Response to the European Securities and Markets Authority discussion paper

Draft Technical Standards for the Regulation on OTC Derivatives, CCPs and Trade Repositories ("EMIR")

August 2012

A BNY MELLON COMPANY[SM]

Insight INVESTMENT

Introduction

Insight Investment is a leading asset manager focused on designing investment solutions to meet our clients' needs. Launched in 2002, Insight is responsible for assets under management of €225bn[1] on behalf of predominantly European pension funds and other long-term savings institutions. Pension funds use financial derivatives to protect and stabilise their solvency through asset and liability risk management overlay programmes. This provides security of retirement income for current and future pensioners. As such, we make extensive use of interest rate, inflation, credit and equity OTC derivatives to execute these risk management programmes on behalf of our clients.

Insight welcomes the opportunity to provide our views and we are pleased to submit our response to the "Draft Technical Standards for the Regulation on OTC Derivatives, CCPs and Trade Repositories" published by the European Securities and Markets Authority (ESMA) on 25 June 2012.

In this document, we provide our key responses to the proposed draft rules. Please do not hesitate to get in touch with us if you would like any further information on the points raised.

1. Article 4 MAR on portfolio margining (p.106)

We support margin offsets to be allowed between different instruments within a portfolio. End-users, including pension funds, use a variety of instruments to manage risk exposures. The offset that different financial instruments provide to each other is an important part of the risk management process and regulators need to recognise this in the margin calculations. We are concerned that ESMA may not allow the appropriate margin offsets between products where there is a structural, fundamental or economic relationship because the proposal only looks narrowly at correlation analysis. The proposal does not take into consideration how sets of financial derivatives are used in combination for hedging (as further explained below). This could lead to a series of unintended consequences for the market. This could include more derivatives falling outside the scope of clearing, discourage end-users from prudent risk management, increase risk within the system, and increase costs and therefore reduce retirement income for pensioners.

We broadly support the provision of margin offsets to be allowed only where there is a strong relationship between financial instruments. The use of correlation analysis to objectively determine whether a strong relationship exists between financial instruments can work in some instances. However, we are concerned that there may be an over reliance on this correlation analysis to determine which financial instruments would fall within the same set for the purposes of portfolio margining. Correlation analysis is not always reliable, especially when there is not enough historical data. In fact, there are many derivative instruments that do not have more than a few years of data and therefore not enough through varied economic cycles.

In the first instance there needs to be a consideration made as to whether certain financial instruments have a strong fundamental, economic or structural relationship. Only when that does not exist should a correlation test be applied to determine if offsets should be allowed for margin calculations.

We consider interest rate derivatives and inflation derivatives to part of the same set of financial instruments and margin offsets should be allowed without the need for any minimum correlation test. This can be justified on the basis of a strong fundamental, economic and structural relationship existing between interest rates and inflation. Many central banks set their interest rate and monetary policy targets based on expected rates of inflation, creating a strong link between the two. There are also other fundamental, economic and structural relationships between the two instruments.

[1] Data as at 30 June 2012.

Many end-users of derivatives, including pension funds, use interest rates and inflation derivatives together to create a real rate hedge to hedge their real rates exposures. This is an important risk management strategy that pension schemes undertake to manage their financial solvency. Regulators should recognise the use of these instruments as two parts of the same hedge and allow margin offsets between them.

We do not know yet, based on the proposed rules, if ESMA will consider these instruments to fall within the same set of financial instruments (and therefore not apply the correlation test) or not. Inflation derivatives have only been liquid since about 2006 and as such we are concerned that any correlation analysis will produce results that cannot be relied upon. Due to this limited historical data, any correlation analysis on these instruments would not include the full breadth of possible scenarios, including both high inflationary as well as low inflationary environments.

If interest rates and inflation derivatives were not permitted to have margin offset treatment, we estimate that this would double the amount of initial margins that pension funds (and other end-users hedging real rate exposures) would have to post. This could discourage pension funds from appropriately risk managing their solvency risk. Alternatively, for pension funds who wish to manage their solvency risk appropriately, this could require them to hold a greater proportion of cash/government bonds and other eligible collateral for margin purposes and a reduced proportion of return seeking assets. This will lead to a lower retirement income for current and future pensioners. Please do not hesitate to get in touch with us if you require further information or any analysis conducted on this.

It is not necessary to treat financial instruments separately for the purposes of margin calculations in order to adopt prudent risk management. By choosing an appropriately conservative confidence interval (e.g. the 99.5% as suggested by ESMA for OTC derivatives), any margin offset that would be allowed would be prudent.

We are concerned that if ESMA requires interest rate and inflation derivatives to have a minimum negative price correlation, this could prevent offsets from being allowed between these instruments. This is likely to discourage clearing by forcing end-users to use either existing but less liquid instruments, or other innovative instruments that would allow such margin offsets. For example the use of real rate derivatives would, in our view, be encouraged if interest rates and inflation derivatives are not permitted the correct offset treatment. These provide the same economic effect as combining interest rate and inflation derivatives but are far less liquid than either instrument. The poor liquidity of real rate derivatives may mean that these instruments are less likely to be cleared. The net impact of this is that end-users are encouraged to use derivatives that are likely to fall outside of clearing.

In summary, if ESMA does not allow the appropriate margin offsets between products where there is a fundamental, economic or structural relationship (such as rates and inflation derivatives), we believe this could lead to a series of undesirable consequences for the market. In particular, it could:

- discourage clearing by encouraging end-users to use instruments that fall outside the scope of clearing
- discourage end-users from managing risks prudently, therefore increasing risk within the system
- lead to increased market fragmentation and reduced liquidity as new products are innovated to benefit from margin offset treatments
- lead to a disproportionate increase in costs for pensioners and therefore a reduction in the retirement income for current and future pensioners where pension funds decide to risk manage their solvency risk prudently

2. Article 4 MAR (3) on the requirement for the same default fund to apply for margin offset treatment to apply (p.106)

We understand ESMA's concerns here. However we believe that this requirement could prevent the industry from developing any solutions in the future, even where the risk considerations are appropriately catered for.

We are keen to get more products cleared than the number currently cleared by CCPs today. Although we would be happy for all of them to be applied through the same default fund, we are concerned that CCPs may not offer clearing of some derivatives if they were not allowed to have separate default funds for some products (e.g. for liquidity reasons). This, combined with ESMA's proposed rule, would prohibit any margin offset treatment of derivatives where CCPs require separate default funds, even in situations where alternative structures may be developed to address ESMAs concerns. Alternative structures could include, for example, the use of a third common default fund between the products.

We would like any proposal to be flexible enough such that any suggestion put forward by the industry, can be acceptable if ESMA considers it to meet appropriate risk considerations.

3. Article 3 RM on portfolio compression (p.74)

We raise two points on compression below.

1) **Portfolio compression requirements should take into consideration that investors would need to keep separate transactions in different funds or mandates and therefore compression cannot be conducted across different portfolios or mandates**

   Investors cannot be expected to compress transactions across two different mandates or funds (even if the end-bank counterparty to those transactions executing the transactions is the same). Investors have different investment managers managing different funds or mandates for them. It would be impossible for an investment manager such as ourselves to conduct investment management business if we were required to compress with another fund or mandate managed by a different investment manager on behalf of the same investor, or with a separate mandate or fund that we manage for the same investor.

   Each fund or mandate has specific goals and requirements and therefore they need to be managed individually. In summary, portfolio compression should only be required within each fund or mandate.

2) **Compression should only occur for equal and opposite trades, or what are called 'risk-free' trades**

   Compression should only occur between trades that are equal and opposite in every key element (except for notional where compression can be executed over the smaller notional where trades are matched). The trades should only be compressed if they are matched in the key economic terms that affect pricing. This is what we call risk-free compression and we are supportive of this.

   However some infrastructure providers and market participants also engage in risky compression. This is where the trades are not exactly matched but where similar trades are compressed and a new trade is created reflecting a similar net risk. We would not support this being rolled out to the wider market and any compression required by regulators should be risk-free compression only.

The problem with risky compression is that the new transaction that is created would not have exactly the same risk characteristics as the original transactions. It would be similar but not exactly the same. This would create problems for us in providing risk management solutions for our clients because the new transaction may no longer meet the risk characterises required to hedge our client's exposure. This would make any risk management that we conduct on behalf of our clients to be far less efficient and could even potentially introduce new risks for the client.

4. Other issues

Whilst not directly related to points on the ESMA's consultation paper, we believe the following is also important for ESMA to consider in its Level 2 rule-writing process.

Margining of non-cleared trades should not be applied retrospectively to trades executed between when Level 1 enters into force and when Level 2 margin rules for non-cleared trades enters into force (i.e. front-loading should not apply for margining of non-cleared rules). The margining would impact the economic terms of the transaction and it would be impossible for the market to trade derivatives without knowing the economic terms of the transaction at the point of trade. Margin rules for non-cleared trades should only apply to new trades executed once the Level 2 margin rules are finalised. We acknowledge that ESMA is working with the Commission on this point and we are keen to ensure that the right outcome is reached.

Contact page

Main contact	Andrew Giles
Title	Chief Investment Officer (Solutions)
Telephone	+44 20 7321 1407
Email	andrew.giles@insightinvestment.com
Address	160 Queen Victoria Street, London EC4V 4LA
Website	www.insightinvestment.com