS to provide some flexibility in the transposition of the standards under local rules in order to ensure an appropriate calibration of the framework that takes account of relevant local specificities.

EU pension funds make use of OTC derivatives as an integral part of their investment approach to manage solvency risk.

For most EU pension funds, an integral part of their investment approach is to use 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. The derivatives portfolios used by pension funds are typically long-dated and one-directional, reflecting their liabilities. Combined with the liabilities of the pension schemes, the long-dated, one-directional derivatives portfolio of pension funds results in a more real-world risk-neutral position for pension funds.

US pension schemes typically use corporate bonds as their primary asset for managing financial solvency.

The structure of the US pension market is different from the EU pension market. Unlike EU pension schemes, US pension schemes typically use corporate bonds rather than swaps as their primary asset for managing financial solvency, for several reasons:

- US corporate defined benefit pension funds' liabilities are typically not inflation linked. This has the effect of reducing the average duration of the US pension liabilities (the average term of the liabilities from a risk perspective) to about 10 years.
- The US corporate bond market is broader and deeper, and has greater diversification at long maturities, compared to the European corporate bond market. As a result, the US corporate bond market provides a sufficient maturity profile for hedging US pension funds.
- US pension funds' governance structures typically mean that the corporate sponsor drives hedging decisions, with the key decision maker, often being the Group Treasurer or CFO of the sponsor. The

sponsor's goal in driving the hedging decisions is to minimise the balance sheet impact of their pension fund liabilities. The balance sheet impact is calculated using the US GAAP accounting standard, which broadly discounts liabilities using an AA-rated corporate bond yield. Therefore, a portfolio of AA-rated corporate bonds forms the natural hedging asset for US pension schemes to manage their financial solvency.

EU pension funds face very different circumstances. EU pension funds generally have liabilities that are longer in duration (on average of about 20 years, but they can extend to 50 years), and European corporate bond maturities rarely exceed 10 years. Furthermore, the discounting basis used for calculating the value of EU pension funds' liabilities are more closely linked to swap rates rather than corporate bond yields. For these reasons, the market has developed very differently in the US and EU. US pension funds predominantly use corporate bonds, and not swaps, to manage their financial solvency. It must also be said that the EU pensions market even within the European Union varies from member state to member state.

2. The CVA risk framework lacks risk sensitivity and the adopted risk weights do not appropriately reflect the higher creditworthiness of EU pension funds.

The basic approach for the calculation of CVA capital charges (BA-CVA) applies a "one-size-fits-all" treatment to all financial entities and does not differentiate the risk weights that will be assigned to different types of financial counterparties with very different creditworthiness profile. We believe this approach leads to an overestimation of the CVA risks that EU pension funds bring to the system and needs to be reconsidered.

Indeed, EU pension funds post high quality government bonds with banks as variation margin unlike other counterparties and demonstrate higher creditworthiness than other financial institutions. They are typically conservative investors, neither allowed to be leveraged nor to use derivatives for speculative purposes, employ strict investment policy, and hold high-quality assets including a significant proportion of high-quality government bonds.

- EU pension funds are regulated entities that are typically asset rich, long-term hold to maturity investors, and manage their risks prudently. EU pension funds are not allowed to be leveraged under the IORP II Directive. They are fully funded and in the unlikely case of a potential failure, there is no such thing as a residual debt. Pension funds barely pose (counterparty credit) risk and are very robust and highly creditworthy. There are many cases when banks would post (not receive) independent amounts (ie non-regulatory initial margin) to trade with pension funds.
- EU pension funds have significant control over their financial solidity. They can (i) increase pension premiums; (ii) decide on no indexation of pensions; (iii) decrease the value of pension benefits. Due to the non-leveraged and fully funded profile of pension funds, together with subordinated claim of the pensioners relative to general creditors, pension funds have a unique low risk character. Therefore, the risk of their credit quality deteriorating is extremely small and the chance of pension funds not being able to fulfil their obligations is very limited.
- EU pension funds have extensive ex-ante and ex-post policy measures in place in case the value of the assets of pension funds declines. It is unlikely that a decrease of the value of the assets of pension funds' clients lead to an effect on their counterparties or creditors. In case of underfunding, the recovery mechanisms imposed by the EU prudential framework (mainly benefit cuts or sponsor support) would restore the funding levels of EU pension funds well before they are unable to meet their credit obligations. In some E.U. jurisdictions, quasi-governmental organisations or protection funds are also established in order to ensure that the assets and liabilities of pension funds are protected in the event of default of the corporate sponsor.
- While money deposited at banks may be withdrawn easily, this is not possible with pension entitlements. Therefore, pension funds typically have longer time horizons when investing as they only have to pay entitlements at the retirement age. Their long-term horizon allows pension funds to ride out any turbulent times (intergenerational risk sharing). Deficits do not have to be solved at once and

capital of future generations can absorb investment risks. This trade is possible, because pension funds participants are not able to just leave the pension fund. Consequently, capital at a pension funds cannot be withdrawn at once and a transfer to another pension fund (by massively changing jobs) can only be done if the pension funds is healthy. Hence pension funds cannot create a domino effect as banks.

- EU pension funds demonstrate a certain capacity to play a countercyclical role in the economy since their "client base" (i.e. members) remains relatively stable even in case of economic downturn. Moreover, members typically cannot take their entitlements out until retirement, so there is no risk of a 'run'.
- Under the IORP II Directive, derivatives are only allowed for hedging purposes and efficient portfolio management, not for pure speculative purposes.

The application of CVA capital charges would entail significant indirect cost impacts on EU pension funds. Indeed, since the increase in total banks' RWAs arising from the application of CVA capital charges is significant, banks are incentivized to pass on the additional costs to their counterparties. The resulting increase in the trading costs of derivative transactions would be too punitive for certain counterparties and may undermine their capacity to enter into new derivative contracts. The application of the CVA capital charges would therefore dampen EU pension funds' capacities to effectively manage their solvency risk. This effect would be exacerbated if the framework adopts a too punitive and non-risk sensitive approach which does not recognise the higher creditworthiness of EU pension funds.

Against this background, PensionsEurope recommends the BCBS:

- to differentiate the treatment applied to pension funds in BA-CVA from the one applied to other financial institutions. Risk weights should be reviewed downwards to reflect their higher level of creditworthiness.
- to increase the risk sensitivity of the BA-CVA framework which currently only considers two credit quality buckets – i.e. investment grade and high yield - including additional buckets with lower risk weights for highly rated counterparties, such as defined in the current standardised method for CVA.

3. CVA exemptions should be aligned with the exemptions provided by clearing local rules and at least include non-financial counterparties and EU pension funds.

In several jurisdictions, specific counterparties are exempted from any clearing obligation under local rules since the efficiency of their risk management strategy is conditioned upon a guaranteed access to OTC derivative markets.

In the EU, EMIR provides a temporary exemption from any clearing obligation to EU pension funds. Indeed, EMIR Article 89(1) states that the clearing obligation shall temporarily not apply to OTC derivative contracts that are objectively measurable as reducing investment risks directly relating to the financial solvency of EU pension funds. This temporary exemption was motivated by the central role of cash collateral in the exchange of variation margins with Central Counterparties Clearing Houses (CCPs), which would force EU pension funds to divest a significant proportion of their assets for cash. Therefore, the clearing obligation does not apply to pension funds until a suitable technical solution for the transfer of non-cash collateral as variation margins is developed by CCPs.

In the United States, commercial end-users rely on the so called "end-user exception" from the mandatory clearing requirement under the Dodd-Frank Act when they trade derivatives for hedging purposes, under specific circumstances. Similarly, in the European Union, non-financial counterparties are exempted from any clearing obligation under EMIR if their non-hedging derivatives are below a clearing threshold. Both the Dodd-

Frank Act in the US and EMIR in the EU recognise that an efficient management of collateral is more than challenging for corporates and standardised instruments often fail to match their specific needs. Therefore, OTC derivatives are usually the only option for corporates to hedge risks that arise from their businesses. The exemption is essential to avoid adverse effects on employment and growth.

Since derivative transactions with EU pension funds are mostly traded for hedging purposes with no current reasonable alternative for central clearing, it is highly undesirable that OTC derivative markets become unworkable for EU pension funds. For this reason, in the EU, the Capital Requirement Regulation (CRR) exempts from the CVA risk charge those transactions with such counterparties that are exempted from any clearing obligation under EMIR, i.e. non-financial counterparties below a certain threshold and pension funds². This ensures that these entities are treated consistently with the approach under EMIR and that the benefit in terms of avoiding the costs associated with posting cash collateral is not jeopardised by the cost of the CVA charge. The CVA exemption in the CRR package is a clear example of EU policymakers working well together to ensure that any exemptions provided in EMIR are not undermined by the bank capital rules.

Rationale behind the exemption provided to EU pension funds under EMIR

EU pension funds use over-the-counter (OTC) derivatives as an integral part of their investment approach to manage their funding level or financial solvency risk. Pension funds collateralise and post variation margin on these transactions using high-quality government bonds – usually HQLA Level 1 assets, as defined in the liquidity coverage ratio rules – without disturbing their asset-allocation and increasing their financial solvency risk.

However, CCP will only accept cash as variation margin due to operational and other limitations. The inability of EU pension funds to post margin in cash remains the most significant issue for EU pension funds relating to derivatives reform.

This is because pension fund assets need to grow at least in line with the expected increase in liabilities to fulfil their obligation to pay pensioners' retirement income into the future. This means they hold relatively little in cash, preferring instead to hold high-quality government bonds, because:

- cash is not a good match for pension fund liabilities
- cash typically generates lower returns potentially eroding financial solvency
- cash instruments (such as bank deposits and commercial deposits) typically introduce non-sovereign credit risk

Increasing cash allocations - to ensure variation margin can be posted - would therefore increase financial solvency risk to pension funds and ultimately lead to reduced pensions for EU retirees. It was in recognition of this that EMIR policymakers exempted pension funds from clearing until a robust solution is found for the cash variation margin clearing issue. This exemption was extended until June 2021 as part of the EMIR Refit process that concluded in June 2019, and the European Commission has been convening regular stakeholder discussions with both the industry and policymakers to help facilitate the development of a solution. The exemption can be renewed until June 2023 or until a suitable technical solution for the transfer of non-cash collateral as variation margins is developed by CCPs.

Meanwhile, the clearing exemption allows EU pension funds to carry on trading non-cleared OTC derivatives while posting high quality government bond as collateral.

² CRR Article 382(4)(c) exempts from the CVA risk charge transactions with pension scheme arrangements defined under EMIR Article 2(10) that are subject to the transitional provisions set out in EMIR Article 89(1). CRR Article 482 reiterates this exemption, but without a time limit.

Against this background, PensionsEurope recommends the BCBS:

- to preserve the access to OTC bilateral derivative markets for those counterparties exempted from any clearing obligation under local rules.
- to align the CVA exemptions with the exemptions provided by clearing local rules and at least include non-financial counterparties and EU pension funds.

PensionsEurope understands that there are concerns of certain jurisdictions having specific CVA exemptions. However, removing the exemption is not the only way to achieve a higher-level playing field. Indeed, exemptions provided in the BCBS standards can be extended to all clearing exempted entities in the relevant jurisdictions for example.

About PensionsEurope

PensionsEurope represents national associations of pension funds and similar institutions for workplace and other funded pensions. Some members operate purely individual pension schemes. PensionsEurope has **23 member associations** in 18 EU Member States and 3 other European countries³.

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 **30 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.

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;

Our members 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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³ EU Member States: Austria, Belgium, Bulgaria, Croatia, Estonia, Finland, France, Germany, Hungary, Ireland, Italy, Luxembourg, Netherlands, Portugal, Romania, Spain, Sweden, UK. Non-EU Member States: Iceland, Norway, Switzerland.