APG Asset Management

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Subject: Regulation OTC derivatives markets

1. Summary

- We appreciate the opportunity to provide comments on the consultation of the HKMA and SFC. APG strongly supports proposals to regulate the OTC derivatives markets to make those markets stronger, safer and more efficient. We also welcome standardization of OTC derivatives contacts.
- We would like to express that we are not against the introduction of a clearing system, if such a system is well designed and not based "on a one size fits all approach". We believe that a clearing system should recognize the differences between all participants within a clearing system and differentiate between the various types of end users and other participants in such a clearing system. Otherwise a clearing system may have unintended consequences for end users such as pension funds and would do exactly the opposite of one of its principles, namely offer protection.
- By making the use of a central counterparty (**"CCP"**) mandatory, pension funds, being conservative and very solvent, feel that their solvency is absorbed by less conservative, more risk seeking and less solvent participants within the clearing system. In our view, pension funds should not be obliged to bear the risks of those less solvent parties by being mandated to clear via a CCP. It is essential that pension funds' choice whether or not to clear via a CCP is based on the assessment of risks associated with central clearing versus "bilateral clearing".
- From a pension funds' perspective, a clearing model must reduce risks for pension funds and avoid a disproportionate and unjust cost impact on pension provision. We believe that the current clearing models do not have such added value above our currently functioning bilateral derivatives arrangements, which are properly netted and collateralized and accompanied by optimal risk management tools.
- We are therefore looking for pension funds and their dedicated investment vehicles to be exempted from mandatory clearing in the same way as proposed in the European Union. Such an exemption should also apply when European pension funds and/or their dedicated investment vehicles transact with Hong Kong counterparties.

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2. About APG and its pension funds clients

APG Asia is regulated by the Securities and Futures Commission and is a wholly owned subsidiary of APG Algemene Pensioen Groep N.V. ("**APG**"). APG is a Netherlands based asset manager for pension funds exclusively with assets under management of approximately €275 billion as at 31 August 2011. APG is itself a subsidiary of Stichting Pensioenfonds ABP, the Dutch pension fund for Dutch civil servants and the second largest pension fund globally. APG provides for the income of more than 4.5 million Dutch citizens managing over 30% of all collective pensions in the Netherlands.

The assets managed by APG are invested for each pension fund client according to a strategic investment plan including various hedging policies for currency and interest rate risk. APG typically seeks a suitable match between the assets and the retirement commitments the pension funds have contracted ("liabilities"). These hedging policies are implemented through the use of derivatives. As such, APG is a substantial user of derivatives.

Dutch pension funds are solvent, conservative, stable and long-term investors on the financial markets. They operate as foundations which are independent and not-for-profit organizations that are controlled by employee and employer organizations. They are not part of any company and do not have shareholders. Therefore, they do not have to comply with investors' demand for a specific return on equity (i.e. pay dividend).

Those pension funds have certain specific means to deal with difficult market circumstances. They can rebalance 'bad times' by sharing the risks between retired and active workers, by setting up buffers or by increasing the contributions from employees and employers. Given the fact that pension funds' conservative strategies typically aim at long term, low risk and low turnover, their use of the derivative markets in the spectrum of investors can be characterized as opposite to high risk trading funds. The theoretical risk of bankruptcy of a pension fund is therefore extremely limited.

European pension funds use large amounts of OTC derivatives with the objective of meeting the obligations of pension plans (by hedging asset or liability risks with the aim of minimizing volatility between assets and liabilities). They hedge their liabilities (pension cash flows) against inflation, currency and interest rate risks to offer regulatory protection for pension beneficiaries. Pension funds do not speculate with derivatives. Article 18d of the European IORP Directive 2003/41/EC) obliges pension funds to use derivatives for risk mitigation purposes and for efficient portfolio management only.

As major institutional investors and as institutions responsible for the provision of pensions to millions of pensioners, pension funds generally support efforts to improve the safety and integrity of financial markets. However, it is essential that any measure to regulate the OTC derivatives markets does not undermine pension provision.

3. APG position on the regulation of the OTC derivatives markets

We strongly support legislative proposals to ensure the soundness, safety and efficiency of CCPs and trade repositories. We also welcome proposals to encourage standardization of derivatives contracts. However, any clearing model can only be acceptable for us and our clients if it genuinely reduces risk for pension funds and does not disproportionably increases the cost of pension provision. Our concerns are as follows:

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- **Disproportionate cost impact**

Pension funds typically use large numbers of OTC derivatives to mitigate risks arising from movements in interest rates, currency exposure or life expectancy. Pension fund investment strategies create in general substantial "one directional" OTC derivatives exposure. CCPs' margin requirements however are based on open outstanding position and do not take the creditworthiness of the end user into account. If pension funds were to be required to clear OTC derivatives transactions through CCPs, they would have to post huge amounts of initial margin. In the current OTC markets pension funds never pay initial margin because of their creditworthiness. Pension funds then would end up making a disproportionate contribution to the CCPs, effectively subsidizing more active and less creditworthy market participants who participate in the clearing system.

In addition, variation margin, when required in the form of cash would also have a tremendous cost impact. In the current OTC markets pension funds often use government bonds to fulfill (variation) margin requirements. If only cash is eligible this would lead to a significant opportunity loss.

Those additional costs would have an impact on the investment returns of pension funds. If pension funds are obliged to centrally clear and no solutions would be found to avoid such cost impact, these costs will be passed on to individual pensioners and savers, at a time when pensions are already under considerable stress. To avoid such an impact, the European Union has decided to exempt pension funds and their investment vehicles set up for the purpose of pension investment and acting solely and exclusively in the interest of pension funds for a period of at least 3 years, with the possibility to extend this period as long as no solution has been found by the CCPs to solve these problems. We would be grateful if the HKMA and SFC would follow the European Union and exempt pension funds and their dedicated investment vehicles from mandatory clearing.

- **Increase of risks for pension funds**

We feel that the clearing system will expose pension funds to additional risks associated with clearing members (and other risk seeking participants in the clearing system). Such a concentration of risk within the clearing system should in our view not be mitigated by forcing creditworthy and solvent pension funds to participate in the system. As mentioned above, the theoretical risk of bankruptcy of pension funds is extremely limited, and they do not pose systemic risk. This is why we believe that they should be fully protected against counterparty risk instead of being exposed to such risks.

- **Segregation and portability**

In a mandatory clearing system CCPs are accessible for pension funds via commercial clearing members only. Unlike pension funds, clearing members tend to be broker-dealers that represent a much higher default probability. Pension funds would have to enter into a contractual relationship with one or more clearing members. This exposes pension funds to the risk of failure of such a clearing member. Therefore:

a) It is essential that insolvency rules provide pension funds with adequate protection in case a clearing member defaults;
b) It is essential that pension funds have the opportunity to use segregated collateral accounts. It is important that such full legal and operational segregation of pension funds' positions and collateral is not only guaranteed at the level of the CCP, but also at a clearing member level. Omnibus accounts will lead to a situation in which pension funds could end up paying losses for other clients. CCPs and clearing members should also not be allowed to give (financial) incentives to use omnibus collateral accounts instead of segregated accounts. This should be regulated at the level of primary legislation level and not left to the discretion of the CCPs and clearing members;
c) We have a strong preference for a pledged account structure so that collateral can be held at the level of a custodian (with the CCP holding a pledge in case of default) instead of transferring huge amounts of collateral to the CCP;
d) A system of guaranteed portability is crucial in order to ensure that positions and collateral can be transferred in case of a clearing member default.

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CONCLUSION:

Based on the above, we would like to ask to exempt pension funds and their dedicated investment vehicles from mandatory clearing in the same way as proposed in the European Union. Such an exemption should equally apply when these parties transact with Hong Kong counterparties.

In case an exemption will not be granted, a more fair division of the costs of central clearing should be ensured, so that pension funds are not subsidising the mitigation of the risks that other more active and less creditworthy market participants pose to the financial system. Pension funds should therefore not be forced to post capital in the form of initial and variation margin, in excess to the risks they represent to the financial system. Otherwise the need to post collateral will reduce pension schemes investment returns and increase the costs for pensioners. Please be informed that the total cost impact of the margin requirements if mandatory clearing would have been imposed in the European Union would amount between EUR 1.5 and 4.5 billion (Annex). Finally, adequate arrangements should be put in place to ensure the safety of the assets of pension funds that have been put up as collateral. CCPs and clearing members should therefore be required to offer full segregation of assets and positions.

Please also find below our detailed answers to the question in the consultation document. We hope the Hong Kong authorities will roll out a regime for the regulation of the OTC derivatives markets which will have competitive advantage for the financial market of Hong Kong.

Should you have any further questions or would like any additional clarification(s), please do not hesitate to contact us.

Yours sincerely,

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Potential consequences mandatory CCP Clearing for a big pension fund in Europe:

The calculations below are based on the following assumptions:

- All OTC derivatives will be subject to mandatory clearing
- Variation margin can be posted in cash only
- There is only one CCP and one Clearing Member[1]
- Assets under management 100 billion with a hedging ratio of 70%[2]
- Initial margin percentage between 10 and 15% of the notional amount[3].

	Bilateral environment	**CCP-environment**
Initial Margin amount	N/A	EUR 7 / 10.5 billion[4]
Variation Margin amount	-4 / +4 billion (*cash/securities*)[5]	EUR -4 / +4 billion (*cash only*)
+ cash buffer	N/A	1.2 billion
+ committed repo / credit line	N/A	2 billion

Type of additional costs	**Amount of additional costs.**
CCP fees initial margin (securities)	10.5 million[6]
CCP fees variation margin (cash)	13 million[7]
Fees Clearing Member	2 million[8]
Opportunity loss cash variation margin	182 million[9]
Credit / repo lines	2 million[10]
Operational costs	1 million[11]
Total additional yearly costs	**EUR 210.5 million per annum**

[1] More CCPs and/or Clearing Members creates market fragmentation and will lead to additional costs and loss of netting benefits.

[2] The hedging percentage may fluctuate based on the coverage ratio of the pension fund and the investment horizon. Smaller pension funds often use a 100% ratio.

[3] The percentage will be different depending on the type of product and the maturity date. In a crisis (with increased volatility) these percentages may increase dramatically.

[4] Initial margin is estimated between 10-15% of the notional (70 billion).

[5] Variation margin can fluctuate significantly and can be either negative (*i.e.* receiving collateral) or positive (*i.e.* posting collateral). In a crisis, these margins may increase dramatically.

[6] This is based on an initial margin obligation of 10.5 billion and the current Clearnet fees. In case of securities margin, the fee will be 10.5 million (10bp).

[7] Based on a variation margin of 5.2 billion and a clearing fee of 25bp (Clearnet cash fee).

[8] This is based on the assumption that the services of two Clearing Members will be used. Clearing Member fees are unknown and therefore estimated.

[9] Based on a cash variation margin + financial buffer of 5.2 billion and an opportunity loss of 3.5%. Clearnet offers an interest rate on cash which is below the interest rates offered in the market.

[10] Based on a 2 billion committed credit line and a fee of 10bp. Obviously extra costs will be incurred when money will be borrowed under these credit / repo lines.

[11] This is an estimation and does not include the one-off costs for the initial setup. Given the fact that the current bilateral systems will remain in existence for derivatives, which are not eligible for clearing, a separate system has to be set up for CCP Clearing.

Assumption initial margin in cash only as well – EUR 594 million per annum.

If initial margin would be required in cash only as well, which we do not foresee, this would lead to huge extra costs which are estimated at EUR 383.5 million[12] per annum. This would lead to a total cost of EUR 594 million per annum[13].

Type of instrument	Rough indication of OTC-derivatives usage based on notional amount[14]
FX	50-65%
IRS/ILS	30-50%
Other (CDS etc)	01-03%

Conclusion **Additional yearly costs between EUR 1.5 – 4.5 billion**

This calculation is based on the estimated additional costs for a large pension fund for a EUR 100 billion portfolio with a hedging percentage of 70%. Since the Dutch pension fund sector is approximately EUR 750 billion in size this would trigger additional yearly costs for our clients between EUR 1.5 and 4.5 billion. Given the fact that especially smaller pension funds apply hedging percentage of 100% the total costs will be even bigger.

[12] If it would be required to post initial margin in cash only as well this would lead to huge extra costs (3.5% opportunity loss over 10.5 billion) + extra 15bp CCP clearing fees i.e. 15.5 million. At present Clearnet accepts securities collateral as well.

[13] Eur 383.5 + Eur 210.5 = Eur 594

[14] This overview is just to give a general idea of the usage. Obviously the percentages may differ considerably over time and per pension fund.