FSB FINANCIAL STABILITY BOARD

Liquidity Preparedness for Margin and Collateral Calls: Consultation report

Response to Consultation

PensionsEurope

1. **Does the outlined approach identify all key causes of some non-bank market participant's inadequate liquidity preparedness with respect to spikes in margin and collateral calls during times of stress? Are there any sector specific causes that should be considered?**

PensionsEurope welcomes the opportunity to respond to the FSB Consultation Report on Liquidity Preparedness for Margin and Collateral Calls.

As an integral part of their investment approach, pension funds use derivatives to manage their financial solvency risk as their liabilities are often long-dated, one-directional and linked to interest rates. This is a very common practice in the Netherlands and in Denmark. The use of derivatives is more limited in other Member States. Pension funds are investing in assets and the return on these assets must be maximized to meet future pension liabilities (pensioners' retirement income). They typically invest in high-quality government bonds to hedge their interest rate risks. However, it is challenging to closely match the duration of the liabilities using bonds alone and the hedging strategy can be optimized using derivatives. 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.

To meet future pension liabilities, any cash margin settlement requirement must not lead to a situation where large amounts of otherwise investable funds are kept in cash for an eventuality which may rarely occur. This will hurt returns and thus reduce future pension payments.

PensionsEurope on various occasions has warned policymakers about the liquidity risks involved in central clearing. In the EU, so-called pension scheme arrangements (PSA) were granted an exemption from central clearing for this very reason. After more than ten years of deliberations between PSAs, clearing members, CCPs and policymakers, the exemption expired without a solution. It is now up to pension funds to manage liquidity risks.

From a pension fund/participant perspective, the interest rate is a non-rewarded risk. The starting point for any fund should be that the interest rate risk is fully hedged. Therefore, hedging for a pension fund is not a risk-seeking exercise but a risk-mitigating measure. Given its relevant societal role, not-for-profit pension fund sector should be able to get ultimate repo back spot support from the relevant authorities in this risk-mitigating environment. PensionsEurope strongly believes that authorities – in particular, central banks - recognize that keeping repo markets afloat by offering ample amounts of liquidity in periods of stress is of the utmost importance.

In adverse market conditions, the spike in margin calls for pension funds that extensively use derivatives can be very serious. We therefore recognize for those pension funds the importance of liquidity risk management policies and governance. We believe the recommendations in the Consultation paper are reasonable and already implemented by those pension funds even before the UK LDI crisis.

The seriousness of the UK LDI crisis only reinforced the attention given to the subject of liquidity. Nevertheless, there seems to be a general understanding that the problems leading to the September 2022 problems in the UK LDI sector are not problems we see in the EU pension sector. Below, we will present the main reasons:

- As described in the Consultation Paper, in the UK, LDI strategies are executed by investing in pooled investment funds. In the EU, most pension funds appoint a fiduciary manager who enters into a derivates position for the pension fund and at the same time oversees treasury functions. By centralizing both functions, the pension fund is operationally better prepared to meet intraday margin calls. This structure also avoids incorporating entities that are leveraged with more than 100% interest rate exposure.

- Furthermore, in some countries, pension providers maintain a centralized overview of their portfolio composition, derivative positions etc. therefore, the governance of both short-term and long-term risks to the investment portfolio is much better. Such differences across EU countries should be considered.

- In many cases, the level of interest rate hedging is lower. For example, pension funds in the Netherlands, including the large industry-wide pension funds that manage most assets, hedge somewhere between 30% and 70% of interest rate risk.

- While the derivative exposures of the pension sector in certain countries (e.g. the Netherlands) are large, it does not nearly play the same role in the EU bond markets as the UK pension funds do in the UK gilt market. This preponderance set off the negative feedback loop, when pension investors were selling off gilts to meet margin requirements further pushing bond prices down and leading to more margin calls.

2. **Is the scope of the proposed policy recommendations appropriate?**

In general, PensionsEurope believes that the policy recommendations are suitable and that the scope is appropriate.

Moreover, we would like to stress that pension providers in general already implement the policy recommendations as part of their risk management and back-office practices.

In addition, SSBs and many national authorities, such as the Dutch Central Bank etc. have already set out rules and guidance on liquidity risk management and governance of regulated financial institutions.

Therefore, PensionsEurope interprets these recommendations in this consultation report as intended to reinforce or complement existing rules and guidance to enhance liquidity preparedness for margin and collateral calls during times of market-wide stress.

3. **Is the focus of the FSB's policy recommendations on liquidity risk management and governance, stress testing and scenario design and collateral management practices appropriate? Are there any other areas the FSB should consider?**

   While risk management and governance of pension funds are adequate, pension funds do not operate on their own. Pension funds rely on intermediaries and other actors to access cash to meet VM calls, as pension funds cannot hold sufficient cash to meet calls that occur under adverse market conditions. They will need to rely on liquidity facilities and transform assets.

   Moreover, other institutions than NBFIs have a responsibility for keeping markets running in periods of severe stress. Central banks must ensure that cash is available for repo purposes. Banks must fulfil their responsibilities and ensure that central bank cash gets pushed through to NBFIs that need to transform assets into cash. PensionsEurope believes that in times of stress, a second line of defense is needed – involving central banks as the only reliable provider of liquidity. Central banks in the United Kingdom, the United States and Canada have recognized this issue. They put in place, or are in the process of doing so, liquidity facilities to prop up the resilience of repo markets or to provide a backstop repo facility directly to pension funds and insurance companies, as is the case in the UK. Unfortunately, the ECB has refused to consider similar arrangements, thereby exposing EU pension funds to risks that are beyond the scope of their own policies and governance structures.

   As expressed earlier, PensionsEurope is deeply concerned that repo markets cannot be relied on in stressed conditions. In these instances, the demand for cash by all market participants is likely to increase. At the same time, the supply of cash is likely to either shrink or at least not fully meet the increased demand as banks reduce their risk appetite and pull back from deploying balance sheets to support clients to protect their businesses. Market participants unable to access cash will be forced to sell physical assets, which is likely to exacerbate any downward spiral of asset prices.

   During the Covid-19 crisis, a sell-off of all risk assets (equity and credit) and even high-quality government bonds, and dislocations of currency markets, led to sudden VM calls across several investment portfolios for many market participants. This increased demand for cash, and while the repo markets functioned well for intra-bank transactions, it did not function well for the buy-side. The International Capital Market Association (ICMA) market report on repo market functioning during Covid states the following: "While the demand to access the repo market increased during the height of the crisis, banks' capacity to intermediate that access did not. Buy-side participants report an increased reliance on the repo market as fund outflows drove the need to generate cash against holdings, as well as to meet margin calls against derivatives positions as volatility increased. However, it would

seem that banks struggled to keep pace with client demand. Many report limiting business to top tier clients, with no capacity for new business."

Similarly to the stressed conditions during Covid, we also see tensions in the repo market at the end of quarters, when banks seem to reduce liquidity for reporting purposes.

To conclude, PensionsEurope believes that emphasizing only on stress testing and scenario designs is not the solution to the liquidity issue. Stress testing is something pension providers and other NBFIs with substantial derivative exposures should perform to plan what actions to take in particular situations. However, if repo markets are not properly functioning in stressed conditions, even the most precise and well-executed stress tests and the most carefully planned management responses will not resolve the emerging liquidity challenges in case central banks and credit institutions do not fulfil their mission.

4. **Is the approach to proportionality and materiality clear for all non-bank market participants?**

   Yes, PensionsEurope supports proportionality in applying these recommendations. We agree with the elements mentioned in considering proportionality. One aspect that is not mentioned is that measures to address liquidity risk should also be proportionate to their costs. If pension funds would protect themselves against VM calls stemming from an e.g. 100bps rate hike only by investing in cash instruments (instead of using additional instruments such as repo, liquidity facilities, etc.), this could have a significant impact on investment returns, and as a result pensions. In 2014, a report drafted for the European Commission estimated that covering the potential VM calls for such a rate hike would cost European pension fund participants 2.9 billion euros in return annually.

5. **Section 3.1 sets out key elements of a liquidity risk management framework to identify, monitor and manage liquidity risk exposures arising from margin and collateral calls. Are these sufficiently clear for all non-bank market participants?**

   Yes

6. **Are the recommendations on liquidity stress testing and scenario design with respect to margin and collateral calls clear and sufficiently specified?**

   Yes

7. **Are there any jurisdictional or sector-specific differences that are not accounted for in the recommendations?**

   Yes. PensionsEurope believes that it should be made clear that liquidity stress testing as part of preparing for spikes in margin calls is something that only NBFIs with large derivative positions should carry out. In many Member States, many pension providers have limited derivative positions or positions mainly aimed at hedging currency risks. Where this is the case, authorities should recognize that the need to develop a complex and costly setup is less relevant. Proportionality based on each NBFI's particularities is essential.

8. **Collateral readiness at the right time, quality and location is a critical aspect of effective liquidity preparedness for spikes in margin and collateral calls to mitigate the risk of having to liquidate collateral under stressed market conditions. Do the FSB's recommendations in Section 3.3 address all key elements required to be effective in mitigating liquidity risk arising from margin and collateral calls?**

   Yes

9. **Are there any material challenges to collateral management practices that some non-bank market participants may face that should be considered?**

   NA

   If you have any additional comments, please provide them below.

PensionsEurope's answer to FSB's consultation report on liquidity preparedness for margin and collateral calls.

June 2024

www.pensionseurope.eu

Questions

Section 1

1. **Does the outlined approach identify all key causes of some non-bank market participant's inadequate liquidity preparedness with respect to spikes in margin and collateral calls during times of stress? Are there any sector specific causes that should be considered?**

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- Furthermore, in some countries, pension providers maintain a centralized overview of their portfolio composition, derivative positions etc. therefore, the governance of both short-term and long-term risks to the investment portfolio is much better. Such differences across EU countries should be considered.
- In many cases, the level of interest rate hedging is lower. For example, pension funds in the Netherlands, including the large industry-wide pension funds that manage most assets, hedge somewhere between 30% and 70% of interest rate risk.
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Section 2

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[1] ICMA (2020) link

will not resolve the emerging liquidity challenges in case central banks and credit institutions do not fulfil their mission.

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Section 3.1

5. Section 3.1 sets out key elements of a liquidity risk management framework to identify, monitor and manage liquidity risk exposures arising from margin and collateral calls. Are these sufficiently clear for all non-bank market participants?

Yes

Section 3.2

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[2] Europe Economics & Bourse Consult (2014) link

About PensionsEurope

PensionsEurope represents national associations of pension funds and similar institutions for workplace and other funded pensions. Some members operate purely individual pension schemes. PensionsEurope has **24 member associations** in 18 EU Member States and 3 other European countries[3].

PensionsEurope member organisations cover different types of workplace pensions for approximately over **90 million people.** Through its Member Associations PensionsEurope represents approximately **€ 5 trillion of assets** managed for future pension payments. In addition, many members of PensionsEurope also cover personal pensions, which are connected with an employment relation.

PensionsEurope also has **18 Corporate and Supporter Members** which are various service providers and stakeholders that work with IORPs.

PensionsEurope has established a **Central & Eastern European Countries Forum (CEEC Forum)** to discuss issues common to pension systems in that region.

PensionsEurope has established a **Multinational Advisory Group (MAG)** which delivers advice on pension issues to PensionsEurope. It provides a collective voice and information sharing for the expertise and opinions of multinationals.

What PensionsEurope stands for

- A regulatory environment encouraging workplace pension membership;
- Ensure that more and more Europeans can benefit from an adequate income in retirement;
- Policies which will enable sufficient contributions and good returns.

Our members offer

- Economies of scale in governance, administration and asset management;
- Risk pooling and often intergenerational risk-sharing;
- Often “not-for-profit” and some/all of the costs are borne by the employer;
- Members of workplace pension schemes often benefit from a contribution paid by the employer;
- Wide-scale coverage due to mandatory participation, sector-wide participation based on collective agreements and soft-compulsion elements such as auto-enrolment;
- Good governance and alignment of interest due to participation of the main stakeholders.

Contact:
PensionsEurope

[3] EU Member States: Austria, Belgium, Bulgaria, Croatia, Denmark, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Luxembourg, Netherlands, Portugal, Romania, Spain, Sweden. Non-EU Member States: Iceland, Norway, Switzerland.

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