European Markets Infrastructure Regulation: input for opinion OPSG

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Goal EMIR to mitigate risks of OTC derivatives and improve transparency of derivative contracts

Over-the-counter derivatives ('OTC derivative contracts') lack transparency as they are privately negotiated contracts and any information concerning them is usually only available to the contracting parties. They create a complex web of interdependence which can make it difficult to identify the nature and level of risks involved. The financial crisis has demonstrated that such characteristics increase uncertainty in times of market stress and, accordingly, pose risks to financial stability. This Regulation lays down conditions for mitigating those risks and improving the transparency of derivative contracts.

Regulation (EU) No 648/2012 of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories (4 July 2012)

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Implementation EMIR via central clearing and reporting

At the 26 September 2009 summit in Pittsburgh, G20 leaders agreed that all standardised OTC derivative contracts should be cleared through a central counterparty (CCP) by the end of 2012 and that OTC derivative contracts should be reported to trade repositories. In June 2010, G20 leaders in Toronto reaffirmed their commitment and also committed to accelerate the implementation of strong measures to improve transparency and regulatory oversight of OTC derivative contracts in an internationally consistent and non-discriminatory way.

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EMIR addresses three themes

1. Central clearing of OTC-derivative transactions
2. Reporting OTC-derivative transactions to trade repository
3. Additional requirements for OTC-derivative transactions not centrally cleared, in particular margining requirements

- 1 and 3 impact costs
- 2 leads to higher transparency (and marginally higher costs)

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EMIR recognises special role IORPs

Such a technical solution should take into account the special role of pension scheme arrangements and avoid materially adverse effects on pensioners. During a transitional period, OTC derivative contracts entered into with a view to decreasing investment risks directly relating to the financial solvency of pension scheme arrangements should be subject not only to the reporting obligation, but also to bilateral collateralisation requirements.

Regulation (EU) No 648/2012 of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories (4 July 2012)

- August 2012: start 3 year exemption period for IORPs (for central clearing only)
- Exemption from central clearing when not exceeding thresholds

Planning EMIR process

- August 2012: entry into force August 16th
- August 2012: 3 year exemption for IORPs
  - For central clearing only
- February 2014: start reporting obligation (to trade repositories)
- March 2014: first CCP authorised
- April-July 2014: ESMA consultation: closing July 14th
- August 2014: European Commission presents report on solution IORPs exemption
- End 2014, beginning 2015: start clearing obligation
- August 2015: end of exemption IORPs
- Q4 2015: margining uncleared trades

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Impact and (unintended) consequences of EMIR

- Increased costs – for Dutch IORPs alone – could rise by EUR 1.5-4.5 bn
  - Possibly double of current costs, initial margin multiplier
  - Fees to counterparties and loss of return on (cash) collateral
- Disincentivising market risk management of liabilities and balance sheet
  - Conflicting interest between IORP (improving risk management) and EMIR (costs)
  - Increasing balance sheet, liability and underfunding risk (liquidity risk)
- Liquidity squeeze: more liquid assets needed for collateral
  - Negative impact on long term assets allocation (LTI) due to switch to liquid assets

Example of use of OTC derivative

IORP balance sheet

Assets		Liabilities	
Equities	40	Liabilities (duration=20)	100
Bonds (duration=5)	60	Surplus	0

- Liabilities marked to market → sensitive for interest rate
- IORP decides to hedge 50% of interest rate liabilities with 30 year interest rate swap (receiving fixed, paying floating)
- Collateral requirements for swap at start and after fluctuations

- Other derivatives include options (on equities, bonds/swaps), currency hedges, commodities

Mixed experiences of IORPs in market (during negotiations with CCPs and CMs)

Next to execution increased costs, disincentivising market risk management and liquidity squeeze

1. Impact on liquidity (due to ‘additional collateral’ conditions)
2. Assets posted as collateral insufficiently protected
3. No guarantee that collateral posted will be returned (same ISIN)
4. Posting of non cash variation margin not yet possible

Possible consequences

- Higher costs: lower benefits, higher contributions (employer(s) and employees)
- Less allocation to illiquid assets: lower return, less LTI
- Disincentivising market risk management

Conclusion: EMIR could lead to increased market and liquidity risk, opposite to ambition

Initial proposal position OPSG (1)

- OPSG in principle positive to EMIR
  - Increased transparency, increased financial stability, better functioning financial markets
- EC should prevent (over)piling of regulations
  - Both IORP and EMIR target to lower financial risk, causing double safety nets, possibly too much safety and higher costs
- EC should solve issue of conflicting regulation
  - IORP possibly leading to extra risk management, EMIR penalising use of derivatives for risk management
- EC, ESMA and EIOPA should recognise special position of IORPs (low counterparty credit risk) and possible negative impact on its stakeholders (in form of lower, less secure benefits and/or higher contributions). Initial margin requirement should reflect low default risk IORPs
- EC, ESMA and EIOPA should mitigate possible negative impact on IORPs

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Initial proposal position OPSG (2)

- EC should link 3 year exemption period for IORPs to start date of mandatory clearing (end 2014 at the earliest)
  - Further exemption if undesired consequences for IORPs still not solved (issues with non cash variation margin)
- Consideration: if IORP has knowledge/expertise and derivatives decrease risks, should IORPs be exempt?
  - So exemption for derivatives used to decrease risks
- Possible measures to mitigate impact
  - Recognition of low risk characteristics of providers of pension scheme arrangements via
    - Giving direct access to ECB
    - Direct access to CCP
    - Fully segregated accounts
    - Solution for non cash variation margin
  - Guaranteed return of specific collateral posted (same ISIN)
  - …

Topics for discussion

- Consideration: if IORP has knowledge/expertise and uses derivatives to manage/decrease risks, should IORP be exempt?
  - So exemption for derivatives used to decrease risks
- Some issues also relevant for insurers: does OPSG want joint position with IRSG?
- Suggestion subgroup: written procedure (see next sheet) so that OPSG will have timely position (before closure of current EMIR consultation)

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Proposal for follow up process after OPSG meeting

- Subgroup will write opinion on behalf of OPSG, of which the summary will be submitted to the public consultations.
- By June 17, a draft paper will be sent to IRSG and OPSG
- IRSG meeting 24: June. IRSG and OPSG feedback expected by June 26th;
- Draft opinion to be circulated to OPSG on 30 June of OPSG meeting 7 July.
- DL Public Consultation=> 14 July