# PENSIOEN FEDERATIE

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# POSITION PAPER

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## Executive summary

Stable and efficient derivatives markets are in the interest of end-users such as pension funds, as well as the pension fund participants on whose behalf risks are hedged. The Dutch Federation of Pension Funds supports the objective of the European Commission to foster central clearing within the European Union. Nevertheless, we have the following concerns concerning the EMIR3 proposal:

- The requirement to clear a minimum proportion on the active account contradicts the principles of best execution and ultimately leads to lower pensions.
- Alternatives to defining an “active account” are available.
- New reporting requirements in Article 7b are duplicative and burdensome


## 1. Adequate supervision of CCP is paramount

Dutch pension funds recognize the benefits of central clearing. Central clearing bundles counterparty risk. The systemic financial stability risks of a potential CCP default are widely acknowledged. Hence, strict supervision and management of these risks is vital for maintaining financial stability. This means that European supervisors need appropriate tools to supervise CCPs with systemic relevance for the European Union. Significant progress has already been made with EMIR 2.2, which developed ESMA’s powers to supervise third country CCPs. In fact, ESMA already has the power to require a relocation of Tier 2 CCPs, which raises the question why a location policy should be enforced by regulating the activities of (end-)users.

## 2. Feedback on the active account requirement

Article 7a introduces the requirement to hold an active account at an EU CCP for a number of derivatives, including interest rate swaps. The proposal delegates to ESMA the power to define a fixed proportion of minimum transactions to be conducted through the EU account.

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The Dutch pension sector understands the benefits of holding an active account with a EU CCP. It is customary for larger Dutch pension funds to have multiple accounts in order to diversify risk and to be able to enjoy the best market conditions. We believe criteria could be developed to verify that accounts are indeed 'active' and not exist merely on paper. **However, we do not support the requirement for clearing a fixed proportion, for reasons set out below**.

***Forcing to clear a fixed proportion at an EU CCP contradicts the principals of Best Execution***

Best Execution regulations requires investment managers to execute trades in the best possible manner for their pension fund clients. Important factors that determine the venue for clearing are amongst others: pricing, liquidity, certainty of execution and collateral segregation. These factors vary between different CCPs. Being obliged to pick sub-optimal market conditions would reduce returns for the pension funds, thus leading to lower pensions and as such in contradiction with best execution principles.

***Alternative approaches to defining an active account are available***

As mentioned, we believe it is possible to develop criteria to assess whether an account is operationally 'live', without requiring a minimum proportion of trades. These criteria could include demonstrating that legal documentation, IT connectivity and internal processes are in place. It could also be possible to require small annual test trades. Supervisors would then be able to verify that European market participants would be able to switch all new trades to an EU CCP, should market circumstances require this.

## 3. EU policies should focus on making EU CCPs more attractive

When applying best execution principles pension funds look at the liquidity, price, risk and other relevant factors. One very important factor for pension funds would be a solution for the challenge of cash variation margin. Pension funds were granted a temporary exemption from central clearing under EMIR in order to provide time to find a solution for the challenge posed by the requirement to post variation margin (VM) in cash instead of high-quality bonds. Although this solution has not been found to date, yet the exemption is set to expire in June 2023.

***Holding cash or near-cash buffers reduces returns and exposes pension funds to counterparty risks***

Pension funds are asset rich, but ordinarily try to minimise their allocation towards cash. They do typically have a large allocation to high-quality government bonds, usually matching the currency of their liabilities. Pension funds therefore would prefer to be able to post variation margin in high-quality government bonds that form part of their investment portfolio. Holding cash or near-cash buffers reduces returns and exposes pension funds to counterparty risks, as in many cases governments bonds lower counterparty risk than bank deposits. Having to post cash instead has significant adverse implications for pension funds' investment portfolios, and consequently for

European pensioners.[1] While we understand that CCP's operational model does not allow for the posting of cash, solutions to guarantee collateral transformation are possible.

**Should the EU find a solution for the cash VM challenge for trades conducted through an EU CCP, this would be taken into account when applying best execution principles and will form a clear incentive for pension funds to make use of such a CCP.**

***Unforeseen consequences of mandatory clearing on a EU CCP***

We are concerned that an obligation to clear a minimum proportion of transactions on an EU CCP would distort the market, which, being ultimately a global market, would likely have unforeseen consequences and lead to worse outcomes for end-users. An imbalance between the type of market participants that are obliged to clear in the EU and market participants that have no such obligation, can for example create large differences in pricing levels and other factors. We therefore believe it is of the upmost importance that a level playing field is always maintained between EU and non-EU financial institutions. Currently, there is only one viable option for clearing within the EU and therefore the active account requirement as currently drafted would mean a significant reduction in choice.

Moreover, smaller pension funds may only conduct a few trades per year. Having any minimum percentage for clearing at an EU CCP at all could lead to the situation where they have very little flexibility.

## 4. Reporting obligations

The proposed rules under EMIR 3 impose additional reporting obligations both for clearing members and clients. In particular, the obligation in Article 7b would be burdensome for pension funds. The current rules already provide for extensive reporting obligations from which competent authorities should be able to collect all data necessary. **The current proposal would therefore lead to duplicative requirements.**

## 5. Why pension funds use derivatives

Pension funds invest contributions on behalf of their participants in order to meet future pension liabilities (pensioners' retirement income). Interest rate

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[1] An independent report published by Europe Economics and Bourse Consult in 2014 for the European Commission (hereafter referred to as the "Europe Economics and Bourse Consult report") estimates that if European pension funds were required to post VM in cash, the total cash collateral needed by them to support a 100bp (1%) move in rates would amount to €205 billion to €255 billion, increasing to €420 billion in more stressed scenarios. It further estimates that this would cost European pensioners between €2.3 billion and €4.7 billion annually. See Page 10, *Baseline report on solutions for the posting of non-cash collateral to central counterparties by pension scheme arrangements: a report for the European Commission* prepared by Europe Economics and Bourse Consult. 2014

risk is a very significant risk, but one that can be managed. Pension funds typically invest in high-quality government bonds to hedge their interest rate risks, but their ability to hedge such risks completely with bonds is limited as the amount of bonds that can be used to match long-dated liabilities is inadequate. Derivatives have the advantage of being available for longer maturities and can also be tailored to match the dates of pension funds' liabilities more accurately, which is not generally possible with bonds. Derivatives can often also be the best matching asset for pension fund liabilities that are discounted using swap rates. The use of derivatives therefore helps to protect a pension funds ability to pay out pensions at the foreseen level and is an important tool in order to offer fixed annuities.

***The role of the Dutch pension fund sector in the IRS market***

Dutch pension funds manage 1400 billion euros worth of assets on behalf of the vast majority of Dutch employees and pensioners. With pension funds hedging typically between 30% and 70% of the interest rate risk, Dutch pension funds are significant players in the market for interest rate swaps (IRS).

The counterparty credit risk posed by pension funds' derivative portfolios is limited. The aggregate derivatives exposure of pension fund portfolios itself does not raise significant concerns from a systemic risk point of view: although the derivatives portfolios of pension funds are typically long-dated and one-directional, they are generally held to reflect and offset their liabilities resulting in a risk-neutral position overall. Typically, pension funds also collateralize their derivatives portfolios daily. Therefore, while the steady increase of interest rates in 2022 led to a significant drop in the value of the IRS portfolio, the value of the liabilities shrank even further, leading to a significantly improved solvency position.

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