Response to the DG FISMA Consultation paper on further considerations for the implementation of the NSFR in the EU

PGGM is a Dutch Pension Fund Asset Manager. The rules introduced by the Basel Committee on Banking Supervision and implemented in Europe via the CRR are not directly applicable to PGGM or to its Pension Fund clients. However, these ‘capital rules’ do have a significant indirect impact on PGGM and its clients and therefore PGGM responds to this consultation on further considerations for the implementation of the NSFR in the EU.

Key messages:

- **The implementation of the proposed NSFR will have a significant negative impact on pension incomes. The current NSFR proposal will result in banks requiring cash as VM from its counterparties which in turn will have a disproportionate negative impact on pension funds and ultimately retirees. The EU already acknowledged that the negative impact of cash-only VM on pension funds is disproportionate. The implementation of the NSFR, if not amended, will have an even bigger negative impact on pension funds than mandatory clearing under EMIR. In case of PGGM this negative impact will be at least twice as big.**

- **We recommend the NSFR to take into account the low risk nature of executing hedging derivative transactions with pension funds. The current, ‘rule based’ proposal is overly punitive for pension funds that use derivatives to hedge unwanted risks to ensure more stable returns.**

- **Cash is not always safer than high quality liquid assets (HQLA). For non-bank institutions that have no direct access to a central bank, cash is equivalent to unsecured exposure to commercial banks.**

- **We urge to investigate the possibility to treat HQLA in a similar way as cash. In our opinion this would take away many issues for end-users and would make the entire financial system more resilient towards liquidity crises.**

1. *In light of previous consultations, could you describe more specifically, if appropriate, the specific activities, transactions and business models where you have evidence that the implementation of the NSFR could have an excessive impact or important unintended consequences?*

The implementation of the NSFR will impact the derivatives market and the (reverse) repo market, which will be covered in the remaining part of this consultation. Pension Scheme Arrangements (PSAs) use derivatives to hedge their interest rate risk, currency risk and inflation risk in the investment portfolios. The main purpose of hedging these risks is to reduce the volatility of the returns of the investments. More stable returns create more certainty for PSAs on the ability to pay their future pension liabilities to pensioners. Local regulators have set up stringent rules on how much risk PSAs are allowed to run within their investments portfolios. These rules make it practically impossible to meet the pension ambition of a PSA without the use of derivatives. Any impact on the derivatives markets is felt by PSAs.

2. *If a respondent is a bank, could you please quantify the level of your expected shortfall of stable funding, the changes to the composition of your balance sheet that may result from meeting the NSFR and what the impact of these changes may be on the European economy?*

Not applicable

3. *In light of previous consultations,*
   a. *could you provide substantiated evidence about possible issues caused by the application of the BCBS NSFR standard to derivative transactions at European level and which have not been taken into account at Basel level?*

- The Required Stable Funding (RSF) of the derivative assets is calculated based on the replacement cost (where positive), taking into account the netting set. However, collateral received by a bank may not offset that replacement cost amount, unless it is cash.

  Pension Funds typically minimize their allocation to cash in order to maximize the efficiency and the return for their policy holders. This is acknowledged by policymakers within the EMIR level 1 text[1]. Currently, pension funds are according to their Credit Support Annex (CSA) with the banks allowed to post non-cash collateral to fulfil their collateral requirements. However, under the NSFR rules banks are not allowed to net the non-cash collateral received against the positive mark-to-market exposure of derivatives and therefore banks will require their clients to post cash collateral.

An independent report[2] published by Europe Economics and Bourse Consult for the European Commission estimates that if European pension funds were required to clear their derivative trades and post cash as variation margin (VM) (which is currently required in the Central Clearing structure), the total cash collateral needed by them to support a 100bps (1%) move in interest rates would amount to €205 billion to €255 billion, increasing to €420 billion in more stressed scenarios. It further estimates that this would cost European pensioners between €2.3 billion and €4.7 billion annually, a drop of 3.1% in future income for Dutch pensioners.

The impact described above is calculated taking into account the derivatives which can be cleared. However, the NSFR is taking into account all derivatives, which means that the impact of posting only cash collateral will be more extreme than the figures provided in the independent report. Most notably the NSFR will also impact currency hedging programs of PSAs on top of the impact on interest rate and inflation hedging programs.

PGGM used to trade derivatives on a regular basis with 16 major counterparties. With only two of those banks PGGM is still able to do transactions under the current CSA terms, in which it is possible to post securities as collateral. It is worth mentioning that these two banks are US regulated banks. All other banks have addressed that accepting securities as collateral is becoming an issue for them. Some of these counterparties want to increase the costs of doing transactions and four banks are already indicating that they will no longer trade under the current CSA.

1 *Recital 26. European Market Infrastructure Regulation Level 1 text. REGULATION (EU) No 648/2012 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 4 July 2012 on OTC derivatives, central counterparties and trade repositories found here: http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32012R0648&from=EN*

2 *Page 10. Baseline report on solutions for the posting of non-cash collateral to central counterparties by pension scheme arrangements: a report for the European Commission prepared by Europe Economics and Bourse Consult can be found here: http://ec.europa.eu/finance/financial-markets/docs/derivatives/150203-external-study_en.pdf*

For one of the largest pension fund clients of PGGM the impact of cash-only CSAs is illustrated. This pension fund has a total investment portfolio worth € 175 billion. It structurally hedges about 40% of the interest rate risk of its liabilities and 70% to 100% of the currency risk. Based on these exposures the amount of cash needed to meet potential variation margin requirements is roughly € 20 billion (€ 10 billion for interest and € 10 billion for FX). The drag on performance of holding this cash buffer is in the order of 0.70% per annum or € 1.2 billion annually. Consistent with the methodology used in the report of Europe Economics and Bourse Consult this impact is equivalent to a drop of more than 6% in future retirement income for our members.

- The netting that is allowed within the NSFR is dependent on the Leverage ratio netting criteria. However, when there is a minimal amount of under collateralization with one counterparty which is not due to dispute or settlement timing, it is not allowed to net the total amount of collateral. This basically means that the derivative portfolio with that counterparty is treated as uncollateralized which has severe impact on the NSFR requirement. To avoid the impact on the NSFR PGGM came across an example in which one of its counterparties wanted to post more collateral than PGGM, the valuation agent in this case, required. It basically means that the bank will always be the valuation agent.

b. *If yes, what alternative treatment would you propose for NSFR calculation purposes to deal with the funding needs arising from derivatives transactions? If possible, please provide the impact on your institution of the alternative treatment you propose (as compared to the BCBS standards).*

- As a consideration PGGM suggest to investigate the possibility to treat High Quality Liquid Assets (HQLAs) posted as variation margin in a similar way as cash, with applying appropriate haircuts. In our opinion this would take away many issues for end users and has the potential of creating a safer financial system. PGGM has four main arguments why treating HQLA similar to cash is worthwhile investigating:

1. It strongly reduces the need for PSAs to hold cash buffers and thereby reduces the negative impact on future retirement income as banks will no longer push for cash-only CSAs.
2. It will increase the liquidity of HQLA in general, both in the secondary market as in the repo market. The existence of a liquid market for high quality government paper is crucial for the stability of the financial system. It forms an essential part of the safety buffers of banks, but also for CCP's as they need to be able to liquidate Initial Margins quickly and smoothly in case of a default.
3. It reduces the liquidity risk of the entire system. Less parties will have the need to sell assets to generate cash in stressed markets. This forced selling will have a pro-cyclical effect and by doing so creating even more stress in the market.
4. It helps to facilitate finding a solution for the non-cash VM problem of Central Clearing. When cash and HQLA are treated similar it becomes more likely that more institutions will accept HQLA as VM, making it easier for CCPs to pass through HQLA received as VM. A solution for the cash-VM problem opens the door for PSAs to Central Clearing so that they can also benefit from the advantages of Central Clearing.

In addition, PGGM would like to take the opportunity to explain that for institutions that have no direct access to a central bank, 'cash' is not safer than high quality government paper. For most non-bank institutions (e.g. corporates and PSAs) cash is equivalent to money on an unsecured bank account at a commercial bank. It is not regarded as prudent behavior to hold large amounts of cash at a bank account. These institutions prefer to hold short dated government paper instead. The conceptual idea that cash is more safe than HQLA might be defendable for banks but it is certainly not true for non-banks. PGGM kindly asks the European Commission to take this point into consideration as the overall objective of regulation should be to make the entire financial system safer and not to focus on banks in isolation.

- The collateral which is exchanged with a certain counterparty needs to be recognized aand netting should be allowed within NSFR.

4. *More specifically, regarding the 20% RSF factor applicable to gross derivatives liabilities, do you think it would be possible and appropriate to develop a more risk-sensitive approach that would take better account of the funding risk arising from banks' derivative activities over a one-year horizon? In that case, what could be this approach? Do you think that the use of the SA-CRR could provide an appropriate measure? If possible, please provide the impact on your institution of the alternative treatment you propose (as compared to the BCBS standards).*

The add on of 20% of derivative liabilities in any case and excluding any collateral, implies incremental funding requirements. The cost of this additional funding will be passed on to end-users. PGGM feels that it would be appropriate to develop a more risk sensitive measure. The assessment of funding risks for any bank should be

made on balance sheet level and not on transaction by transaction basis. Banks typically hedge their exposure with one end user with another end user or market participant, resulting in a relative large number of trades but with relative limited risk (on a netted basis).
Any method to calculate the potential future liabilities of a bank should take this offsetting effect on portfolio level into account.

Next to that PGGM requests to acknowledge the low risk nature of pension funds and their transactions as is acknowledged by policymakers within EMIR. The 20% add on should not be applicable to transactions with hedging purposes.

5. *If you propose special treatment for specific activities (e.g. hedging instruments, clients clearing…), how would you define these activities?*

PGGM suggest to apply the same definition as is used within EMIR where transactions that are clearly identifiable as hedging transactions are exempt from mandatory clearing for PSAs. Consistent with EMIR, in the NSFR calculations these hedging transactions should not be confronted with disproportional costs.

6. *In light of previous consultations, could you provide substantiated evidence about possible issues caused by the application of the BCBS NSFR standard to short term transactions with financial institutions at European level and which have not been taken into account at Basel level? If yes, what alternative treatment would you propose for NSFR calculation purposes to deal with the funding needs arising from short-term transactions with financial institutions? If possible, please provide the impact on your institution of the alternative treatment you propose (as compared to the BCBS standards).*

PGGM believes that the NSFR will significantly increase the demand for cash, especially in times of stress.
The high quality government bond repurchase agreement (repo) market plays a crucial role in the well-functioning and smooth running of financial markets by providing access to liquidity and allowing market participants to transform securities into cash. Due to the capital rules the cost of running a repo business has increased disproportionately for banks and as such banks' appetite to support this important market is shrinking.

PGGM notes that the number of institutions that are willing to act as a liquidity provider to the repo market has shrunk considerably. A typical example is of a European bank with whom PGGM was able to have a rolling reverse repo position of about € 4 billion. This bank has almost entirely retreated from the repo markets. This is the practice in normal market conditions. It needs to be seen if the repo market remains open in times of stress.

7. *If you propose special treatment for specific activities (e.g. client's short facilitations activities, prime brokerage businesses…), how would you define these activities?*

Banks should be able to fulfil their role as liquidity provider to the (repo)market. Banks have a unique place in the financial ecosystem. They are crucial in providing credit and liquidity to the real economy. To support this role banks have access to central bank liquidity. It should remain possible for banks to transfer this liquidity to "the street" or real economy.

The repo market has become the most important market place to manage liquidity risks. This market is more and more used by asset managers, pension funds, corporates to get short term funding or to invest excess cash safely. It is crucial that the repo market keeps functioning orderly under any circumstances. Banks are the only institutions that can support this market under more stressed situations.

8. *What do you believe the appropriate level of application of the NSFR to be? Is there scope to make the NSFR requirements more proportionate and, if so, on the basis of what criteria?*

PGGM feels that we are not in the right position to answer these questions.

9. *In particular, what criteria could be used to define institutions with a "low liquidity risk profile"? What simplified metrics (e.g. core funding ratio close to loans to deposits + capital) could be used to identify these institutions? Should certain institutions be completely exempted from the NSFR and on what basis?*

PGGM feels that we are not in the right position to answer these questions.

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PGGM
Voor een waardevolle toekomst

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