

**Margin requirements for non-
centrally cleared derivatives:
a response by the National
Association of Pension Funds**

March 2013

Executive summary

- The NAPF strongly supports action to ensure that savers, investors and the wider economy are protected from volatility and risk in the derivatives markets. The new regulatory regime should, however, genuinely reduce risks for pension schemes and not increase the cost of pension provision.
- As guided by UK pension law, pension schemes use derivatives largely to hedge liabilities and, thereby, reduce risk. Extra costs or processes that provide a disincentive for pension schemes to use derivatives could in fact *increase* the degree of risk in the markets.
- Together with the other new requirements being introduced in the European Union through EMIR, the new margin requirements would significantly increase the cost of hedging to pension schemes. This would have an impact on individual pension scheme members through lower pensions, increased contributions, increased risks, higher pension ages or scheme closures.
- Small schemes that pursue liability-driven investment strategies, involving substantial use of derivatives, will inevitably be heavily exposed to the extra costs incurred by their asset managers.
- Pension schemes' use of derivatives is generally restricted to hedging risks (as opposed to seeking returns) and long-tenure. Our members' derivatives holdings are across two closely related underlying markets - interest rates and inflation. This means that our members would see a greater impact from the initial margin proposals than would general portfolio managers, who will benefit from a more mixed balance of longs and shorts across a number of different product areas.
- Pension schemes exhibit low systemic risk. Indeed, they are obliged by the EU Directive on Institutions for Occupational Retirement Provision ('IORP Directive') and by UK trust law to use derivatives in a carefully risk-controlled manner. Ideally, this should be recognised by exempting pension schemes from the new initial margining requirements. If this is not possible, then an alternative approach would be to reflect pension schemes' creditworthiness and the long-term one-direction nature of their derivatives positions by reducing the amounts of collateral that they are required to post.
- It is vital that inflation-based swaps are included in the category of interest rate products and have the same margin requirements. Different treatment would dramatically increase margining costs by making it difficult to benefit from the high correlation between inflation and interest rate products.

- Margining requirements must include adequate arrangements to ensure the safety of pensions schemes' assets when posted as collateral.
- The NAPF would support exempting physically-settled FX forwards and swaps from initial margin requirements of under one year in tenure.
- The NAPF would not support re-hypothecation of posted collateral – even under the conditions indicated in the question. Schemes will want to ensure that any 'overcollateralisation' represented by initial margin is adequately protected if their counterparty defaults. It would be very difficult to convince trustees that a scheme's assets would be adequately secured under a re-hypothecation arrangement.

About the NAPF

The National Association of Pension Funds is the UK's leading voice for workplace pensions. Our members operate 1,200 pension schemes. They provide retirement income for nearly 15 million people and have over €1 trillion of assets under management. Our membership also includes over 400 providers of essential advice and services to the pensions sector. This includes accounting firms, solicitors, fund managers, consultants and actuaries.

Pensions and derivatives – the NAPF's approach

Derivatives are used extensively by pension schemes. The 2012 NAPF Annual Survey (a comprehensive survey of our own members), showed that 57% of pension schemes make use of derivatives, with inflation and interest rate swaps the most widely used. More detailed statistics and extracts from the *NAPF Annual Survey 2012* are set out in *Annex 1*.

The NAPF strongly supports action to ensure that savers, investors and the wider economy are protected from volatility and risk in the derivatives markets. We support many of the proposals currently being implemented through the European Market Infrastructure Regulation, which should inject more transparency into derivatives trades and will, in due course, lead to greater use of central clearing.

The new regulatory regime should, however, genuinely *reduce* risks for pension schemes and not *increase* the cost of pension provision.

Using derivatives to reduce risk

It is important to note that pension schemes do not invest in derivatives as growth assets. Rather, they use derivatives largely to hedge liabilities and, thereby, reduce risk. The use of derivatives helps

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to ensure that pension schemes are sustainable and able to pay pensions to their members over the long term. It follows that extra costs or processes that provide a disincentive for pension schemes to use derivatives could in fact *increase* the degree of risk in the markets and could make pension schemes' funding positions more volatile.

UK defined benefit pension schemes have over €2 trillion of liabilities if calculated on the 'Level A' (risk-free) basis proposed as part of EIOPA's 'Holistic Balance Sheet'.¹

There is a concern that the increased costs associated with additional margining requirements will reduce schemes' investment returns. Ultimately, this would have an impact on individual pension scheme members through lower pensions, increased contributions, higher pension ages or scheme closures.

One-directional use of derivatives

Pension schemes' use of derivatives – like that of corporate end-users – is one-directional, undertaken with the purpose of mitigating risks to the scheme arising from, for example, movements in interest rates, inflation or in life expectancy. As the clearing houses' margin requirements are based on net – rather than gross – positions, pension schemes would end up making a disproportionate contribution to the clearing houses' capital requirements.

Well regulated and credit-worthy

Pension schemes are already well regulated (in the UK, by the Pensions Regulator and, at EU level, by the requirements of the EU Directive on Institutions for Occupational Retirement Provision). Furthermore, pension schemes exhibit a low level of systemic risk. Existing legal requirements (notably the IORP Directive and UK trust law) oblige pension schemes to use derivatives in a manner that carefully controls risks.

Ideally the NAPF would like these factors to be recognised by exempting pension schemes from the new margining requirements. If this is not possible, (the NAPF recognises that a complete exemption is no longer under consideration), then alternative options should be discussed. These should include introducing a component into the margin calculation that results in lower margin requirements for institutions with high creditworthiness. The qualifying criteria for these lower margin requirements might be based on funding ratio (perhaps a funding ratio of at least 80%) and low leverage on assets.

Security of assets

A separate – but very important – concern for pension schemes is the security of their assets. The new system of margining requirements must include adequate arrangements to ensure the safety of pension scheme assets put up as collateral.

¹ *UK Impact Assessment*, The Pensions Regulator, October 2012, p.26

Answers to questions in consultation paper

- Q1. Given the particular characteristics of physically-settled FX forwards and swaps, should they be exempted from initial margin requirements with variation margin required as a result of either supervisory guidance or national regulation? Should physically-settled FX forwards and swaps with different maturities be subject to different treatments?**

Answer. The vast majority of pension fund FX forward contracts have a duration of one or three months.

The NAPF would support exempting physically-settled FX forwards and swaps from initial margin requirements and allowing national regulators to determine the regime for variation margin. This would recognise the short-term, low-risk characteristics of FX-based derivatives.

If, however, initial margin requirements were to apply, then the NAPF would agree that different treatments would be appropriate for different maturities.

- Q2. Should re-hypothecation be allowed to finance/hedge customer positions if re-hypothecated customer assets are protected in a manner consistent with the key principle? Specifically, should re-hypothecation be allowed under strict conditions such as (i) collateral can only be re-hypothecated to finance/hedge customer, non-proprietary position; (ii) the pledgee treats re-hypothecated collateral as customer assets; and (iii) the applicable insolvency regime allows customer first priority claim over the pledged collateral.**

Answer: The NAPF would not support re-hypothecation of posted collateral – even under the conditions indicated in the question. Schemes will want to ensure that any ‘overcollateralisation’ represented by initial margin is adequately protected if their counterparty defaults.

It would be very difficult to convince trustees that a scheme’s assets would be adequately secured under a re-hypothecation arrangement. Allowing a counterparty to lend collateral on or use it in transactions with third parties could put it at risk.

It is just possible that re-hypothecation of cash posted as variation margin could be acceptable, but this would need to be tightly controlled.

Pension scheme trustees will want to be sure that collateral posted as margin is not posted by title transfer, as this would open the door to re-hypothecation. Trustees will be wary of finding themselves in the position of making an unsecured claim for return of collateral if a bank defaults. For this reason, it is likely that they would look for tri-party arrangements,

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under which collateral would be posted into a separate account in the trustees' name, subject to security in favour of the counterparty.

Q3. Are the proposed phase-in arrangements appropriate? Do they appropriately trade off the systemic risk reduction and the incentive benefits with the liquidity, operational and transition costs associated with implementing the requirements? Are the proposed triggers and dates that provide for the phase-in of the requirements appropriately calibrated so that (i) the largest and most systemically-risky covered entities would be subject to the margining requirements at an earlier stage so as to reduce the systemic risk of non-centrally cleared derivatives and create incentive for central clearing, and (ii) the smaller and less systemically risky covered entities would be allowed more time to implement the new requirements? Should the phase-in arrangements apply to the exchange of variation margin, in addition to the exchange of initial margin as currently suggested? Or, given that variation margin is already a widely-adopted market practice, should variation margin be required as soon as the margin framework becomes effective (on 1 January 2015 as currently proposed) so as to remove existing gaps and reduce systemic risk? Do differences of market circumstances such as readiness of market participants and relatively small volumes of derivatives trading in emerging markets require flexibility with phase-in treatment, even for variation margin?

Answer: The proposals for phase-in of initial margin look sensible.

Q4. The BCBS and IOSCO seek comment on the accuracy and applicability of the QIS results discussed above.

Answer: Although the €8 billion threshold proposed in paragraph 2(g) would exempt the vast majority of NAPF member pension schemes, our larger members would be required to post substantial amounts of initial margin. Together with the other new requirements set out in EMIR, the new margin requirements would increase the cost of hedging significantly.

Treatment of interest rate and inflation swaps

A key concern for pension schemes is that interest rate and inflation swaps should be treated in the same way. (The consultation paper proposes that initial margin would range from 1 to 4% for interest rate swaps, depending on duration, but would be set at 15% for 'other' derivative types, such as those based on inflation). BIS-IOSCO should provide urgent clarification that the margin requirements for inflation-based derivatives will be reduced to levels similar to (and preferably identical to) those for interest rate-based derivatives. If inflation-based derivatives are treated as an "other" product, then this will increase initial margins by a factor of almost four times.

One of the UK's largest pension schemes (which represents approximately 3% of the UK pension market) estimates that it would be required to post around €1.25-1.7bn of initial

margin if interest rate and inflation swaps were treated identically and the amounts were calculated according to the BIS/IOSCO standard approach, but as much as €2.8-3.4 billion under the current proposal.

Liability-driven investment

Smaller pension schemes would still feel a significant impact from the initial margin requirements, as their fund managers would inevitably pass the costs of margining back to their pension scheme clients through higher charges or lower returns on investments. Furthermore, small schemes that pursue liability-driven investment strategies, involving substantial use of derivatives, will inevitably be heavily exposed to the extra costs incurred by their asset managers. There is a risk that small and medium-sized pension schemes that outsource LDI to large investment managers will be fully and immediately impacted by these rules with little benefit to them.

Annex 1: Pension funds' use of derivatives: extracts from NAPF Annual Survey 2012

About the NAPF Annual Survey 2012

734 NAPF fund members were invited to take part in an online survey between 7 September 2012 and 25 October 2012. 280 members responded, giving an overall response rate of 38%.

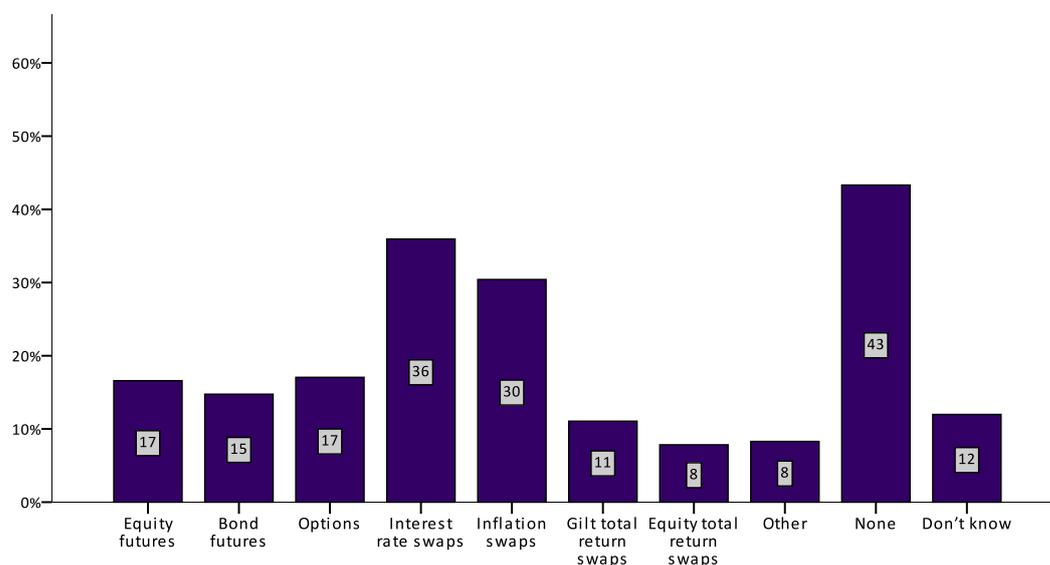
80% of respondents were in the private sector, 11% were local authority pension funds and 8% were 'other public sector'.

Defined benefit schemes covered by the Survey (excluding the Local Government Pension Scheme) had 6 million members and held €610 billion assets in total.

Pension schemes' holding of derivatives

Respondents were asked about derivative instruments used in their schemes (Figure 1). Almost half did not use derivatives at all. Those that did were most likely to use interest rate swaps (36%) and inflation swaps (30%). This is consistent with increased tendency for DB schemes to seek investments which can help them to hedge their inflation-linked long term liabilities.

Figure 1: Derivative types in use by UK pension schemes



Base: 191 respondents

Annex 2: Hedging - extracts from the Pensions Regulator's Purple Book 2012

The UK's Pensions Regulator publishes an annual statistical publication, the 'Purple Book', which gives a comprehensive assessment of pension scheme funding in the UK. This short extract, which draws on research by F&C, summarises liability hedging arranged by investment banks for pension funds.

"Quarterly F&C Asset Management surveys of volumes traded by investment banks suggest that:

- *£53.3 billion of liabilities were hedged using interest rate derivatives in the year to the second quarter of 2012, up 21 per cent from 2011.*
- *£58.4 billion of liabilities were hedged using inflation derivatives in the year to the first quarter of 2012. Inflation hedging activity totalled £18.5 billion in the second quarter of 2012, exceeding 2009 record levels.*

Total risk transfer business covering buy-outs, buy-ins and longevity hedges amounted to around £40 billion between the end of 2006 and the first quarter of 2012. Most of the total reflected longevity hedges, 23 per cent reflected buy-ins and 21 per cent buy-outs. £7 billion of longevity hedges were put in place in the second half of 2011, up from £3 billion traded in 2010."

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