DUFAS

<u>**ANSWERS to EMIR PSA Consultation (submitted in ESMA template response form 2020-06-12)**</u>

Q1: Do you agree with the description made of the portfolios of EU pension funds as well as their use of derivatives? In particular, do you agree that PSAs use derivatives to build synthetic long-dated positions in order to overcome the availability of suitable sovereign or corporate bonds alternatives? Please elaborate on the reasons for your answer.

In principle, we agree with the description made of the portfolios of EU pension funds as well as their use of derivatives.

Q2: Do you have any data with respect to the structure of PSAs' portfolios? In particular regarding the duration gap which derivative strategies are designed to address?

Derivatives are an essential part of the interest rate hedging strategy for an average Dutch PSA. The average interest rate hedge ratio of a Dutch pension fund is 49% (DNB data - Q4 2019). The contribution of the fixed income portfolio will differ among pension funds. Based on our experience the fixed income portfolio contributes approximately for 10-25% of the total hedge ratio of 49%. Therefore 25-40% is additionally hedged with derivatives, which means that more than 50% of the interest rate hedge has to be achieved through derivatives.

Q3: Do you have any data on the volume and nature of the activity of PSAs in cleared and non-cleared OTC derivatives markets, within each asset class, and any related systemic risk they might pose to the financial system? What portion of non-cleared derivatives would be replaceable by cleared products if the impediments to clearing were removed?

For most of the small and medium-sized PSAs, cleared derivatives would be sufficiently available. We think that in general the advantages of central clearing outweigh the disadvantages for the small and medium-sized PSAs, although this could be case specific, as we set out in the answer to Q4.

Q4: Do you think that PSAs fulfilling the clearing requirement would have significant consequences on their investment strategies, including any shift in their cash and non-cash asset allocation? Please elaborate on the reasons for your answer and provide numerical data supporting your answer where available.

Central clearing has an impact on cash holdings for PSAs because there is a shift from bond collateral to cash collateral as variation margin in the central clearing space must be posted in cash. The consequences of fulfilling the clearing cash requirements will differ between PSAs as this depends on multiple factors, including the current investment strategy, the hedge ratio of the PSA's liabilities and the cash management policy . However, an integrated cash management approach could limit the negative impact of additional cash holdings for small and medium-sized PSAs.

To achieve this, cash management should be part of the strategic asset allocation of PSAs. A clear cash management with sufficient high buffers with the objective to fulfil cash requirements in case of (extreme) market movements must be set up. The cash buffer depends on the interest rate sensitivity of the swap portfolio, so that the cash buffer moves with the size of the swap portfolio.

Upper and lower limits for the cash buffer provide a high degree of certainty that collateral obligations can be fulfilled under normal circumstances and that the cash buffer is not too large. Those limits can be based on the initial margin requirements and on historical interest rate movements. Because future interest rate movements can vary from historical ones the minimum buffer should be efficient enough to deal with more extreme market movements than historically seen. PSAs should have a maximum buffer to ensure that cash positions won't become too high.

PSAs can combine their cash requirements from the VM swap clearing requirements with the cash collateral requirements of FX instruments. This can potentially lower the required cash buffers.

We do note that it is important that also in stress scenarios sufficient cash collateral is available to PSAs to fulfil their VM requirements Essential element is a functioning commercial paper and/or repo market, but is not always enough. The recent Covid-19 crisis has shown that adequate risk management is key in this regard but it may be insufficient to acquire cash in time, and DUFAS supports additional measures from policy makers and regulators on ensuring cash requirements can be met at all times.

Q5: Are there further considerations, other than investment strategies mentioned above, either driving or constraining the use of derivatives for PSAs*?*

The use of derivatives for PSAs is an essential part of the PSAs investment strategy and allows the PSA to comply with the prudent person principle. When considering the method to use derivatives, in general centrally cleared derivatives show advantages for most pension funds, which is mainly related to standardization of contracts/instruments and independency to counterparties, making it more transparent and more efficient. Generally speaking, centrally cleared derivatives could decrease the financial stability risk, provided that a robust solution is implemented to mitigate the risks as described in our answers to questions 21-23.

When trading cleared derivatives the use of trading venues is more transparent. The existing venues are mainly focussed on cleared execution. Venues do provide non-cleared solutions, but this has never been as streamlined as cleared, which makes sense: non-cleared is tailor made. Hence more complicated and hence (in general) less liquid.

Closing a non-cleared trade always means dependency on the original counterpart (either via direct unwind or via novation which the counterparties have to approve). Closing a cleared trade (by trading an opposite trade and netting the 2 trades at the CCP) is not dependent upon the counterparty.

Another advantage of standardization can be seen in the Eonia/€STR transition. For the CCP switch the process is completely transparent. The impact on bilateral derivatives however requires negotiation, which will never be as transparent as the CCP switch which is closely monitored by all market participants.

Finally, when using venues for cleared trades the operational process is more efficient: ease of use, integration with Order Management Systems, less operational risks, etc.

Q6: Do you agree with the description of the challenges met by PSAs to post variation margin in cash? Please elaborate on the reasons for your answer.

As mentioned in the answer to Q4, we agree with the description of the challenges, as well as ways to address these challenges.

Q7: Do you have any data with respect to the value and/or share of cash holdings in PSAs' portfolios? Can you provide estimates of how much those would need to be increased to service cash variation margin calls?

Q8: Do you have any data with respect to estimated changes in variation margin for your outstanding contracts for a +/- 1% parallel shift in the yield curve for: a) cash VM of centrally cleared contracts, b) cash VM for OTC contracts, c) bonds VM for OTC contracts, and d) for all your outstanding contracts?

Q9: Can you provide data on the prevalence of acceptance of non-cash collateral in the context of bilateral OTC trades? And conversely on the limitations imposed by counterparties to post initial margins in the form of cash?

In respect of VM for bilateral OTC trades, historically PSA's bank counterparties accept high quality government bonds. Their willingness to do this is however reducing because of a direct impact of the leverage ratio rules under CRR which only permits cash VM to offset against replacement cost (or mark to market of the trade). As a result, a number of banks are exerting pressure on PSAs to amend their bilateral CSAs to only allow for cash collateral being posted as VM for bilateral OTC trades.

With respect to initial margin (IM) for bilateral OTC trades, the eligibility of collateral is very much dependent on the terms of the relevant contractual arrangement. Cash-only collateral agreements, bond-only collateral agreements and a mixture of both are all common in the market. However, PSAs currently do not post IM for bilateral OTC trades because of their high credit worthiness. This will however change after phase 5 and 6 of the implementation of UMR takes effect. These rules do permit non-cash IM. This would not necessarily mean that there is no cash issue for IM under bilateral OTC trades, as this depends on the balance sheet of the bank counterparty.

Q10: Can you provide data on the size of the yield drag from holding cash buffers to service variation margin calls in cash? Possibly differentiating between drag from under-investment and costs of funding temporary high liquidity demands?

The OECD has pointed out in its annual pension report statistics[1] that the Dutch pension sector had an annual average return over the past 15 years of around 6.1%. An extra allocation to cash of 5%-10% would mean a drag on annual returns of around 0.3%-0.6%, assuming the return on cash is negligible. For the Dutch pension sector, with assets of around €1.3 trillion, that would mean a negative impact of c.€4 billion to €8 billion in expected returns.

Extrapolating from the above, in Table 1 we provide an estimate of the impact to Dutch pension funds of different allocations to cash up to 20% of assets (the estimated cash buffer required to support a 1% move in rates).

Table 1: How increased allocations to cash could drag on pension fund returns

Cash holding	Reduction in annual return	Reduction in annual return (€ bn)
5%	0.3%	4
10%	0.6%	8
15%	0.9%	12
20%	1.2%	16

[1] http://www.oecd.org/daf/fin/private-pensions/globalpensionstatistics.htm

Q11: Are you (or are you aware of) a PSA which is a direct clearing member to a CCP? How have you addressed the issues regarding the posting of cash VM?

We are only aware of PSAs being direct clearing member to CCPs for repo and/or securities lending clearing, not OTC derivatives clearing. As far as we are aware, where PSAs do so, they typically use the relatively recently introduced sponsored clearing models. However, also in a sponsored clearing model, the PSA needs to rely on the services of a broker/dealer acting as 'clearing agent'. Since under the sponsored clearing models a clearing agent typically guarantees the (basic) clearing member's performance (i.e. that of the PSA), the contractual arrangements that PSAs have in place with clearing agents contain a large number of substantially similar provisions to the contractual arrangement with a clearing member in a traditional clearing model.

In any case, and most importantly, we do not see direct clearing member models as a means to resolve the cash VM issue. The requirement to post VM in cash comes from the CCPs rather than the clearing members. As such, if you would take the clearing members out of the equation, this feature does not change.

In addition, since these sponsored clearing models are quite sophisticated, generally speaking, they are practically only available to the largest PSAs.

Finally, to be complete, there are a number of hurdles for PSAs to become direct clearing members without a sponsor in the current market, including (but not limited to) the following:

- Strict membership criteria by CCPs;
- Most PSAs inability to provide mandatory bids in hedging rounds/participate in the auction process under a CCP's default management framework;
- Some PSAs inability to contribute to default funds, as this is prohibited under the laws in a number of jurisdictions; and
- Most PSAs may have limited operational capability to meet intra-day margin calls.

Q12: Can you indicate whether you have considered becoming a direct clearing member to a CCP for the purpose of clearing mandated contracts? If not, what were the reasons against becoming a direct member? Specifically, were there other considerations beyond the issue of cash variation margins?

Some of our members have considered this, but found the current requirements very challenging if not prohibitive.

With respect to OTC derivatives, as far as we are aware, no viable models exist. Please refer to our answer to Question 11.

Q13: Do you agree that the central clearing of OTC derivatives by PSAs by June 2023 at the latest is the ultimate aim? Do you agree that the entry into force of this requirement should be subject to regulatory and market developments enabling market participants to develop appropriate technical solutions within that period? Please elaborate on the reasons for your answer.

Yes, we agree. The reduction in bilateral counterparty credit risk, increased market transparency, together with the improved efficiency in trade execution outweigh the significant operational costs incurred by market participants and end-investors to comply with clearing mandates.

However, any robust solution that is developed to solve the cash VM issue must be reliable in stressed markets. The European Commission's expert group has an essential role to play in this

process. The solution must be developed in close cooperation between market participants and policymakers. Indeed, policymakers have played an important role in shifting the market structure, and any unintended consequences created by it need their involvement as the market is constrained by regulation and we cannot innovate around regulation.

There are stages that must be met before the exemption expires: designing a solution, operational connectivity, testing and on-boarding. Enough time must be provided to allow for this before the exemption expires. Pension funds are keen to move through this quickly to find a robust long-term solution.

The deadline should not be linked to an arbitrary date, but to all preconditions being satisfied.

Q14. In the hypothetical scenario where the exemption were to be made permanent, do you think that there would be a price handicap for less-liquid non-cleared contracts vis-à-vis the cleared alternatives? Can you provide estimates of the size of the price differential and the impact, also in terms of yield drag on PSA portfolios?

Q15. Under the new regime provided in EMIR Refit with respect to the scope of application of the clearing obligation and the calculation of the positions, do you expect to be or not subject to the clearing obligation once the clearing exemption has come to an end?

Many pension funds, particularly larger ones, will be subject to the clearing requirement. There will be some pension funds that benefit from the small financial counterparty exemption provided in EMIR Refit. But even if some pension funds opt for a clearing exemption under EMIR Refit they would remain subject to margin requirements for uncleared OTC derivatives. Each pension fund would therefore have to carefully weigh costs vs benefits of continuing to operate under the pensions exemption.

Q16. Do you agree with the pre-conditions for a workable solution as described in paragraph 51? Please elaborate on the reasons for your answer.

Yes, we agree. It is extremely important that the solution takes due consideration of pension funds' obligations, particularly the obligation to maintain an asset allocation that is most likely to ensure a pension fund can fulfil its obligations to policyholders and beneficiaries. For this reason, we believe cash holdings must be minimised in order not to forgo potential returns (see our answer to question 4). This is entirely in line with the requirements under the prudent person principle.

It must also be noted that time will be needed to operationalise, test, and implement the solution before pension funds are mandated to clear.

It is also very important that the solution does not impose a cost on end users, which is disproportionate compared to the policy objectives. It is also important that the solution is robust enough to be relied upon in both normal and stressed market conditions, not least since there is a concern for PSA as to the reputational as well as commercial impacts of a potential default on margin calls.

Q17. Are there any other features that the solution should try and achieve?

Pension funds vary in size and operational capacity. It is important to find a cost-efficient solution without a significant increase in operational costs that can be implemented by all pension funds, both large and small, and regardless of whether they exceed the OTC-derivative clearing threshold or not. This is because it is not clear if

the non-cleared markets will remain workable for smaller pension funds below the OTC-derivative clearing threshold, which means it is also not clear whether they can rely on the small financial counterparty exemption in practice.

Q18. Do you agree with the statement that no or few PSAs were onboarded with the status of clearing members, but instead clear as direct clients of a clearing member? Do you think that this situation may evolve in the coming years? Please elaborate on the reasons for your answer.

We are only aware of PSAs being direct clearing member to CCPs for repo and/or securities lending clearing, not OTC derivatives clearing. As far as we are aware, where PSAs do so, they typically use the relatively recently introduced sponsored clearing models. However, also in a sponsored clearing model, the PSA needs to rely on the services of a broker/dealer acting as 'clearing agent'. Since under the sponsored clearing models a clearing agent typically guarantees the (basic) clearing member's performance (i.e. that of the PSA), the contractual arrangements that PSAs have in place with clearing agents contain a large number of substantially similar provisions to the contractual arrangement with a clearing member in a traditional clearing model.

In any case, and most importantly, we do not see direct clearing member models as a means to resolve the cash VM issue. The requirement to post VM in cash comes from the CCPs rather than the clearing members. As such, if you would take the clearing members out of the equation, this feature does not change.

In addition, since these sponsored clearing models are quite sophisticated, generally speaking, they are practically only available to the largest PSAs.

Finally, to be complete, there are a number of hurdles for PSAs to become direct clearing members without a sponsor in the current market, including (but not limited to) the following:

- Strict membership criteria by CCPs;
- Most PSAs inability to provide mandatory bids in hedging rounds/participate in the auction process under a CCP's default management framework;
- Some PSAs inability to contribute to default funds, as this is prohibited under the laws in a number of jurisdictions; and
- Most PSAs may have limited operational capability to meet intra-day margin calls.

Q19. Do you agree that relying on collateral transformation services already offered by clearing members to their direct clients may be part of the solution?

We see some interesting connecting factors from the point where clearing members offer additional transformation services. We spoke to several clearing members and investigated if we could give the securities lending right to an equity portfolio. This in addition to their regular clearing member services and in exchange for a credit facility. In case the solution is not used the clearing member will pay a compensation to the lending right.

Main advantages we see in this solution is that both services are provided under one roof so cash can be moved within short timelines and even when timeliness could not be met the clearing member has view on the credibility of the client. Second advantage is that current income from securities lending is very limited, this alternative use is a cheap solution for guaranteed cash.

The disadvantage is that the solution is not live yet. Although talks are ongoing for several years none of the clearing members has a proven proposition with this service. It is unattractive business for clearing members in the current capital environment and there is very little to no appetite for

this from banks. In the very limited circumstances where a bank may consider providing such a service for their clients, under strict conditions, the volumes are small and would not meet the demand from pension funds. Unfortunately, this would not solve the cash VM issue. CM-provided collateral transformation services relied upon by pension funds only cover intra-day VM calls that must be met with cash VM by the end of the day. A backstop to all market-based solutions, be it collateral transformation by the clearing member or the repo market is required.

Q20. To what extent has the constraint on the bank clearing members' capital requirements been eased and now allows for their role of collateral transformation to be better fulfilled?

The increased demand for cash during the recent Covid-19 crisis, showed that while the repo markets functioned well for intra-bank transactions, it did not function well for the buy-side. Even if capital requirements would allow a bank to offer more collateral transformation services in normal times, it will not guarantee that the bank will be willing or able to perform these services in stressed periods.

Q21. Do you think that modifying the calculation of the leverage ratio might have an impact on the offer on repo intermediation activities by banks and be a part of the solution? Please elaborate on the reasons for your answer.

We do indeed think that modifying the calculation of the leverage ratio (LR) will have an impact and could be part of a solution. With current regulations, banks will have to hold additional capital for repo (intermediation) activities which results in a less liquid repo market and less favorable rates for PSA's than there would be with changes in the LR calculation. If the calculation of the LR would not be modified, repos could only be a solution for PSA's if PSA's could engage in repos off-market without a capital charge for banks.

Current method of leverage ratio calculation is subject to a bit of window dressing by the banks. The outstanding repos at the end of the month, quarter and year are input to the LR calculation, intra month repos are out of consideration. Although we see repo's as very low risk, the risk during the month is not taken in to consideration and banks limit their repo book over month end to keep the leverage ratio artificial low. We think that a lower leverage charge or a method where all the repos during the month are taken in to consideration are more efficient in overcoming the dip in supply in repo's at month end.

However, again, under stressed conditions PSAs need a reliable provider of cash that are not balance sheet constrained. Central banks are the only option in these circumstances to resolve cash VM issues.

Q22. Can you elaborate on issues you have encountered, or risks you perceive, in relying of clearing members to provide collateral transformation services, including transformation into cash to meet variation margin requirements? Is this a service that is available to you? If not, what are the obstacles?

What we mostly encounter in the issue that we have in collateral transformation services is the lack of live solutions. Clearing Members rely on their bank to provide a liquidity service or a guaranteed repo line to PSA but non or very little solutions from the clearing members are live. We are willing to negotiate a service where we have the clearing agreement and the guaranteed liquidity solution as one package. In practice this service is unavailable to us. It is unattractive business for CMs in the current capital environment and there is very little to no appetite for this from banks. In the very limited circumstances where a bank may consider providing such a service for their clients, under

strict conditions, the volumes are small and would not meet the demand from pension funds. Unfortunately, this would not solve the cash VM issue. CM-provided collateral transformation services relied upon by pension funds only cover intra-day VM calls that must be met with cash VM by the end of the day. A backstop to all market-based solutions, be it collateral transformation by the clearing member or the repo market is required.

Q23. What is your view on solutions based on collateral transformation via the repo market? Do you think that initiatives on collateral transformation solutions via the repo market constitute one possible solution? What other solutions are worth exploring?

Currently this solution is not feasible. The lack of guarantee that there will be a market and depth of the market during stress are the main concerns. Although this solution can be one of the directions for the futures. A direct repo market between non banks will mitigate the lack of supply at month end. Key in the solution is a lender of last resort. We hope that a solution can be found where the cleared repo market can be backed by a clearing member to access to ECB cash or the ECB directly. By this backing spikes in rates and dips in liquidity will be exceptions. The use of the repo market would only work if there was a backstop for times of reduced liquidity, for instance by the central bank.

Q24. Do you think that the repo market is suitable for PSAs' needs? If not, what are the impediments for PSAs to access the repo market? Please elaborate on the reasons for your answer, specifying if these are related to cost, operational complexities or regulatory constraints.

Repo markets are suitable for pension funds to rely upon in normal market conditions but not in stressed conditions. See also our answers to 23

Q25. Do you have any data with respect to PSAs' potential liquidity demand in business-as-usual? Also, do you have any data with respect to PSAs' maximum liquidity needs in stressed market conditions?

We refer to responses by pension funds industry associations.

Q26. Do you think that PSAs fulfilling their liquidity needs via the repo market will have strong implications on this market's liquidity and procyclicality? Can you provide quantification of the risk of the likelihood of a failure of market-based repo solutions to meet PSAs' needs? Under which conditions?

In times of stress, the likelihood of a failure of market-based repo solutions to meet pension funds' needs is high. As was illustrated at the height of the Covid -19 crisis (see our answer to question 20), the rush for cash to cover margin calls and the demand to access the repo markets significantly increased, while banks' capacity to intermediate remained constrained. Liquidity was scarce and often granted only to top-tier clients.

Requiring pension funds to post cash VM in such an environment would increase demand for cash and exacerbate the pressure on the repo markets. Against this backdrop, we believe the market-based repo solution alone is unreliable and there is a clear need to ensure that liquidity will be granted in the repo markets in times of market stress.

Q27. Do you think that there is agreement or evidence that the impact of the limitations of the solutions explored so far would be such that there is a need for devising and developing some

form of emergency liquidity tools? If so, under which scenarios and how could such tools actionably and realistically be deployed?

Yes, unless banks would be alleviated of their capital charge on repos we would be strongly in favour to develop some sort of emergency liquidity tools for PSA's. Currently banks are often unwilling to pass through their emergency liquidity or guarantee repo lines. Therefore there could be two solutions:

1) Banks should be encouraged/incentivized to pass through their emergency liquidity to PSA's for VM obligations. It should be noted that this is not a liquidity facility, nor is it a bail-out. Pension funds have large amounts of high-quality assets. This facility would simply provide transformation of liquid high-quality government bonds to cash.
2) PSA's should be able to also get access to emergency liquidity directly after for instance receiving a bank license in a PSA collective.

Q28. In the hypothetical scenario where central banks extended liquidity support to PSAs, can you provide estimates of the costs, also in terms of infrastructure, ancillary requirements, and regulatory obligations that this option would entail? Can you express the cost in term of yield drag on PSAs performance, especially vis-à-vis the null option of increasing cash allocation in PSAs' investment portfolios?

It is not possible to answer this question without engagement with central banks on what this structure could look like. The set-up costs do not need to be high as the activity is simple: transforming high-quality bonds into cash. Central banks do this regularly and building the infrastructure therefore should not be too complicated, though this will of course depend on the complexity of the agreed solution.

Q29. What type / form of emergency liquidity tools do you think could be deployed? And whom should they be accessible to? In particular, is there any tool other that central bank liquidity that you would recommend to ESMA to consider?

See our answer to question 27.