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14 July 2014

Dear Sir/Madam

This response is prepared on behalf of Towers Watson, a leading global professional services company with over 14,000 associates around the world. In the UK, we have a particular strength in the area of pensions and we advise over half of the 100 largest corporate pension schemes. We welcome the opportunity to respond to the consultation paper on the draft regulatory technical standards on risk mitigation techniques for OTC derivatives not cleared by a CCP.

We completely support the European Supervisory Authorities' aims of ensuring that receivers of collateral are able to realise sufficient value to replace OTC contracts associated with a defaulted counterparty. Indeed, since the credit crisis, we have spent a significant amount of time and effort improving the security of the collateral arrangements that our UK pension scheme clients have in place with their counterparty banks.

Notwithstanding the above comments, however, we have serious concerns about the current proposals relating to concentration limits applying to government bonds and the implications this will have on UK pension schemes' ability to meet their strategic objectives and manage risk effectively.

We outline our answers to the specific questions on the following pages, together with some additional supplementary comments.

Yours faithfully

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Question 1. *What costs will the proposed collateral requirements create for small or medium-sized entities, particular types of counterparties and particular jurisdictions? Is it possible to quantify these costs? How could the costs be reduced without compromising the objective of sound risk management and keeping the proposal aligned with international standards?*

Many small and medium sized investors, such as pension funds, use external investment managers to manage their assets. Adding complexity to the management of collateral arrangements will increase the management fees charged by these external managers and this increase will be felt most by smaller investors where fees represent a higher percentage of their assets. This is particularly the case where a minimum fee level bites.

As outlined under question 5 we believe that allowing the full collateral requirement to be met by posting high quality government bonds is a perfectly reasonable and would not compromise the objectives of sound risk management and keeping proposals aligned with international standards. Where there are limited government bond issuers in a currency, such as GBP, then this means not applying a diversification limit to those government bond issuers.

The direct and indirect impact of an imposition of a government bond issuer diversification limit where there are limited government bond issuers in a currency, such as GBP, could substantially increase the investment management fee for some portfolios. Quantification of the management fee increase from such a limit alone is difficult to quantify but could easily increase the management fees by 10% for certain portfolios.

Question 2. *Are there particular aspects, for instance of an operational nature, that are not addressed in an appropriate manner? If yes, please provide the rationale for the concerns and potential solutions.*

As outlined under question 5, UK pension schemes are currently almost universally set up to post solely UK gilts as and when collateral is required for OTC derivatives transactions under ISDAs. These pension schemes do not hold large cash balances and hence the imposition of a diversification limit on the amount of UK gilts that can be posted will require either (i) the raising of cash using repo transactions or (ii) the separation and posting of lower quality non-government bonds.

The requirement to use repo under the first option brings increased risk, such as operational risk or roll risk, to the pension scheme in question.

The second option of posting non-government bonds (typically of lower quality and liquidity than gilts) also adds risks, such as operational risk, as the non-government bonds to be posted will normally be managed by a different investment manager to the agent arranging the posting of collateral. Such arrangements are currently typically avoided at present due to the likes of operational risk should say the investment manager try to sell a specific bond at the same time as the collateral agent tries to post the specific bond as collateral. Such collateral is also less attractive due to its lower liquidity and typically lower credit quality, leading to larger haircuts.

Due to the unattractive nature of the two options outlined above pension schemes may attempt to separate legacy and new transactions. This would require the likes of two Credit Support Annexes (CSAs) with each OTC derivatives counterparty which would:

- reduce portability in counterparty failure events and make replacement of transactions more challenging going forward
- add material management and operational complexity and risk
- make portfolio compression and the netting of offsetting positions more challenging.

We note that the imposition of a diversification limit on UK government bonds could well force UK pension schemes towards having to use cash collateral. This would seem at odds with the original purpose of the pension scheme exemption to mandatory clearing of derivatives which was to give CCPs time to solve the technical issues associated with accepting non-cash collateral from the likes of pension schemes.

Question 3. *Does the proposal adequately address the risks and concerns of counterparties to derivatives in cover pools or should the requirements be further tightened? Are the requirements, such as the use of the CRR instead of a UCITS definition of covered bonds, necessary ones to address the risks adequately? Is the market-based solution as outlined in the cost-benefit analysis section, e.g. where a third party would post the collateral on behalf of the covered bond issuer/cover pool, an adequate and feasible alternative for covered bonds which do not meet the conditions mentioned in the proposed technical standards?*

We have no comments.

Question 4. *In respect of the use of a counterparty IRB model, are the counterparties confident that they will be able to access sufficient information to ensure appropriate transparency and to allow them to demonstrate an adequate understanding to their supervisory authority?*

We have no comments.

Question 5. *How would the introduction of concentration limits impact the management of collateral (please provide if possible quantitative information)? Are there arguments for exempting specific securities from concentration limits and how could negative effects be mitigated? What are the pros and cons of exempting securities issued by the governments or central banks of the same jurisdiction? Should proportionality requirements be introduced, if yes, how should these be calibrated to prevent liquidation issues under stressed market conditions?*

Whilst we are supportive of the idea behind concentration limits applied to low credit quality or illiquid collateral, we have serious concerns around the application of concentration limits to government bonds. This is primarily an issue for GBP collateral as the UK government is the only major government bond issuer in GBP. Placing a diversification limit on the UK government's bonds will force either:

1. The use of cash collateral arrangements;
2. The use of non-government bond collateral; or
3. The purchase and use of government bonds in a different currency to the currency of the derivatives.

Both the second and third alternatives are for good reason against current market practice for UK pension schemes.

By way of background, UK pension schemes are significant users of OTC derivatives in the context of managing the material interest rate and inflation risks they face due to the very long dated nature of their liabilities (eg over 100 years in many cases). At the time of writing it is still not possible to clear inflation swaps, so UK pension schemes will be subject to these requirements.

We believe that the lowest risk Sterling assets are Sterling cash and gilts. This view is shared in OTC derivative markets and has been recognised in the pricing of derivatives. Since the credit crisis, 'market standard' derivatives are priced on the basis of only permitting the posting of these assets as collateral.

The use on non-government bond collateral by pension funds is unattractive as it would:

- Increase counterparty risk both due to greater over-collateralisation due to haircuts when posting collateral and due to the correlation risk with the derivative counterparties when receiving collateral. Indeed we believe that, contrary to the objective, received collateral would be more risky and less liquid than receiving 100% UK gilts.
- Decrease liquidity of derivatives that cannot be cleared further as there will be a dispersion in 'standard' collateral terms (despite these derivatives being used for risk management rather than speculation purposes in the case of inflation swaps)
- Reduce transparency of pricing and lead to inconsistency with the pricing approaches adopted by the major CCPs. Potentially adversely impact the ability to compress transactions or port transactions between counterparties or into clearing once available in an efficient manner
- Increase investment management cost and expense as:
    - The costs of a more complex collateral management process will be passed on
    - The non-government bonds would have to be held in a segregated portfolio where at present a pooled fund is often used for efficiency
    - The investment manager selecting the non-government bonds to be bought/sold is typically different from the investment manager of the interest rate and inflation derivatives used for liability hedging
- Bank counterparties pricing for transactions where collateral eligibility is wider than GBP cash and UK gilts is meaningfully worse than where collateral eligibility is limited to GBP cash and UK gilts.

The use of cash collateral by pension schemes is also unattractive and this was the basis for granting pension schemes a temporary exemption to mandatory clearing. The issues with pension schemes posting cash collateral include:

- A requirement to invest in cash so that this is available as collateral. This would have a material drag on pension scheme expected returns as cash is not a natural investment for pension schemes.
- As an alternative to holding additional cash pension schemes are likely to plan to use repo transactions to release cash from their government bond holdings as and when required. This has three main cost and risk implications:

- The interest rate earned on the cash posted as collateral is likely to be less than the interest rate paid on the government bond repo transactions
- There will be an additional investment management cost compared to simply posting the government bonds as collateral
- There will be a requirement to roll the additional repo contracts which is either an additional risk or requires payment to ensure this facility is available.

We believe that the cost of using cash collateral rather than government bond collateral could be in the order of 0.1% to 0.25% per annum of the expected collateral balance.

In our view, this means that securities issued by the government or central bank should not be limited so that in effect non-government bond collateral is required. For currencies such as GBP this means exempting UK gilts from any diversification limit. If there is a desire to mitigate the risk of this then a credit criteria could be adopted, whereby limits do apply if UK gilts were rated below perhaps AA-.

Question 6. *How will market participants be able to ensure the fulfilment of all the conditions for the reuse of initial margins as required in the BCBS-IOSCO framework? Can the respondents identify which companies in the EU would require reuse or re-hypothecation of collateral as an essential component of their business models?*

We have no comments.

Additional comments

We make the following specific comments:

- Credit Support Annex (CSA) specific pricing of derivatives means that market pricing of derivative instruments has evolved such that UK government bonds and GBP cash are viewed as 'market standard'. Sterling collateral and contracts executed on such terms are typically discounted using OIS interest rates. Derivatives under which other forms of collateral, such as highly rated UK corporate bonds or non-domestic government bonds, are priced using a higher discount rate (which is bespoke but will typically be closer to LIBOR) to reflect the funding rate of this collateral.

- Since 2008, pension funds have responded to this changing market dynamic by narrowing the range of eligible collateral on their CSAs to be in line with market standards (ie Sterling cash and gilts). Enforcing concentration limits on UK gilts will actually increase risk in our view as 1). There is a huge scarcity of non-government high quality Sterling bonds, and 2) these bonds tend to be illiquid and of lower quality in the main. While the technical standards have clear merit in the EU where there are government bonds of varying credit quality, forcing UK pension schemes to hold non-gilt assets as collateral will in our view, increase counterparty risk due to the unknown realisability of non-gilt Sterling collateral in stressed market conditions. It is very likely to reduce liquidity as banks will need to price derivatives off bespoke funding curves (rather than OIS curves).

- This discounting effect can have a significant impact on the pricing of the trade, particularly for long maturity swaps typically traded by pension schemes. For example, a zero coupon interest rate swap might have around a 5-10% difference in mark-to-market value depending on whether the eligible collateral is restricted to cash and UK government bonds, or whether other collateral such as highly rated corporate bonds is eligible. This difficulty in determining the correct discount rate is amplified where collateral in multiple currencies is eligible. This would reduce transparency of pricing.

- Forcing pension schemes to hold more cash will require them to make greater use of derivatives. Pension schemes currently use a combination of physical bonds and derivatives to manage interest rate and inflation risk. As cash does not provide a hedge against the interest rate / inflation risks of pension schemes' long maturity liabilities, this will mean that pension schemes will need to make more use of derivatives to manage these risks (increasing the notional size of derivative holdings) which appears to conflict with many of the other aspects of the new regulations, for example, portfolio compression objectives.

- We note that gilts have benefited from 'right way risk' in stressed market conditions i.e. the price increases during a market crisis as a result of a 'flight to quality'. They are also generally much more liquid than highly rated corporate bonds and Sterling supranational bonds, particularly in stressed market conditions. In our view, it is very likely that a portfolio of highly rated government bonds will retain its value and be easier to liquidate than a portfolio of 50% corporate bonds and 50% highly rated government bonds in a market crisis.

- Pension schemes typically have large one way positions because derivatives are primarily used to hedge the interest rate and inflation risk of the liabilities and therefore do not benefit from netting. Therefore the introduction of concentration limits would have a disproportionately large effect on pension schemes.