Response to the Bank for International Settlements on its Consultative Document ‘Revisions to the Basel III leverage ratio framework’.

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 revisions to the leverage ratio framework.

Key messages:

- **The implementation of the proposed Leverage Ratio methodology will have a significant negative impact on pension income. The current methodology 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 SA-CCR methodology in which the Initial Margin is not permitted to offset the exposure is disproportional for one directional PSA portfolios.**

- **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 makes the entire financial system more resilient towards liquidity crises.**

- **The importance of a well-functioning repo market will increase significantly due to amongst others, the increased demand for cash collateral. However, due to the bank capital rules the willingness of bank to act as liquidity provider to the repo market is diminishing rapidly. A sub-optimal or non-functioning repo market poses a threat to the financial stability and further increases the need for the ability to post non-cash VM.**

1. Cash-only VM will lead to a fall in future pension of 6%.

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 therefore felt by PSAs.

The restriction of the recognition of collateral within the framework by allowing only eligible cash variation margin (CVM) to offset the Replacement Cost component, is in particular a main concern to PSAs. As acknowledged by policy makers within the EMIR level 1 text[1], Pension Funds typically minimize their allocation to cash in order to maximize the efficiency and the return for their policy holders. Therefore, 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, due to the design of the leverage ratio and the NSFR, banks will push towards cash only CSAs to be able to offset the Replacement Cost component.

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 Leverage Ratio methodology is taking into account all derivatives which means including the currency hedging programs. This means that the impact of posting only cash as collateral will be more extreme than the figures provided in the independent report.

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. All other banks have addressed that accepting securities as collateral is becoming an issue for them. Some of these counterparties want to increase to costs of doing transactions and four banks are already indicating that they will no longer trade under the current CSA.

For one of the largest pension fund clients of PGGM the impact of cash only collateral 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.

2. Treatment of HQLA in a similar way as cash would solve many issues

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.

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*

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.

3. SA-CCR methodology is overly punitive for hedging programs of pension funds

PGGM's (potential) clearing members have informed us that the proposed SA-CCR methodology has a large impact on capital requirements for client clearing where the client has a large directional portfolio.
Clearing members have calculated that in PGGM's case the capital required will roughly be four times bigger than under the current CEM model.

Below the impact of the SA-CCR model vis-à-vis the CEM methodology is shown for a sample portfolio. It can be seen that the capital required for a directional portfolio is substantially higher under the SA-CCR methodology in which the Initial Margin received is not permitted to reduce the Client Members PFE compared to the CEM model.

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Portfolio	Gross Notional	DV01	IM (EUR)	CEM Net PFE	EAD (SACCR exc IM)	EAD (SACCR inc IM)
15y	€ 3,600,000,000	€ 5,050,569	£ 231,473,456	€ 21,600,000	€ 56,096,708	€ 5,352,892
25y	€ 2,300,000,000	€ 4,971,556	£ 247,427,084	€ 13,800,000	€ 48,478,802	€ 3,495,509
30y	€ 2,000,000,000	€ 5,013,431	£ 259,806,305	€ 12,000,000	€ 45,900,935	€ 2,968,426
Combined	**€ 7,900,000,000**	**€ 15,035,556**	**£ 765,609,994**	**€ 47,400,000**	**€ 150,476,445**	**€ 10,889,165**

Source: Barclays

It is difficult to see why Initial Margins are not allowed to reduce the PFE in the leverage ratio. Initial Margins have a very clear objective: it reduces the risks in case a counterparty goes into default. Therefore, Initial Margins that consist of high quality securities, which are fully segregated and unencumbered should be able to reduce the counterparty exposures. Please be aware that Initial Margins posted by pension funds do meet these criteria. Again, not allowing clearing members to use Initial Margins to reduce their capital requirements under the leverage ratio calculations makes client clearing unnecessary expensive and the cost of these capital requirements will be borne by end users.

Substantially increasing the cost of hedging has multiple negative effects which the Basel Committee should take into consideration when designing an appropriate methodology:

- If client clearing becomes too unattractive for institutions to offer as a service, the number of institutions willing to offer this service will decline, creating a highly concentrated market where most risks are with a handful of players. We believe this is opposite to the goal of a safer and more robust financial system.
- The capacity of the market to offer client clearing services to end users like pension funds might not be large enough. We are concerned whether there are enough clearing members that are willing to offer us trading limits which are large enough to cover PGGM's entire interest rate portfolio. This is certainly a big concern for the pension fund industry in total.
- The hedging programs of PSAs are one directional by nature, but this does not automatically mean that these positions create additional risk to the system as a whole. Pension funds hedge their risks to dampen the volatility of their returns. Stable returns enlarge the certainty about future pension payments. This creates the possibility for pension funds to act as long term investors and be a stabilizing factor in financial markets. Without hedging programs pension funds will much sooner be forced to sell assets in already stressed markets.

We would like to ask the Basel Committee to acknowledge the useful purpose of the hedging programs and to take the low risk nature of pension funds into consideration.

4. Inflation should be part of the interest rate asset class.

Within the SA-CCR netting is possible within an asset class but not across asset classes. Asset classes are defined to be interest rate, foreign exchange, credit, equity and commodities. One of the instruments which is not explicitly classified within a certain asset class is inflation. We would expect inflation to be treated within the same asset class as interest rates given their strong economic link. The non-cleared margin standards agreed by BCBS and IOSCO treat inflation within the same asset class as interest rates as well. Therefore, we request that regulators make this clear and explicitly state that inflation should be within the same asset class as interest rates for the SA-CCR calculation.

5. Repo markets are crucial for financial stability and the leverage ratio rules should support this role.

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. PGGM believes that the importance of this market will grow as demand for cash increases significantly once mandated central clearing is fully implemented in Europe (because clearing houses only accept cash as VM) and as the leverage ratio and other capital rules come into full force.

However, as a result of the bank 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. We expect this trend to continue. A report published in 2015 by the International Capital Market Association (ICMA) estimates that where the historical bid-offer spreads of short-dated liquid instruments were in the region of 5bps (0.05%) or less, the break-even rate to make the repo business profitable for banks following the introduction of leverage ratio rules is likely to range from 40bps (0.40%) up to potentially 75bps (0.75%)[3]. The leverage ratio, NSFR, liquidity coverage ratio and other bank capital rules are expected to have a profound impact on the repo market, resulting in

3 Page 11. Perspectives from the eye of the storm: The current state and future evolution of the European repo market published by the International Capital Market Association in November 2015 can be found on the link below: http://www.icmagroup.org/Regulatory-Policy-and-Market-Practice/short-term-markets/Repo-Markets/icma-european-repo-market-reportsand-white-papers/The-current-state-and-future-evolution-of-the-European-repo-market/

repos becoming unprofitable for banks as a traded product. PGGM already experiences 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 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.

At a time when regulation is expected to significantly increase the demand for cash, a shrinking repo market would reduce the supply of cash. We are concerned the combination of the two would reduce financial stability and is likely to cause a liquidity crisis in the future.
The consequence of a dysfunctional repo market must not be underestimated. If market participants are unable to transform their 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 defaulting on their contracts or forced unwinds of positions at a time of market stress which would further exacerbate any crisis. We request that policymakers recognize the importance of the high quality government bond repo market and support the smooth functioning of this very important market. We further request that a full analysis is conducted on the impact of bank regulations, including but not limited to, the leverage ratio, NSFR and liquidity coverage ratios on the repo markets.

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PGGM
Voor een waardevolle toekomst

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