DG FISMA consultation paper on further considerations for the implementation of the NSFR in the EU

Insight Investment response

24 June 2016

A BNY MELLON COMPANY[SM]

Insight INVESTMENT

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 welcome the opportunity to provide our views and are pleased to submit our response to DG FISMA consultation paper on further considerations for the implementation of the NSFR in the EU, issued in May 2016.

QUESTIONS AND ANSWERS

1. *In light of previous consultations, could you describe more specifically, if appropriate, the specific activities, transactions and business models where you have evidence that the implementation of the NSFR could have an excessive impact or important unintended consequences?*

We believe that the combined effect of the NSFR and leverage ratio rules would have unintended consequences to European pension funds. Mirroring the leverage ratio rule, the NSFR derivative asset calculation for OTC derivatives only allows cash variation margin (VM) to offset the replacement cost for banks. **We believe that high quality government bond VM, with appropriate haircut, should also be permitted to offset replacement cost of OTC derivatives.**

The impact of the rules as it is stands right now is as follows:

- Banks are putting pressure on clients to post cash only VM when trading non-cleared derivatives with them. Many banks are restricting 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.
- This above market reaction 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 earlier policy decisions of European policymakers where they recognised that European pension funds should not be forced to post margin in cash and should be allowed to access the derivatives market while posting high quality securities margin. As such they a provided a temporary exemption from central clearing to European pension funds which would relieve them from having to post variation margin (VM) in cash (as clearing houses only accept cash as VM) but still access the derivatives market through non-cleared trades. However the treatment of non-cash VM from NSFR and leverage ratio rules undermine the policy intention of European policymakers' in allowing European pension funds to access the derivatives market while posting high quality securities.
- 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

[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

[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

disproportionate cost to European pensioners. 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.

Please see further information section below on why we believe that high quality government bond securities VM should receive the same treatment as cash VM for NSFR derivative asset calculations.

2. *If a respondent is a bank, could you please quantify the level of your expected shortfall of stable funding, the changes to the composition of your balance sheet that may result from meeting the NSFR and what the impact of these changes may be on the European economy?*

Not applicable.

3. *In light of previous consultations, could you provide substantiated evidence about possible issues caused by the application of the BCBS NSFR standard to derivative transactions at European level and which have not been taken into account at Basel level? If yes, what alternative treatment would you propose for NSFR calculation purposes to deal with the funding needs arising from derivatives transactions? If possible, please provide the impact on your institution of the alternative treatment you propose (as compared to the BCBS standards).*

We repeat our answer to question 1 above which also answers this question.

We believe that the combined effect of the NSFR and leverage ratio rules would have unintended consequences to European pension funds. Mirroring the leverage ratio rule, the NSFR derivative asset for OTC derivatives only allows cash variation margin (VM) to offset the replacement cost for banks. **We believe that high quality government bond VM, with appropriate haircut, should also be permitted to offset replacement cost of OTC derivatives.**

The impact of the rules as it is set is as follows:

- Banks are putting pressure on clients to post cash only VM when trading non-cleared derivatives with them. Many banks are restricting 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.
- This above market reaction 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 earlier policy decisions of European policymakers where they recognised that European pension funds should not be forced to post margin in cash and should be allowed to access the derivatives market while posting high quality securities margin. As such they a provided a temporary exemption from central clearing to European pension funds which would relieve them from having to post variation margin (VM) in cash (as clearing houses only accept cash as VM) but still access the derivatives market through non-cleared trades. However the treatment of non-cash VM from NSFR and leverage ratio rules undermine the policy intention of European policymakers' in allowing European pension funds to access the derivatives market while posting high quality securities.

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.

- 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.[3] This is a significant and disproportionate cost to European pensioners. 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.

Please see further information section below on why we believe that high quality government bond securities VM should receive the same treatment as cash VM for NSFR derivative asset calculations.

4. *More specifically, regarding the 20% RSF factor applicable to gross derivatives liabilities, do you think it would be possible and appropriate to develop a more risk-sensitive approach that would take better account of the funding risk arising from banks' derivative activities over a one-year horizon? In that case, what could be this approach? Do you think that the use of the SA-CRR could provide an appropriate measure? If possible, please provide the impact on your institution of the alternative treatment you propose (as compared to the BCBS standards)*

We are concerned that this penalisation of derivatives, combined with the overall impact on the derivatives market from both NSFR and leverage ratio rules could make the non-cleared markets too costly and illiquid, and therefore unworkable, for end-users as banks pass on the cost and impact of bank capital rules to end-users.

We believe the non-cleared markets must remain accessible and liquid for end-users, particularly where the end-users benefit from any clearing exemptions.

5. *If you propose special treatment for specific activities (eg hedging instruments, clients clearing…), how would you define these activities?*

Banks trading with European pension funds benefiting from the EMIR clearing exemption should be allowed to post high quality government bonds as securities for their non-cleared trades and it be permitted to offset replacement cost of OTC derivatives in the NSFR derivative asset calculations. These trades can be defined as follows:

"*Trades benefiting from the transitional provisions of Article 89(1) of Regulation (EU) 648/2012"*

6. *In light of previous consultations, could you provide substantiated evidence about possible issues caused by the application of the BCBS NSFR standard to short term transactions with financial institutions at European level and which have not been taken into account at Basel level? If yes, what alternative treatment would you propose for NSFR calculation purposes to deal with the funding needs arising from short-term transactions with financial institutions? If possible, please provide the impact on your institution of the alternative treatment you propose (as compared to the BCBS standards).*

[3] 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.

The asymmetry of NSFR RSF and ASF below 6m is likely to create a burden on the repo markets. We are concerned about the impact on the liquidity of the repo markets resulting from this.

At a time when regulation is expected to significantly increase the demand for cash collateralisation (from mandated clearing and preferential treatment of cash over non-cash VM in the leverage ratio rules), a well-functioning repo market would be critical to transform non-cash to cash VM.

7. *If you propose special treatment for specific activities (e.g. client's short facilitations activities, prime brokerage businesses…), how would you define these activities?*

No comment.

8. *What do you believe the appropriate level of application of the NSFR to be? Is there scope to make the NSFR requirements more proportionate and, if so, on the basis of what criteria?*

No comment.

9. *9. In particular, what criteria could be used to define institutions with a "low liquidity risk profile"? What simplified metrics (e.g. core funding ratio close to loans to deposits + capital) could be used to identify these institutions? Should certain institutions be completely exempted from the NSFR and on what basis?*

No comment.

FURTHER INFORMATION

We believe that high quality government bonds should receive the same treatment as cash for offsetting replacement cost of OTC derivatives in the NSFR derivative asset calculations. We set out below further reasons for this to supplement answers to questions 1 and 3 above.

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, and therefore this preferential treatment is mirrored in the NSFR derivative asset calculations. 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.

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.

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