Please note that the comments expressed herein are solely my personal views

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- To the Joint Committee of European Supervisory Authorities
- Your Ref: Comment letter on the Joint Discussion Paper on Draft Regulatory Technical Standards on risk mitigation techniques for OTC derivatives not cleared by a CCP under the Regulation on OTC derivatives, CCPs and Trade Repositories

Dear Sir.

Thank you for giving us the opportunity to comment on your Joint Discussion Paper on Draft Regulatory Technical Standards on risk mitigation techniques for OTC derivatives not cleared by a CCP under the Regulation on OTC derivatives, CCPs and Trade Repositories. These proposals will increase the safety and transparency of the OTC derivatives market and will therefore promote market integrity and reduce the risks associated with the OTC derivatives market, particularly counterparty credit risk and general systemic risk. I will restrict my comments here to those pertaining to the effect of the proposals outlined in the discussion paper on the risk management of insurers and institutions for occupational retirement provision (IORPs). For completeness, please also refer to my previous comments on the discussion paper on ESMA's Draft Technical Standards for the Regulation on OTC Derivatives, CCPs and Trade Repositories.[1]

Insurers and IORPs main business aim is to provide financial security and secure the finances and retirement provision for customers. These entities use derivatives in a targeted and prudent way in order to meet these aims. First of all, insurers and IORPs normally enter into OTC derivatives transactions in order to hedge or mitigate specific risk and for asset liability management rather than for speculation. In fact, local insurance laws and EU regulations heavily regulate the use of derivatives here and restrict their use for speculative purposes.

[1] Available at http://www.esma.europa.eu/system/files/comment_letter_esma_2012-95_ccps_trs_chris_barnard_120312.pdf

Insurers and IORPs use plain vanilla interest rate swaps and options, exchange traded futures and bespoke, highly customised swaps to hedge and mitigate risks in their businesses.[2] Under the proposals, insurers and IORPs should clear standardised OTC derivative transactions and implement risk mitigation techniques for non-standardised OTC derivatives, which include bilaterally collateralising OTC derivatives not cleared by a CCP. Insurers and IORPs will have to exchange variation margin, subject to collateral requirements, and possibly post initial margin. These proposals will significantly increase costs for insurers and IORPs, particularly through increased initial margin requirements and more restrictive collateral rules[3]. This will lead to either: reduced use of OTC derivatives for hedging and risk mitigation, leading to insurers and IORPs carrying greater risk themselves, or reducing the extent of guarantees and options in their products and business; or the increased costs being passed onto customers, which will make their business less attractive, especially in a low interest rate environment. Conversely, these proposals will offset the greater risk associated with non-centrally cleared OTC derivatives.

In summary, it is important that you find the right balance between improving financial stability and minimising disruption in current business and market practice for insurers and IORPs. Given the prudential regulatory regimes applicable to insurers and IORPs, which encourage use of derivatives for hedging and risk mitigation only, I would suggest that the right balance should err on the side of the current business practices.

Yours faithfully

C.R.B.

Chris Barnard

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[2] For example, insurers can hedge: variable annuity products with put options, delta hedging and dynamic hedging, total return swaps and index futures; annuities with interest rate swaps; guaranteed annuity options with swaptions; and costs of options and guarantees for participating (with-profit) business with dynamic hedging. Insurers and IORPs also use various inflation swaps (capped or uncapped) and total return swaps on index-linked bonds in order to hedge inflation risk. Finally IORPs use interest rate swaps, longevity swaps and LDI techniques in order to manage and mitigate market and demographic risks.

[3] Insurers and IORPs investment portfolios typically contain a high proportion of fixed income securities, including high-quality corporate bonds. Restricting the eligible collateral to cash, for example, would be a departure from current practice and will require a rebalancing of investment portfolios into shorter, lower-yielding assets, which will increase costs and reduce the attractiveness of OTC derivatives for hedging and risk mitigation purposes.