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September 28, 2012

BY E-MAIL

Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland

International Organization for Securities Commission
C/Oquendo 12
28006 Madrid
Spain

Dear Sirs/Mesdames:

RE: Comments on Consultative Document: Margin requirements for non-centrally-cleared derivatives, issued by the Working Group on Margining Requirements of the Basel Committee on Banking Supervision and the Board of the International Organization of Securities Commissions (July 2012

Ontario Teachers' Pension Plan ("OTPP") is the largest single-profession pension plan in Canada, with $117.1 billion in net assets.[1] It was created by its two sponsors, the Ontario government and the Ontario Teachers' Federation, and is an independent organization. In carrying out its mandate, OTPP administers the pension benefits of 180,000 current elementary and secondary school teachers in addition to 120,000 members.[2] OTPP operates in a highly regulated environment and is governed by the *Teachers' Pension Act*[3] and complies with the *Pension Benefits Act* ("PBA")[4] and the *Income Tax Act*.[5] More than 800 employees of OTPP

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1 Asset value current as of December 31, 2011. "Fast Facts", online: Ontario Teachers' Pension Plan Board <http://www.otpp.com/wps/wcm/connect/otpp_en/home/investments/fast+facts>.

2 Ontario Teachers' Pension Plan Board, Annual Report, "Leading the Way: 2011 Annual Report" online: OTPP <http://docs.otpp.com/annual_report/PDF2012/AnnRepCommentary2011.pdf> at 12.

3 *Teachers' Pension Act*, RSO 1990, c T.1.

4 *Pension Benefits Act*, RSO 1990, c P.8.

help to invest the fund's assets, administer the pension plan, pay out benefits, and report and advise on the plan's funding status and regulatory environment.[6] OTPP consistently receives accolades from industry groups for its investment returns and pension strategy.[7]

In July 2012, the Working Group on Margining Requirements of the Basel Committee on Banking Supervision ("BCBS") and the Board of the International Organization of Securities Commissions ("IOSCO") (together the "Working Group") issued a Consultative Document titled "Margin requirements for non-centrally-cleared derivatives" (the "Consultative Document"). OTPP appreciates the opportunity to provide comments with respect to the proposals for margin for uncleared swaps in the Consultative Document.

We refer to the letter (the "BCBS/IOSCO Letter") dated September 28, 2012 from each of The American Benefits Council (the "Council"), the Committee on Investment of Employee Benefit Assets, the European Federation for Retirement Provision, the European Association of Paritarian Institutions, the National Coordinating Committee for Multiemployer Plans and the Pension Investment Association of Canada ("PIAC"). We are one of the many Canadian pension funds represented by PIAC as a signatory to the BCBS/IOSCO Letter. We wish to re-assert each of the arguments and comments made in the BCBS/IOSCO Letter and we confirm our full support for the positions enunciated therein. In our view, pension funds occupy a unique and important position in the Canadian and international derivatives markets. In determining margin requirements for uncleared swaps entered into by pension funds, we urge BCBS, IOSCO and all prudential regulators to consider the contribution pension funds make to such markets while introducing de-minimis systemic risk. We describe below some of the unique circumstances relating to OTPP and other pension funds in Canada that support the propositions set forth in the BCBS/IOSCO Letter.

Systemic Risk

From the G-20 meetings in Pittsburgh and Toronto to the Dodd-Frank Act[8] and the proposals for regulatory reform of the Canadian derivatives markets,[9] it is clear that the primary objective of new derivatives regulatory regimes around the world is to mitigate systemic risk in financial markets. In short, in our view Canadian pension funds neither create nor increase systemic risk as a result of their derivatives trading and, as explained in the BCBS/IOSCO Letter, may in fact

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5 *Income Tax Act*, RSC 1985, c 1 (5th Supp).

6 *Supra* note 2.

7 *Ibid* at 3.

8 *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111-203, 124 Stat. 1376 (2010). The text of the Dodd-Frank Act may be accessed at http://www.cftc.gov/LawRegulation/OTCDERIVATIVES/index.htm.

9 *See* Consultation Papers 91-401 to 406 published by Canadian Securities Administrators. The text of Consultation Papers 91-401 to 406 may be accessed at http://www.osc.gov.on.ca/en/6453.htm.

reduce systemic risk. As such, the costs to pension funds of the mandatory margin requirements for uncleared swaps proposed in the Consultative Document are too high.

It is important to emphasize that pension funds are end-users of OTC derivatives. Dealers, banks and other intermediaries, by their nature, are exposed to both the OTC derivatives transaction entered into with a client and a corresponding hedge, often in the form of one or more other OTC derivatives. An intermediary's role in the market gives rise to the problem of interconnected cross-defaulting, the hallmark of systemic risk. By contrast, end-user pension funds are exposed to only the credit risk of their counterparty in any given transaction. In addition, pension assets are held separately from the pension sponsor's assets and generally from the assets of its custodian, each of which facilitates access to the pension's assets for trade settlement and other liabilities. Bilateral arrangements do not give rise to the problem of interconnected cross-defaults, and therefore do not contribute to the element of systemic risk caused by such interconnectedness and pension funds' assets are isolated from the insolvency of sponsors and custodians.

Additionally, pension funds themselves pose negligible credit risk to their derivatives counterparties due to the following factors, discussed in further detail below. Unlike other participants in the OTC derivatives market, pension funds seek longer term stability in their investments and are driven by the necessity to hedge against their pension liabilities by generating targeted returns at acceptable levels of risk. Furthermore, OTPP and other pension plans are subject to comprehensive prudential regulatory regimes spanning from governance to investment concentration restrictions. Importantly, Canadian pension funds are statutorily prohibited from borrowing, other than in certain circumstances, and so operate at a fraction of the level of leverage utilized by most banks, dealers and other financial institutions.

The negligible risk of non-payment by pension funds together with their lack of any material interconnectedness within the financial system put pension funds in the unique position of not creating or increasing systemic risk through their OTC derivatives transactions.

No Corporate Profit Motive

In light of the objectives of the proposed reform of the OTC derivatives market, the regulation of a party to an OTC derivatives transaction should depend on the risk posed by such party. Therefore, a counterparty with a greater risk profile should attract more rigorous regulation, including mandatory initial and variation margin. Profit-driven enterprises, such as investment dealers, banks and hedge funds, carry significant inherent risk and may in some cases rely significantly on leveraged OTC derivatives to enhance their return on capital in the shorter term resulting in increased credit risk.

In contrast to almost all intermediaries and other end-users in the OTC derivatives market, pension funds are not driven by the desire for the highest possible returns at the lowest possible costs to satisfy investors, shareholders and other stake holders. Rather a pension fund focuses its resources on generating long term targeted returns to meet, or hedge against, its pension

liabilities. For example, OTPP's mandate is to deliver defined benefits to retired teachers for life[10] and its overall investment strategy is designed to earn targeted returns that contribute to stable contribution rates and pension sustainability, while meeting the plan's long-term funding needs.[11] OTPP's overall mandate dramatically impacts its derivatives strategy. OTPP uses OTC derivatives, together with its broader investment program, to achieve a targeted return within risk levels set by the board and to hedge its pension liabilities. In addition, derivatives transactions allow OTPP to increase diversification, reducing risk, as they allow OTPP to gain exposure to global markets on a cost-effective basis[12] and may be used to obtain exposure to other investments and asset classes. OTPP has an established history of prudently engaging in derivatives contracts, which have played a large part in its investment strategy for approximately 20 years. On this basis, OTPP and other pension funds should be exempt from the mandatory margin requirements proposed by the Consultative Document.

No Borrowing

Canadian pension funds, including OTPP, are generally prohibited from borrowing money pursuant to section 8502(i) of the *Income Tax Regulations*, subject to specified exceptions with respect to unsecured short term borrowing and borrowing against real property. Accordingly, pension funds, including OTPP, are prohibited from borrowing money to finance derivatives transactions. In addition, as a matter of internal policy, or as mandated by agreements with counterparties, pension funds generally post variation margin in respect of outstanding exposure. This, together with limitations on leverage, result in pension funds having a very low to no risk of defaulting as a result of an inability to pay their counterparties.

Prudential Regulation

In addition to borrowing restrictions, Canadian pension plans are subject to comprehensive regulatory regimes dealing with funding, governance, investment standards, structure and other aspects of their administration. Such regulations are designed to construct a sound, stable and effective platform for collecting and investing pension contributions and paying pension benefits. OTPP, for example, is governed by the *Teachers' Pension Act*, the PBA, the *Income Tax Act* and all of the applicable regulations thereunder. In Ontario, all pension funds are subject to oversight by the Financial Services Commission of Ontario. The administrators of OTPP and other pension funds are "fiduciaries" of the assets they manage. Plan administrators are subject to a prudent investment portfolio standard, investment concentration limits and other restrictions. Administrators of pension funds regulated under the PBA and other provincial laws are required to "exercise the care, diligence and skill in the administration and investment of the pension fund that a person of ordinary prudence would exercise in dealing with the property of another

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10 *Supra* note 2 at 15.

11 "Investment Strategy", online: Ontario Teachers' Pension Plan Board <http://www.otpp.com/wps/wcm/connect/otpp_en/Home/Investments/Investment+Strategy/>.

12 *Supra* note 2 at 41.

person."[13] In doing so, the administrator must use all relevant knowledge and skill that it possesses, or ought to possess, in the administration and investment of the pension fund.[14] The administrator is also subject to strict prohibitions concerning conflicts of interest. Under the PBA, these restrictions are also imposed on agents of the administrator.[15] The *Pension Benefits Standards Regulations*[16] contain federal investment regulations that apply to pension funds governed by the PBA.[17] Importantly, under Section 7.1 of the *Pension Benefit Standards Regulation*, all pension plans must establish a detailed statement of investment policies and procedures, including with respect to the use of derivatives, options and futures.

The funding of Canadian pension plans is also subject to regulatory oversight and assists in creating entities that pose little to no risk of default for non-payment of their obligations. Shortfalls may be funded by the fund's corporate or government sponsor, by increasing contributions of members or by lowering benefit payments, depending on the nature of the plan. In addition, there are no provisions under Canadian law for pension funds to file for bankruptcy or reorganization to avoid their obligations to creditors and voluntary termination of a plan does not relieve a plan of its financial obligations.

Pension plans are in a unique position in the OTC derivatives market in that they pose de-minimis credit risk to their counterparties as a result of their inherent mandate and objectives, their prudential regulation, including borrowing restrictions, and their sound governance and administrative policies. They do not suffer from the interconnectedness that contributed to the financial crisis, the aftermath of which continues today.

Disproportionate Impact on Pension Plans

In light of the current economic environment and the demographic realities for pension plans, the potential cost of the proposed margin requirements for uncleared swaps in the Consultative Document does not appear to be justifiable. In our view, mandatory margin requirements will result in a significant reduction in the returns earned by pension plans. Various pension plans, non-governmental organizations and representatives of pension schemes have estimated that the cost of central clearing could reduce returns by between one and two percent per annum.[18] The

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13 *Supra* note 4 at s 22(1).

14 *Ibid* at s 22(2).

15 *Ibid* at s 22(8).

16 *Pension Benefits Standards Regulations*, 1985, SOR/87-19.

17 Pursuant to *PBA Reg* 909, s 66(1) ""federal investment regulations" means sections 6, 7, 7.1 and 7.2 and Schedule III to the "Pension Benefits Standards Regulations, 1985" made under the *Pension Benefits Standards Act, 1985* (Canada) as they may be amended from time to time."

18 See for example: Position Paper by the Dutch Pension Fund Organisations OPF, UvB and VB on the European Commission's Proposal for a Regulation on the OTC Derivatives Markets of 15 September 2010, at Annex I; National Association of Pension Funds Joint Committee of European Supervisory Authorities

cost to pension funds of the proposals in the Consultative Document for analogous margin for non-centrally cleared OTC derivatives would likely be similar to the cost of central clearing.

OTPP and other pension plans are currently faced with high anticipated pension costs and only moderate asset growth, which results in funding challenges. OTPP has experienced funding shortfalls (the difference between benefits paid and contributions received) recurring for the past 10 years. The shortfalls occurred despite increased contribution rates, decreased benefits, and strong asset growth.[19]

The current shortfall is a result of both economic and demographic factors. Economically, OTPP is able to predict only modest investment returns due to uncertain markets. Additionally, prevailing low interest rates have a significant deleterious effect on pension funds. OTPP, like other pension funds, relies heavily on interest rate dependent investments. Lower interest rates require OTPP to set more money aside for future payments to members. In addition, unlike most market participants, pension funds are unable to take advantage of low interest rates to obtain leveraged returns. The imposition of mandatory margin requirements for uncleared swaps at this time will impose a serious strain on Canadian pension funds, potentially leading to the need for increased contributions by sponsors and for lower benefit payments.

Opportunity Cost of Collateral

Mandatory margin requirements for uncleared swaps are likely to result in pension funds having a significantly greater need for highly liquid collateral than is required in bilateral trading. Cash and other highly liquid investments generate returns significantly below the targeted returns for OTPP and other pension funds. In our view, the impact on pension funds is significantly disproportionate to the de-minimis risk they add to the financial system.

As discussed above and in the BCBS/IOSCO Letter, pension plans pose very little credit risk and may reduce systemic risk. In recognition of this, counterparties in bilaterally negotiated derivatives transactions with OTPP have never required upfront collateral and have granted significant thresholds for exposure, where no collateral is required below such thresholds. Mandatory margin requirements, on the other hand, will mandate upfront collateral based on the nature of each transaction and irrespective of the creditworthiness of the direct participants in the central counterparty or other indirect trading clients. In addition, thresholds will likely be set lower or at zero. This problem is exacerbated by the volume of trades made by pension funds and by the longer tenure of their derivatives transactions as central counterparties will mandate much higher initial margin for such transactions. OTPP and other pension funds will be pledging more collateral than experienced in bilaterally negotiated derivatives transactions notwithstanding that they do not pose any material systemic risk.

Discussion Paper: Draft Regulatory Technical Standards on Risk Mitigation Techniques for OTC Derivatives not Cleared by a CCP, at page 1; and Responses on ESMA, EBA and EIOPA Joint Discussion Paper by Insight Investment, at page 6.

19 *Supra* note 2 at 2.

Pension plans will also likely lose some of the netting benefits they currently experience with their collateral arrangements with bilateral counterparties, again resulting in the need for additional collateral. Currently pension plans benefit from only having to collateralize net exposure under their derivatives transactions with each counterparty and they have the ability to manage their trades and collateral requirements. When derivatives trades have minimum mandatory margin requirements, particularly initial margin, some of the benefits of netting will be lost. In addition, intermediaries may pass on the costs of their higher margin requirements to end-users like pension funds.

In bilaterally negotiated derivatives trades, 85% of the collateral received is cash and the remainder is composed of government or other highly rated bonds that are appropriately discounted.[20] Unlike financial intermediaries such as dealers and banks, pension plans hold almost all of their asset value in investments selected to meet their return targets. Assets are monetized primarily to meet beneficiary payment obligations. As a result of having to hold more cash and near cash collateral, pension funds will be under additional pressure to earn their targeted returns and meet their pension benefit obligations. A reduction in overall return could result in funding short falls leading to higher contribution requirements of the plan's sponsor and lower benefit payments. It does not seem reasonable to ask that the beneficiaries of pension plans bear a higher proportion of the additional costs of mandatory margin requirements for uncleared swaps when pension funds do not contribute in any material way to systemic risk.

Further, depending on the relationship between pension plans and their counterparties, OTPP and other pension plans may bear some solvency risk in relation to a solvency event in respect of a counterparty holding collateral posted by the pension fund. In our view this unnecessarily shifts risk onto pension funds unless collateral is segregated as recommended in the BCBS/IOSCO Letter.

Regulators and market participants recognize that the additional demand for near cash collateral will result in a general liquidity squeeze, particularly in the shorter term. In the longer term, the potential impact of a general greater need for high quality liquid collateral is uncertain but is likely to negatively impact pension funds' ability to optimally manage their portfolios to meet targeted returns.

Conclusion

We are strongly in favour of regulation that is pragmatically tailored to meeting the objective of reducing systemic risk. However, the costs of any regulatory regime should be proportionate to the potential harm that could result from failing to impose such regulation. As outlined above and in the BCBS/IOSCO Letter, mandatory collateral for uncleared swaps entered into by pension plans is inconsequential in achieving the objective of mitigating systemic risk and will result in pension funds bearing a disproportionate portion of the costs of such regulation. The

[20] The Study Group Established by the Committee on the Global Financial System, "The role of margin requirements and haircuts in procyclicality" (CGFS Papers, March 2010), No 36.

higher costs associated with derivatives trading under a mandatory initial and variation margin regime could result in some pension funds electing to leave risks un-hedged or could lead to the need for higher contributions and lower payments to pension beneficiaries. Either result is unsatisfactory and in our view, results in undue harm to pension funds and possibly the economy as a whole. As such, we respectfully submit that BCBS, IOSCO and prudential regulators consider the arguments and proposals set out in the BCBS/IOSCO Letter in any revised proposals for margin requirements for uncleared swaps.

Yours very truly,

Gregory O'Donohue
Ontario Teachers' Pension Plan Board

cc:

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