CIEBA

The Committee on Investment of Employee Benefit Assets

American Benefits Council

Segregation of Customer Margin for Cleared Swaps

Objectives

- To ensure that by moving from the bilaterally-settled OTC model to the centrally-cleared model, swap participants:
  - *do not become exposed to additional risks that are not typical for the bilateral OTC model*
    - (*e.g.*, possibility of credit exposure to other customers of a clearing member in the event of other customer's or clearing member's default); and
  - *do not lose additional protections available in the bilateral model*

ERISA Plans – Unique Concerns

- **Plans regulated by ERISA* are unique users of OTC derivatives because**:
  - ERISA plans use swaps to manage risk and to reduce the volatility of the plan funding obligations, e.g. minimize interest rate swings.
  - ERISA plans' many fiduciaries utilize *customized swaps* solely for the benefit of the participants.
  - ERISA plans and their fiduciaries *are already subject to the oversight* of multiple regulators, including the Department of Labor and the Internal Revenue Service.
  - Each ERISA fiduciary is required to *act solely in the best interests* of plan participants.
  - Each transaction executed by an ERISA fiduciary with a dealer is required to be done *at "arms length."*
  - Each ERISA fiduciary is subject to the *highest fiduciary standard* under any US regulatory scheme – that of a prudent expert.

** The Employee Retirement Income Security Act of 1974*

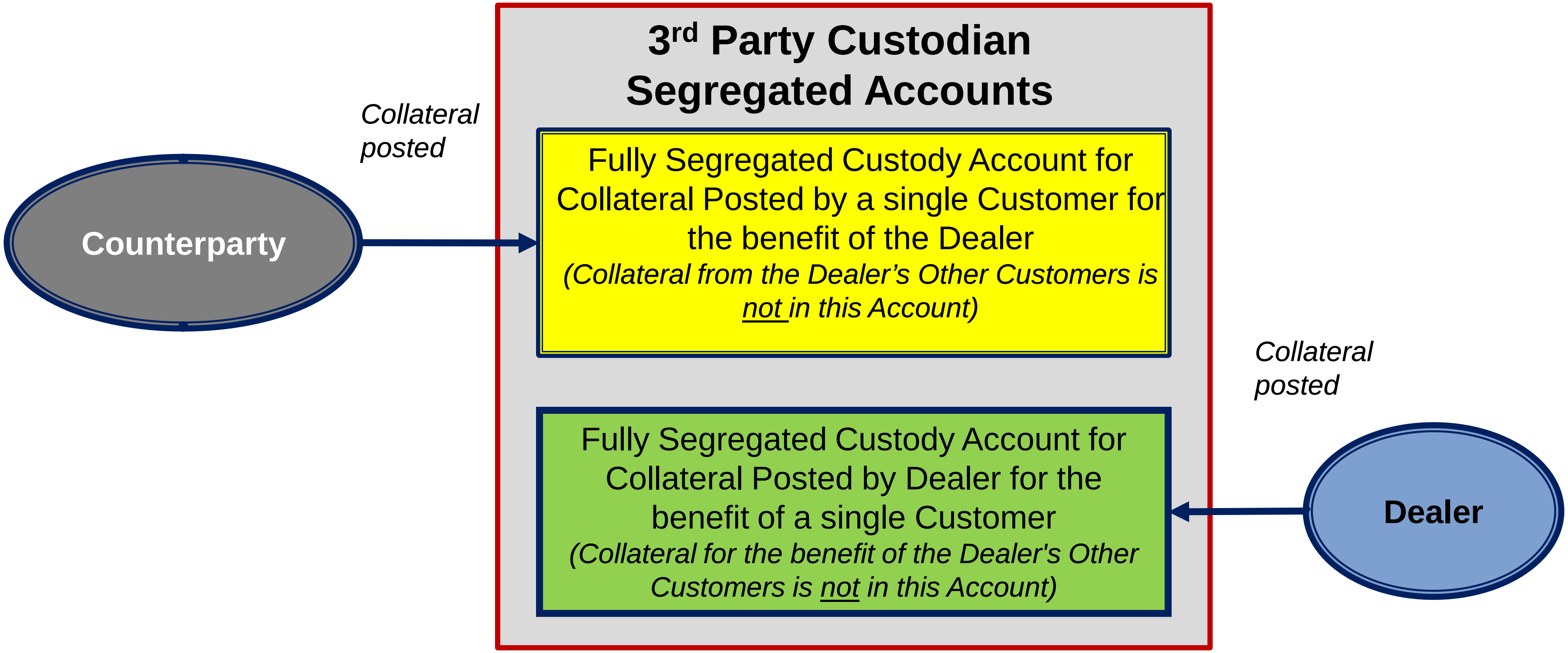
Pension Plans Risks In Clearing

- Current clearing systems (*e.g.*, futures clearing systems) expose plans to some risks not incurred for many uncleared swaps.

- Currently, the clearing member typically holds funds it receives from customers to margin their customer swaps in a <u>single aggregate</u> customer account. Likewise, the clearinghouse holds margin it receives from the clearing member for swaps held by the clearing member for its customers in a <u>single aggregate</u> customer account.

- This could place the customer's margin at risk if one of the other customers who has margin held in that same account defaults and the clearing member cannot make up the shortfall.

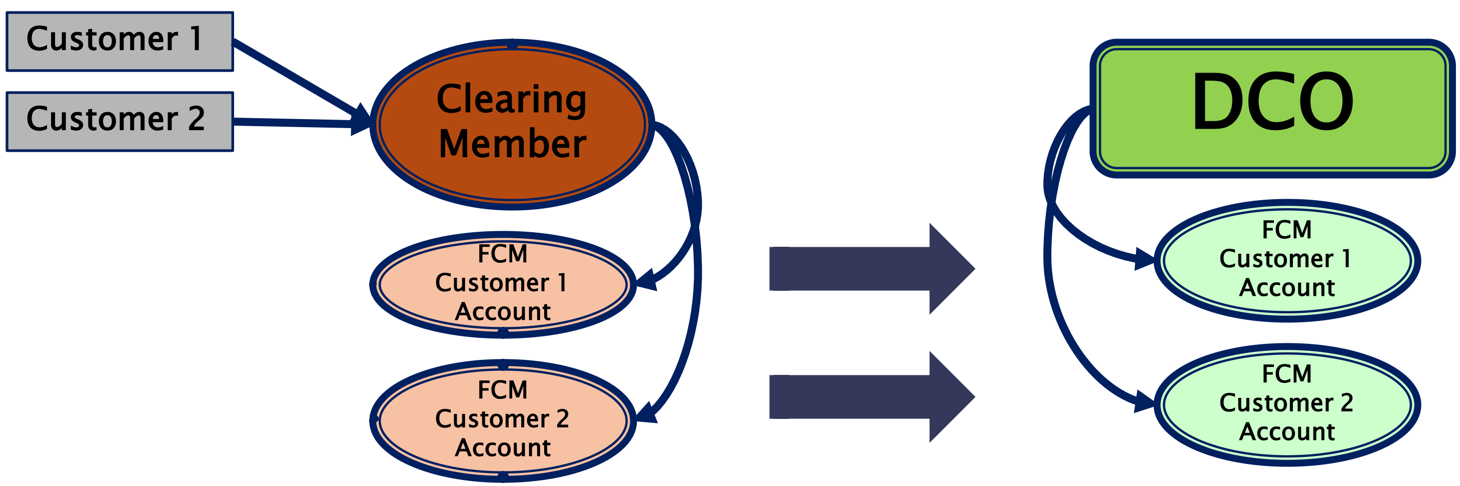
Segregated Collateral OTC Model



The above model served to protect a significant amount of pension plan assets when Lehman, as a swap dealer, went into bankruptcy. Collateral posted by a pension plan customer for the benefit of Lehman was utilized <u>only</u> to satisfy the obligation of such pension plan to Lehman (not the obligations to Lehman of other Lehman customers). Lehman's obligations to such pension plan customer were also collateralized.

Proposed Segregation Model

Proposed **Full Legal Segregation** Clearing Model for Pension Fund Swaps



Segregated Accounts

Segregated Accounts

No *recourse to* ***other*** *customer funds upon one customer's default shortfall.*

Pension Plan Risks in OTC

- In OTC swaps, while another customer's default to an OTC swap dealer could impact the financial health of that dealer, the risk of a pension plan customer of that same dealer losing its collateral as a result is not a risk that many pension plans have with their OTC trades.
  - Plans generally do not post initial margin in the OTC context;
  - Plans monitor the exchange of collateral very carefully, so that the dealer does not hold "extra" plan collateral;
  - A significant amount of pension plan assets enjoy negotiated protections for collateral in fully segregated third-party custodian accounts in the OTC context;
  - These protections include prohibitions on rehypothecation, lending or borrowing of plan collateral.
- Although plans have participated in the futures markets with similar pooled customer margin account risks, such participation could be weighed against the risks/benefits of OTC swap trading.

Margin Account Risks

- Pension plans are some of the lowest leveraged, least risky customers. By combining their margin with highly leveraged entities that are engaged in risky strategies (*e.g.*, hedge funds) and that are more likely to default than pension plans, pension plans are essentially being forced to take on the risk created by these customers' aggressive strategies and leverage.

- As indicated by the level of trading on futures exchanges globally (some estimate only 16% of the total derivatives market*), many plans' derivatives trading has been primarily done on an OTC basis. Thus, plans have not been exposed to these margin risks for most of their derivatives positions.

** "The Global Derivatives Market: An Introduction," Deutsche, Boise/Eurex White Paper, April 2008.*

Margin Account Risks

- The risk of losing margin due to another customer’s default can be expected to increase significantly as the volume of cleared trades increases.
- The amount of customers in combined customer margin accounts also is likely to increase.

Replicating Pension Plan Protections for Cleared Swaps

- If a pension plan is required to clear its swap trades, it should be able to elect that a ***<u>separate fully and legally</u>*** segregated account (<u>not</u> an aggregate account) be maintained by the clearing member at the clearinghouse solely on its behalf.

Replicating Pension Plan Protections for Cleared Swaps

- **Segregated margin accounts should**:
  - Not allow the margin of one customer to be used for any reason other than that customer's account and trading activity;
  - Be held at a third-party custodian;
  - Be held in the United States; and
  - Be protected from rehypothecation, borrowing or lending by the dealer.

Costs Issues

- **Possible Argument #1:**
  - "*Full legal segregation is too costly*"

- **Response #1:**
  - In the OTC market, full segregation is commonly provided without dealers charging plans additional fees.
  - Plans simply pay 3rd-party custody costs for segregation, which they deem reasonable and worth the expense.
  - One pension plan has informed ABC/CIEBA that its per account segregation costs for custody, reconciliation services (to the dealer and to its investment manager), margin services, transaction charges, and custody statements are only $20,000 - $25,000 per year.
    - These costs are paid to a 3rd-party custodian.
  - Pension plans have the ability to require their margin (collateral) to be segregated for their OTC swaps.
  - **Accordingly, clearing members and dealers already have the ability to separately account for and segregate pension funds moneys on commercially reasonable terms.**

Current Practice Issues

- **Possible Argument #2:**
  - "*Full legal segregation is not current practice*"

- **Response #2**:
  - Full legal segregation is not current practice for futures, but it is common practice for swaps dealers in OTC.
  - It is universal practice in the OTC world that no clients cross-collateralize other clients.
  - It is the practice to segregate and use 3rd-party custodians in the OTC world with respect to all U.S.-registered investment companies and with respect to a significant number of ERISA-regulated pension funds.

Proposal for Regulation

- CFTC rules on segregation, customer protection and clearing should require that:

  - ERISA-regulated funds should have an option to require that their funds deposited with the clearing member or a DCO be held in a separately and legally segregated account that under no circumstances may become a source of funds to cover other customers' or clearing member's positions.

  - Clearing members should be required to accommodate ERISA-regulated plan requests to hold collateral in such segregated accounts on commercially reasonable terms and conditions that prohibit rehypothecation, borrowing, or lending.

About CIEBA

The Committee on the Investment of Employee Benefit Assets, better known as CIEBA, is the voice of the Association for Financial Professionals (AFP) on employee benefit plan asset management and investment issues. CIEBA represents more than 100 of the country's largest private sector retirement funds. Its members manage $1.4 trillion of defined benefit and defined contribution plan assets, on behalf of 17 million plan participants and beneficiaries.

CIEBA was formed in 1985 to provide a nationally recognized forum and voice in Washington for ERISA-governed corporate pension plan sponsors on fiduciary and investment issues. Members are the senior corporate financial officers who individually manage and administer ERISA-governed corporate pension plan assets.

CIEBA's mission is to improve retirement security and increase investment management effectiveness by:

- Informing pension plan sponsors of legislative, regulatory and investment issues affecting defined benefit and defined contribution plans
- Providing a forum for discussion of these issues and development of effective solutions
- Helping its members address these issues and effectively discharge their fiduciary responsibilities
- Serving as an information resource for legislative and regulatory bodies
- Supporting constructive policy and legislative initiatives
- Building understanding and support for the private sector pension system

CIEBA is committed to strengthening the private sector pension system so that it continues as a major source of retirement income for millions of Americans. Its members also recognize that the private pension system's assets provide a significant source of long-term capital essential for growth.

Robert Hunkeler, Vice President of Investments at International Paper, is the current chairman of CIEBA.

About the American Benefits Council

- The American Benefits Council (the Council) is a public policy organization principally representing Fortune 500 companies and other organizations that assist employers of all sizes in providing benefits to employees. Collectively, the Council's members either sponsor directly or provide services to retirement and health plans that cover more than 100 million Americans.
- We are professionals in the benefits field with expertise in investments, retirement, health insurance, accounting, actuarial science, banking, law, and benefits consulting who provide service and support to corporate benefit plan sponsors.
- We serve as a technical resource on benefits issues for lawmakers, the media and other industry trade associations. We also lead other public policy organizations in developing and communicating a collective business community position and forge alliances on benefits issues.
- Our mission is to be the most effective advocate for voluntary private employee benefits.

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