P-Solve

Margin requirements for non-centrally-cleared derivatives

P-Solve response to BCBS and BSIOSC Consultation

September 2012

Dear Sir / Madam,

P-Solve welcome the opportunity to provide comments and views on the joint discussion paper on margin requirements for non-centrally-cleared derivatives issued by the Working Group on Margining Requirements of the Basel Committee on Banking Supervision and the International Organization of Securities Commissions.

About the Firm

P-Solve are part of the Punter Southall Group and were founded in March 2001 to provide advice to liability-driven organisations such as trustee groups, corporations, charities and insurance companies.

We currently advise over 175 clients, covering defined benefit and defined contribution pension schemes and charities of sizes ranging from £2 million to £6 billion.

P-Solve advise clients on over £24 billion of assets and also have approximately £8 billion of assets under management. In addition, P-Solve manage over £15 billion notional of derivatives for pension schemes, with the primary purpose being to hedge market risk.

Scope of our response

P-Solve appreciate the opportunity to respond to the joint discussion paper and would ask that the regulators and other recognised professional bodies continue this dialogue on important regulatory changes.

Given the range of questions posed we have not looked to answer each one. Instead we have split our answer into six headings which we feel covers the range of issues and broadly capture our view. Given our client base we have intentionally focused on issues that are most relevant to UK pension schemes.

Should you have any further questions please do not hesitate to contact us.

Yours sincerely,

G. Sauvé

Geoffroy Sauvé

Head of Derivatives

+44 (0)20 3327 5135

11 Strand,

London, WC2N 5HR

1. Implementation and timing

The phase in period should be of appropriate length to allow market participants to adjust to the new regime – six to twelve months from the finalisation date may be an appropriate timescale. Given the number of regulatory changes that are being implemented across various jurisdictions (Dodd-Frank Act in the US, EMIR in the EU), harmonising the process for centrally-cleared and non-centrally-cleared derivatives will result in lower costs and greater transparency. Similarly, maintaining consistency will ensure that the key tenant of systematic risk reduction and stability is upheld.

More frequent and concise briefing notes issued by the WGMR to help market participants keep abreast of changes prior to mandates being issued would help smooth the process.

2. Scope of coverage

Increased standardisation, transparency and collateralisation/margining in the OTC market should be welcomed as a way of readily identifying risk concentrations. However this should not be done in a way that penalises excessively current users of derivatives, in particular those that use derivatives to hedge their risks and that already use appropriate techniques to mitigate counterparty exposure.

Threshold amounts should vary depending on industry, the level of systemic risk that the counterparties present, contract size and availability of capital. For example, a large insurer subject to Solvency II capital requirements should not be required to post the same initial margin as a small investment bank for the same risk exposure.

In particular pension schemes, particularly under UK regulations, should be exempt from initial margin requirements for a number of reasons.

Firstly, requirements under UK Trust Law and UK Pensions Legislation require Trustees to act prudently. This generally means that currently OTC derivative strategies are generally used for hedging purposes or to provide a restructured payoff (whilst limiting downside) and not for speculative or arbitrage purposes. These transactions are usually collateralised (via the exchange of collateral in proportion to the value of the derivatives) and subject to criteria stipulated in governing documentation (Credit Support Annexes to ISDA agreements) which limits risk aggregation (for example by limiting maximum counterparty exposure or specifying minimum credit ratings).

Secondly, the primary purpose of a pension scheme is to fund member benefits and not to profit from leveraged trading activities. Generally, they will be on one side of a transaction and will not aggregate risk in the way that a bank, insurer or other financial entity will. This means that they tend not to pose systemic risk in the case of default.

In addition any requirement to post initial margin (with or without exemption) should be introduced in a gradual way as this might have a very significant impact on the liquidity of eligible collateral. In particular, if they were required to post initial margin (on top of variation margin, which they tend to already exchange) a pension scheme would need to significantly alter their asset allocation. In our view this is another reason why pension schemes should be exempt from the requirement to post initial margin, or at least have a temporary exemption to allow them to rebalance their asset allocation to make it compatible with the requirement to post initial margin. Such exemption would also be consistent with the temporary exemption from central clearing that has been granted to pension schemes in the EU under EMIR.

3. Margin

Initial margin is the baseline that should be exchanged to ensure that the correct balance of risk mitigation and simplicity is struck. It is important that, whilst market participants are able to develop their own models to suit their risk appetite, this is prudently managed and that competition does not erode market security (i.e. through a "race to the bottom" in terms of initial margin).

In our view, initial margin should be calculated in a simple and transparent way – the use of a confidence interval is inherently dependent on the underlying distribution and the choice of parameters which is dependent on the past profile of the distribution. Regulators and supervisory authorities should subject these models to robust scenario and stress testing to verify that outputs exhibit sensible joint behaviours and that margin requirements are justifiable in the context of their overall business. Models should not be overly complex and the standardised schedule represents a sensible starting point for discussions.

It is likely that, as the requirement to post initial margin becomes mandatory, a number of risk models will come to dominate (in particular models developed by CCPs when central clearing becomes more prevalent). Regulators should

keep abreast of model developments and seek to challenge results to ensure that there is no regulatory arbitrage and that risk concentrations do not simply migrate to particular market participants or CCPs.

Margin calculations should not take account of diversification benefits across asset classes – in times of extreme market stress correlations between asset classes will behave abnormally and established relationships may break down. To protect market stability therefore, taking a prudent and simplistic view is beneficial. Similarly, were correlations to be accounted for, it may not be immediately apparent where risk concentration lies.

4. Collateral

The scope of proposed collateral should be securities that can be reasonably assumed to remain marketable and liquid in times of market stress and the list provided by the WGMR largely fulfils this requirement. However we would request that further clarity is given around the definition of "high quality" as this has been left open to interpretation. Alternatively this definition could be left open to individual participants to negotiate on a case by case basis (e.g. as is currently the case under a CSA).

A reduction in scope of collateral could lead to the concentration of certain instruments being posted as initial or variation margin (e.g. sovereigns). Given the size of the market which falls under the scope of new regulation for centrally-cleared derivatives and non-centrally-cleared derivatives pressures on availability of collateral could impact volatility, liquidity and market stability particularly if an asset class suffers a reduction in perceived quality. This problem is exacerbated given that margin is proposed to be exchanged on a gross and not a net basis. Some of those liquidity issues could be alleviated by granting exemptions to post initial margin to less systemically important institutions (in particular pension schemes).

5. Treatment of provided margin

In our view, for participants that are subject to the requirement to post initial margin (i.e. systemically important institutions), it should be exchanged on a gross basis and be segregated with no possibility to re-hypothecate to ensure that counterparty and systemic risk is effectively reduced and that the posting party is fully protected.

However it should be noted that if the requirement to post initial margin was extended to all market participants, this would increase the reliance on a limited number of custodian banks and could in turn increase systemic risk. In addition, as the requirement to exchange initial margin on a gross basis may lead to shortages of suitable collateral, it might be appropriate to exempt certain market participants in order not to exacerbate problems in a downturn.

6. Cross border regimes

We agree with the principle that to avoid regulatory arbitrage, rules and regulations should be applied consistently across borders. However, given that market participants will be transacting with multiple entities in multiple jurisdictions, further clarity should be given on how a windup will be dealt with in the event of counterparty failure.

P-Solve

Issued by P-Solve Investments Limited.

P-Solve Investments Limited is authorised and regulated by the Financial Services Authority.

Registered office: 11 Strand, London WC2N 5HR · Registered in England and Wales · No. 3359127 · FSA Registration No. 195028