European Markets Infrastructure Regulation: IRSG and OPSG Perspectives

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Goal of IRSG and OPSG on EMIR

- While insurers are subject to EMIR central clearing obligation, at present IORPs are exempt until August 2015
- Both insurers and IORPs will be subject to the OTC derivatives rules in the ESAs draft RTS
- Goal is to present a joint IRSG and OPSG position to EIOPA where possible, with individual sections specific to insurers and IORPs

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Goal of 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)

Implementation of 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.

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

EMIR addresses three themes

1. Central clearing of standardised OTC derivative transactions
2. Reporting of all standardised and OTC derivative transactions to trade repository
3. Additional requirements for OTC-derivative transactions (i.e. non-clearable), in particular margining requirements

   – 1 and 3 have an impact on costs and can also impact asset allocation
   – 2 leads to higher transparency (and marginally higher costs)

EMIR recognises the special role of 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 of 3 year exemption period for IORPs (for central clearing only)
- Exemption from central clearing when not exceeding thresholds
- Note: The exemption from central clearing was also given to life insurance companies providing occupational retirement products, but its application is very limited in practice

The EMIR Planning 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: Joint ESA consultation: closing July 14th
- August 2014: European Commission presents report on IORPs exemption
- End 2014, beginning 2015: start clearing obligation
- August 2015: end of exemption IORPs
- Q4 2015: margining uncleared trades

Impact and (unintended) consequences of EMIR for IRSG and OPSG Participants

- Increased costs for IORPs, insurers and banks. For example, 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
- Liquidity squeeze: more liquid assets needed for collateral
  - Negative impact on long term assets allocation (LTI) of insurers due to need for highly liquid assets (ie cash in the case of central clearing)
- 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)

Example of use of OTC derivatives

- Long term liabilities are sensitive to interest rates
- Insurers and IORPs decide to hedge fixed liabilities with fixed to floating long term interest rate swap (receiving fixed, paying floating)
- Initial margin will require collateral requirements for swap at start, and variation margin thereafter
- Other derivatives include options (on equities, bonds/swaps), currency hedges, commodities

Potential Implications of EMIR

EMIR likely to result in increased execution costs, disincentivising market risk management and create a liquidity squeeze

1. Posting of non cash variation margin not possible on centrally cleared derivatives, however, is possible on OTC derivatives
2. Impact on liquidity (due to 'additional collateral' conditions)
3. Assets posted as collateral insufficiently protected
4. No guarantee that collateral posted will be returned (same ISIN)

Possible consequences:

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

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

Initial proposal by OPSG

- Regarding the exemption from central clearing, OPSG recommends that the European Commission should link the 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)
- Other

Initial proposal by IRSG

- Insurer-related concerns
  - Strong concerns around increased need for cash in the central clearing environment
  - Concerns regarding a number of provisions in the ESAs consultation (e.g. concentration limits, use of internal models, global consistency of rules, etc.)
- Bank-related concerns
  - Concentration limits, models verification by counterparties
  - Securitisation needs to be exempted, like CB
  - Lack of rehypothecation may result in differential pricing depending on collateral posted.

Key Questions for EIOPA joint subgroup

- Internal Models: Derivative counterparties can use internal models. How will insurers, IORPs (unless exempt) and banks verify that model-based initial margin and variation margin are accurate?
  - Three options – lack of mutual verification, sole use of standardised approach, or development of a single model

- Concentration Limits: Are the proposed ESA concentration limits of 50% government bonds, single issuer of 10%, and "other (CB, ABS, converts, equities) of 40% workable?
  - Alternative approach: EBA/Commission liquidity coverage ratio approach (e.g. no limits on government bonds, 15% on slightly less liquid)

Suggested Next Steps

- Joint draft IRSG and OPSG opinion is in circulation
- Next OPSG on 7 July
- Suggest comments by IRSG by COB Thursday 26 June, so can recirculate to OPSG in time for 7 July OPSG meeting
- Final letter to be submitted by 14 July deadline