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Contact:
Matti LEPPÄLÄ, PensionsEurope's Secretary General/CEO
Koningsstraat 97, rue Royale – 1000 Brussels
Tel: +32 (0)2 289 14 14 – Fax: +32 (0) 289 14 15
Matti.leppala@pensionseurope.eu

PENSIONSEUROPE'S ANSWER TO THE REVISIONS TO THE BASEL III LEVERAGE RATIO FRAMEWORK OF THE BASEL COMMITTEE ON BANKING SUPERVISION

General remarks

PensionsEurope welcomes the opportunity to comment on the Revisions to the Basel III leverage ratio framework.

We believe that the impact of the proposed Leverage Ratio Framework has a negative effect on end users in the financial market and more specifically competition in the clearing market. In fact, certain elements of the Basel III leverage ratio framework have strong opposing incentives for banks to only receive variation margin in cash to support non-cleared OTC derivatives positions. More precisely, the leverage ratio and net stable funding ratio (NSFR) rules could force pension funds to post Variation Margin in cash only, and not permit other assets for collateralizing non-cleared derivative trade. It would introduce disproportionate cost and risk to EU pensioners.

Pension funds use derivative contracts to manage their risks in their balance sheet and liabilities by hedging – among others – their interest rate, inflation or currency risks. In Europe, the IORP Directive explicitly allows pension funds to use derivatives for mitigating investment risks or and for efficient portfolio management.

In addition the leverage ratio and NSFR rules only allow cash Variation Margin (VM) to offset any positive mark-to-market exposures borne by a bank on OTC derivatives positions. Non-cash VM, even high quality government bonds, are not permitted to offset the mark-to-market exposures. As a result, many banks are now restricting OTC derivatives trades to those that are collateralised with cash VM only, where previously banks would also accept high quality government bonds as VM.

The Capital requirements for banks, imposed by Basel III, have had also a negative impact on market liquidity, especially in the repo market as they restrict the liquidity on the repo market.

We suggest policymakers to consider allowing high-quality government bonds with appropriate haircuts to offset the mark-to-market exposures of OTC derivatives in leverage ratio and NSFR calculations and to exempt pension funds from posting collateral in non-cleared transactions until HQLA are recognised to offset the MtM in the Replacement Costs of the LR.

Specific comments

1. High Quality Liquid Assets should be permitted to reduce Replacement Costs

In the proposed Basel III Leverage Ratio Framework only received Variation Margin (VM) in cash reduces the Replacements Costs (RC). However, HQLA subject to appropriate haircuts can also suffice the criteria mentioned in the Leverage Ratio framework.

Unfortunately, there is currently no recognition of HQLA as VM to reduce the RC of OTC derivatives. Therefore banks already put pressure on end users to post cash VM when trading OTC derivatives bilaterally. Many banks have also restricted OTC derivatives trades to those that are collateralised with cash VM only, while previously they would have accepted high quality government bonds as VM. We expect this trend to continue in the market as the leverage ratio and the net stable funding ratio (NSFR) rules are fully implemented. Adjusting the leverage ratio framework to recognize HQLA to reduce the RC would help curb this trend.

Furthermore, another negative “side effect” of not recognizing HQLA as VM is a strong discouragement for developing a solution to the higher liquidity requirements in the derivatives market for pension funds. This discouragement is very unfortunate bearing in mind that the European Securities and Markets Authority (ESMA) has given the market (not only banks) the task to find a clearing solution for pension funds. A viable solution would most likely involve, indirectly or directly, high quality bonds being posted for VM or cash.

Another worrisome “side effect” is an increased chance of a financial liquidity crisis. We believe the preferential treatment of cash VM over HQLA VM will greatly increase the demand for cash, especially in times of stress. This is likely to substantially increase liquidity risk and exacerbate downward pressure on falling asset prices as market participants probably will sell “physical” assets in order to meet cash VM calls. This increases pro-cyclicality risk and reduces financial stability.

We urge the Basel Committee on Banking Supervision to modify the leverage ratio framework to allow High Quality Liquid Assets posted as VM to reduce Replacement Costs.

2. Initial Margin should be incorporated into the Potential Future Exposure calculation

In the current central clearing setup under the EMIR pension funds will post Initial Margin (IM) collateral based on their cleared OTC derivatives. This IM collateral is meant to cover losses in a crisis scenario as defined by a CCP (e.g. London Clearing House). Many (simulated) crisis scenarios are also used to determine the Potential Future Exposure (PFE) under the SA-CCR methodology within the proposed Leverage Ratio Framework. Therefore, not recognizing IM collateral to reduce the PFE would disproportionately overstate OTC derivatives exposures in this context. Especially, in case of European pension fund portfolios, which hold long-term interest rate swaps and have a very directional "net" exposure.

Also, in the bilateral OTC derivatives market, it is envisaged to post IM in the future. The reasoning mentioned for cleared OTC derivatives will be similarly applicable at that time. Furthermore, IM collateral posted by pension funds in the cleared and bilateral market cannot be re-used and therefore it cannot be leveraged by a bank to take on more risk.

We recommend the Basel Committee on Banking Supervision to incorporate IM into the Potential Future Exposure calculation for (non) cleared OTC derivatives exposure.

3. The impact of the proposed Leverage Ratio Framework needs to be closely looked at

While the SA-CCR methodology is widely reported to be better for banks because of its netting benefits, it seems to disproportionately penalise European pension funds' one-directional long term derivatives portfolios. The impact of SA-CCR should be fully calibrated to portfolios of all derivative users including pension funds and other end-users.

As already mentioned, while European pension funds typically have one-directional portfolios, we believe they should not be overly penalised as a result of banking regulation intended for risky and leveraged institutions. Pension fund's derivatives portfolios generally offset risks that are naturally inherent to pension funds.

Moreover, the current bank capital rules that affect central clearing are causing banks to exit the clearing broker business. Pension funds and other end users are therefore left with a small and decreasing number of (big) banks willing to provide sound clearing broker services.

This trend of less and less clearing members combined with mandatory clearing is likely to significantly increase clients' concentration risk on (banking) counterparties. Also, the shrinking market for clearing members puts into question whether porting can really work in either stressed market conditions. The ability to port to an alternate clearing member is very important in a stressed market environment.

Due to this trend of reduced numbers of banks offering client clearing services, the commercial terms will be negatively impacted leading to increased costs of clearing for pension funds.

4. Inflation should be explicitly mentioned

The rules regarding inflation are not explicit in terms of where inflation sits as a class, such as interest rates. We would expect inflation to be treated within the same class as interest rates given their strong economic link. In this context, one should be reminded that the nominal interest rate (often referred to simply as interest rate) is built up of the real interest rate and inflation rate.

We request the Basel Committee on Banking Supervision to explicitly state that inflation should be within the same asset class as interest rates for the SA-CCR calculation.

5. Repurchase agreement (Repo) markets should not be disproportionately affected

The Repo market in which high quality government bonds are used to generate cash plays a crucial role in the functioning and smooth running of financial markets. The cash obtained can, for example, be used as collateral for posting Variation Margin. The importance of this market will grow significantly as demand for cash increases substantially once the central clearing obligation is fully in force throughout Europe and the current proposed legislation on the Leverage Ratio Framework (LR) and Net Stable Funding Ratio (NSFR) is not modified.

The legislation on LR and NSFR is expected to significantly increase the demand for cash and simultaneously shrink the repo market. We are concerned the combination of these two will reduce financial stability and cause a possible liquidity crisis in the future. The consequence of a dysfunctional repo market must not be underestimated. If market participants are unable to transform high quality securities collateral into cash quickly, cash VM calls on cleared and non-cleared trades may not be met, which could lead to market participants, such as pension funds, defaulting on their contracts or result in the forced unwinding of positions at times of market stress.

We advise the Basel Committee on Banking Supervision to address our concerns on the repo markets and treat high quality government bonds, with appropriate haircuts, similar to cash and allow netting between cash and high quality government bonds.