JULY 2014

OTC DERIVATIVES RISK MITIGATION
RESPONSE FROM INSIGHT INVESTMENT

INSIGHT INVESTMENT IS RESPONSIBLE FOR €381BN[1] OF ASSETS UNDER MANAGEMENT INCLUDING €291BN 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 the consultation document *Draft regulatory technical standards on risk-mitigation techniques for OTC-derivative contracts not cleared by a CCP under Article 11(15) of Regulation (EU) No 648/2012*, issued in April 2014.

We believe that the most problematic of the proposals is the introduction of issuer concentration limits applied to variation margin collateral held in the form of government securities issued by European Union (EU) countries that fall outside the eurozone.

In our opinion, while this proposal may be appropriate for users of euro-denominated OTC derivatives, users of non-euro OTC derivatives would experience substantial new risks, costs and other practical difficulties associated with the imposition of a concentration limit applied to sovereign bonds. The measure therefore has the potential to materially undermine their best interests. We outline and explain below the negative implications for such users.

Separately, the consultation includes a proposed obligation to pay variation margin on forward FX contracts. We believe this could discourage some investors from prudent currency risk management, and that regulators should therefore reconsider this proposal. We explain our conclusion in an additional note below.

5. How would the introduction of concentration limits impact the management of collateral (please provide if possible quantitative information)? Are there arguments for exempting specific securities from concentration limits and how could negative effects be mitigated? What are the pros and cons of exempting securities issued by the governments or central banks of the same jurisdiction? Should proportionality requirements be introduced, if yes, how should these be calibrated to prevent liquidation issues under stressed market conditions?

We believe that the proposed issuer concentration limit, when applied to sovereign bonds issued by EU governments outside the eurozone, would have significant adverse implications specific to users of non-euro denominated OTC derivatives. This would include, for example, derivatives denominated in British sterling, the Polish zloty, the Hungarian forint and the Swedish krona.

We believe that it is inappropriate to apply the proposed issuer concentration limit on collateral to bonds issued by such sovereign issuers when used to collateralise derivatives denominated in the same non-euro currency.

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[1] As at end April 2014. Assets under management are represented by the value of cash securities and other economic exposure managed for clients.

In recent years, market best practice for collateralising OTC derivatives has changed significantly in order to improve pricing transparency and better mitigate the associated risk. Best practice is now to limit eligible collateral solely to cash and government bonds denominated in the same currency as the underlying derivative. Government bonds denominated in other currencies are typically not permitted, and nor are corporate bonds irrespective of the currency of denomination.

The reason for limiting eligible collateral to cash and government bonds denominated in the currency of the underlying derivative is to remove valuation ambiguity that would otherwise be introduced and, therefore, provide greater transparency and certainty over the pricing and valuation of the derivative in question.

Prior to this narrowing of eligibility criteria, the optionality afforded by a broader range of eligible collateral was increasingly leading to material differences in valuation methodology being applied by different counterparties, reflecting the differential between internal financing costs for the different types of eligible collateral. This therefore introduced substantial opacity and inconsistency into the valuation of otherwise vanilla derivative contracts such as interest rate swaps.

For UK sterling-denominated derivatives, for example, only UK government bonds and sterling cash are now typically deemed eligible as collateral. This effectively mitigates potential cross-counterparty valuation differences and provides fungibility and hence the ability to novate (transfer) contracts from one counterparty to another. Furthermore, this policy is consistent with the approach adopted by clearing houses, where eligible collateral is required in the same currency as the underlying swap contract, so as to avoid any unnecessary currency risk.

The introduction of a collateral concentration limit on non-euro sovereign bonds would undermine the benefits of price transparency and fungibility and have several further adverse implications for users of non-euro OTC derivatives, including the following:

- **Reduced returns and increased use of derivatives**

  In order to comply with the concentration limit of 50% applied to sovereign debt, users of non-euro OTC derivatives that wished to avoid introducing currency risk into their collateral management programme would be effectively forced to substitute that collateral with cash. In the current environment this would result in them sacrificing the higher yield on bonds and replacing it with much lower yielding cash. This would represent a material cost to these users.

  These investors would also lose any hedging contribution provided by the domestic sovereign bonds that would otherwise have been held as collateral, thereby compelling them to make use of additional derivatives to replace this lost exposure and thereby increasing their overall leverage.

  For example, if the collateral in a scheme’s liability-hedging portfolio is currently wholly invested in UK government bonds, a 50% single issuer limit on collateral would reduce the overall holdings in UK government debt by half, and increase the cash holding to 50%. The yield generated by the collateral would currently be reduced by half, and the required notional exposure of swaps held by the scheme would need to increase by 50% to maintain the liability hedge.

- **Reduced transparency**

  Mandating users of non-euro OTC derivatives to widen the pool of eligible collateral would introduce differences in derivative valuation methodology depending on which instruments were used to collateralise the derivative. This would lead to reduced pricing transparency and dispersion in valuation between different market participants reflecting their own unique internal funding costs for alternative forms of collateral (as explained above).

- **Currency risk**

  If users of non-euro denominated OTC derivatives were subject to the proposed collateral concentration limit they might naturally consider using government bonds issued by other European sovereign issuers. These issues would be primarily euro-denominated. However, including such debt would introduce currency risk within the collateral pool that would require additional hedging.

  This issue is recognised elsewhere in the consultation paper, which proposes a haircut of 8% to the market value of assets where the collateral currency is different from the settlement currency (see page 50).

- **Basis risk**

  Bonds denominated in a currency other than that of the underlying derivative would not provide an accurate interest rate or inflation match for the exposure that the derivative was intending to hedge. For instance, bonds denominated in one currency would not provide an effective hedge for liabilities denominated in another, thereby introducing a basis risk that would also require hedging.

- **Increased reliance on the repo market**

  The introduction of issuer concentration limits, applied to non-euro government bonds issued by EU member states, could create bifurcated collateral pools for OTC derivatives traded before and after 1 December 2015 (the date when the proposed limits would come into force).

  For example, UK pension schemes might be expected to hold close to 100% UK government bonds as variation margin for derivatives originated before 1 December 2015, to take advantage of the yield and hedge provided by the bonds. After that date they would be required to adhere to the concentration limit.

  Such schemes could therefore find themselves with opposing derivative positions in each collateral pool, but unable to use the UK government bonds received in the earlier collateral pool to meet the margin call of the later collateral pool (and vice-versa). This would increase a scheme's reliance on the repo market, whereby a pension scheme pays the repo rate to lend securities to borrow cash collateral, ultimately leading to a performance drag. This drag and the risks associated with repo availability, and the requirement to periodically roll exposure, are the primary reason that pension schemes were granted a temporary exemption from the European Market Infrastructure Regulation.

In conclusion, given the negative implications outlined above, we believe that the proposed issuer concentration limit, applied to sovereign bonds issued by EU member states outside the euro area, would have significant adverse consequences on the management of non-euro denominated OTC derivatives. It would introduce material new risks and costs and therefore should not be applied to variation margin collateral posted in the form of non-euro denominated sovereign bonds issues by EU member states outside the euro zone.

Additional note: on the proposed requirement for variation margin on forward foreign exchange (FX) contracts

The consultation includes a proposed obligation to pay variation margin on forward FX contracts, which are typically used by investors to either generate investment returns or hedge currency exposure (see pages 77 and 78). In this section we focus on the potential impact on investors aiming to hedge currency exposure.

We believe the proposal would increase the investment and operational costs of using forward FX contracts, and could therefore discourage investors from prudent currency risk management. This could leave pension schemes exposed to currency risk, which would typically have a greater impact on a pension scheme's investment returns than the credit risk arising from uncollateralised positions. We therefore believe this proposal, which aims to reduce credit risk, could leave pension schemes exposed to a far greater risk in the form of unhedged currency exposure.

We explain how the proposal could lead to increased costs and operational complexity for currency hedges below:

- **Increased costs**

  Pension schemes implement currency hedges in order to offset the foreign currency exposure that results from holding international assets. Therefore every currency hedge is fully backed by underlying assets, but the proposed requirement to make available an additional pool of collateral to support variation margin would increase the cost of holding foreign assets with currency protection.

  Given the typical level of volatility for developed market currencies, we estimate that for every 100% invested in the asset, another 10% may be required to support variation margin. This means that a pension scheme would need to make €110 principal available for every €100 of fully-hedged overseas investment. This additional cost is particularly burdensome when the underlying investments are illiquid and cannot be offered as collateral: these might include foreign property, infrastructure or private equity investments.

- **Increased operational complexity**

  Operational difficulties in dealing with variation margin for FX hedges are likely to result in some pension schemes either ceasing to protect themselves against foreign currency exposure or holding lower than optimal levels of overseas assets. Pension funds with smaller investment teams are likely to be most affected, as they have less capacity to absorb the additional operational requirements and extensive legal documentation that arise from managing margin and collateral, and may need to incur additional costs by employing a third party to manage the process.

A good manager of a currency hedge will already take responsibility for minimising credit risk by selecting the highest quality counterparties and monitoring credit risk over time. The prudent diversification of exposure across counterparties and the use of short-dated instruments are typically used to further reduce counterparty risk. Relative to other derivatives, forward FX contracts are among the simplest, representing something as simple as a delayed cash settlement. Using them can offset the impact of currency moves, which can be large and unpredictable and lie outside the control of a pension scheme. We therefore believe regulators should reconsider the proposed requirement.