European Market Infrastructure Regulation
Position Paper

General remarks

This position paper is part of a joint response to the public consultation on Regulation (EU) 648/2012 on OTC derivatives, central counterparties and trade repositories (EMIR) of the Dutch Pension fund for Metalworking and Mechanical Engineering (PMT), the Pension fund for the Metal and Electrical Engineering Industries (PME) and their service provider MN.

We endorse the response provided by PensionsEurope to the public consultation on EMIR. In this position paper we briefly state our own position, and we provide further explanations and details to the questions asked in the consultation.

Introduction

After the financial crisis EMIR was introduced to regulate derivatives markets and establish a safer and sounder regulatory framework for European financial markets. The Regulation requires all standard OTC derivative contracts to be cleared through Central Counterparties (CCPs) and introduces trade reporting and risk mitigation requirements for derivative counterparties. Whereas Pension Scheme Arrangements (PSAs) have been granted an exemption from central clearing (until August 2017), we have gathered some extensive experience in implementing EMIR. We would like to highlight some ongoing impediments with respect to certain provisions under the Regulation.

Pension funds (or PSAs) have been granted a three-year exemption from the clearing obligation in order to provide CCPs with sufficient time to develop technical solutions for the transfer of non-cash collateral to meet Variation Margin (VM) calls. Pension funds are generally fully invested and hold no significant amounts of cash as interest rates on cash collateral are low. Holding high cash reserves reduces the opportunity to invest in the real economy in order to earn high returns for pensioners. For PMT and PME, which provide pensions for workers in the industry sector, a key investment belief is that underlying economic activity is the driver of sustained value creation within an asset class. Current collateral arrangements under EMIR for Variation Margin (cash only) will increase liquidity risk for pension funds significantly and will have a negative impact on investment returns, which could in turn affect the retirement income of European citizens.

In our response to the public consultation, we express our support for a technical solution for pension funds to meet Variation Margin calls, whilst simultaneously not holding large amounts of cash. This will prevent central clearing from negatively affecting retirement incomes.

Our remarks

General
We support the underlying goals of EMIR to achieve more stable, transparent and efficient derivatives markets. In our view, EMIR could contribute to the safe workings of European financial markets, provided that the interests and characteristics of different market players are taken into account. A one-size-fits-all approach should not be applied in the regulatory framework for derivatives trading. Policy initiatives should be proportionate and must be assessed both in terms of social and economic impact.

CCP Margins and Collateral

For central clearing, the Variation Margin requirement (VM) is restricted to cash only. This causes high liquidity risks for pension funds that are generally fully invested. Pension funds hold no significant amounts of cash because of the low level of interest on cash reserves. Holding high cash reserves reduces the available budget for investing and therefore negatively impacts aggregate investment returns. This in turn has a negative impact on pension incomes. Current collateral arrangements under EMIR also limit the possibilities for long term investment linked to the recent Capital Markets Union (CMU) initiative of the European Commission. The CMU initiative seeks to mobilize investments by institutional investors in SMEs and infrastructure in order stimulate economic growth and employment in Europe.

CCP Liquidity

Facilitation of (unlimited) access of CCPs to central bank liquidity facilities will decrease the counterparty risk of pension funds to CCPs tremendously, especially in times of market stress. In addition, CCPs authorized under EMIR can use their access to additional liquidity from central banks to take on liquidity risk from pension funds and set up a guaranteed repo facility for pension funds. A guaranteed repo facility can provide a solution for CCPs to accept non-cash assets from pension funds as collateral to meet Variation Margin (VM) calls[1]. In this solution, pension funds use repos to transform their non-cash assets into cash to meet VM calls, without losing the investment returns in the long term. With this solution, pension income of European citizens would not be jeopardized. In order to secure sufficient capacity in the repo markets in times of market stress, central banks should be prepared to offer liquidity to CCPs. For pension funds the opportunity costs of this facility should not exceed the costs of maintaining a large cash buffer.

Client Clearing Relationships

Pension funds use OTC derivatives to mitigate investment risks, such as interest rate risk and currency risk. When the clearing capacity is limited due to risk limits set by Clearing Members and CCP's, pension funds would have no capacity to clear their OTC derivates. As a result, pension funds can no longer hedge their investment risks, which increases risks to pension income. Furthermore, only a limited number of Clearing Members is available to the market and access to Clearing Members is limited for smaller market players who have to rely on so-called 'indirect client arrangements'. These developments cause significant concentration risks. In an ideal case, central clearing would be defined as a non-commercial obligation in order to mitigate market externalities arising from the central clearing obligation under EMIR.

Trade Reporting

The implementation of trade reporting obligations brings about significant costs to end-users. Some counterparties make reporting errors regarding transactions. In the United States this problem is solved by having brokers report on the trades, and not the end-users. This model would be a viable solution for the reporting requirements under EMIR and should be implemented on EU level as well.

Post Clearing Member Default

Porting of cleared transactions during a crisis (e.g. post Clearing Member default) is a major concern to end-users. Successful porting after a Clearing Member's default is almost impossible. After a default the entire portfolio of cleared OTC-derivatives needs to be ported in one set to a single other non-defaulted Clearing Member. This requires an end-user to open multiple accounts at different Clearing Members just to make sure that every portfolio can be ported to another Clearing Member. If an end-user cannot port its cleared OTC-derivatives trades set, it will lose its market exposure and possibly incur unforeseen losses. As a result there is high demand for the limited number of Clearing Members which will be reflected in the price setting of these CMs, causing higher costs for end-users.

[1] Under the proposed repo service, PSAs would enter into repo transactions with other market participants of the trading service using the securities that it already holds. These transactions would be executed on the CCP's repo trading platform and would automatically be cleared through its clearing service. The cash raised by the repo transactions could then be posted to the CCP to meet VM calls. The repos themselves would be cleared through the CCP and therefore the PSA's counterparty credit risk on this transaction would be mitigated by the CCP (see also the European Commission report assessing the progress and effort made by CCPs in developing technical solutions for the transfer by pension scheme arrangements of non cash collateral as variation margins, 2015).

Joint response of PMT, PME and MN to the public consultation on Regulation (EU) 648/2012 on OTC derivatives, central counterparties and trade repositories (EMIR)

Question 1.1 CCP Liquidity

i. Is there a need for measures to facilitate the access of CCPs to central bank liquidity facilities?

Yes, there is a need for measures to facilitate (unlimited) access of all CCPs to central bank liquidity facilities, especially in times of market stress or crisis situations. In the system of central clearing, risks are concentrated within a small number of CCP's. Financial stability and the solidity of CCP's should therefore be guaranteed at all times, especially in times of market stress.

Moreover, the rights of end-users such as pension funds in case of a defaulting CCP are defined by contractual arrangements with the Clearing Member. These contractual arrangements determine to what extent the CM can be held liable in order to recover the losses of a defaulting CCP. The Clearing Member's stance in these contractual arrangements is that of a "riskless principle". This means that (liquidity) risks are transferred to end-users. A default of any Clearing Member or CCP can have large negative consequences for pension funds and ultimately affect pensioners' income.

ii. If your answer to i. is yes, what are the measures that should be considered and why?

Facilitation of (unlimited) access of CCP's to central bank liquidity facilities will decrease the counterparty risk to CCP's tremendously, especially in times of market stress (as it decreases systemic risk). In addition, CCP's authorised under EMIR can use their access to additional liquidity from central banks to set up a guaranteed repo facility for pension funds / Pension Scheme Arrangements (PSAs), which face high liquidity risks as a result of the margin requirements under EMIR. The proposed guaranteed repo facility can provide a solution for the inability of CCP's to accept non-cash assets from pension funds as collateral to meet Variation Margin (VM) calls. With this solution, the retirement incomes of European citizens would not be jeopardized as is the case when pension funds were required to post cash to meet VM calls.

In the baseline report on solutions for the posting of non-cash collateral to CCP's by PSAs prepared by Europe Economics and Bourse Consult, it is stated that collateral transformation by CCP's could provide the best viable alternative for the posting of cash-collateral to CCP's by pension funds. This solution should entail a guaranteed repo service offered by CCP's to pension funds in which the CCP would be a principal, providing cash to pension funds in return for securities. This would further entail executing a back-to-back repo with a third party (central bank) to raise the cash.

As will become clear from our example under question 1.5, pension funds are exposed to high liquidity risks as a result of margin requirements under EMIR. A guaranteed repo facility offered by the CCP and backed by central bank liquidity facilities will diminish increased liquidity risk for pension funds as a result of EMIR to a great extent and thereby contribute to financial stability. For pension funds it is important that the haircuts and eligible collateral used in these repo transactions should be proportionate and not unlimited in order to secure sufficient access to liquidity. To this end, ECB defined haircuts could be applied.

Question 1.4 Procyclicality

(a) i. Are the requirements under Article 41 EMIR and Article 28 Regulation (EU) No 153/2013 adequate to limit procyclical effects on CCPs' financial resources?

Yes, the requirements are more than adequate.

(b) i. Is there a need to define additional capacity for authorities to intervene in this area?

No, there is no need for additional capacity for authorities to intervene.

Question 1.5 CCP Margins and Collateral

(a) i. Have CCPs' policies on collateral and margin developed in a balanced and effective way?

No, CCPs' policies on collateral and margin have not developed in a balanced and effective way.

ii. If your answer to i. is no, for what reasons? How could they be improved?

The variation margin requirement is restricted to cash only. This causes high liquidity risks for pension funds that are generally fully invested. A guaranteed repo facility offered by CCP's for pension funds will mitigate these liquidity risks to a great extent. This repo transaction should involve a back-to-back repo with a third party (e.g. central bank) to raise cash.

(b) i. Is the spectrum of eligible collateral appropriate to strike the right balance between the liquidity needs of the CCP and its participants?

No, as institutional investors with a long term investment horizon, pension funds aim to be fully-invested. Current eligible collateral arrangements under EMIR for Variation Margin will increase liquidity risks for pension funds to a great extent. Holding large amounts of cash to post Variation Margin, reduces the available budget for productive investments in the real economy.

Current collateral arrangements under EMIR also limit the possibilities for long term investment linked to the recent Capital Markets Union (CMU) initiative of the European Commission. Within the CMU framework the Commission tries to mobilize investments by institutional investors in SME and infrastructure investments, in order to decrease bank dependence for external financing and to stimulate economic growth and employment in Europe. Holding larger amounts of cash negatively impacts investment returns, which in turn has a negative impact on retirement income for (future) pensioners.

Below we provide an example of the liquidity needs for an average pension fund under the European Market Infrastructure Regulation (EMIR) in a stress scenario (interest rate hike and euro depreciation), in order to illustrate increased liquidity risk for pension funds under EMIR.

Example illustrating increased liquidity risk for pension funds under EMIR

Table 1 shows the asset side of the pension fund's balance sheet. It also shows how the different derivatives and assets contribute towards hedging against interest rate and currency risks. The pension fund's total assets amount to 1 billion euros. Its pension liabilities involve 1 billion euros with a duration (interest rate sensitivity) of 20. Its funding ratio is 100% and 50% of the fund's interest rate risk is hedged.

Table 1. Balance sheet of the pension fund (assets side)

Asset mix (EURm)	Market value	Nominal value	Duration	Share of interest rate hedge	Share of currency hedge
Government bonds	400	400	12.5	25%	0%
Interest rate swaps	0	250	20	25%	0%
US equities	300	300	0	0%	0%
European equities	300	300	0	0%	0%
Currency swaps	0	300	0	0%	100%
Total	1000			50%	100%

The pension fund holds the following assets:

- EUR 400 million in government bonds;
- EUR 300 million in European equities;
- EUR 300 million in US equities.

The fund has also a portfolio of OTC derivatives (interest rate and currency swaps) so as to increase its interest rate hedge from 25% to 50% and to fully hedge the euro/dollar exchange rate.

The fund's derivatives portfolio comprises:

- EUR 250 million in notional interest rate swaps, no market value;
- EUR 300 million in notional currency derivatives, no market value.

Collateral in current OTC markets

The pension fund has made arrangements with counterparty banks in the OTC market to exchange physical collateral to cover changes in the market value of derivatives. The fund's EUR 400 million sovereign debt portfolio is in this respect eligible as collateral. The liquidity risk is very low as the pension fund has a large buffer available to meet its collateral obligations arising from changes in the value of derivatives. The chances of the pension fund defaulting are virtually non-existent. With regard to currency swaps, the fund needs to settle these trades within relatively short periods of time, but payments may be spread out over time. The payment obligations can be met by using "repos" to generate cash or by maintaining a small long-term cash buffer. The pension fund in the example uses repos and has no long-term cash buffer.

Central clearing and collateral requirements

If derivative contracts are cleared in accordance with EMIR, the pension fund's liquidity needs will change substantially. The effects are twofold. First, the pension fund will need to post 'initial margin' that acts as a buffer in times of crises. Physical collateral is allowed and the fund can use its government bond portfolio to this end. Initial calculations have revealed that, in practice, the initial margin requirement translates into approximately 10% of the nominal value of the cleared OTC derivatives. However, in times of crisis, the initial margin requirement may increase to around 30%, based on average contract terms of a pension fund with a Clearing Member.

Secondly, the pension fund will need to deliver 'variation margin' daily. CCP's do not allow government bonds to be used for this purpose; variation margin is restricted to cash only. This means that an average pension fund, if fully invested, will have a potential liquidity problem if it cannot access cash in the repo markets. When derivatives develop a negative value, the full market value must be paid in cash. If a pension fund does not succeed in generating sufficient cash to meet the VM call (on a daily basis), there is a risk that the entire position is closed out even though the pension fund is solvent. In such a situation, the reputation and creditworthiness of a pension fund is also seriously damaged.

Liquidity needs in a stress scenario
The table below shows the pension's funds liquidity needs in a stress scenario. The stress scenario includes a 0.45% rise in interest rates (45 basis points) and a 7% depreciation of the euro against the dollar. Moreover, the initial margin requirement increases from 10% to 20% of the notional of the cleared OTC derivatives.

Table 2. Liquidity needs for the pension fund in a stress scenario

Liquidity needs (EURm)	Variation margin requirement	Variation margin (% assets)	Initial margin requirement	Initial margin (% assets)
Interest rate swaps	EUR 23	2.25%	EUR 50	5.00%
Currency swaps	EUR 21	2.10%	EUR 60	6.00%
Total	EUR 44	4.35%	EUR 110	11.00%

The amount of cash the pension fund would need increases to EUR 44 million (4.4% of the total portfolio). The daily exchange of Variation Margin could actually lead to the fund having to sell its bonds or shares directly in order to generate cash. This could trigger fire sales where pension funds would have to sell their assets at high discounts in order to get liquidity/generate cash. If the pension fund fails to deliver the EUR 44 million in cash, the pension fund would be in default. The initial margin requirement also increases from EUR 55 million to EUR 110 million, or 11% of total assets. Moreover, the bond portfolio, used as a buffer to meet the initial margin requirement, declines by EUR 22.5 million.

ii. If your answer to i. is no, for what reasons? How could it be improved?

Please refer to our answer under Question 1.1: CCP Liquidity (ii). In order to reduce liquidity risks for pension funds and strike the right balance between the liquidity needs of the CCP and its participants, a guaranteed repo service should be offered by CCPs to pension funds. In this repo transaction the CCP provides cash to pension funds in return for securities. This transaction involves executing a back-to-back repo with a third party (e.g. central bank) to raise cash.

Question 2.2 Clearing Obligations

(a) i. With respect to access to clearing for counterparties that intend to clear directly or indirectly as clients; are there any unforeseen difficulties that have arisen with respect to establishing client clearing relationships in accordance with EMIR?

There are three unforeseen difficulties with respect to establishing client clearing relationships in accordance with EMIR.

1. Tight Risk Limits
End-users are restricted in clearing their OTC derivatives due to risk limits set by Clearing Members. A CCP will in turn (and on their behalf) use risk limits to restrict Clearing Members. Clearing Members have to take into account these risk limits set by the CCP in their processes and systems and transfer them to end-users. This creates additional risks for end-users, such as pension funds, in the sense that the capacity to clear could be limited. Pension funds use OTC derivatives to mitigate investment risks, such as interest rate risk and currency risk. If risk limits are too tight, pension funds have no capacity to clear their all their OTC derivates. In this case pension funds can no longer hedge their investment risks and pension income is at risk.

2. Concentration Risk due to limited number of CCPs and CMs
Due to the necessity of economies of scale only a couple of relevant clearing houses will emerge. Moreover these clearing houses will initially specialize in specific types of derivatives. Furthermore, significant requirements are set by clearing houses (e.g. systems requirements, intellectual capital, etc.) to become a Clearing Member, which results in a limited number of available Clearing Members to the market. Both developments cause considerable concentration risks for market participants.

3. Insufficient access to Clearing Members
Especially regarding smaller pension funds, access to Clearing Members is limited. Small and medium sized pension funds are therefore dependent on 'indirect client arrangements'. In this case the smaller end-users will need a bigger end-user (e.g. a bank) that has a relationship with a Clearing Member. Indirect client arrangements are still being developed and it should be noted that this needs further attention and investigation by legislators.

ii If your answer to i. is yes, please provide evidence or specific examples. How could these be addressed?

The difficulties as described under question 2.2 (a) have in common that there are significant barriers for new Clearing Members to enter the market. Moreover, it could be concluded that existing Clearing Members have a benefit to keep their market share high. Because competition on this market is lacking, it causes difficulties for other market participants with respect to establishing client clearing relationships in accordance with EMIR. In an ideal case, central clearing would be defined as a non-commercial obligation in order to mitigate market externalities as a result of the central clearing obligation under EMIR.

Question 2.3 Trade reporting

i. Are there any significant ongoing impediments or unintended consequences with respect to meeting trade reporting obligations in accordance with Article 9 of EMIR?

Yes, the implementation of the trade reporting obligations brings about significant costs to end-users. Furthermore the reported data is of relatively low quality.

ii. If your answer to i. is yes, please provide evidence or specific examples. How could these be addressed?

One example is that some counterparties make reporting errors regarding transactions. In the United States this problem is solved by having brokers report on the trades, not the end-users. In our view, this model would be a viable solution for the reporting requirements under EMIR.

Question 2.10 Additional Stakeholder Feedback

i. Are there any significant ongoing impediments or unintended consequences with respect to any requirements or provisions under EMIR and not referenced in the preceding questions that have arisen during implementation?

Yes.

ii. If your answer to i. is yes, please provide evidence or specific examples. How could these be addressed?

Porting of cleared transactions during a crisis (e.g. post Clearing Member default) is a major concern to end-users. Successful porting after a Clearing Member's default is almost impossible. After a default the entire portfolio of cleared OTC-derivatives needs to be ported in one set to a single other non-defaulted Clearing Member. This requires an end-user to open multiple accounts at different Clearing Members just to make sure that every portfolio can be ported to another Clearing Member. If an end-user cannot port its cleared OTC-derivatives trades set, it will lose its market exposure and possibly incur unforeseen losses. As a result there is a high demand for the limited number of Clearing Members which will be reflected in the price setting of CM's, causing higher costs to end-users.