

September 2016

ESMA Consultation Paper Responses to ESMA/2016/1125

On the clearing obligation for financial counterparties with a limited volume of activity

Publication of Response

This response may be published.

Background to River and Mercantile Derivatives (RMD)

River and Mercantile Group is an advisory and investment solutions business with a broad range of services, from derivatives advisory and implementation to fully-delegated fiduciary and fund management. R&M Group is focused on creating investment solutions for its clients across its core markets: predominately UK defined benefit pension schemes and UK defined contribution pension schemes.

R&M Group was formed by the merger of P-Solve Limited (P-Solve) and River and Mercantile Asset Management LLP (RAMAM), a leading institutional adviser and a leading equity solutions provider respectively, which was approved by the FCA on 27 March 2014. River and Mercantile Group was listed on the London Stock Exchange in June 2014.

River and Mercantile Derivatives (RMD) is the part of the group that trades and manages derivatives on behalf of the underlying client. RMD operates an agency business model. RMD itself does not enter derivative positions as a principal. RMD's clients are the counterparties to OTC derivative trades, some of which are subject to EMIR clearing obligation. RMD operates its business on a segregated mandate basis and does not operate any funds.

RMD's clients whose derivative trades are subject to EMIR are UK pension schemes.

RMD only offers segregated mandates for derivatives to its clients and does not mingle them into a pooled fund. This means that there are a large number of mandates but some of these may be quite small in size. We believe that this gives us a greater insight into the problems that have been highlighted in the consultation paper and therefore are very pleased to have an opportunity to respond to the questions raised.

For more information, visit our website at www.riverandmercantile.com or get in touch with your usual Derivatives contact

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Registered office: 11 Strand, London, WC2N 5HR

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Question 1: To which category of counterparties does your organisation belong: (1) in the context of the 1st Commission Delegated Regulation on the clearing obligation, and (2) in the context of the 2nd Commission Delegated Regulation on the clearing obligation?

Please indicate the likely category of counterparties if the determination has not been done yet. For respondents that are in none of the four categories, please indicate the nature of the activity performed in relation to the clearing obligation (e.g. CCP). For associations, please indicate the category of counterparties that you mainly represent.

For the purposes of Commission Delegated Regulation (EU) 2015/2205 (the 1st Commission Delegated Regulation), RMD's clients are classified as Category 3.

For the purposes of Commission Delegated Regulation (EU) 2016/592 (the 2nd Commission Delegated Regulation), RMD's clients are likely to be classified as Category 3, however, this determination has not been formally made.

Question 2: If you offer clearing services, please provide evidence on the constraints that would prevent you from offering clearing services to a wider range of clients.

RMD does not offer clearing services.

Question 3: Have you already established clearing arrangements (1) for interest rate swaps? (2) For credit default swaps? If not, please explain why (including the difficulties that you may be facing in establishing such arrangements) and provide an estimation of the time needed to finalise the arrangements.

RMD's clients are not able to access CCP directly for clearing purposes as they are not eligible to become CCP members due to their financial scale. As mentioned previously RMD only offers segregated mandates for derivatives to its clients and does not mingle them into a pooled fund. This means that there are a large number of mandates but some of these may be quite small in size.

At the time of writing RMD is engaged in a tender process for the clearing of IRS and inflation swaps. The tender process was open to a range of CCP members initially and has since been narrowed to a final selection of CCP members with whom RMD will progress with legal negotiations. RMD aims to be in a position to clear IRS and inflation swaps for those clients who chose to do so by the end of 2016.

The tender process highlighted that the current clearing solutions available to end user clients is heavily weighted towards the largest and most active clients. Whilst it is true that the clearing providers have responded to our tender process it is also very clear from their responses that they are only interested in clearing for our client base due to the large number of clients we represent. On a standalone basis we believe that less than 10% of our clients would be acceptable to the clearing providers.

RMD has found the following key difficulties in establishing clearing arrangements for its clients, in no particular order:

1. Client onboarding with CCP members for clearing is a difficult and time consuming process
2. A very limited number of CCP members that are willing to consider counterparties that are classified as Category 3 and are not active in the IRS market but do trade IRS for hedging purposes
3. Assigning trades to main or backup CCP member in order to maintain portability between CCP members is likely to conflict with RMD's best execution responsibilities
4. Limited support for clearing related OTC derivatives such as inflation swaps at commercially sensible levels for RMD's clients
5. Establishing pre default and post default porting arrangements
6. Account structure
 - a. Monthly recurring cost of an Individual Segregated Account is likely to be prohibitive for many of RMD's clients
 - b. Introduction of cross client exposure – something that does not exist in the segregated mandate bilateral collateralised structure
 - c. Fairly applying Gross Omnibus Segregated Account/ Net Omnibus Segregated Account charges across clients given their different sizes and profiles

- d. Differences in account structures at CCP members makes comparability difficult
- 7. Total cost of clearing to the client for a given portfolio is not transparent
- 8. Excessive charge on posted initial margin
- 9. Excessive "per ticket" fees
- 10. High levels of minimum fees despite having a charge on initial margin
- 11. Inability of CCP members to offer variation margin transformation services at a reasonable level. This is relevant to RMD's clients, which as UK pension schemes, tend to have high levels of UK government bonds but not cash
- 12. Uncertainty around any extension to the exemption from clearing obligations available to pension schemes

RMD as the derivatives manager is primarily responsible for delivering the most appropriate solution to our clients, the solution will account for the factors raised above. A further set of issues also needs to be raised; these concern the process of implementation of the clearing solution for our clients. The process involves

- 1. Education around the reason the current bilateral arrangements are no longer adequate
- 2. Education on the clearing solution with a focus on the risks and cost implications
- 3. Buy in to our tender process and the choice of clearing counterparties chosen
- 4. Documentation:
 - a. Explanation of the additional documentation that needs to be reviewed including
 - b. Clearing Addendum - Our intention is to negotiate this on an "Umbrella" basis. We believe that this approach is the most straightforward for clients (rather than each client negotiating with the Clearing Member individually).
 - c. Execution Agreements
 - d. IMA changes

The points raised above are costly for clients both in terms of legal review costs by their lawyers and also in governance costs. This process will take many months to complete.

For some of our client base there will be further education and documentation around the use of Repos as some of RMD's clients do not currently use this type of instrument. The lack of assets that are allowable for variation margin in the cleared world mean that cash transformation issues will be an additional hurdle that will need to be overcome prior to the implementation of a cleared solution.

The above difficulties mean that effective hedging risk management through IRS may no longer be available to a number of smaller financial counterparties.

Question 4: Please provide information and data you may have that could complement this analysis on the level of experience and preparedness of financial counterparties with CCP clearing.

As mentioned in RMD's response to Question 3, RMD is organising clearing arrangement for its clients with CCP members and as a consequence is preparing its clients and reviewing its own processes for clearing.

RMD is in the process of updating its internal authorities and investment management agreements to allow RMD to trade cleared OTC IRS on behalf of its clients.

At the time of writing, RMD's clients do not clear OTC IRS. RMD does not expect its clients to enter cleared OTC IRS trades until such time they are obligated to do so by law or the total cost of entering cleared OTC IRS trades falls materially below the total cost of entering into bilateral collateralised trades with the same Category 1 counterparties. RMD would be in breach of its best execution duties towards its clients were it to trade cleared OTC IRS trades on behalf of its clients before being legally obligated to do so if the costs associated with such cleared OTC IRS trades exceeded those of bilateral collateralised trades.

Question 5: Do you agree with the proposal to keep the definitions of the categories of counterparties as they currently are and to postpone the date of application of the clearing obligation for Category 3? If not, which alternative would achieve a better outcome?

Yes, RMD agrees that the proposal to keep the definitions of counterparties as they currently are and to postpone the date of application of clearing obligation for Category 3 counterparties.

Question 6: Do you agree with the proposal to modify the phase-in period applicable to Category 3, by adding two years to the current compliance deadlines?

RMD believes that the phase-in period applicable to Category 3 counterparties should be extended by 2 years. Such an extended period will allow the CCP members who provide clearing services to have worked out a sustainable service model. This in turn is likely to provide greater comparability between pricing structures, account standards and such also provide much needed clarity and price transparency to RMD's end clients. In addition, the extension period will allow for other classes of OTC derivatives to be more readily cleared through CCP members.

The extension period is also supported by ESMA's own analysis as presented in this consultation paper, specifically, the counterparties that introduce the greatest systematic risk are either already clearing or will be clearing by the end of 2016.

Question 7: Do you agree with the proposal to modify the three Commission Delegated Regulations on the clearing obligation at the same time?

Yes, it would be preferable if ESMA modified all relevant Commission Delegated Regulations on the clearing obligation simultaneously.

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