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SUBJECT: Response to ESMA Consultation Paper "Draft Technical Standards for the Regulation on OTC Derivatives, CCPs and Trade Repositories"

Dear Sir/Madam,

1. Introductory Statement

Regardless of the (temporary) exemption from the clearing obligation for pension schemes arrangements, we welcome the opportunity to respond to the ESMA consultation paper on the Draft Technical Standards for the Regulation on OTC Derivatives, CCPs and Trade Repositories. Please note that we have responded to this consultation paper primarily from a pension fund perspective. Our remarks stem from the fact that pension funds and their dedicated investment vehicles are large institutional investors acting in the interest of pensioners.

We note that we previously have also provided you with a reaction to the discussion paper on this same topic, as was issued by ESMA on 16 February, 2012. The following are our remaining <u>reactions to the present consultation paper</u>. As requested during the ESMA public hearing in Paris on 12 July 2012, we will do so by making reference to the relevant topic and (draft) technical standards as included in the consultation paper in the same following order as included therein.

2. Key remarks

- We are concerned that the proposals - and especially the increase of the confidence interval level to 99,5% - will result in a substantial increase of margin requirements for individual end users. This could have a substantial impact on the costs for the pension fund industry as a whole.
  In the end this will have to be borne by the beneficiaries we represent (i.e. the pensioners).
- In general we are not convinced that the increase of the confidence level with regard to the margin will automatically lead to more safety.
- For front-running risk (and alike) reasons, we are strongly opposed to any information on intra-group trades being made public. At least, such information should never include the identities of the counterparties involved in the relevant transactions.
- In line with the utility-like character of CCPs we feel that as a matter of urgency ESMA should consider including in the technical standards a prohibition of re-use (or for that matter rehypothecation) by the CCP of ‘our’ non-cash collateral.
- According to us non-cash collateral should be held in a segregated account in the name of the end user with a security interest for the CCP.
- In our view the reporting threshold in relation to disputes as currently proposed is set far too low. A (far) higher threshold of e.g. EUR 500 million instead of the currently proposed EUR 15 million would in our view be more sufficient both in terms of offering sufficient insight to regulators and avoiding overburdening market parties with onerous reporting requirements.

3. Reaction to the Consultation Paper

Risk mitigation for OTC derivative contracts not cleared by a CCP
(ANNEX II - Draft regulatory technical standards on OTC derivatives)

Timely confirmation (Chapter VIII, Art. 1 RM)

- We would like to reiterate the view expressed in our previous reply to ESMA’s discussion paper that the proposed timing seems extremely strict and the requirement may be difficult to meet for some counterparties.

- The proposal requires counterparties to confirm within one business day whilst current market practice is two business days, which for most transactions is practically feasible and provides enough time to accommodate counterparties in different time zones.
  However, as this proposal concerns non-cleared transactions, more complicated transactions such as some forms of equity derivatives should also be taken into consideration. Such transactions can take considerably longer to confirm.

- We would welcome the proposal to be amended to adhere with current market practice and to require both financial and non-financial counterparties to strive for confirmation within two business days rather than requiring confirmation in a one business day period. We have no objection to the monthly reporting of transactions where confirmation has taken longer than five business days.

Portfolio reconciliation (Chapter VIII, Art. 2 RM)

- The proposal makes reconciliation mandatory, albeit that the frequency increases with the number of transactions. In our view reconciliation, especially for non-cleared OTC transactions that are almost by definition non-standard and more difficult to reconcile, uses up substantial resources and mandatory reconciliation should therefore be limited to a minimum, not only in the number of instances, but also regarding the transaction details to be reconciled. Reconciliation should not be an end in itself.

- Whilst we appreciate and agree to ESMA's intention as set out on page 18, no. 80, for parties to conduct portfolio reconciliation on the basis of valuation of transactions, we feel this is not adequately reflected in the text of the article. Article 2(3) RM provides for reconciliation covering an unspecified number of key trade terms, including *at least* the valuation of transactions. We furthermore recommend that valuation statements as exchanged between parties are put into a standardised format in order to facilitate easier reconciliation.

- We view the arrangements in the ISDA Credit Support Annex to be sufficient to resolve discrepancies in a material term of a contract or in its valuation.

Portfolio compression (Chapter VIII, Art. 3 RM)

- We are pleased to see that ESMA has modified its proposal to having the procedures in place for conducting a portfolio compression possibility analysis twice a year. We are in favour of mitigation credit risk and have already voiced our support for the principle underlying the portfolio compression initiative in our contribution to the discussion following ESMA's discussion paper. However, we are of the opinion that compression is not easily achieved for non-cleared OTC transactions given their diverse nature and should not be forced upon parties.

- We would also like to reiterate our view that the time provided in which the compression exercise is to be finalised should be sufficient to be able to perform the analysis correctly and reach agreement with the counterparty in the transactions on how to settle the off-setting transactions.

Dispute resolution (Chapter VIII, Art. 4 RM)

- We agree with the principle of having dispute resolution procedures in place when entering into OTC derivative contracts. As we have said previously in our answer to the questions in ESMA's discussion paper, these procedures should be straightforward and not require too many resources whilst stimulating the development of best practices. Putting effort into creating uniform pricing standards would likely help to reduce disputes significantly.

- We consider that the procedures provided in ISDA's Credit Support Annex and equivalent documentation provides for an adequate dispute resolution procedural framework.

- We stress that the proposed reporting obligation relating to an amount or a value higher than EUR 15 million and outstanding for at least 15 business days appears random and that the proposed level of EUR 15 million is too low. In our view a reporting obligation with respect to unsettled disputes, with similar criteria as proposed in Annex II but a (far) higher reporting threshold of e.g. EUR 500 million at the end of each month, would offer sufficient insight to regulators without overburdening market parties with onerous reporting requirements, would be more appropriate to the goal of reducing systemic risk and easier to fit into standard and existing operating procedures and market practices.

- For the same reasons, in respect of valuation issues only material differences in valuation should in our view be included in the mandatory dispute processes.

Marking-to-market and marking-to-model (Chapter VIII, Art. 5 and 6 RM)

- We welcome the changes made by ESMA to the proposals set out in ESMA's discussion paper as being perceptive of the difficulties and the dangers of being too prescriptive. We take the view that the proposed amendments are largely beneficial.

Intra-group exemptions (Chapter VIII, Art. 7 and 8 RM)

- As has been acknowledged by ESMA in the consultation paper, which we support and appreciate, it should at all times be avoided that commercially sensitive information would become available to the market in order to avoid 'front-running' and/or other unintended consequences of the proposed new regulations. For the same reasons we are strongly opposed to <u>any</u> information in relation to intra-group trades being made public. If ESMA would nonetheless decide that such disclosures are to be made, at the very least and for the exact same reasons, these should not contain the identities of the counterparties involved. Disclosure of the names and/or identifiers of these parties in relation to the (aggregated) size of the transactions will likely have the exact same -undesired- effects.

CCP Requirements

(ANNEX III - Draft regulatory technical standards on CCP requirements)

Organisational requirements - Governance arrangements (Chapter IV, Art. 1 ORG)

- We appreciate that ESMA has acknowledged that accountability to stakeholders by CCPs should be established, as it is essential for having sound corporate governance arrangements in place. We strongly support including such statement -at least- in the recitals of the technical standards on CCP requirements. We trust such to fall within ESMA's mandate, based on Article 26 of ESMA's legislative mandate to develop draft technical standards (Annex I of the consultation paper), as it authorizes ESMA to set further requirements in relation to CCPs governance arrangements.

Margins (Chapter VII, Art. 1-5 MAR)

- In general we appreciate the efforts by ESMA to try to take into account the pros and cons of its suggested margin regime. At the same time we feel that there should be a balance between on the one hand creating an incentive for more safety in the clearing system and on the other hand the costs of this safer margin regime for us as end users.

- The consultation paper suggests to set confidence levels for the initial margin calculation for OTC derivatives at 99.5%. In our view this is simply too high. In comparison: the standard confidence level for uncleared OTC transactions proposed in the recent consultation paper of the BCBS and IOSCO is 99%. It is not very logical to make this distinction between cleared and non-cleared derivatives. We have been informed that a confidence level of 99.5% could result in an initial margin increase of almost 23% for an end user. In effect through these confidence interval levels a redefinition of margin and default fund split respectively is achieved. At the same time it is not necessarily the case that a higher confidence level leads to more safety. All of this could well mean a substantial increase of margin requirements for individual end users with corresponding cost increases for the industry as a whole. These costs will be at the detriment of the pensioners we represent. In case such a big impact as a result of requirements over and above the BCBS/ISOCO standard is deemed necessary then this would in any event require a more fundamental cost-benefit analysis.

- The consultation paper suggests on page 32, nr. 167(d), that for end users such as the Dutch pension funds we represent in this letter, a 99.5% confidence level will have no impact because clearing members already charge higher margin levels to end users. We know for a fact that this is not the case. Although clearing members do indeed reserve the possibility to increase margin levels in times of market volatility (as do CCPs vis-à-vis clearing members) this is certainly not the default situation. As a result Article 1 MAR would lead to substantially higher margin for end users than was foreseen.

- The consultation paper suggests to set confidence levels for the initial margin calculation for OTC derivatives at 99.5%, while the financial instruments 'other than OTC derivatives' will be subject to a 99% confidence interval level. This distinction does not seem to be the appropriate criterion for determining the confidence interval, is not properly motivated and at the very least open to different interpretation. As a matter of fact OTC instruments can be very standardized and liquid.

- We note that the most stressed period of the last 30 years is rather arbitrary and may not reflect the true underlying risks in portfolios. As a result it may not offer the best protection from a margining perspective, but can result in unnecessary high margins for safer portfolios and perhaps even lower margins for portfolios with more risk.

- Article 4(3) MAR states that all financial instruments to which portfolio margining is applied shall be covered by the same default fund. We wonder if this should indeed be the intention and if the instruments between which the CCP makes a distinction should not be covered by separate default funds.

Collateral Requirements (Chapter XI)

- With respect to the highly liquid financial instruments that are identified in Article 1 COL, we note that gold is still included. We advise against the inclusion of gold as a highly liquid type of collateral as the valuation of gold is speculative and can be considered highly speculative in comparison to the other types of collateral that are allowed.

- We strongly feel that not only bank guarantees, but also guarantees issued by other financial institutions, most notably (global) custodians, that meet the proposed criteria should qualify. In the market, various ways of providing collateral are currently considered.

CCP – Investment Policy (Chapter XII)

- ESMA has chosen for a CCP investment policy on the basis of criteria and not on the basis of the specific rules. However, this opens up the possibility for interpretation of these criteria by CCPs and we feel that especially when it comes to the treatment of collateral from clearing members – which eventually comes from us as buy-side institutions – CCPs should be utility-like entities and as safe as possible. Too much flexibility on an investment policy could jeopardize this. If ESMA were to go forward with this approach then at the very least more strict governance and monitoring arrangements should be required, for instance through regulators (even more than currently suggested) and CCPs risk committees with involvement of the buy-side.

- In this regard another important item is the requirement to actually post (non-cash) collateral with CCPs through a title transfer. In the end that collateral is posted by us to the CCP via the clearing member. Fundamentally we feel that there is no reason why non-cash collateral should remain with the CCP and not in a segregated account in the name of the end user with a security interest for the CCP. This should not hamper liquidity at all, would avoid risk concentration at the CCP and create less concerns around the use by the CCP of the collateral and the protection that is offered in the event of a CCP insolvency.

- Finally, in line with the utility-like character of CCPs we feel that as a matter of urgency, ESMA should consider including in the technical standards a prohibition of re-use (or rehypothecation for that matter) by the CCP of ‘our’ non-cash collateral. Not restricting this in our view opens up the possibility that if a CCP goes bankrupt the non-cash collateral (mostly government bonds in our case) could be seen as being part of the bankruptcy estate of the CCP. In line with this, we would also like to show our concern about the possibility that CCPs could repo out cash collateral without that being supported by a robust framework.

Trade Repositories
(ANNEX V – Draft regulatory technical standards on trade repositories)

Transparency and data availability (Chapter 1, ART 2)

- ESMA believes a weekly disclosure is the appropriate period to be considered as a minimum frequency. For liquid instruments this might work, but we believe ESMA is underestimating the effect this can have on illiquid instruments (like long dated swaps). For these instruments we believe monthly or quarterly disclosing is vital in order to prevent market participants from front-running.

Transparency and data availability (Chapter 1, ART 3)

- We are pleased to note that ESMA has incorporated our concerns with regard to confidentiality as there seems to be more emphasis on the confidentiality of the information.

Reporting obligation

- We support ESMA's objective to reach a common reporting mechanism for MIFID and EMIR. Not reaching this common reporting mechanism will lead to much higher costs.

We hope that our response is of assistance. Should you have any (remaining) questions or would like additional clarification, please do not hesitate to contact us.

Kind regards,

Edith Maat
Head of Policy
Federation of the Dutch Pension Funds

About the Federation of the Dutch Pension Funds:
On behalf of approximately 350 pension funds, the Federation of the Dutch Pension Funds promotes the pension interests of 5.6 million participants, 2.7 million pensioners and 8.3 million early leavers.

About 85% of the total number of Dutch employees is participant of a pension fund which is associated with the Federation of the Dutch Pension Funds. The Federation of the Dutch Pension Funds is a cooperation between the umbrella organizations for industry-wide (VB), occupational (UvB) and company (OPF) pension funds.

The present response to ESMA Consultation Paper “Draft Technical Standards for the Regulation on OTC Derivatives, CCPs and Trade Repositories” has been prepared by a joint working group of the Federation of the Dutch Pension Funds together with APG, MN, PGGM, SAMCo and Syntrus Achmea. They are service providers of Dutch pension funds.

APG Asset Management (**APG**) is a Netherlands based asset manager for Dutch pension funds with assets under management of approximately EUR 302 billion as at May 2012. APG is itself an indirect subsidiary of Stichting Pensioenfonds ABP, the Dutch pension fund for the government and education sector and the third largest pension fund globally. APG works for more than 20,000 employers and provides for the income of more than 4.5 million Dutch citizens managing over 30% of all collective pensions in the Netherlands.

MN is a Netherlands based asset manager for a broad variety of pension funds in the Netherlands and the United Kingdom. With assets under management of approximately EUR 70 billion as per 31 December 2011, MN is one of the largest pension administrators and asset managers in the Netherlands.

PGGM Vermogensbeheer B.V. (“PGGM”) is an asset manager for Dutch pension funds in the care and welfare services based in The Netherlands, with assets under management of approximately EUR 114 billion as at 31 December 2011.

PGGM is a wholly-owned subsidiary of PGGM N.V., which is 100% owned by PGGM Coöperatie U.A., a co-operative with more than half a million members. PGGM manages the pension assets of about 2.5 million Dutch citizens.

Shell Asset Management Company B.V. (**SAMCo**) is an asset and fund management company that provides investment advice and asset management services to pension funds associated with Royal Dutch Shell worldwide. SAMCo has approximately EUR 45 billion assets under management.

Syntrus Achmea (**SA**) is an asset manager, real estate and administration company for Dutch industry-wide, occupational and company pension funds. With approximately € 57 billion assets under management as per 31 December 2011, SA manages and administrates the pension of about 3.8 million Dutch citizens.