Pension
Protection
Fund

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

28 September 2012

Dear Sir/Madam,

Re: Consultative Document: Margin requirements for non-centrally-cleared derivatives

The Pension Protection Fund (PPF) welcomes the opportunity to respond to the consultation. We recognise the importance of reducing systemic risk in the financial markets, and the part derivatives can play in this risk. As such, we broadly support the BCBS's and IOSCO's initial policy proposals for margin requirements for non-centrally-cleared derivatives, as articulated through key principles addressing seven main elements. We are particularly pleased to note the proposal to permit non-cash assets to be used as collateral.

However, we do have concerns about the impact that some aspects of the proposal could have on systemic liquidity and the costs of hedging programmes. While we accept that reducing systemic risk will necessarily have an impact on liquidity and costs, in some areas we are not convinced that current proposals would reduce systemic risk, and yet the liquidity and cost impacts could be significant. Moreover, we have specific concerns about the impact of this and other initiatives on the PPF, other pension protection schemes, and individual pension schemes. It is vital that the low risk profile of these organisations is recognised in the final margin requirements. Failure to do so would impede these organisations in their aim to provide cost-effective, secure retirement benefits for scheme members.

The Pension Protection Fund

The PPF was established by the Pensions Act 2004 to provide compensation to members of eligible defined benefit pension schemes, when there is a qualifying insolvency event in relation to the employer, and where there are insufficient assets in the pension scheme to cover the PPF level of compensation.   The Fund is administered by the Board of the PPF, a public corporation.

The PPF is not a pension scheme in its own right but it provides protection for members of such schemes in the event of employer insolvency. The PPF takes over the assets of

Knollys House, 17 Addiscombe Road, Croydon, Surrey CR0 6SR
T 0845 600 2541 F 020 8633 4903
www.pensionprotectionfund.org.uk

the schemes affected and then pays future compensation over the life of the member, rather than just meeting any short term shortfall in funding.

The PPF is funded by four main sources of income. These include:

- an annual Pension Protection Levy paid by eligible pension schemes,
- recoveries of money, and other assets, from insolvent employers of schemes taken on by the PPF,
- taking on the assets of schemes that transfer to the PPF, and
- returns on the PPF's own investments**.**

The PPF levy is payable by all UK defined benefit pension schemes whose members would be eligible for PPF compensation.

There are currently 6,432 schemes with over 10 million members eligible for PPF protection. The PPF currently pays compensation directly to over 140,000 members from 459 eligible schemes. To date PPF has paid out over £510 million in compensation, and holds assets in excess of £12 billion.

Response

Q1. We would expect there to be coordination with the ESMA Technical Standards for the Regulation of OTC Derivatives, CCPs and Trade Repositories, implementation of which is expected by 30 June 2013. Any exemption under Article 71 of the EMIR directive is worthless if an entity is forced into clearing by onerous requirements for non-cleared trades. Entities may also be forced into clearing because the requirements for uncleared trades are unclear, but there is concern that they will be more onerous than going through clearing. Sufficient time is needed for organisations to develop systems and documentation to meet the requirements; this timescale will depend on the finalised requirements but we expect a lead-in time of at least 6-12 months will be necessary.

Q2. We do not comment on this question.

Q3. We do not comment on this question.

Q4. We recognise the role that variation and initial margin can play in improving security, however there is a need to consider the specific characteristics of counterparties. We are concerned that significantly increasing collateral requirements will have an adverse impact on systemic liquidity, and that in some circumstances this impact will not be compensated by any reduction in systemic risk, because the parties impacted do not contribute to systemic risk.

Requiring bilateral IM for all trades will significantly increase costs for end users and lead to systemic liquidity strains, as this will require four-way posting of collateral when banks carry out back-to-back trades with each other. Consideration should be given for banks to be exempt from IM requirements (or

have higher thresholds) to avoid the liquidity drain and costs of back-to-back trades, especially in light of banks' stringent capital requirements and the ongoing legislative activity to strengthen these capital requirements.

We consider that pension schemes and pension protection schemes should have their high credit-worthiness recognised through scaled thresholds for IM. This would permit IM to begin at zero or close to zero if it appropriately takes into account counterparty credit quality, position risk, and portfolio netting.

While we understand the intention to promote central clearing, some derivatives may never be sufficiently standardised to allow central clearing and we believe that counterparties should not be penalised for this.

Q5. Initial margin thresholds are one way of reducing liquidity impacts but we still have other concerns. Levels of initial margin and liquidity should not be considered in isolation in light of the number of imminent Directives/Regulations, including IORP II, CRD IV, MFID, MIFIR and EMIR, which are intended to target risk in the financial markets. It is likely that, based on current proposals, pension schemes may be forced to divest assets in order to meet margin requirements, or abandon hedging programmes altogether. Not only does this increase the risk associated with mismatching assets and liabilities but also decreases the expected return on the portfolio and hence the long-term cost to the corporate sponsor. This is inconsistent with overarching principles to reduce risk in financial system.

Q6. We would expect initial margin thresholds to differ across different entities, and for it to be possible for high thresholds to apply. This would permit IM to begin at zero or close to zero if it appropriately takes into account counterparty credit quality, position risk, and portfolio netting. High quality counterparties such as pension schemes should post less IM for the same transaction exposure, reflecting lower probability of default and expected loss. Systemic risk is also an important consideration in setting margin thresholds and counterparties which do not represent a systemic risk, eg pension schemes and pension protection schemes, should have lower IM requirements. Where pension schemes (and the PPF) are concerned the reference to a level playing field is not relevant as these entities are only seeking to mitigate risk and not to speculate.

Q7. The regulatory regime an entity is subject to is important but not the only factor when determining thresholds. High quality counterparties such as pension schemes should post less IM for the same transaction exposure, reflecting lower probability of default and expected loss. We support lower thresholds for pension schemes and pension protection schemes should be considered together with prudently-regulated entities.

Systemic risk is also an important consideration in setting margin thresholds and counterparties which do not represent a systemic risk, eg pension schemes and pension protection schemes, should have lower IM requirements. Consideration should be given for banks to be exempt to avoid liquidity drain and costs of back-to-back trades, especially in light of banks' stringent capital requirements.

Q8. We recognise the arguments for both approaches. A possible alternative would be to allow use of either the proposed standardised IM requirements or an approved model to determine IM. The standardised approach could be used for smaller exposures and an approved model approach for larger exposures or where this approach was elected to be used.

Q9. Measures which dis-incentivise pension schemes from hedging their risks may lead to the continuation of immature investment strategies, e.g. simple bond and equity baskets, from some and encourage other more sophisticated investors to seek returns to offset the costs of clearing and collateral obligations - possibly through less onerously regulated means. This will retain rather than remove risk in the system. Levels of initial margin and liquidity should not be considered in isolation in light of the number of imminent Directives/Regulations, including IORP II, CRD IV, MFID, MIFIR and EMIR, which are intended to target risk in the financial markets. It is likely that, based on current proposals, pension schemes may be forced to divest assets in order to meet margin requirements, or abandon hedging programmes altogether. Not only does this increase the risk associated with mismatching assets and liabilities but also decreases the expected return on the portfolio and hence the long-term cost to the corporate sponsor. This is inconsistent with overarching principles to reduce risk in financial system.

Q10. In our view it is vital to consider the creditworthiness of an institution rather than just dividing organisations by type. For example, in some cases banks post collateral to pension schemes as the bank in question is less credit-worthy than the pension scheme.

Q11. The proposed exemption for non-financial entities introduces an inconsistency: a pension scheme sponsor may be exempted from margining requirements (if they are deemed not systemically important) but the pension scheme of that entity is not exempt. This presents the risk of regulatory arbitrage. It incentivises sponsors of pension schemes to keep pension assets outside the pension scheme in order to make use of their exemption. Not only is this negative from a systemic risk perspective, but it is also bad for the members of pension schemes, because assets which should be used to provide their benefits are no longer protected by pensions legislation and fiduciary requirements.

Q12. We would consider ourselves (the PPF) and pension schemes to be an exemption that would not compromise the goal of reducing systemic risk and promoting central clearing. This is due to the prudent nature of our investment strategies, the role we fulfil, and the fact we are asset-rich. In nearly all areas where new regulations are being introduced to limit systemic risk in the financial markets it is proving necessary to recognise and address the considerable knock-on effects to pension schemes and their corporate sponsors. In particular it is vital to recognise that pension schemes provide a different social function and as investors their approach and needs significantly differ from those with profit-driven business models. The pension scheme model is in contrast prudent and long-term with the only interest being security for members' retirement income. These considerations

are in harmony with the European Commission's ambition stated in the White Paper on adequate, safe and sustainable pensions: to enable adequate and sustainable pension provision across member states. Measures that erode funds' ability to provide security undermine both outcomes.

Q13. We do not comment on this question.

Q14. We do not comment on this question.

Q15. We do not comment on this question.

Q16. We do not comment on this question.

Q17. We would support collateralisation on a daily basis.

Q18. We do not comment on this question.

Q19. Suitable minimum transfer amounts will depend on the size of the transaction and the counterparties, hence a single minimum transfer amount may not be appropriate. We would be happy to provide details of our minimum transfer amounts if this would be helpful.

Q20. The list of eligible collateral is greater than the classes we currently use, but we do not view it as inappropriate. We welcome the inclusion of government and other high-quality bonds in the eligible collateral. We note that it is important that eligible collateral is broad enough not to create systemic liquidity problems.

Q21. We do not comment on this question.

Q22. We have a concern that the increased margin requirements together with a small number of custodians may create concentration risk, increasing rather than decreasing systemic risk. We believe that local legislation should act to discourage concentration risk and we would welcome high-level principles expressing this.

Q23. Whilst we agree that initial margin should be exchanged by both parties without netting of amounts collected by each party (ie on a gross basis), we believe that consideration should be given to the netting of aggregate positions. For example, due to the correlation between interest and inflation rates the aggregate position of these swaps is sometimes considered with any margining requirements netted off. Consideration of the separate gross positions would require two sets of IM and two sets of operational costs, exacerbating liquidity issues.

Q24. We do not currently see a need for rehypothecation in the near term. The circumstances and conditions outlined seem sensible regarding rehypothecation of collateral.

Q25. We do not comment on this question.

Q26. We do not comment on this question.

Q27. We do not comment on this question.

Yours faithfully,

Lucy Currie
Actuarial Practice Leader – Policy & Process

email: lucy.currie@ppf.gsi.gov.uk
direct telephone: 0208 633 5985