Insurance & Pension Denmark

IPD's response to FSB report on incentives to centrally clear

06.09.2018

Insurance & Pension Denmark
Philip Heymans Allé 1
DK-2900 Hellerup
Phone: +45 41 91 91 91
Fax: +45 41 91 91 92
fp@forsikringogpension.dk
www.forsikringogpension.dk

Kathrine Høg Riis
Senior Policy Advisor
Dir. 41919122
khr@forsikringogpension.dk

Case No. GES-2017-00002
DocID 366804

Insurance & Pension Denmark have read the consultation report "Incentives to centrally clear over-the-counter (OTC) derivatives". While overall we find that the consultation report adequately describes how the buy-side on the cleared OTC-derivatives market is incentivised to clear, we have some views on the matter, which we would like to present to the FSB, since the regulation on OTC derivatives has a great impact on Danish pension companies' use of derivatives. Views concerning issues that, we regret, are not dealt with in the consultation report but nevertheless are of great importance for the market, not least from a perspective of financial stability.

Background

The vast majority of the Danish market for retirement savings consist of mandatory occupational pensions provided by life insurance companies and multi-employer pension funds regulated by Solvency II. Approximately **90 pct. of the active workforce** in Denmark is covered by an occupational pension scheme and the total pillar 2 and pillar 3 pension assets in Denmark amount to some **450 billion EUR**, close to twice the Danish GDP.

Danish pension products are covered by the temporary exemption in EMIR (EU Reg. 648/2012) article 89, which means that Danish pension funds are exempted from centrally clearing OTC derivatives. The exemption is of great importance to the Danish pension industry. Due to a large proportion of guaranteed products, Danish pension funds use OTC-derivatives as a risk-reducing tool. Consequently, they are obliged to transfer and receive large amounts of collateral as variation margin. In the cleared market all variation margin has to be settled in cash. Going forward this constitutes perhaps the biggest challenge for clearing OTC derivatives, and may amount to a significant systemic risk unless adequate measures are taken.

Why is cash as collateral a problem for the pension companies?

It is the general perception that a prerequisite for the adoption of the EMIR regulation was that CCPs (Central Counterparty Clearing) should develop a model that would enable settling variation margin in the form of HQLA (High Quality Liquid Assets). This has not happened, and all collateral as variation margin must be handled in cash, causing a situation where pension companies must either hold very large amounts of cash or rely on the repo market to always be a reliable source of cash. This situation poses some challenges:

- Holding a large amount of cash is incompatible with the obligation of pension funds to invest their funds in the best interests of their customers.

- The repo market is under significant pressure already, not least due to emerging regulatory rules on the banking side. Consequently, clearing members have been offering collateral transformation services at unreasonable prices. This has a disproportionate effect for pension providers, who could be forced to reduce their use of important hedging tools due to the excessive costs.

- In a situation where the repo markets are stressed and do not function properly, pensions companies and others on the buy side may experience difficulties accessing the necessary cash to settle variation margin. There could thus be a significant risk that companies may default on their margin obligations solely because they cannot cover their cash needs fast enough and despite the fact that they comply with the formal regulation requirements. This could create a systemic liquidity risk, causing significant challenges for derivatives markets and beyond.

The pension exemption is temporary and would most likely expire in two years (negotiations on the revised EMIR regulation (EMIR REFIT) is not finalized yet).
Insurance & Pension Denmark stress that it is of great importance that solutions are found, making it possible either to use other assets than cash to settle variation margin or to ensure that illiquid repo markets do not become the root cause of a new crisis where derivatives markets collapse solely because cash is not available.