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POSITION PAPER

DATE: 18-6-2024
SUBJECT: FSB CONSULTATION ON LIQUIDITY PREPAREDNESS FOR MARGIN AND COLLATERAL CALLS

Questions Section 1

1. **Does the outlined approach identify all key causes of some non-bank market participant's inadequate liquidity preparedness with respect to spikes in margin and collateral calls during times of stress? Are there any sector specific causes that should be considered?**

We welcome the opportunity to respond to the FSB Consultation Report on Liquidity Preparedness for Margin and Collateral Calls. As an integral part of their investment approach, many pension funds use derivatives to manage their financial solvency risk as their liabilities are often long-dated, one-directional and linked to interest rates. Pension funds are invested in assets and the return on these assets must be maximised to meet future pension liabilities (pensioners' retirement income). From the perspective of the pension fund participant, interest rate risk is a non-rewarded risk. Pension funds typically invest in high-quality government bonds to hedge their interest rate risks, but can optimise the hedging strategy by using derivatives. Derivatives have the advantage of being available for longer maturities and can also be tailored to match the dates of pension funds' liabilities more accurately, which is not generally possible with bonds. Derivatives can often also be the best matching asset for pension fund liabilities that are discounted using swap rates.

The Dutch pension sector has long warned policymakers about the liquidity risks involved in central clearing. In the EU, so-called pension scheme arrangements (PSA) were granted an exemption from central clearing for this very reason. After more than ten years of deliberations between PSAs, clearing members, CCPs and policymakers, the exemption expired without any solution being implemented. Thus, the liquidity risk arising from central clearing of derivatives has been left to pension funds to manage, on top of their normal liquidity management activities.

In adverse market conditions the spikes in margin calls for Dutch pension funds can be very serious. We therefore recognize the importance of liquidity risk management policies and governance. We believe the recommendations in the Consultation paper are reasonable and already implemented by pension funds in the Netherlands and our supervisor, even prior to the UK LDI crisis.

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The seriousness of the UK LDI crisis only reinforced the attention given to the subject. In assessing the degree to which pension funds were inadequately prepared and importantly the degree to which these inadequacies are relevant for other jurisdictions and sectors, it is indeed important to consider the idiosyncrasies of the pension fund sector in different countries. We would like to stress the following differences between the UK and The Netherlands:

- As described in the Consultation Paper, in the UK LDI strategies are executed by investing in pooled investment funds. In The Netherlands, pension funds appoint a fiduciary manager that enters into derivates positions for the pension fund and at the same time oversees treasury functions. By centralizing both functions, the pension fund is operationally better prepared to meet intraday margin calls. This structure also avoids incorporating entities that are leveraged by taking on more than 100% interest rate exposure.
- The level of interest rate hedging in the Netherlands is lower. Most pension funds, including the large industry-wide pension funds that manage the majority of assets, hedge somewhere between 30% and 70% of interest rate risk.
- While the derivative exposures of the Dutch pension sector are large, it does not nearly play the same role in the EU bond markets as the UK pension funds do in the UK gilt market. This preponderance set off the negative feedback loop, when UK pension investors were selling off gilts to meet margin requirements pushed bond prices down further, leading to more margin calls.

2. Is the scope of the proposed policy recommendations appropriate?

Yes, although SSBs and many national authorities, such as the Dutch Central Bank have already set out rules and guidance on liquidity risk management and governance of regulated financial institutions. Therefore we also see the recommendations in this consultation report as intended to reinforce or complement existing rules and as guidance to enhance liquidity preparedness for margin and collateral calls during times of market-wide stress.

3. Is the focus of the FSB's policy recommendations on liquidity risk management and governance, stress testing and scenario design and collateral management practices appropriate? Are there any other areas the FSB should consider?

While risk management and governance of pension funds should be adequate, they do not operate in a vacuum. Pension funds rely on intermediaries and other actors in order to access cash to meet VM calls, as pension funds cannot hold sufficient cash to meet calls that occur under adverse market conditions. They will need to rely on liquidity facilities and need to be able to transform assets.

Repo and reverse repo, in different models and types, are the designated market-based collateral transformation tools in normal market conditions to provide intraday liquidity. However, we have grave misgivings about whether repo markets can be relied on in stressed conditions. Under such conditions the demand for cash by all market participants is likely to increase – and at the same time the supply of cash is likely to either shrink or

at least not fully meet the increased demand, as banks reduce their risk appetite and pull back from deploying balance sheet for supporting clients in order to protect their own business. Market participants unable to access cash will be forced sellers of physical assets, which is likely to exacerbate any downward spiral of asset prices.

During the Covid-19 crisis a sell-off of all risk assets (equity and credit) and even high-quality government bonds as well as dislocations of currency markets led to sudden VM calls across a number of investment portfolios for many market participants. This increased demand for cash and, while the repo markets functioned well enough for intra-bank transactions, it did not function well for the buy-side. The International Capital Market Association (ICMA) market report on the functioning of the repo market during Covid states the following: “While the demand to access the repo market increased during the height of the crisis, banks’ capacity to intermediate that access did not. Buy-side participants report an increased reliance on the repo market as fund outflows drove the need to generate cash against holdings, as well as to meet margin calls against derivatives positions as volatility increased. However, it would seem that banks struggled to keep pace with client demand. Many report limiting business to top tier clients, with no capacity for new business.”[1] Similar to the stressed conditions during Covid, we also see tensions in the repo market at the end of quarters, when banks seem to reduce liquidity for reporting purposes.

PensionsEurope estimated in 2020 that a 100bps shift in rates would cause a cash VM requirement of circa €95bn across Dutch, Danish and Irish pension funds using swaps alone. This is contrasted with the daily average volume in the repo market, which was calculated at the time by the ICMA between €300 billion to €350 billion[2]. Most of this volume is likely to be in inter-bank transactions and not available to buy-side participants. Given that, we believe it is unlikely the repo market would be able to fully absorb the potential additional cash demand from pension funds in the case of such a rate hike in an extremely short timeframe.

For this reason we believe a second line of defence is needed - involving central banks as the only reliable provider of liquidity in stressed conditions. Central banks in the United Kingdom, United States and Canada have recognized this issue. They put in place liquidity facilities to prop up the resilience of repo markets or to provide a backstop repo facility directly to pension funds and insurance companies, or are in the process of doing so, as is the case in the UK. Unfortunately, the ECB has refused to consider adopting similar arrangements, thereby exposing EU pension funds to risks that are beyond the scope of their own policies and governance structures.

4. Is the approach to proportionality and materiality clear for all non-bank market participants

Yes, we support proportionality on applying these recommendations. We agree with the elements mentioned in considering proportionality. One aspect that is not mentioned is that measures to address liquidity risk should also be proportionate to their costs. If pension funds could only protect themselves against VM calls stemming from an e.g.

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[1] ICMA (2020) link

[2] PensionsEurope (2020) link

100bps rate hike by investing in cash instruments (instead of using additional instruments such as repo, liquidity facilities, etc.), this could have a significant impact on investment returns, and subsequently pensions. In 2014, a report drafted for the European Commission estimated that that covering the potential VM calls for such a rate hike would costs European pension fund participants 2.9 billion euros in return[3] annually.

Section 3.1

5. Section 3.1 sets out key elements of a liquidity risk management framework to identify, monitor and manage liquidity risk exposures arising from margin and collateral calls. Are these sufficiently clear for all non-bank market participants?

Yes.

Section 3.2

6. Are the recommendations on liquidity stress testing and scenario design with respect to margin and collateral calls clear and sufficiently specified?

Yes.

7. Are there any jurisdictional or sector-specific differences that are not accounted for in the recommendations?

No.

Section 3.3

8. Collateral readiness at the right time, quality and location is a critical aspect of effective liquidity preparedness for spikes in margin and collateral calls to mitigate the risk of having to liquidate collateral under stressed market conditions. Do the FSB's recommendations in Section 3.3 address all key elements required to be effective in mitigating liquidity risk arising from margin and collateral calls?

Yes

9. Are there any material challenges to collateral management practices that some nonbank market participants may face that should be considered?

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[3] Europe Economics & Bourse Consult (2014) link