Central clearing of derivatives

What does this mean for pension funds?

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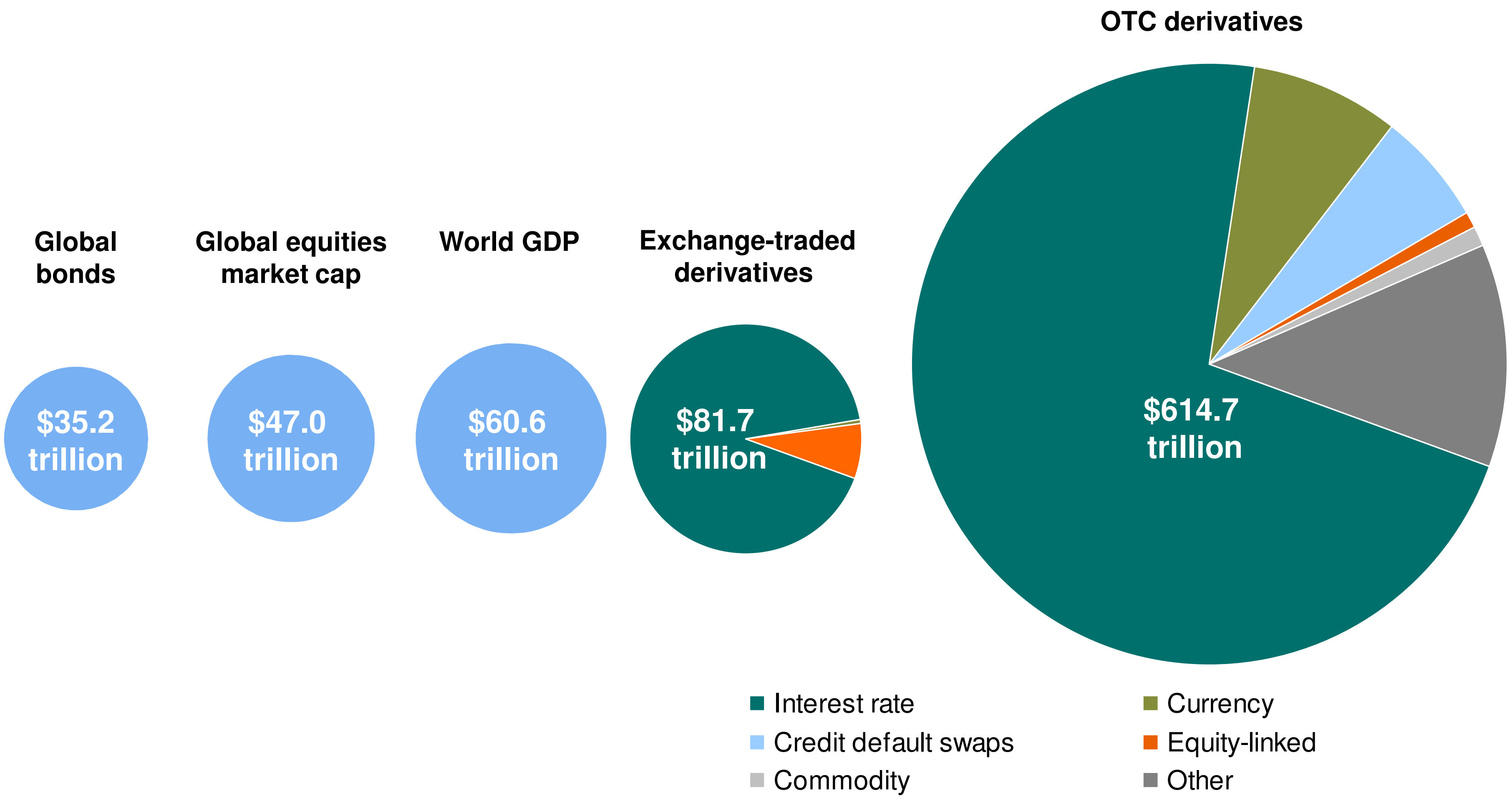
Context for Financial Market Reform

The elephant in the room



Sources: Barclays, World Federation of Exchanges members IMF, BIS.
All data as at Dec 2009, except World GDP at Dec 2008.

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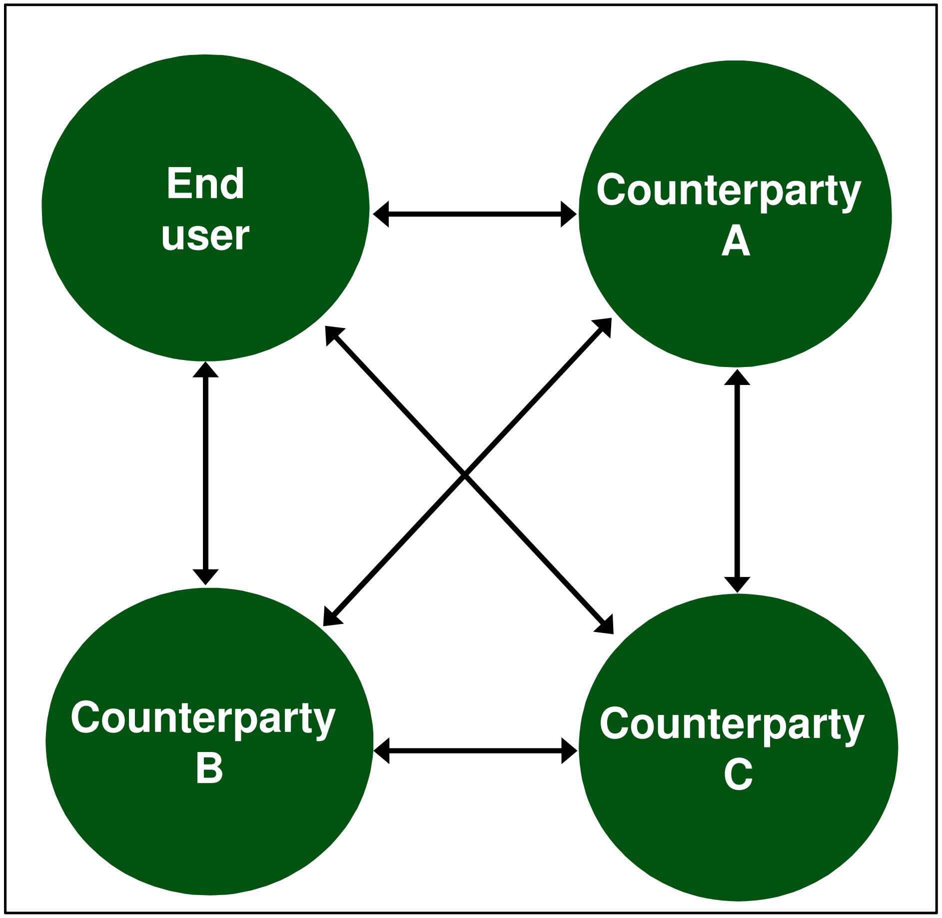
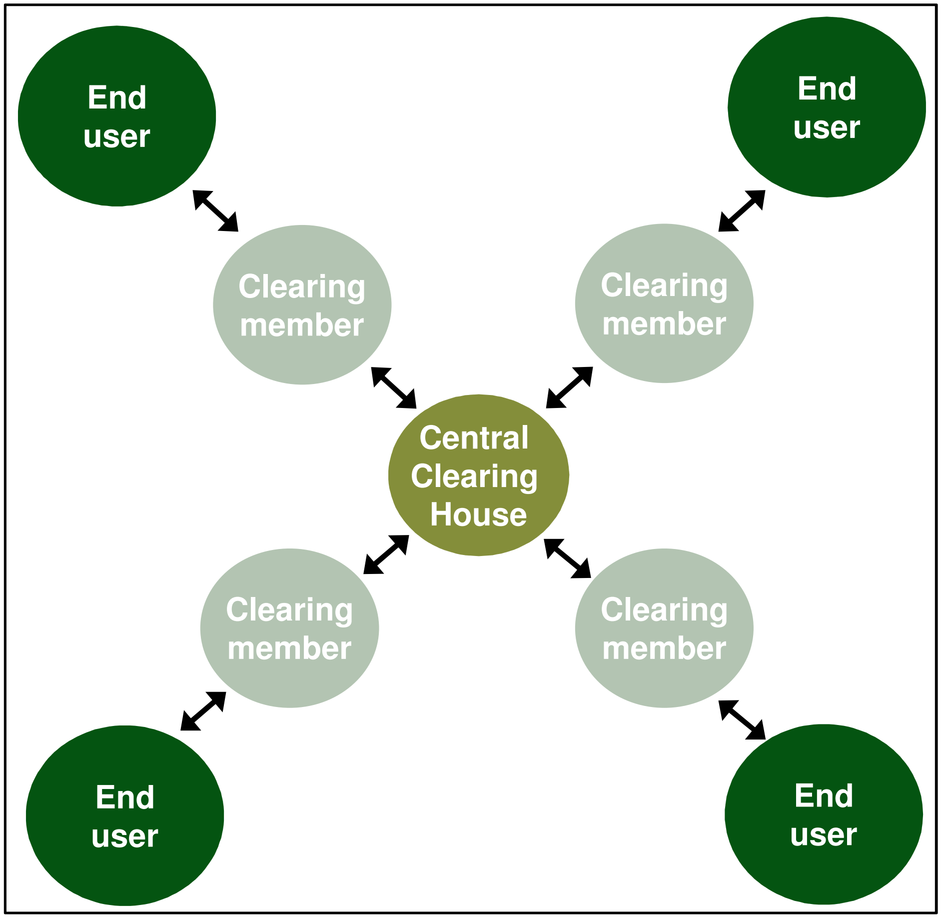
What is proposed?
Mandatory centralised counterparty clearing





The case in favour …
Benefits of centralised clearing

- Reduces ‘systemic’ risk
  - additional capital introduced into the system
  - standardised contracts facilitate multi-lateral netting
  - regulatory oversight and risk management strengthened
- Increases price transparency
- Reduces governments’ TBTF risk
- Addresses political need for action

Key features

- Initial margin
  - deposit of ‘good faith’ to cover potential replacement cost
- Variation margin
  - settling daily mark-to-market
- Security interest
  - direct legal claim on collateral in event of default

What happens on default?

Multiple layers of 'protection'

- Level (1) Portability
- Level (2) Default Management Process
- Level (3) Credit protection cushion
  - initial and variation margin
  - Default Fund contributions
  - clearing house and member firm's capital

Impact on pension funds

Solvency reduced by up to 30%

- Costs increase disproportionately (c. 1.5% p.a.)
  - execution fees, clearing fees, asset servicing charges (c. 0.1% p.a.) and cash spreads (c. 0.3% p.a.)
  - reduced liquidity
  - reduced capital and collateral efficiency (c. 3.5% p.a.)

- Risks remain
  - Default Management Process
  - credit exposure concentrated on clearing house
  - hedge effectiveness compromised
  - new counterparty risks potentially introduced

The way forward
Changes required by pension schemes

- Initial margin
  - variable to reflect risk of different market participants
  - fairer balance between IM and the clearing house Default Fund
- Variation margin settled in government bonds or cash
- Compulsion suspended pending comprehensive instrument coverage
- Asset servicing charges and cash rates revisited

The timetable

- Consultation period closed 10 July 2010
- Draft legislation end-September 2010
- European Parliament and Council aim to finish their “co-decision” process by end 2011

- 30 November 2010	First exchange of views
- 24 January 2011	Presentation of draft report by Werner Langen
- 15 February 2011	Deadline for tabling amendments
- 15 March 2011	Consideration of amendments

- Earliest obligation to clear likely to be mid 2012