

**EPFSF Lunch Discussion**  
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**“Derivatives”**

**Speech from Alan J. Brown**  
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I am here today speaking on behalf of the European Fund and Asset Management Association (EFAMA). As the Chief Investment Officer of Schroders, I should make it clear that we fully support EFAMA's position. We recognise the need for Central Clearing, and would like to actively engage to make it work effectively.

In the time available, I want to make some general comments on derivatives and their uses, and then to touch on three specific issues that we believe need to be addressed.

**Derivatives and their uses**

When asked, most private individuals believe they have never personally bought or sold a derivative. Yet most individuals have bought or sold a house. Certainly in the UK, when you buy a house, you agree a date in the future when you will complete the purchase at an agreed price and you pay an initial, good faith deposit (initial margin in futures terminology). The only reason that the buyer does not pay or receive variation margin up to the completion date is because no one is revaluing the house. However, the house purchase was a futures contract in all but name. The purchase did not feel risky or speculative because individuals do not go around buying houses without finance, and do not sell houses they do not own. If one follows the same rules with financial derivatives then they too are not risky.

There are many legitimate, low risk uses of derivatives:

- Asset allocation (Adjusting market exposures to take advantage of perceived mispricing opportunities)
- Cash flow anticipation (Acquiring (or reducing) market exposures in anticipation of known cash flows in (or out))
- Hedging (establishing a position in one market in an attempt to offset exposure to price fluctuations in another market with the goal of minimizing exposure to unwanted risk)

Low risk strategies can almost always be implemented in the cash market. Positions are typically fully “cash” backed in that they could have been executed without using derivatives. For example, a long S&P500/short FTSE100 position could have been executed by a pension fund physically selling its UK equities and buying US stocks. Derivatives are used as an alternative principally because of their efficiency and low cost.

Pension schemes and other investors who only use derivatives for these purposes and who always hold sufficient physical assets in their portfolios to ‘cover’ their derivative activities (analogous to the homeowners above), do not add to the risk of the financial system – on the contrary they may actually *reduce* it. This is the opposite case to speculators, whose derivative positions are typically leveraged.

It is also important to realise that derivatives markets do not by themselves create or destroy wealth. When a stock market rises (or falls) the sum of all investors gain (or lose) wealth. When derivatives markets rise or fall, for every winner there is an equal and opposite loser. When Barings went bankrupt through speculative futures trading, every pound of loss for Barings was a gain for other market participants.

It is important therefore to make a clear distinction between the economic impact of futures markets on individual investors and the economy as a whole, and the systemic risks that may arise from the settlement and clearing mechanisms applied. It is of course this second risk that the Commission has been addressing through its consultation on market infrastructure.

Let me then turn to the three specific issues we believe need to be addressed.

### **Issue 1 – Costs of central clearing should be proportionate to the risks**

As a general principle, the cost of central clearing should be proportionate to the risks. However, a weakness of implementation at many Central Counterparties (CCPs) is that default or counterparty risk has not been factored in to the initial margin proposals put forward by them. This means that asset-rich, long term savers, such as pension and insurance funds and UCITS, will be cross-subsidising the CCPs' clearing members and leveraged market users as initial margin is set at a standard rate.

Using available industry data, we have calculated that the cost of this cross-subsidy could be a massive 2% performance drag year-on-year for pension funds, and 2.5% for insurance funds.

A more sophisticated margining system would take into account the different risks inherent in different forms of trading strategies. The unintended consequence, which in itself would not be risk free, if this issue is not addressed, would be that pension and insurance funds might either reduce their use of derivatives to manage risk, or would be forced to run higher risk investment strategies to attempt to recover costs.

### **Issue 2 – Counterparty default procedures/Segregation of Client Assets**

The proposed legislation is open to interpretation in a number of areas. The market should not be in a position to decide on how it is translated or adopted.

Areas of particular concern are around:

- Specifying how asset segregation will be made effective across the EU in the event of counterparty default and similarly setting regulations covering contract portability. This may also require adherence to best practice standards for default management within the CCPs, with full transparency for the auction process and published procedures for moving positions.
- Definitively establishing within the EU how certainty of contract is to be achieved within the central clearing arena (dealing with the legal relationships between the executing member, clearing member, clearing house, investment manager, the manager's client and the client's custodian).
- Ensuring that rules covering central clearing taking place in the EU cannot be set aside by the application of local insolvency law (within the EU) in the event of counterparty default.

Paying attention to these small, yet significant requirements will ensure that the directive that is put in place will provide pension funds (and others) with the certainty of outcome that this entire initiative is striving for.

### **Issue 3 – Transitional arrangements**

There is an issue not yet addressed concerning fragmentation of margin. Given the instrument by instrument transfer to clearing, problems will arise for funds that use multiple OTC instruments to manage exposures. In particular, this could be a severe problem for Liability Driven Investment strategies (LDI). The specific concern relates to the lack of netting opportunities between securities that will be in clearing and those that will not. This introduces additional capital requirements, as well as greater operational risk as margin and collateral are moved more frequently.

There are however, at least two possible solutions available:

- Mandatory central clearing could be delayed until all asset classes are in clearing. The resulting transitional period would not be too long as we expect the clearing implementation timeline to be short.
- Or, funds could be offered a temporary waiver until all the instruments being traded by that entity are centrally cleared

Adopting either one of these solutions would mean that funds for whom this would be a problem would not face additional capital requirements during the transition period to central clearing.

## **Conclusion**

Derivatives, properly managed, can be a very useful tool allowing funds to carry out cost effective asset allocation strategies and to reduce risks. However, market clearing mechanisms can be a source of systemic risk and we fully support the Commissions initiative to introduce central clearing wherever possible.

To help achieve these goals, I have raised three issues that we believe need to be addressed.

- First, initial margin requirements should reflect the default risks of different types of trading strategies.
- Second, an EU wide approach needs to be adopted to provide clarity of procedures in the event of counterparty default. In particular, there must be certainty of contract that can not be set aside through local insolvency laws, and there must be full transparency for the auction process and procedures for moving positions.
- Finally, adequate transitional arrangements need to be introduced to cover the period until all contracts are in central clearing.

Addressing these points, will help the Commission achieve its important objectives to the benefit of all.

I am grateful for this opportunity to address you on behalf of EFAMA on this important topic and I look forward to your questions.

Thank you.