PensionsEurope response to European Commission's consultation on the implementation of the final Basel III reforms in the European Union

03 January 2020

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1. Credit Risk

1.1. Standardised approach

1.1.3 Exposures to corporates

Question 14. What other measures, if any, could be taken to increase the risk-sensitivity of the standardised RW treatment of corporate exposures which currently have no external rating? Please elaborate and provide relevant evidence.

We are concerned the output floor and the push towards the standardised model over the internal models would have significant indirect cost impact to end-users such as pension funds.

Under the reviewed standardised approach, banks' exposures to pension funds would be classified as corporate exposures and would be extremely penalised. Indeed, pension funds make very little use of rating agencies and have therefore to be considered as unrated corporates which are assigned a high-risk weight of 100% under the reviewed framework.

We believe this approach leads to an overstatement of the risks that pension funds bring to the system and needs to be reconsidered.

- The risk of default posed by pension funds is very low since they are regulated entities that are typically asset rich, long-term hold to maturity investors, and manage their risks prudently. Pension funds are usually considered to be of high creditworthiness and indeed there are many cases when banks would post (not receive) independent amounts (ie non-regulatory initial margin) to trade with pension funds.
- Prudential regulation will impose recovery mechanisms (mainly benefit cuts or sponsor support) which will restore their funding levels in case of underfunding. These mechanisms would be triggered well before pension funds would be unable to meet their credit obligations. In some jurisdictions, quasi-governmental organisations or protection funds are also established in order to ensure that the assets and liabilities of pension funds are protected in the event of default of the corporate sponsor.
- Pension funds demonstrate a certain capacity to play a countercyclical role in the economy since their "client base" (i.e. members) remains relatively stable even in case of economic downturn. Moreover, members typically cannot take their entitlements out until retirement, so there is no risk of a 'run'.
- The IORP2 Directive bans pension funds from any significant leverage and derivatives are only allowed for hedging purposes.

For all these reasons, we would recommend the adoption of an approach that would recognise the higher creditworthiness of pension funds in the framework and differentiate their treatment from the one that applies to corporates. A suitable approach would consist in the adoption of a separate category for pension funds with a 20% risk weight which would adequately reflect their high level of credit quality.

We understand that, at least according to some banks, a treatment of 100% risk weight for pension funds would increase their risk weight about 3 to 4 times that from the advanced models when trading certain products such as repos.

1.2. Internal Ratings Based Approaches (IRBA)

1.2.8. Maturity Factor

84. In your view, which other aspects, if any, should be considered in the context of the treatment of the maturity parameter? Please provide relevant evidence to substantiate your views.

For banks using the foundation approach for exposures to corporates and pension funds, effective maturity for repo-style transactions will be 6 months. Repo transactions provide short-term cash borrowing to pensions funds in exchange of government securities for liquidity purposes. The repo markets are fundamental to the

financial system and play an important role in ensuring that liquidity is passed around the system between asset rich entities that are cash poor, and those that have excess cash. We believe any punitive treatment of repos will negatively impact end-users such as corporates and pension funds.
It is important to consider that pensions funds hold relatively little in cash, preferring instead to hold high-quality government bonds. This is because pension fund assets need to grow at least in line with the expected increase in liabilities to fulfil their obligation to pay pensioners' retirement income into the future. Repo transactions are therefore used by pension funds to achieve cash and manage their margins that cover their derivative positions which remain essential to manage their funding level and their financial solvency risk. Usually, these operations conclude on an overnight basis, and pensions funds buy back the government securities the following day. We consider that establishing a fixed maturity of 6 months for repo transactions in the F-IRB approach leads to an undue decrease in risk sensitivity and to an overestimation of the risks associated with repo transactions.

5. Credit Valuation Adjustment (CVA) Risk

5.2. Exemption under the CRR

Question 166. In your view, which clarifications, if any, should be provided regarding the definition of the current exemptions, should these exemptions be retained under the CRR? Please provide relevant evidence to substantiate your views.

We believe that the CVA exemption provided in current CRR rules for corporates and pension funds should be maintained.

Policymakers need to be consistent in the overall objective they are trying to achieve. EMIR provides an exemption from central clearing for pension funds and corporates below a clearing threshold, to minimise the negative impact to the European pensioners and the real economy. The CVA exemption in the CRR package was an example of European policymakers working well together to ensure that any exemptions provided in EMIR are not undermined by the bank capital rules.

Any suggestion of the CVA exemption being removed, either directly or via Pillar 2 measures, as suggested by the European Banking Authority in their policy advice published on 4 December 2019, would undermine the exemptions provided in EMIR and more broadly undermine the European political and legislative process. This would result in greater costs to European pensioners and the economy as a whole. We believe this would undermine the overarching goals of the G20 objectives in 2009 which set in motion a series of regulatory changes.

We understand that the changes adopted in the CVA methodology (2017 Basel III standards) could increase the CVA charge for trades with pension funds by multiple folds. Removing the exemption and changing the methodology to be more punitive could make the non-cleared markets unworkable for pension funds and undermine the current exemption.

We understand there is concern that the European CVA exemption is inconsistent with global rules. However, this can be easily addressed: international policymakers could align clearing and bank capital rules globally, by ensuring CVA charges do not apply to trades that are exempted from clearing.

Background for pension fund exemption
European pension funds use over-the-counter (OTC) derivatives as an integral part of their investment approach to manage their funding level or financial solvency risk. Pension funds collateralise and post variation margin on these transactions using high-quality government bonds – usually HQLA Level 1 assets, as defined in the liquidity coverage ratio rules – without disturbing their asset-allocation and increasing their financial solvency risk.

However, central counterparties (CCPs) will only accept cash as variation margin due to operational and other limitations. The inability of European pension funds to post margin in cash remains the most significant issue for European pension funds relating to derivatives reform.

This is because pension fund assets need to grow at least in line with the expected increase in liabilities to fulfil their obligation to pay pensioners' retirement income into the future. This means they hold relatively little in cash, preferring instead to hold high-quality government bonds, because:

- cash is not a good match for pension fund liabilities
- cash typically generates lower returns potentially eroding financial solvency
- cash instruments (such as bank deposits and commercial deposits) typically introduce non-sovereign credit risk

Increasing cash allocations -to ensure variation margin can be posted - would therefore increase financial solvency risk to pension funds and ultimately lead to reduced pensions for European retirees. It was in recognition of this that EMIR policymakers exempted pension funds from clearing until a robust solution is found for the cash variation margin clearing issue. This exemption was renewed again as part of the EMIR Refit process that concluded in June 2019, and the European Commission has been convening regular stakeholder discussions with both the industry and policymakers to help facilitate the development of a solution. Any attempt to remove the CVA exemption before a robust solution is developed undermines this process.

The clearing exemption allows pension funds to carry on trading non-cleared OTC derivatives while posting high quality government bond as collateral. Therefore, any bank capital rules that penalise these non-cleared trades – whether through a CVA charge or other means – undermine the exemption provided.

5.6. Other Provisions

Question 174. In your view, which other aspects, if any, should be considered in the context of revising the CVA framework? Please specify and rank your answers from the most important to the least important aspect.

We recommend the following priorities with regard to the CVA framework:

- Maintain the current CVA exemptions provided to end-users such as pension funds and corporates.
- Align CVA exemptions to changes made in EMIR Refit to ensure that all entities benefitting from a clearing exemption also benefit from a CVA exemption. EMIR Refit included a new category of counterparties, namely small financial counterparties below certain clearing thresholds, that also benefit from clearing exemptions. The CVA exemption should also be extended to these entities to ensure that the wider policy intention for these entities is maintained.

6. Output Floor

6.4. Other Provisions

Response 185. In your view, which other aspects, if any, should be considered in the context of implementing the OF? Please elaborate and rank your answers from the most important to the least important aspect.

We are concerned the output floor and the push towards the standardised model over the internal models would have significant indirect cost impact to end-users such as pension funds. Specifically we have the following concerns:

- Under the reviewed standardised approach, banks' exposures to pension funds would be classified as corporate exposures and would be extremely penalised. Indeed, pension funds make very little use of rating agencies and have therefore to be considered as unrated corporates which are assigned a high-risk weight of 100% under the reviewed framework. We believe this approach leads to a gross overstatement of the risk that pension funds bring to the system and needs to be reconsidered.
    - The risk of default posed by pension funds is very low since they are regulated entities that are typically asset rich, long-term hold to maturity investors, and manage their risks prudently. Pension funds are usually considered to be of high creditworthiness and indeed there are many cases when banks would post (not receive) independent amounts (ie non-regulatory initial margin) to trade with pension funds because of their high level of creditworthiness.
    - Pension funds set up different recovery mechanisms (mainly benefit cuts or sponsor support) that will restore their funding levels in case of underfunding. These mechanisms would be triggered well before pension funds would be unable to meet their credit obligations. In some jurisdictions, quasi-governmental organisations or protection funds are also established in order to ensure that the assets and liabilities of pension funds are protected in the event of default of the corporate sponsor.
    - Pension funds demonstrate a certain capacity to play a countercyclical role in the economy since their "client base" (or Members) remains fairly stable even in case of economic downturn.
    - The IORP2 Directive bans pension funds from any significant leverage and derivatives are only allowed for hedging purposes.

  For all these reasons, we would recommend the adoption of an approach that would recognise the higher creditworthiness of pension funds in the framework and differentiate their treatment from the one that applies to corporates. A suitable approach would consist in the adoption of a separate category for pension funds with a 20% risk weight which would adequately reflect their high level of credit quality.
- SA-CCR is likely to significantly increase exposures to long-dated one-directional trades of pension funds making non-cleared trades unworkable for them.
- We recommend that trades with pension funds and corporates should have an alpha factor of 1 (instead of 1.4), similar to trades with commercial end-users in the Dodd-Frank rules that were published recently.
- SA-CCR does not fully recognise the risk-reducing property of initial margin. We believe this should be modified so that initial margin can be an effective risk reducing tool.
- SA-CCR within CRR II does not permit rates and inflation derivatives to be treated within the same hedging set as permitted by Basel rules. This would harm pension funds with large directional rates and inflation portfolios by not recognising the naturally economic offsetting property of rates and inflation. We recommend that rates and inflation are permitted to be within the same hedging set as permitted within the Basel rules.

We would like to take this opportunity to raise another important issue relating to increases in costs that end-users such as pension funds are likely to face as banks pass on the cost of trades to their clients.

- Leverage ratio rules for non-cleared trades with pension funds should permit Level 1 high quality liquid assets (HQLA) posted as variation margin in order to offset the replacement cost of derivatives. Recognising only cash variation margin undermines the purpose of the temporary clearing exemption under EMIR, which was provided specifically in recognition of the cash variation margin issue for pension funds. More detail on the cash variation margin issue can be found in the response we provided to question 166.

About PensionsEurope

PensionsEurope represents national associations of pension funds and similar institutions for workplace and other funded pensions. Some members operate purely individual pension schemes. PensionsEurope has **23 member associations** in 18 EU Member States and 3 other European countries[1].

PensionsEurope member organisations cover different types of workplace pensions for over **110 million people.** Through its Member Associations PensionsEurope represents more than **€ 4 trillion of assets** managed for future pension payments. In addition, many members of PensionsEurope also cover personal pensions, which are connected with an employment relation.

PensionsEurope also has **30 Corporate and Supporter Members** which are various service providers and stakeholders that work with IORPs.

PensionsEurope has established a **Central & Eastern European Countries Forum (CEEC Forum)** to discuss issues common to pension systems in that region.

PensionsEurope has established a **Multinational Advisory Group (MAG)** which delivers advice on pension issues to PensionsEurope. It provides a collective voice and information sharing for the expertise and opinions of multinationals.

What PensionsEurope stands for

- A regulatory environment encouraging workplace pension membership;
- Ensure that more and more Europeans can benefit from an adequate income in retirement;
- Policies which will enable sufficient contributions and good returns;

Our members offer

- Economies of scale in governance, administration and asset management;
- Risk pooling and often intergenerational risk-sharing;
- Often "not-for-profit" and some/all of the costs are borne by the employer;
- Members of workplace pension schemes often benefit from a contribution paid by the employer;
- Wide-scale coverage due to mandatory participation, sector-wide participation based on collective agreements and soft-compulsion elements such as auto-enrolment;
- Good governance and alignment of interest due to participation of the main stakeholders.

Contact:
PensionsEurope
Rue Montoyer 23 - 1000 Brussels
Belgium
Tel: +32 (0)2 289 14 14 – Fax: +32 (0) 289 14 15

[1] EU Member States: Austria, Belgium, Bulgaria, Croatia, Estonia, Finland, France, Germany, Hungary, Ireland, Italy, Luxembourg, Netherlands, Portugal, Romania, Spain, Sweden, UK. Non-EU Member States: Iceland, Norway, Switzerland.