



Response to the joint discussion paper on non-cleared OTC derivatives

London, April 2012

Dear Sir or Madam,

P-Solve welcomes the opportunity to provide comments and views 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 (JC/DP/2012/1) issued by EBA, ESMA and EIOPA.

P-Solve is a UK integrated consultant providing consulting and asset management services to pension schemes. As such, all our responses to this ESMA discussion paper should be seen in the specific context of UK pension schemes (i.e. UK-based IORPs).

We agree with the global aim of EMIR to improve risk management practices and transparency within the financial industry. As such we have a positive view towards the requirement of the Regulation for counterparties to exchange collateral for non-cleared OTC contracts and to hold appropriate capital against their risks.

However the need for better risk management and greater transparency, whilst essential, should not be excessively costly for market participants, including pension schemes, nor prevent them from conducting their normal activities.

The political agreement reached by the European Commission, the European Parliament and the Council of the European Union on 9 February 2012 grants pension schemes (IORPs) a temporary exemption from mandatory clearing on CCPs for 3 to 5 years. We think that this temporary exemption will be useful to pension schemes so they can adapt to the requirements of central clearing and to CCPs for them to develop a clearing model that can be compatible with the constraints and needs of pension schemes. In particular the key issues identified by pension schemes were related to the posting of initial margin and the extensive use of cash as collateral. However pension schemes that do not centrally clear should not be exposed (via the regulatory technical standards on risk mitigation techniques for OTC derivatives not cleared by a CCP) to the same issues as this would make the exemption from mandatory clearing

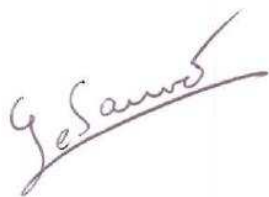
ineffective. As such we think that if those regulatory technical standards were to impose similar requirements to central clearing, pension schemes shall also be exempt from them for the same transition period.

In particular pension schemes shall be exempt from the obligation to post initial margin (if this was to be the chosen route), as this would constrain them in their asset allocation policy and restrict the pool of assets they could invest into (pension schemes typically invest in asset classes targeting higher returns which are usually not eligible for collateral).

On top of that, pension schemes tend to use derivatives to manage their liability and asset risks and not to speculate: those derivatives are hedging and risk reduction instruments rather than speculative ones. As such those derivatives are reducing risk across the financial industry rather than increasing it, and do not require the same level of over-collateralisation (such as initial margin) than derivative transactions entered into by other market participants with speculative views.

P-Solve appreciates the opportunity to respond to the joint discussion paper and stimulates the regulators to continue the dialogue on these important regulatory changes. Should you have any further questions please do not hesitate to contact us.

Yours sincerely,

A handwritten signature in dark ink, appearing to read 'Geoffroy Sauvé', with a stylized flourish at the end.

Geoffroy Sauvé

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P-Solve's response to 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 (JC/DP/2012/1) issued by EBA, ESMA and EIOPA, where questions are applicable to their clients:

Q1. What would be the effect of the proposals outlined in this discussion paper on the risk management of insurers and institutions for occupational retirement provision (IORPs)?

We are of the opinion that the proposals outlined in the discussion paper will improve the risk management processes for pension schemes. Whilst all of our clients currently collateralise their derivatives, we accept that a proportion of pension schemes may not have any form of counterparty risk management. As such requirements to exchange collateral shall increase the use of risk management techniques across the pension industry. We are supportive of measures that require the regular exchange of collateral to cover the value of derivative transactions (variation margin), as we see this as normal practice and as an effective way to manage counterparty risk. However all the requirements of the regulatory technical standards should be weighted against the additional costs and constraints any new requirement would impose on pension schemes that are currently using appropriate risk management techniques. In particular, the potential requirement to post initial margin, which would come on top of existing collateralisation processes (variation margining), would certainly improve the management of counterparty risk by covering potential losses in the case of a counterparty default. However any requirement to post initial margin would require the provision of safe and stable assets that could have otherwise been invested in other asset classes targeting higher returns, thus reducing the return on pension scheme assets and increasing, potentially, the cost to corporate sponsors. Hence we do not think the requirement to post initial margin (if applicable) should apply to pension schemes.

Q2. What are your views regarding option 1 (general initial margin requirement)?

As mentioned above although this approach will provide consistency across the market we are of the view that the risk management benefits of having to post initial margin on a bilateral trade, from the perspective of a pension scheme, do not outweigh the costs, liquidity issues and performance drag (and hence impact on potential corporate costs).

Besides that point, we are also of the view that the main criteria for differentiation on whether to post and collect initial margin shall be on whether the counterparty uses OTC derivatives for speculation purposes or for hedging purposes. The risk profiles of these counterparties are very different and should therefore be subject to different initial margin requirements. We are of the opinion that pension schemes and market participants that use derivatives for hedging and risk reduction purposes should be exempt from posting initial margin.

Obviously pension schemes would be more than happy to collect initial margin as this would increase their risk management, but the posting of initial margin presents a number of challenges, especially if only cash is permitted.

Although we agree that the requirement for initial margin would reduce residual counterparty credit risk we do not think that these benefits outweigh the costs incurred for pension schemes of having to post initial margin. Currently there is no such requirement for OTC trades and the extra pool of assets that will need to be posted to cover the initial margin request will require pension schemes to set more assets aside which will lead to a performance drag as pension schemes will not be able to invest these assets in higher yielding asset classes, which are usually not eligible for collateral. As a result the expected return on pension scheme assets may be lower, potentially increasing the cash contributions required from corporate sponsors. The motivation for transparency and risk reduction are good but adverse complications would cause administration and / or performance issues for many derivatives users, including pension schemes. This is one of the reasons explaining why pension schemes requested an exemption from mandatory clearing. If those same rules now apply to non-cleared derivatives, the exemption will become ineffective.

Most pension schemes would like to develop their risk management processes but this should be seen in the wider context of the associated costs and constraints.

Q3. Could PRFCs adequately protect against default without collecting initial margins?

Pension schemes tend to use derivatives to manage risk and not to speculate: we think that derivatives entered into by pension schemes reduce systemic risk rather than increase it. As such we think that the regular exchange by pension schemes of collateral against the value of derivatives (variation margin) is sufficient to protect pension scheme counterparties (and in particular PRFCs that transact with pension schemes) against default and that the posting of initial margin by pension schemes is not required.

Q4. What are the cost implications of a requirement for PRFC, NPRFC and NFCs+ to post and collect appropriate initial margin? If possible, please provide estimates of opportunity costs of collateral and other incremental compliance cost that may arise from the requirement.

We think the main cost implication for pension schemes would relate to the potential obligation to post initial margin rather than to the collection of initial margin: posting initial margin would require pension schemes to allocate specific assets to this and would restrict in some way the asset allocation and return possibilities available to pension schemes.

Clearly the cost implications of posting initial margin highly depend on the amount of initial margin that would be required and the type of assets that would be eligible, but regardless of the exact technical requirements adopted, we note that pension schemes currently take their asset allocation decisions with a fairly long term investment horizon. If the asset allocation had to be changed in order to “free up” some assets to post initial margin, this could have big implications on pension scheme returns. On top of that, having to post initial margin could lead to liquidity constraints and increase the cost of trading.

Q5. What are your views regarding option 2?

As discussed above in our response to *Question 2*, we think that counterparties with different levels of risk should be treated differently. Hence we think it is right to introduce differentiation across various types of counterparties when considering the exchange of initial margin. However this should not only be driven by the need to ensure that PRFCs are appropriately protected but also by recognising that some counterparties (such as pension schemes) present less risk than others, due to their use of derivatives as hedging tools rather than speculative instruments.

Under both option 1 and 2 the temporary exemption from mandatory clearing for pension schemes is made ineffective if pension schemes are not also exempt from the obligation to post initial margin.

Q8. For which types of counterparties should a threshold be applicable?

As mentioned in our responses to the previous questions, we think pension schemes should be amongst the counterparties for which a threshold should be applicable. This would ensure that their PRFC counterparties could decide to request the posting of initial margin only when it is appropriate given the risk profile of the pension scheme.

Q9. How should the threshold be calculated? Should it be capped at a fixed amount and/ or should it be linked to certain criteria the counterparty should meet?

The threshold should be linked to criteria such as the risk posed by the various counterparties, the use of OTC derivatives for hedging or speculation purposes, the credit rating and capital requirements. If the threshold was set such that a pension scheme that has the appropriate risk management processes (e.g. the regular exchange of variation margin) as well as sound financials did not have to post initial margin, we would favour this third option for pension schemes as the liquidity, cost and performance drag issues mentioned earlier would not be penalising.

Q14. As the valuation of the outstanding contracts is required on a daily basis, should there also be the requirement of a daily exchange of collateral? If not, in which situations should a daily exchange of collateral not be required?

As mentioned in our responses to previous questions, we are totally supportive of the regular exchange of variation margin, as we see this as the key process to manage counterparty risk. However we think that whilst the daily exchange of variation margin is appropriate for most pension schemes, it might not be necessary for smaller ones for which a less frequent exchange (e.g. weekly) might be more appropriate: in this case the additional risk benefit of a daily exchange of collateral versus lower frequencies would not necessarily compensate for the additional operational costs of managing collateral transfers on a daily basis.

Q31. What will be the impact if re-use of collateral was no longer possible?

If the re-use of collateral posted for variation margin was no longer possible, market participants would need to significantly increase the size of their pools of collateral (as offsetting trades would no longer have the possibility to be neutral from a collateral point of view) and this would reduce dramatically the liquidity in OTC markets and potentially increase costs.

Q34. What consequences would changing the range of eligible collateral have for market practices?

A wider range of eligible collateral would be good for pension schemes if they were to post initial margin as this would avoid having to transform current assets into more liquid assets for the purpose of posting initial margin, saving pension schemes costs as well as avoiding the potential performance drag that could happen when the asset allocation needs to be changed to free up assets for the margining.

However, pension schemes are likely to want to receive quality assets only such as highly rated Government bonds.

Q40. Do you support the use of own estimates of haircuts to be limited to PRFCs?

The choice of haircuts should be left to the counterparties for them to agree on a level of haircut that is in line with their own risk appetite. However, this should be set within a predefined range for each type of collateral to ensure that no regulatory arbitrage is possible.