

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

6 July 2016

Subject: Negative Effects on Pension Funds Caused by Basel Leverage Ratio

Introduction

APG Asset Management N.V. (**APG AM**) appreciates the opportunity to comment on the Basel Committee's Consultative Document: Revisions to the Basel III Leverage Ratio Framework (**Proposal**). APG AM is a Netherlands based asset manager that works exclusively for pension funds. We work for more than 20,000 employers and provide for the income of more than 4.5 million citizens in the Netherlands and manage over 30% of all collective pensions in the Netherlands. APG AM had assets under management of approximately € 416 billion as per April 2016. APG AM is an indirect subsidiary of Stichting Pensioenfond ABP, the Dutch pension fund for the government and education sector and the second largest pension fund globally.

Use of OTC derivatives by pension funds

- The structure of pension systems (and their regulatory framework) varies internationally. The specific needs of European pension funds, particularly defined benefit schemes, can be different to the needs of pension funds in other jurisdictions, such as in the United States. European pension funds use OTC derivatives as an integral part of their investment approach to manage their financial solvency risk. The use of OTC derivatives is also encouraged by regulations requiring pension funds to manage risks prudently.
- Any regulation of the OTC derivatives will therefore particularly affect those pension funds that rely on OTC derivatives to hedge their risks. Although European pension funds are not directly impacted by bank capital rules, they trade with banks and those banks will pass on any impact of the capital rules to pension funds.
- European pension funds are liability driven investors who need to manage currency and interest rate risk. OTC derivatives are a key risk mitigation tool for matching the duration of pension funds' assets with the duration of their liabilities. Pension funds use OTC derivatives to manage risk and mitigate volatility that would be harmful to the participants of the pension funds. Unlike some other market participants that may take risks with OTC derivatives for business and competitive reasons, European pension funds do not have such business or competitive motivations and exist solely to provide retirement security for pensioners and utilize derivatives to hedge risks which could jeopardize such retirement security. Additionally, pension funds provide a crucial source of stable, risk-reducing liquidity to the derivatives markets because they are highly creditworthy and asset rich

counterparties. They are conservative investors and as such are generally considered by the market to be of low risk and high credit quality investors.

- The OTC derivatives portfolios of pension funds are typically long-dated and one directional in nature to offset the liability risk pension funds have. This reflects the long-dated nature of the liabilities of pension funds. The nature of the derivatives portfolios of pension funds magnifies any intended or unintended consequences of OTC derivatives regulations to pension funds. We believe this is unjustified given the credit quality of European pension funds and as the OTC derivatives portfolios offset risks that are naturally inherent for pension funds and therefore help pension funds to reach a minimal risk position.

Key concerns with the Proposal

- Due to the adverse effects of the cash Variation Margin (**VM**) requirement European pension funds are (temporarily) exempted from mandatory clearing as long as CCPs have not developed an alternative for cash VM.
- The reasons for this exemption are as follows: Pension funds do not hold much cash and are typically fully invested to generate long-term returns allowing them to discharge their duty to pay pensions to retirees. Keeping a large pool of cash collateral available would therefore be extremely costly for European pension funds. It would result in a very significant opportunity loss for pension funds, having a disproportionate negative impact on pension returns and pension income on the one hand and the ability to contribute to economic growth/financing on the other.
- Cash collateral may also increase liquidity risk for pension funds as pension funds will face difficulties in meeting large cash VM calls in stressed markets. Cash collateral increases the demand for cash in times of market stress when large mark-to-market moves occur. It increases liquidity risk, pro-cyclicality and reduces financial stability. Pension funds are put under pressure to manage liquidity risks, increased by regulation itself. The challenge here is to mitigate the increase of liquidity risks for both regular markets and stressed markets, when large amounts of (cash) collateral are required, and repo-markets are in fact non-existent.
- This cash collateral requirement creates several (major) problems for European pension funds:
 - (i) Pension funds do not hold cash and may not be able to access the OTC derivatives market in the future. We are already seeing evidence of reduced liquidity being made available to pension funds and other end-users. Pension funds could stop using derivatives to manage risk and therefore retain more risk, but regulation requires them to manage their risks. Not managing risk would increase financial solvency risk and increase the chance that pension funds may not meet their liabilities (pay pensioners) when they become due.
 - (ii) Pension funds could either keep large sums of cash available or ensure access to a guaranteed repo facility in stressed markets. Holding more cash would lead to pension funds withdrawing money from asset holdings and discourage them from investing in growth initiatives. It would also reduce the returns generated by pension funds and lead to greater financial solvency risk, as pension funds' portfolios may not generate the returns necessary to meet their pension liabilities. Generating cash via repurchase (repo) transactions when necessary to post cash upon a margin call is unlikely to work in stressed markets or provide

sufficient capacity for pension funds to rely on. This would increase liquidity risk within the market, especially at times of stress, and could force pension funds to sell out of assets when asset prices are likely to be falling.

- In this regard: we refer to an independent report published by Europe Economics and Bourse Consult for the European Commission on the impact of cash VM to pension funds. This report shows that the total cash collateral needed by pension funds to support a 100bps (1%) move in interest rates would amount to €205 billion to €255 billion, increasing to €420 billion in more stressed scenarios. This report further estimates that the cash collateral requirement would cost European pensioners between €2.3 billion and €4.7 billion annually, a drop of 3.1% in future income for Dutch pensioners (see http://ec.europa.eu/finance/financial-markets/docs/derivatives/150203-external-study_en.pdf). The problems with cash collateral were the reason why European pension funds are temporarily exempted from mandatory clearing. The EU policymakers have agreed that European pension funds should not be required to post cash VM given the negative impact on their beneficiaries. Instead CCPs are encouraged to find an alternative for cash VM so that pension funds can participate in the clearing system. The Net Stable Funding Ratio rules and the Proposal now undermine the clearing exemption as banks are increasingly pushing for cash CSAs.
- In this context, we would suggest the BCBS conducts an impact analysis of the Proposal on the end clients of banks, also with a view to whether their proposed rules / capital requirements actually do reduce risk within the broader financial sector. Given that the regulatory framework for OTC derivatives has shifted the transformation risk (transform securities into cash) from banks to end users in the OTC derivatives markets and these end users do not have no access to a lender of last resort / guaranteed repo facility, the smooth functioning of a liquid repo market is crucial. In our view it is crucial that end users such as pension funds can rely on a functioning repo markets, in times of markets stress and cash collateral calls.
- We would suggest the following approach under the Proposal:

1. High quality government bond securities with appropriate haircut should be permitted to offset replacement cost in OTC derivative exposure

Under bilateral OTC derivatives, pension funds are still allowed to post high quality government bonds as collateral. Now capital rules under the Proposal and the Net Stable Funding Ratio require pension funds post cash VM instead of government bonds. The Leverage Ratio framework and the NSFR rules are already impacting the bilateral OTC derivatives agreements whereby cash is more preferred as eligible collateral.

Allowing only cash to offset replacement cost in OTC derivatives exposure calculation (paragraph 25 of the Basel III Leverage Ratio framework whereby Cash VM (under conditions) is only recognized as offsetting the RC) will have a disproportionate impact as described above.

The non-recognition of High Quality Liquid Assets as offsetting for the replacement costs (RC) would be unfair in terms of significant costs. At the same time it does not achieve the desire policy objective, which is to increase financial stability. Cash collateral would increase liquidity risk for end user and European pension funds relying on the use of OTC derivatives to hedge their risks may find difficulties in meeting large cash VM calls in stressed markets. Thus, in our view pension funds should be allowed to continue posting high quality securities collateral.

2. SA-CCR should not penalize one-directional portfolios in long dated swaps of European pension funds

The proposed SA-CCR model to calculate exposure to OTC derivatives is supposed to reduce exposure for portfolios with netting benefits. However, the SA-CCR model actually makes the exposure calculation much worse for pension funds, because pension funds have one-directional portfolios to manage their liability risk. While the SA-CCR model may have a positive impact on banks overall (as they typically manage a balanced exposure of OTC derivatives), OTC derivatives with pension funds will be unduly penalised.

Compared to the CEM method, the use of SA-CCR will be disadvantageous for the swap portfolios of European pension funds. Please see the following example as an illustration of this:

A bank clears for its Client (pension fund) a 30 year at the money IRS with notional 1 billion USD. Using the CEM method, the EAD resulting from this swap is \$15 million (notional X 1.5% add-on), while the EAD calculated using SA CCR (without the recognition of IM) is \$19,2 million.

The net result of the SA-CCR method would be that banks are (i) pushed from clearing OTC derivatives for pension funds or (ii) use a higher add-on for the potential future exposure (PFE) and therefore meet higher capital requirements. The reason is that in SA-CCR, the long dated swaps receive a higher “supervisory duration” (explained in paragraph 157 of BCBS279), which increases the PFE compared to the CEM method, where a 30 year swap will have similar PFE as a 5 year swap.

If such methodology is accepted, a fair treatment would require a different treatment for pension funds, taking into account the lower credit risk of the entities (pension funds are less likely to default). A possible solution could be to account for the initial margin in both bilateral and cleared OTC derivatives transactions with pension funds.

3. The exposure reducing effect of posted initial margin should be recognized

The CEM method, which is currently used in the Leverage Ratio calculation, does not take into account the impact of posted initial margin in reducing the counterparty exposure of an OTC derivative transaction. The originally designed SA-CCR method did take into account the exposure reducing impact of initial margin, albeit subject to a floor. Removing this improvement of the SA-CCR over CEM will have the impact of ignoring the fact that initial margin is required to be segregated and therefore cannot lead to leveraged exposure.

When the clearing exemption for European pension funds expires, this shortcoming will be devastating for their clearing portfolios, as pension funds will have to keep higher initial margin (stemming from the nature of their hedging activity), which will be disregarded as exposure reducing. The same can be said about the bilateral transactions of pension funds as by the year 2020 most pension funds that use derivatives will be required to exchange bilateral initial margin with their counterparties.

4. Repo markets should not be disproportionately affected

The Leverage Ratio framework is punitive for the market makers in the short term repo market and in this way they impact the end users of liquidity on this market (like buy side participants or smaller financial institutions). Banks, which stand as intermediaries in the repo market are not

able to net exposures with the same counterparty or conditions are imposed to that netting. This will lead to gradual drying up of the liquidity on the repo market.

Pension funds cannot afford to hold cash due to the obligation to be fully invested. In addition, the move to cash only *Credit Support Annexes* and the cash VM requirement for cleared transactions increases the importance of a liquid repo market for pension funds. Unfortunately, the Leverage ratio framework will not favor the banks to participate actively on the repo market.

The impact on our organization can be summarized as follows:

- Difficulty to sign new Global Master Repurchase Agreements and therefore losing potential repo counterparties. We note that reduced liquidity in this market will harm pension funds and may be detrimental to financial stability. Given that mandatory clearing will shift the transformation risk (securities into cash) from banks to end users of OTC derivatives and end users do not have no access to a lender of last resort / guaranteed repo facility, the smooth functioning of a liquid repo market is crucial. In our view it is crucial that end users such as pension funds can rely on a functioning repo markets, in times of markets stress and cash collateral calls.
- Holding more cash in order to compensate for the worse liquidity of the repo market. Pension funds could keep large sums of cash available but holding more cash would lead to pension funds withdrawing money from asset holdings and discourage them from investing in growth initiatives. It would also reduce the returns generated by pension funds and lead to greater financial solvency risk, as pension funds' portfolios may not generate the returns necessary to meet their pension liabilities.
