efama

European Fund and Asset Management Association

EFAMA response to CPSS-IOSCO consultation on Guidance on the application of the 2004 CPSS-IOSCO Recommendations for Central Counterparties to OTC derivatives CCPs

EFAMA[1] welcomes the possibility to comment on CPSS-IOSCO's consultation on Guidance on the application of the 2004 CPSS-IOSCO Recommendations for Central Counterparties to OTC derivatives CCPs

EFAMA finds CPSS-IOSCO's guidance sensible and proportionate and we support its adoption.

There are two areas in which we would like to recommend further wording.

Recommendation 2: Participation requirements

We support in general the possibility of participation requirements for non-regulated entities and therefore the need to have recommendations on the treatment of these participants.

Most investment managers would expect to access central clearing for OTC derivatives purely as a customer, without taking direct clearing membership. This scenario occurs because: firstly, it is not usual for an investment manager to offer clearing services to clients; and, secondly, because investment managers do not in general hold client assets, as these are typically held for underlying clients (including UCITS and other authorised funds) by third party custodians. However, many investment managers are keen to see clearing houses offer segregated accounts directly to end customers, without therefore requiring intermediation through a clearing member of a CCP (usually a bank). It is not clear where this type of "participation" is dealt with and it may vary from CCP to CCP. However, clearly this type of arrangement is purely intended to deal with segregating client assets/monies. We therefore request that it be made clear that arrangements of this type will not be considered a form of clearing membership participation, and therefore will not under any circumstances attract prudential treatment or inclusion in broad default procedures.

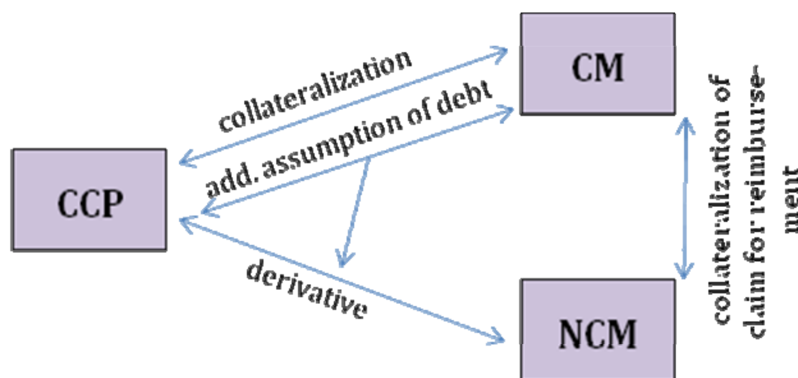
However, some EFAMA members suggest exploring the possibility of non-clearing memberships which could be used by investment managers.

[1] EFAMA is the representative association for the European investment management industry. It represents through its 26 member associations and 44 corporate members approximately EUR 12 trillion in assets under management, of which approximately EUR 7 trillion was managed by approximately 52,000 funds at the end of December 2009. Just under 36,000 of these funds were UCITS (Undertakings for Collective Investments in Transferable Securities) funds. For more information about EFAMA, please visit www.efama.org.

In particular, they propose the alternative below, where also the non-clearing members may be a counterparty of the CCP.

The CCP should offer a non-clearing membership with participation requirements which can be met by most of the market participants, including investment companies respectively investment funds. The applicable terms and conditions should allow OTC derivatives between the non-clearing member and the CCP. The fulfillment of the contractual obligations arising from an OTC derivative could be guaranteed e.g. by an additional assumption of debt ("Schuldbeitritt") of the clearing member to whom the non-clearing member is attributed to. On basis of an agreement between the non-clearing member and the clearing member or respective terms and conditions of the membership, the non-clearing member should be obligated to provide the clearing member with sufficient collateral (regarding a future claim for reimbursement which arises at the moment at which the CCP asks the clearing member to provide collateral for the OTC derivative of the non-clearing member) and the clearing member will collateralize the claim of the CCP against it, respectively the non-clearing member, arising from the respective OTC derivative. The possible trade volume may be limited as agreed between the clearing member and the non-clearing member and should be considered at the electronic trading system through which trades with the CCP take place, to avoid OTC derivatives for which the non-clearing member has not provided sufficient collateral to the clearing member.

An overview:



Recommendation 4: Margin requirements

The additional text for margin requirements does not in itself present issues, however we believe it covers only part of the ground. This is perhaps because it is based on the model presented by exchange traded and centrally cleared derivatives, whereas OTC derivatives present difficulties not just with the nature of the contract or product, but also with the reality that the contract has not been traded across a market. This does not make a great deal of difference to the CCP, but it does to the end-client. We expand on this issue in the attached Annex.

We believe that the cost of central clearing should be proportionate to the risks – and that the consequence of not factoring in the client side of the transaction in the guidance could produce perverse results. Clearly, the correct calibration of margin requirements is critical to the success of central clearing. Margin usually comprises two parts: initial margin, acting in effect as a "buffer" amount against the risk of counterparty default and/or extreme market movements occurring intra-day; and variation margin, reflecting pricing changes in the market. A fault of implementation at many CCPs for OTC derivatives currently is that default or counterparty risk has not been factored in to the initial margin calculations but instead this has been set principally in relation to product risk. From a CCP perspective this is not obviously untoward, in that their exposure is to their clearing members and their relationship with each clearing member is much wider, in terms of products cleared, than contracts struck with individual clients. However, the consequence on the client side is that asset-rich long term savers, such as pension and insurance funds and UCITS, are likely to be cross-subsidising the CCP's clearing members, and leveraged market users, as initial margin is usually applied on a standardised basis.

For example, it is not uncommon for a pension fund to own swaps which commit the counterparty to pay the pension fund fixed cash amounts in the future. As such these contracts are all "one way". This is very different from a bank which may have a huge gross exposure to derivatives, but minimises its overall market exposure by netting offsetting positions. The result at the clearing house level is that the pension fund – which is asset rich - will pay initial margin on its entire notional exposure, whilst a bank with much greater gross positions will put up a tiny fraction of that amount, based on its net exposure, and its ability to call gross margin from the underlying pension fund client. As a consequence, much of initial margin that the clearing house draws on as part of its armoury against systemic risk comes from those who pose little or no systemic risk to the market, whilst the banks and high risk traders that the collateral requirements are meant to target escape lightly.

Given that this is the practical reality, we urge that CPSS-IOSCO should reflect it in its guidance. This could possibly be achieved by additional wording in the guidance. We suggest a new penultimate paragraph along the lines of:

> "*As well as considering the risk of cleared products, OTC derivatives CCPs should take account of the overall impact of margining arrangements both on participants and on end-clients (being the contracted other side of the bi-lateral agreement) with a view to managing systemic risk in the market with optimal efficacy. Prospectively this could include the CCP requiring an adjustment to the default fund to reflect the relative default risk as between the clearing member and the end client; and could include the introduction of gross margining across the market, to better reflect the systemic risk presented to the market by the levels of trading undertaken by different participants.*"

Recommendation 6: Default procedures

The proposed additional text includes the words: *"provide its participants with sufficient information on the level of segregation that is achieved in the CCP's operation".* A consequence of

this wording is that non-participants – which in some CCPs may include most end users of OTC derivatives - can prospectively only gain essential information about default procedures through participants. We do not believe that the proposal is therefore adequate, and strongly recommend that the CCPs are required, at least, to provide this information on-line, without restriction of access or of timing. An alternative wording could be: *"provide sufficient information on the level of segregation that is achieved in the CCP's operation on-line and on request in an easily accessible form"*.

We would be very happy to discuss these points further, or answer any questions that you may have.

ANNEX

This Annex describes in more detail the impact that central clearing could have on pension funds that follow liability driven investment strategies if the initial margin requirements set by CCPs are incorrectly calibrated.

Liability Driven Investment (LDI) and OTC derivative market reforms

This Annex discusses the potential impact of OTC derivative market reforms on European pension funds that have implemented Liability Driven Investment (LDI) strategies. Its intention is to provide constructive guidance to European (and other) regulators who are working on the reform proposals.

The focus is narrow and the paper does not seek to cover broader issues relating to derivative markets that affect all investors.

Recommendations

The proposed OTC Derivative market reforms as currently framed will disproportionately impact European pension schemes who are using derivatives to lower risk by improving their asset and liability matching. If enacted, such schemes would need to post capital in the form of initial margin well in excess of the risk they represent to the system. Furthermore the need to post cash for variation margin would reduce their investment flexibility and indirectly generate risks in other OTC markets.

We believe there are a number of amendments to the proposals that would be in keeping with the intent of reform but not overly penalise end users who pose no systemic threat.

- Ensure proper balance between default fund and initial margin – central clearing houses (CCPs) and their clearing members should contribute a far greater amount into the default fund in order to reduce the margin requirements of end users to a fairer level
- Recognise that conservative investors are lower risk – stable structured investments with low turnover such as pension funds adopting LDI strategies should have reduced collateral requirements for centrally cleared trades.
- Broaden the range of permissible collateral – non cash collateral should be permissible to cover variation margin as well as initial margin.

Without these amendments European pensioners and taxpayers will be forced to shoulder a high percentage of the financial burden whilst higher risk investors such as hedge funds and bank trading desks escape relatively unscathed.

LDI reduces pension fund risk

LDI strategies have come to prominence in the Netherlands (through the Financieel Toetsings Kader regulations January 2007) and also the UK principally as a result of regulatory and

accounting led changes aimed at encouraging pension funds to seek more certainty that their assets are suitably matched to meet the retirement commitments they are contracted to provide to their employees and pensioners. An LDI strategy seeks to reduce pension fund risk by hedging, in whole or in part, the fund's exposure to interest rate and inflation risk (and more recently longevity risk) typically through a portfolio of Interest Rate Swaps (IRS) which seek to match future payments to pensioners. In general these investments are bought and held to maturity resulting in the main characteristics of LDI strategies being low trading turnover and an emphasis on matching long maturities.

Dutch LDI funds on their own are estimated to have around €300 billion assets made up of roughly 600 separate funds. The UK has pension liabilities of €1 trillion, comprised of over 7,000 defined benefit schemes covering over 15 million members. With LDI strategies becoming more prevalent we would conservatively estimate around € 250 billion of this to be hedged with a high likelihood of growth. Increasing interest in LDI strategies is being shown by German, French, Irish and Portuguese corporates.

Pension fund liabilities vary considerably from one scheme to another and the OTC swap contracts each chooses to hold to hedge future cash payments are bespoke in nature. Unlike Credit Default Swaps (CDS) which are well suited for the standardisation needed to facilitate central clearing (on which good progress has been made) it is much harder to standardise an IRS contract such as an inflation swap and particularly Limited Price Inflation (LPI) swaps where the maturity can be as long as 50 years. Development of LDI strategies that more closely match the asset liability mismatch and thus further reduce risk may be hampered as the instruments may not be available for CCP clearing, such as swaps on national inflation indices or swaptions.

Hence LDI strategies are long term, low risk, low turnover and carried out by pension funds seeking to protect scheme beneficiaries in the most conservative manner and one that their regulators deem prudent. In the spectrum of investors LDI is perhaps the polar opposite of a high risk trading fund.

How central clearing impacts pension funds pursuing LDI strategies

The focus of the OTC derivative market reforms is to deal with market excesses and the systemic risk that were found to be posed by the activity of banks and other high risk trading entities. However there is a real danger that European pension funds pursuing conservative LDI strategies will bear a disproportionate share of the financial burden to protect against systemic risk. With no direct influence on the market infrastructure (largely owned and controlled by the banks) it is European pensioners and taxpayers who could become the long term victims by having to shoulder an unreasonable share of the costs.

Collateral burden too high – LDI investors own swaps which commit the counterparty to pay the pension fund fixed cash amounts in the future; as such they are all "one way". This is very different from a bank which may have a huge gross exposure to derivatives but minimises overall market exposure by netting offsetting positions. The result at the clearing house level is that the pension

fund pays initial margin on its entire notional exposure whilst a bank which may have much bigger positions puts up a tiny fraction of that amount. It therefore means that much of initial margin that the clearing house draws on as part of their armoury against systemic risk comes from those who pose little systemic risk whilst the banks and high risk traders that the collateral requirements are meant to target escape lightly.

LCH SwapClear (the largest IRS CCP) estimates initial margin of 7-9% for swaps maturing in less than 30 years and 12- 15% for those maturing in 50 years time. In certain stress simulations (7 day worst case, 1200 days) the initial margin could be as much as 34%, 24% and 18% for 50yr zero-coupon nominal, real and inflation swaps respectively. In test portfolios it is not unusual for 20% of the investment value to be demanded just for margin. As a result a pension fund attempting to hedge €100 million of notional liabilities could face the requirement to place up to €20 million in collateral. On top of this the scheme would need to hold 10-20% in acceptable collateral (cash or near cash) to support potential future variation margin calls so the actual cost would be higher still.

Market fragmentation excludes netting – Under current bilateral arrangements pension funds are able to gain some netting benefits from counterparties by offsetting risks between their Interest Rate Swap portfolio and other portfolios (e.g. Inflation Swaps). This same effect could be achieved under central clearing but only where the clearing house concerned covers the full range of asset classes. Since not all LDI transactions are suitable for central clearing and CCPs product range will be fragmented for some time the scope for a pension fund to net exposures is minimal.

Performance drag from CCP charges and cash demands - Non financial corporate end users have pointed out that they have few government bonds to post as collateral. This is very different from most LDI adopters who typically hold government bonds to match liabilities and for derivatives collateral purposes. But the return from these bonds is reduced materially by the charges imposed by the CCPs and clearing members who hold them as collateral. Another concern relates to the availability of cash to cover the daily variation margin calls of centrally cleared contracts. It is prudent for an LDI fund to be almost entirely invested in bonds and/or equities in order to reduce long-term funding costs. For this reason it is likely that many funds will look to the repo market for the provision of short term cash to cover variation margin with the unintended consequence that central clearing introduces a new source of pension fund and systemic risk.

Market infrastructure cost - There has been some discussion regarding whether or not the proposed CCPs should be built as businesses or utilities. In both cases the largest share of the cost will fall on investors and in the case of LDI strategies, European pensioners. The CCPs and clearing member banks look set to pass on their own costs by way of clearing and execution fees, haircuts and intraday funding fees. How much would they be? A charging structure proposed by a major derivatives clearing member is as follows:

- Transaction fee of €8 per € 1 million notional with a €250 minimum on each side of the transaction (i.e. new, assign, unwind etc.)

- In addition there are asset servicing charges at the CCP levied on collateral posted to them. LCH for instance charges at least 0.25% on cash and 0.10% on bonds.

It seems unlikely that competition from the limited number of clearing member banks will prove to be enough to reduce these fees to utility levels given that regulations are likely to force asset managers to centrally clear a large proportion of their transactions.

Adding up the cost to pensioners (A Typical LDI Pension Mandate)

Total Assets	**€1.0bn**	**OTCs for LDI Strategy**	
Gov Bonds	€0.1bn	Notional of Inflation Swaps	€0.7bn
Index-linked Gov Bonds	€0.4bn	Notional of Interest Rate Swaps	€0.8bn
Floating Rate Notes	€0.3bn		
Asset Backed Securities	€0.1bn		
Equities	€0.1bn		

		Optimistic Investment Leakage	**Pessimistic Investment Leakage**
		€ million	**€ million**
Initial Margin Required	**€ 175 MILLION**		
LCH FACILITY FEE : 0.10% ON BONDS & 0.25% ON CASH		***0.18***	***0.44***
Optimistic Variation Margin	**€ 100 MILLION**		
Pessimistic Variation Margin	**€ 300 MILLION**		
YIELD LOSS BETWEEN GILTS AND CASH : 3.5%		***3.5***	***10.5***
LCH FACILITY FEE : 0.25% ON CASH		***0.25***	***0.75***
Fund Held Potential Variation Margin	**€ 200 MILLION**		
YIELD LOSS BETWEEN GILTS AND CASH : 3.5%		***7***	***7***
CLEARING FEES		***0.01***	***0.01***
Total Cost		**10.94**	**18.7**
Investment Strategy - Yield Drag		**circa 1.1%**	**circa 1.9%**

These amounts are clearly untenable. Margin requirements in excess of 5% of notional will have significant detrimental effects on the LDI mandates. LDI funds would be either forced to cut back on their hedging strategy and take on risk or seek an alternative to central clearing. The risk of pension fund insolvencies could actually increase systemic risk.

A fairer approach

- **Ensure proper balance between default fund and initial margin** - It is critical that the combination of margin and default funds held at a CCP is sufficient to ensure an orderly wind down of activities in the event that the CCP/clearing member ceases to operate. Whilst the CCP and clearing member banks contribute to the default fund it is investors like the LDI funds who put up the bulk of the margin. Banks have a clear incentive to set the margin requirements as high as possible as this correspondingly reduces their default fund contributions. This places an unfair burden on end users like pension funds. The recent EU discussion paper (for the 4th meeting of the Derivatives and Market Infrastructures Member States Working Group – 17th May 2010) states that a margin requirement should be sufficient to cover losses that result from at least 99% of the price movements over an appropriate time horizon. Depending on any but the loosest definition of an appropriate time horizon, this would place a tremendous strain on pension funds legitimately using swap transactions to hedge risk. This can be avoided by legislating that CCPs and their clearing members contribute a far greater amount towards the default fund in order to allow for a reduction in margin requirements to levels that reflect the potential one day loss, which can be as low as 1.25% for a pooled fund covering shorter maturity liabilities.

- **Recognise that conservative investors are lower risk** - It has been noted that LDI funds will suffer disproportionally from the fragmentation of bilateral and centrally cleared products and that this will be magnified in the first few years of regulation. To mitigate this cost, products such as LDI pension funds should have reduced collateral requirements for centrally cleared trades and greater opportunity to clear bilaterally if this provides netting opportunities with non eligible trades. Appropriate levels of Initial Margin for different market participants should be driven by the level of credit risk that each introduces to the market. Very credit worthy participants should post lower levels of margin than highly leveraged investors or prop desks. Without this differentiation, low risk participants are essentially subsidising high risk ones. The end result is that pension funds are subsidising banks and hedge funds.

- **Broaden the range of permissible collateral** - A further way of reducing the strain on asset management funds is to increase the range of collateral accepted not just by the clearing members but by the CCPs themselves. The cash requirement of variation margin is a significant issue for LDI accounts which will not typically hold enough to cover the daily calls. It is not enough for clearing members to provide margin funding for clients by imposing a fee for posting their own acceptable collateral at the CCP since not only would this increase the performance drag on the funds but also has detrimental effects on the

segregation of assets at the heart of many CCP models. Non cash collateral should be permissible to cover variation margin and not just initial margin and we recommend consideration that short term money market funds (subject to current CESR definition) be included in the list of acceptable collateral for European CCPs.

[10-4063]