10 July 2015

Record Currency Management Limited response to Second Consultation Paper on Draft Regulatory Technical Standards on risk-mitigation techniques for OTC-derivative contracts not cleared by a CCP under Article 11(15) of Regulation (EU) No 648/2012

Record Currency Management Limited ("Record") is a leading independent currency management firm managing EUR 51.6 billion, at 31 March 2015, for institutional investor clients in the UK, continental Europe, North America and Asia. The principal activities undertaken by Record are passive and dynamic currency hedging services for pension funds and other institutional investors, which seek to reduce or eliminate the currency risk associated with international equity and fixed income investing, and currency for return products. Record always acts as agent for its clients, rather than as principal.

Record continues to be **highly concerned** that the draft Regulatory Technical Standards ("RTS") are unduly burdensome and onerous on EU pension funds and other institutional investors undertaking currency hedging, to the likely extent of discouraging some investors from undertaking this prudent risk management activity altogether.

Currency hedging by pension funds is almost universally undertaken with a portfolio of foreign exchange forwards and foreign exchange swaps (as referred to in Article 5 GEN (a) and (b)), since these instruments offer pension funds the ability to tailor contract maturities to meet their own liquidity schedules, unlike e.g. futures contracts. Furthermore these instruments allow for well-established risk mitigation techniques, including diversification by counterparty to reduce pre-settlement risk, master agreements with netting clauses to minimise pre-settlement risk in the event of default, and the use of Continuous Linked Settlement effectively to eliminate settlement risk.

Specifically, the combination of the following factors makes the RTS excessively burdensome:

1) the inclusion of pension funds within the definition of "financial counterparties" (Article 1 GEN 1);
2) an exemption for collecting initial margin on foreign exchange forwards and foreign exchange swaps (Article 5 GEN (a) and (b)) but no equivalent exemption for variation margin;
3) the maximum threshold for parties to agree not to collect variation margin (the "minimum transfer amount") being set at EUR 500,000 (Article 4 GEN 1) which is unlikely to provide any relief for pension funds since a currency hedging portfolio of EUR 100 million would be modest in the context of EU-wide pension funds, and a daily currency move of ½% would not be excessive;
4) exchange of variation margin being required even if the EUR 8 billion threshold aggregate average notional amount of non-centrally cleared derivatives applicable to initial margin is <u>not</u> met by one party; and

5) the phase-in requirements for variation margin being on a shorter timescale, with no explanation, than that for initial margin such that all counterparties will be required to comply by 1 March 2017 (Article 1 FP 6 (b)).

To us it seems **wholly perverse** that pension funds (either directly or via a professional manager) undertaking a responsible risk management activity should be required to comply with variation margin requirements, on a timescale faster than that being applied to initial margin requirements, and to have to do so despite a likely aggregate notional amount of non-centrally cleared derivatives which would wholly exempt them from initial margin requirements. Since the requirement to collect and receive collateral on a daily basis will be sufficiently operationally burdensome to deter some clients altogether, this proposal seems perverse and set to increase not decrease risk within EU pension funds.

Furthermore this requirement is at odds with international standards. In the United States, foreign exchange forwards and foreign exchange swaps have been exempted from regulation as "swaps" by the Secretary of the Treasury and therefore are not, and will not be, subject to margin requirements for uncleared swaps, absent Congressional action. The RTS would therefore require EU banks to exchange variation margin on foreign exchange forwards and foreign exchange swaps with a counterparty in a third country, when there is no such requirement imposed on banks established in the United States or elsewhere. This would put EU banks at a competitive disadvantage.

We would propose the following range of potential amendments to the RTS, starting with that which we believe would be the most effective:

1) exempt foreign exchange forwards, foreign exchange swaps and currency swaps from the requirement to collect variation margin as well as initial margin by amending Article 5 GEN; failing which

2) exempt pension funds from the RTS, in a manner analogous to the exemption granted to pension funds from central clearing requirements for certain over-the-counter derivative contracts; failing which

3) apply the EUR 8 billion minimum aggregate average notional amount of non-centrally cleared derivatives to variation margin as well as initial margin; failing which

4) materially increase the EUR 500,000 minimum transfer amount threshold in Article 4 GEN 1 to e.g. EUR 5 million or a percentage of the notional amount of exposure to a single counterparty such as 5%; failing which

5) align the implementation timetable for variation margin with that for initial margin, so as not to impose the greater implementation burden on those least likely to benefit.

We **urge the European Supervisory Authorities to re-consider** the proposed requirement for counterparties to exchange variation margin on foreign exchange forwards and foreign exchange swaps entered into by pension funds that are objectively measurable as reducing investment risks directly relating to the financial solvency of these funds.