Basel Committee on Banking Supervision consultative document on Revisions to the Basel III leverage ratio framework

Insight Investment response

6 July 2016

A BNY MELLON COMPANY℠

Insight Investment supports to overall policy goals of the international regulators and we welcome the opportunity to provide our views on this consultation..

Insight Investment is a specialist asset manager responsible for €555 billion[1] in assets under management for institutional investors, including assets managed on behalf of European pension schemes in the form of liability risk management mandates. This positions Insight as one of the largest managers of European pension schemes and a very significant user of over-the-counter (OTC) derivatives on their behalf.

We set out below a summary of our key concerns, followed by background information on European pension funds and further details on our concerns.

SUMMARY OF OUR KEY CONCERNS

This response sets out the concerns we have on behalf of our clients, in particular European pension funds. While our clients are not subject to the leverage ratio rules directly, they often indirectly bear the burden of these rules as banks look to pass on any cost or impact to their clients.

A summary of our concerns are set out below:

1. **High quality government bond securities, with appropriate haircut, should be permitted to offset replacement cost in OTC derivatives exposure calculation**
2. **SA-CCR methodology disproportionately penalises one-directional European pension fund portfolios**
3. **Initial margin should be permitted to offset both cleared and non-cleared trades**
4. **Treatment of inflation swaps within SA-CCR should be explicit and the asset class should be categorised within the same asset class as interest rates**
5. **Repo markets should not be allowed to be disproportionately affected by the leverage ratio rules**

Note that while the G20 has mandated the incentivisation of central clearing via bank capital rules in the 2009 Pittsburgh agreement, we do not believe their intention was to make the non-cleared markets unworkable to market participants. We are concerned that the impacts of the leverage ratio rules would mean exactly that for end-users, and request that those benefiting from clearing exemptions should not be penalised for using OTC derivatives through the non-cleared markets.

We set out in more detail our concerns below, but first start with some background on the role of European pension funds and their use of derivatives.

[1] As at 31 March 2016. Assets under management (AUM) are represented by the value of cash securities and other economic exposure managed for clients. Reflects the AUM of Insight, the corporate brand for certain companies operated by Insight Investment Management Limited (IIML). Insight includes, among others, Insight Investment Management (Global) Limited (IIMG), Pareto Investment Management Limited (PIML), Cutwater Asset Management Corp (CAMC), Cutwater Investor Services Corp (CISC) and Pareto New York LLC (PNY), each of which provides asset management services.. FX rates as per WM Reuters 4pm Spot Rates

BACKGROUND

Below, we provide some background information on European pension funds which we believe is relevant for the discussion below.

Role of European pension funds and their use of derivatives

European pension funds play an important role in the economy. They pay retirement benefits to pensioners, and by undertaking prudent investment and asset liability risk management exercises, they help to mitigate risks borne ultimately by corporate sponsors on their commitment to back retirement income for their retired employees.

For many European pension funds, an integral part of their investment approach is to use OTC derivatives to manage their financial solvency risk. European pension funds often use interest rate and inflation swaps to minimise their interest rate and inflation sensitivity to their liabilities.

Although European pension funds are not directly impacted by any bank capital rules, they will be impacted indirectly as they trade with banks and banks look to pass on any impact to their clients. The one-directional and long-dated nature of European pension funds' portfolios means that changes in regulation often have a disproportionate impact and have the potential to unduly penalise European pensioners. These pension funds' derivatives portfolio reflect the long-dated nature of their liabilities, which can stretch to 60 years based on the actuarial estimation of the life expectancy of its current or future retirees.

Although pension fund derivative portfolios are often one-directional, they should not be overly penalised by regulation intended for risky institutions. This is because derivatives portfolios offset risks that are naturally inherent for pension funds and therefore help them to reach a minimal risk position. Pension funds are asset rich and conservative investors and as such are generally considered by the market to be of low risk and high credit quality investors.

It is important to note that the structure of pensions markets varies internationally and therefore the specific needs of European pension funds, particularly defined benefit schemes, can be different to the needs of pension funds in other jurisdictions.

Temporary clearing exemption provided for pension funds in Europe

Pension funds do not hold much cash. They are typically fully invested and minimise their allocation to cash in order to generate long-term returns that better match their liabilities. European policymakers recognised that European pension funds have a legitimate need to use derivatives and do not hold much cash. As such European policymakers provided a temporary exemption from central clearing to pension funds which would relieve them from having to post variation margin (VM) in cash (as clearing houses only accept cash as variation margin).

Specifically, European policymakers stated that pension funds "*typically minimise their allocation to cash in order to maximise the efficiency and the return for their policy holders. Hence, requiring such entities to clear OTC derivative contracts centrally would lead to divesting a significant proportion of their assets for cash in order for them to meet the ongoing margin requirements of CCPs. To avoid a likely negative impact of such a requirement on the retirement income of future pensioners, the clearing obligation should not apply to pension schemes until a suitable technical solution for the transfer of non-cash collateral as variation margins is developed by CCPs to address this problem. Such a technical solution should take into account the special role of pension scheme arrangements and avoid materially adverse effects on pensioners.*"

The exemption provided was temporary to allow time for alternative clearing solutions to be developed allowing pension funds to use high quality securities as VM for cleared trades. At present no such central clearing solution has been developed and as such the temporary exemption for European pension fund has been extended and still remains in place.

Furthermore, a corresponding exemption was mirrored within the Capital Requirement Regulation (CRR). Under this exemption, banks were not required to apply the Credit Valuation Adjustment (CVA) rules to derivative trades executed with pension funds as long as the EMIR temporary exemption applied. This ensured that the non-cleared derivatives market remained workable for pension funds, meaning pension funds would be able to use non-cleared derivatives and post high-quality, non-cash collateral as VM.

We are concerned that the leverage ratio creates the same issue of cash VM for non-cleared trades as the cleared trades.

Non-cleared markets must remain workable

While we understand the G20's goals to incentivise central clearing, we believe it is important that the non-cleared market still remains useable. This is particularly important given that some institutions such as European pension funds and corporates still benefit from an exemption from central clearing.

<u>OUR CONCERNS</u>

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

We believe that high quality government bonds should receive the same treatment as cash for offsetting replacement cost of OTC derivatives. We set out below some reasons for this.

Non-cleared markets becoming unusable for end users, in particular European pension funds, and goes against the temporary clearing exemption for European pension funds

Any international rule that is written must have due regard to specific jurisdictional need for users of derivatives to ensure that the rule can be implemented globally without creating undue harm to users. We feel that lack of recognition of any non-cash VM, even high-quality government bond collateral, is changing market behaviour such that end-users could be shut out from using the derivatives market, even when it is used for legitimate risk management purposes and goes against the policy intention reached in Europe.

The lack of recognition of any non-cash VM, even high-quality government bond collateral, in being allowed to reduce the replacement cost of OTC derivatives is leading to banks putting pressure on clients to post cash only VM when trading non-cleared derivatives with them. Many banks have already restricted OTC derivatives trades to those that are collateralised with cash VM only, where previously they would also have accepted high quality government bonds as VM. We expect this trend to continue as the leverage ratio and the net stable funding ratio (NSFR) rules are fully implemented. NSFR derivative assets calculation mirrors the approach adopted by the leverage ratio rules in that they do not recognise high quality government bond securities as VM.

This is likely to force European pension funds and other end users to either post VM in cash, or be shut out of the derivatives market. This goes against the earlier policy objective reached by European policymakers for EMIR and CRR where it was recognised that European pension funds should not be forced to post margin in cash and that the non-cleared markets must remain workable for them. As explained earlier, while European pension funds are 'asset rich' in terms of high quality assets, they do not hold much cash.

Europe Economics and Bourse Consult, independent consultants commissioned by the European Commission estimated that an extra €205 billion to €420 billion of cash collateral would be needed if

European pension funds were required to post cash VM, and cost European pensioners €2.3 billion to €4.7 billion annually.[2] This is a significant and disproportionate cost to European pensioners.

This discourages the development of any future clearing solution for pension funds using non-cash VM

While clearing houses only accept cash as VM currently, one of the policy objectives of European policymakers for granting a temporary exemption for pension funds, rather than a permanent exemption, was to incentivise the market to find a clearing solution where non-cash VM could be accepted for central clearing. While such a solution has not been developed yet, the lack of recognition of high quality securities as VM risks the chances of a viable solution from being developed.

High quality government bond collateral is better credit quality than cash

We would like to highlight that cash is not less risky than high quality government bond collateral. Cash would ultimately be invested on an overnight basis in financial instruments including bank deposits, bank certificates of deposit, and bank floating rate notes. These instruments bear bank credit risk and as such they are typically less credit worthy than high-quality government bonds.

Securities collateral do not possess greater re-use risk than cash collateral

We understand that there may be a concern that securities collateral can be re-hypothecated and re-used by counterparties. While this is true, this is equally true for cash. Cash can be easily transferred and re-used by the receiver of cash collateral.

Under both English law ISDA Credit Support Annex and New York law ISDA Credit Support Annex - the two most widely used documents for collateralising non-cleared swaps - the treatment of cash and securities collateral are the same. Under English law ISDA collateral is transferred on a full title transfer basis, and under NY law the collateral is transferred by way of security interest with an explicit right to re-use collateral. The ability to re-use the collateral by the receiver under both documents are the same regardless of it being cash or non-cash collateral. In both cases the return obligation of the collateral is the same – they must return the equivalent, but not the same, collateral. The timescales are also the same.

Securities collateral has the same legal status as cash collateral

We understand that the Basel Leverage Ratio rules provides a preferential treatment for cash VM over securities VM by allowing cash VM to be treated as a form of pre-settlement of the contract. We are struggling to find any legal basis to justify this preferential treatment for OTC derivatives contracts.

Under both English law and New York law Credit Support Annexes, as we see it, the movement of collateral under the Credit Support Annex (CSA) can be thought of as being separate to the transaction cashflows. CSA collateral posted or received does not change the outstanding maturity of the OTC derivatives contracts and do not settle or cancel any transaction cash flows. Upon a close-out or termination the value of the collateral under the CSA would be netted against the value of the transaction cashflows. This treatment is the same regardless of whether the collateral posted under the CSA is cash or securities.

We understand, however, that cash does have a preferential treatment to securities collateral under accounting rules. It was however also our understanding that policymakers wished to normalise any accounting treatment and wanted to take an approach that was based on managing risk rather than accounting principles. We therefore question the basis on which cash is allowed to offset replacement cost but securities collateral is not.

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[2] Page 10. *Baseline report on solutions for the posting of non-cash collateral to central counterparties by pension scheme arrangements: a report for the European Commission prepared by Europe Economics and Bourse Consult* can be found here:
http://ec.europa.eu/finance/financial-markets/docs/derivatives/150203-external-study_en.pdf

While this report focuses on the potential impact of central clearing on pension funds, we would expect the impact to be similar where pension funds are forced to post VM in cash for non-cleared trades as a result of leverage ratio and NSFR rules.

Securities collateral posted as VM plays an important role in reducing risk and it should be recognised as such by regulation.

The preferential treatment provided for cash over securities VM is likely to increase the chances of a liquidity crisis

We believe the preferential treatment of cash VM over securities VM will significantly increase the demand for cash, especially in times of stress when large VM calls would be expected. This is likely to significantly increase liquidity risk and exacerbate downward pressure on falling asset prices as market participants sell out of physical assets in order to meet cash VM calls. This would therefore increase pro-cyclicality risk and reduce financial stability. We believe that permitting high quality securities the same treatment as cash in allowing it to offset replacement cost should help to reduce the chances of any future liquidity crisis in stressed market conditions.

2. SA-CCR methodology disproportionately penalises one-directional European pension fund portfolios

Based on our analysis of an example European pension fund portfolio, the OTC derivatives exposure calculated using the SA-CCR methodology seems to be up to <u>two to</u> four[3] times greater than if calculated using the CEM methodology. This is likely to result in banks significantly increasing the pricing of trading derivatives when trading with European pension funds in the future, or refrain from providing liquidity to them.

While the SA-CCR methodology is widely reported to be better for banks because of its netting benefits, it seems to disproportionately penalise European pension funds' one-directional portfolios. The impact of SA-CCR needs to be fully calibrated to portfolios of all derivative users including pension funds and other end-users, not just banks.

As already mentioned, while European pension funds typically have one-directional portfolios, we believe they should not be overly penalised by regulation intended for risky institutions. Their derivatives portfolios generally offset risks that are naturally inherent to pension funds and ultimately help them achieve a minimal risk position.

We are concerned that this, combined with the lack of recognition of securities VM set out above, is likely to make the non-cleared OTC derivatives market unusable for European pension funds. Entities such as European pension funds that benefit from a clearing exemption should not be penalised for accessing the OTC derivatives market through non-cleared trades.

We would be keen to share our calculations of CEM and SA-CCR methodology on an example European pension fund portfolio with you. We were unable to attach a second attachment onto the response website. Please do not hesitate to get in touch with us if you wish to look at this.

3. Initial margin (IM) should be permitted to offset both cleared and non-cleared trades

[3] We estimate that on a sample portfolio the OTC derivatives exposure calculated using SA-CCR methodology is (i) up to two times higher than CEM methodology if BCBS 279 paragraph 129 applies when SA-CCR methodology is used for leverage ratio calculations, or (ii) up to four times higher than CEM methodology if BCBS 279 paragraph 129 does not apply when SA-CCR methodology is used for leverage ratio calculations.

Segregated IM posted should be allowed to offset OTC derivatives exposure for both cleared and non-cleared trades. Currently the consultation paper only raises the question as to whether IM should offset OTC derivatives exposures of cleared trades. We set out the reasons for allowing IM to offset not just cleared, but also non-cleared trades below.

Segregated IM should be permitted to offset OTC derivatives exposure of non-cleared trades

As mentioned earlier the move to SA-CCR methodology from CEM seems to disproportionately penalise the OTC derivatives exposures of typical European pension fund portfolios. One obvious and prudent way to mitigate this would be to allow for segregated IM to offset OTC derivatives exposures.

Segregated IM cannot be re-used and therefore it cannot be leveraged to take more risk. It is provided by counterparties so that it is available to offset risk in the event of a default, and as such it should be recognised within the leverage ratio rules. We see no reason for not allowing segregated IM to offset OTC derivatives exposure of non-cleared trades.

Given the regulatory requirement to post IM and strict rules around segregation of IM from the Basel Committee on Banking Supervision (BCBS) and Board of the International Organization of Securities Commissions (IOSCO) standards on margining non-cleared derivatives, we are surprised by the lack of recognition by BCBS of such IM in offsetting risk for the purpose of the leverage ratio rules.

Segregated IM posted by clients should be permitted to offset OTC derivatives exposure of client cleared trades

The segregated IM provided by clients is precisely there to provide protection in the event of a client default and should be recognised as such. The lack of recognition for this is making client clearing expensive and making clearing unworkable even though regulators have mandated clearing.

The lack of pragmatic capital rules around central clearing is leading to banks exiting the clearing broker business. Clients are left with a decreasing number of banks willing to provide good clearing broker services and therefore the combined effect of this and mandated clearing is likely to significantly increase clients’ concentration risk to banks. The shrinking market for clearing members puts into question whether porting can really work in either stressed market conditions or in the event of a clearing member default. Ability to port to an alternate clearing member is critical to make client clearing work in a stressed environment.

For client clearing to be robust and resilient in an environment where clearing is mandated internationally, end users need a greater supply of and competition among banks willing to provide clearing broker services. Allowing client IM to offset OTC derivatives exposures to cleared trades goes somewhat towards helping to relieve the capital burden on banks for clearing broker services, which we think will make the client clearing business more viable for banks and more cost effective for clients.

4. Treatment of inflation swaps within SA-CCR should be explicit and the asset class should be categorised within the same asset class as interest rates

SA-CCR sets out that netting is possible within an asset class but not across asset classes. Asset classes are defined to be interest rate, foreign exchange, credit, equity and commodities. The rules are not explicit in terms of where inflation sits as an asset class. We would expect inflation to be treated within the same asset class as interest rates given their strong economic link. We note that the non-cleared margin standards agreed by BCBS and IOSCO treats inflation as being within the same asset class as interest rates.

We request that regulators make this clear and explicitly state that inflation should be within the same asset class as interest rates for the SA-CCR calculation.

5. Repo markets should not be allowed to be disproportionately affected by the leverage ratio rules

The high quality government bond repurchase agreement (repo) market plays a crucial role in the functioning and smooth running of financial markets by providing access to liquidity and allowing market participants to transform securities into cash which can, for example, be used as collateral for posting VM. The importance of this market will grow as demand for cash increases significantly once mandated central clearing is fully implemented in Europe (because clearing houses only accept cash as VM), and if the leverage ratio (and correspondingly the NSFR rules) are not modified to allow high quality non-cash VM to receive the same treatment as cash VM for offsetting replacement of OTC derivatives.

At a time when regulation is expected to significantly increase the demand for cash, the role of the repo markets in providing collateral transformation service and providing cash to those who need it becomes even more important. We are concerned about the potential negative impact of the leverage ratio and other bank capital rules (including NSFR rules) on the functioning of the repo markets. We request that regulators review the potential impact of these rules on the repo markets to ensure that they are proportionate.

The consequence of a dysfunctional repo market must not be underestimated. If market participants are unable to transform high quality securities collateral into cash quickly, cash VM calls on cleared and non-cleared trades may not be met, which could lead to market participants defaulting on their contracts or result in the forced unwinding of positions at a time of market stress, which would further exacerbate any crisis.

One possible approach to lessen the burden of the leverage ratio rules on the repo markets could be for the regulators to consider treating high quality government bond securities, with appropriate haircuts, to be treated similar to cash and allow netting between cash and high quality government bonds. This would significantly reduce the burden on the high quality government bond repo markets.

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