Investment Division
5650 Yonge Street
Toronto, Ontario M2M 4H5

416 228.5900

fax: 416 730.5374

www.otpp.com

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September 23, 2012

BY E-MAIL

British Columbia Securities Commission
Alberta Securities Commission
Manitoba Securities Commission
Ontario Securities Commission
Autorité des marchés financiers
New Brunswick Securities Commission
Nova Scotia Securities Commission

c/o

John Stevenson, Secretary
Ontario Securities Commission
Email: jstevenson@osc.gov.on.ca

Me Anne-Marie Beaudoin, Corporate Secretary
Autorité des marchés financiers
Email: consultation-en-cours@lautorite.qc.ca

Dear Sirs/Mesdames:

Canadian Securities Administrators Consultation Paper 91-406 Derivatives:

OTC Central Counterparty Clearing ("Consultation Paper 91-406")

Ontario Teachers' Pension Plan ("OTPP") is the largest single-profession pension plan in Canada, with $117.1 billion in net assets.[1] It was created by its two sponsors, the Ontario government and the Ontario Teachers' Federation, and is an independent organization. In carrying out its mandate, OTPP administers the pension benefits of 180,000 current elementary and secondary school teachers in addition to 120,000 members.[2] OTPP operates in a highly regulated environment and is governed by the *Teachers' Pension Act*[3] and complies with the *Pension Benefits Act* ("PBA")[4] and the *Income Tax Act*.[5] More than 800 employees of OTPP help to invest the fund's assets, administer the pension plan, pay out benefits, and report and advise on the plan's funding status and regulatory

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1 Asset value current as of December 31, 2011. "Fast Facts", online: Ontario Teachers' Pension Plan Board <http://www.otpp.com/wps/wcm/connect/otpp_en/home/investments/fast+facts>.

2 Ontario Teachers' Pension Plan Board, Annual Report, "Leading the Way: 2011 Annual Report" online: OTPP <http://docs.otpp.com/annual_report/PDF2012/AnnRepCommentary2011.pdf> at 12.

3 *Teachers' Pension Act*, RSO 1990, c T.1.

4 *Pension Benefits Act*, RSO 1990, c P.8 ("*PBA*").

5 *Income Tax Act*, RSC 1985, c 1 (5th Supp).

environment.[6] OTPP consistently receives accolades from industry groups for its investment returns and pension strategy.[7]

We are writing to you in response to the request of the Canadian Securities Administrators (the "CSA") for comments in respect of Consultation Paper 91-406. We appreciate the opportunity provided by the CSA to submit comments on initiatives with respect to derivatives regulation in Canada. We have also been involved in commenting on CSA Consultation Papers through the Canadian Market Infrastructure Committee, which comments specifically address the questions posed by the CSA in Consultation Paper 91-406. Our comments in this letter address our concerns with respect to the application of central clearing to OTPP and other pension funds in Canada. As users of derivatives, we welcome sensible and properly functioning regulation of the over-the-counter ("OTC") derivatives market and support efforts to minimize systemic risk, increase transparency and harmonize Canadian derivatives regulation with that in other regions, while avoiding causing undue harm. However, we have significant concerns with the potential impact that mandatory clearing will have on OTPP and other pension funds.

We urge that the CSA consider granting a full exemption from mandatory central clearing to OTPP and other Canadian pension funds as well as to their respective investment subsidiaries and affiliated entities. As outlined below in further detail, Canadian pension funds do not create or increase systemic risk and should not be required to bear a disproportionate share of the direct and indirect costs of central clearing. Canadian pension funds are end-users of derivatives who are hedging against future pension liabilities and other risks inherent in their respective portfolios. Pension funds are not profit-driven enterprises, are subject to prudential regulation and are generally not permitted to borrow. An exemption from central clearing for pension funds in Canada would be consistent with the goals of the anticipated regulatory regime and with international derivatives regulatory initiatives.

Systemic Risk

From the G-20 meetings in Pittsburgh and Toronto to Consultation Papers 91-401 to 406, it is clear that the primary objective of a new derivatives regulatory regime in Canada is to mitigate systemic risk in the financial markets. Consultation Paper 91-406 proposes a framework for centralized clearing based on regulatory proposals contained in Consultation Paper 91-401.[8] Those regulatory proposals "...are intended to strengthen Canada's financial markets and manage specific risks related to OTC derivatives, implement G20 commitments in a manner appropriate for our markets, harmonize regulatory oversight to the extent possible with international jurisdictions, all while

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6 *Supra* note 2.
7 *Ibid*, at 3.
8 Consultation Paper 91-406 at 4.

avoiding causing undue harm to our markets."[9] In short, in our view Canadian pension funds neither create nor increase systemic risk as a result of their derivatives trading and as such, the cost to pension funds of mandatory clearing is too high.

It is important to emphasize that pension funds are end-users of OTC derivatives. Dealers, banks and other intermediaries, by their nature, are exposed to both the OTC derivatives transaction entered into with their client and a corresponding hedge, often in the form of one or more other OTC derivatives. An intermediary's role in the market gives rise to the problem of interconnected cross-defaulting, the hallmark of systemic risk. By contrast, as end-users pension funds are only exposed to the credit risk of their counterparty in any given transaction. In addition, pension assets are held separately from the pension sponsor's assets and generally from the assets of its custodian, each of which facilitates access to the pension's assets for trade settlement and other liabilities. Bilateral arrangements do not give rise to the problem of interconnected cross-defaults, and therefore do not contribute to the element of systemic risk caused by such interconnectedness and the pension's assets are isolated from the insolvency of sponsors and custodians.

Additionally, pension funds themselves pose negligible credit risk to their derivatives counterparties due to the following factors, discussed in further detail below. Unlike other participants in the OTC derivatives market, pension funds seek longer term stability in their investments, and are driven by the necessity to hedge against their pension liabilities by generating targeted returns at acceptable levels of risk. Furthermore, OTPP and other pension plans are subject to comprehensive prudential regulatory regimes spanning from governance to investment concentration restrictions. Importantly, pension funds are statutorily prohibited from borrowing, other than in certain limited circumstances, and so operate at a fraction of the level of leverage utilized by most banks, dealers and other financial institutions.

The negligible risk of non-payment by pension funds together with their lack of any material interconnectedness within the financial system put pension funds in the unique position of not creating or increasing systemic risk through their OTC derivatives transactions.

No Corporate Profit Motive

In light of the objectives of the proposed reform of the OTC derivatives market, the regulation of a party to an OTC derivatives transaction should depend on the risk posed by such party. Therefore, a counterparty with a greater risk profile should attract more rigorous regulation. Profit-driven enterprises, such as investment dealers, banks and hedge funds, carry significant inherent risk, and may in some cases rely significantly on OTC

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9 Consultation Paper 91-401 at 1.

derivative leverage to enhance their return on capital in the shorter term resulting in increased credit risk.

In contrast to almost all intermediaries and other end-users in the OTC derivatives market, pension funds are not driven by the desire for the highest possible returns at the lowest possible costs to satisfy investors, shareholders and other stake holders. Rather a pension fund focuses its resources on generating long term targeted returns to meet, or hedge against, its pension liabilities. For example, OTPP's mandate is to deliver defined benefits to retired teachers for life[10] and its overall investment strategy is designed to earn targeted returns that contribute to stable contribution rates and pension sustainability, while meeting the plan's long-term funding needs.[11]

OTPP's overall mandate dramatically impacts its derivatives strategy. OTPP uses OTC derivatives, together with its broader investment program to achieve a targeted return within risk levels set by the board and to hedge its pension liabilities. In addition, derivatives transactions allow OTPP to increase diversification, reducing risk, as they allow OTPP to gain exposure to global markets on a cost-effective basis[12] and may be used to obtain exposure to other investments and asset classes. OTPP has an established history of prudently engaging in derivatives contracts, which have played a large part in its investment strategy for approximately 20 years.

No Borrowing

Pension funds, including OTPP, are generally prohibited from borrowing money pursuant to section 8502(i) of the *Income Tax Regulations*, subject to specified exceptions with respect to unsecured short term borrowing and borrowing against real property. Accordingly, pension funds, including OTPP, are prohibited from borrowing money to finance a derivatives transaction.

In addition, as a matter of internal policy, or as mandated by agreements with counterparties, pension funds generally post variation margin in respect of outstanding exposure. This, together with limitations on leverage, result in pension funds having a very low to no risk of defaulting as a result of an inability to pay their counterparties.

Prudential Regulation

In addition to borrowing restrictions, Canadian pension plans are subject to comprehensive regulatory regimes dealing with funding, governance, investment standards, structure and other aspects of their administration. Such regulations are designed to construct a sound, stable and effective platform for collecting and investing pension contributions and paying

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[10] *Ibid*, at 15.

[11] "Investment Strategy", online: Ontario Teachers' Pension Plan Board <http://www.otpp.com/wps/wcm/connect/otpp_en/Home/Investments/Investment+Strategy/>.

[12] *Supra* note 2, at 41.

pension benefits. OTPP, for example, is governed by the *Teachers' Pension Act*, the PBA, the *Income Tax Act* and all of the regulations thereunder. In Ontario, all pension funds are subject to oversight by the Financial Services Commission of Ontario.

Ontario Teachers' Pension Plan Board and other pension administrators are "fiduciaries" of the assets they management. Plan administrators are subject to a prudent investment portfolio standard, investment concentration limits and other restrictions. Administrators of pension funds regulated under the PBA and other provincial laws are required to "exercise the care, diligence and skill in the administration and investment of the pension fund that a person of ordinary prudence would exercise in dealing with the property of another person."[13] In doing so, the administrator must use all relevant knowledge and skill that it possesses, or ought to possess, in the administration and investment of the pension fund.[14] The administrator is also subject to strict prohibitions concerning conflicts of interest. Under the PBA, these restrictions are also imposed on agents of the administrator.[15] The *Pension Benefits Standards Regulations*[16] contain federal investment regulations that apply to pension funds governed by the PBA.[17] Importantly, under Section 7.1 of the *Pension Benefit Standards Regulation*, all pension plans must establish a detailed statement of investment policies and procedures, including with respect to the use of derivatives, options and futures.

The funding of Canadian pension plans is also subject to regulatory oversight and assists in creating entities that pose little to no risk of default for non-payment of their obligations. Shortfalls may be funded by the fund's corporate or government sponsor, by increasing contributions of members or by lowering benefit payments, depending on the nature of the plan. In addition, there are no provisions under Canadian law for pension funds to file for bankruptcy or reorganization to avoid their obligations to creditors and voluntary termination of a plan does not relieve a plan of its financial obligations.

Pension plans are in a unique position in the OTC derivatives market in that they pose *de minimis* credit risk to their counterparties as a result of their inherent mandate and objectives, their prudential regulation, including borrowing restrictions, and their statutorily mandated sound governance and administrative policies. They do not suffer from the interconnectedness that contributed to the financial crisis, the aftermath of which continues today. As such, OTPP and other pension funds should be given an exemption from mandatory central clearing.

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13 *PBA* s 22(1).

14 *PBA* s 22(2).

15 *PBA* s 22(8).

16 *Pension Benefits Standards Regulations*, 1985, SOR/87-19 ("*PBSA Reg*").
Pension Benefits Act, RRO 1990, Reg 909, ("*PBA Reg* 909"), s 79.

17 Pursuant to *PBA Reg* 909, s 66(1) ""federal investment regulations" means sections 6, 7, 7.1 and 7.2 and Schedule III to the "Pension Benefits Standards Regulations, 1985" made under the *Pension Benefits Standards Act, 1985* (Canada) as they may be amended from time to time."

Disproportionate Impact on Pension Plans

In light of the current economic environment and the demographic realities for pension plans, the potential cost of mandatory central clearing of OTC derivatives for pension funds does not appear to be justifiable. In our view, mandatory central clearing will result in a significant reduction in the returns earned by pension plans. Various pension plans, non-governmental organizations and representatives of pension schemes have estimated that the cost of mandatory central clearing could reduce returns by between one and two percent per annum. [18]

OTPP and other pension plans are currently faced with high anticipated pension costs and only moderate asset growth, which results in funding challenges. OTPP has experienced funding shortfalls (the difference between benefits paid and contributions received) recurring for the past 10 years. The shortfalls occurred despite increased contribution rates, decreased benefits, and strong asset growth.[19]

The current shortfall is a result of both economic and demographic factors. Economically, OTPP is able to predict only modest investment returns due to uncertain markets. Additionally, prevailing low interest rates have a significant deleterious effect on pension funds. OTPP, like other pension funds, relies heavily on interest rate dependent investments. Lower interest rates require OTPP to set more money aside for future payments to pension beneficiaries. In addition, pension funds are unable to take advantage of low interest rates to obtain leveraged returns to the same extent as market participants which are permitted to borrow. The imposition of mandatory central clearing of OTC derivatives at this time will impose a serious strain on Canadian pension funds, potentially leading to the need for increased contributions by sponsors and for lower benefit payments.

Opportunity Cost of Collateral

Mandatory central clearing is likely to result in pension funds having a significantly greater need for highly liquid collateral than bilateral trading. Cash and other highly liquid investments generate returns significantly below the targeted returns for OTPP and other pension funds. The result is that central counterparty clearing will have a direct cost to pension funds. In our view, the impact on pension funds is significantly disproportionate to the risk they add to the financial system.

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18 See for example: Position Paper by the Dutch Pension Fund Organisations OPF, UvB and VB on the European Commission's Proposal for a Regulation on the OTC Derivatives Markets of 15 September 2010, at Annex I; National Association of Pension Funds Joint Committee of European Supervisory Authorities Discussion Paper: Draft Regulatory Technical Standards on Risk Mitigation Techniques for OTC Derivatives not Cleared by a CCP, at page 1; and Responses on ESMA, EBA and EIOPA Joint Discussion Paper by Insight Investment, at page 6.

19 *Supra* note 2, at 2.

As discussed above, pension plans pose very little credit risk. In recognition of this, counterparties in bilaterally negotiated derivatives transactions with OTPP have never required upfront collateral and have granted significant thresholds for exposure, where no collateral is required below such thresholds. Central counterparties, on the other hand, will mandate upfront collateral based on the nature of each transaction and irrespective of the creditworthiness of the direct participants in the central counterparty or their indirect trading clients. In addition, thresholds will likely be set lower or at zero. This problem is exacerbated by the volume of trades made by pension funds and by the longer tenure of their derivatives transactions as central counterparties will mandate much higher initial margin for such transactions. OTPP and other pension funds will be pledging more collateral in respect of cleared trades than experienced in bilaterally negotiated derivatives transactions notwithstanding that they do not pose any material systemic risk.

Pension plans will also likely lose some of the netting benefits they currently experience with their bilateral counterparties, again resulting in the need for additional collateral. Only certain trades will be subject to mandatory clearing and not all such trades will be cleared with the same central counterparty. Currently pension plans benefit from only having to collateralize net exposure under their derivatives transactions with each counterparty and they have the ability to manage their trades and collateral requirements. When certain trades are mandatorily cleared, those trades will not benefit from netting with other types of transactions that are either uncleared or cleared with a different central counterparty. In addition, while there may be netting benefits from clearing derivatives transactions with a central counterparty, it is unclear if those benefits will be passed on to indirect users of central clearing by the direct participants.

According to Consultation Paper 91-401, in bilaterally negotiated derivatives trades 85% of collateral received is cash and the remainder is composed of government or other highly rated bonds that are appropriately discounted.[20] The CSA has yet to finalize the types and amounts of collateral requirements, but presumably they will be cash-dominated as Consultation Paper 91-406 contemplates that collateral will have to possess sufficient liquidity in the event of a default.[21] Unlike financial intermediaries such as dealers and banks, pension plans hold almost all of their asset value in investments selected to meet their return targets. Assets are monetized primarily to meet beneficiary payment obligations. As a result of having to hold more cash and near cash collateral, pension funds will be under additional pressure to earn their targeted returns and meet their pension benefit obligations. A reduction in overall return could result in funding short falls leading to higher contribution requirements of the plan's sponsor and lower benefit payments. It does not seem reasonable to ask that the beneficiaries of pension plans bear a higher proportion of the additional costs of central clearing when pension funds did not contribute to the systemic risk that necessitates central clearing.

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[20] The Study Group Established by the Committee on the Global Financial System, "The role of margin requirements and haircuts in procyclicality" (CGS Papers, Mach 2010), No 36.

[21] *Supra* note 8, at 16.

Further, depending on the relationship between the parties involved in central clearing, OTPP and other pension plans may bear some solvency risk in relation to the potential default of a central counterparty. As discussed in Consultation Paper 91-406, after a trade is executed the central counterparty becomes the counterparty to both transaction participants.[22] An argument in support of central clearing of OTC derivatives suggests that counterparty risk will be reduced due to the placement of all applicable OTC derivatives transactions with one central counterparty, as a default event is better absorbed by the central counterparty assuming the credit risk rather than an individual counterparty, having the effect of reducing systemic risk. It is not our intent to dispute the ability of a central clearing model to achieve this goal. However, in our view this proposed risk reallocation unnecessarily shifts risk onto pension funds. One of the sources of assets that could be used to satisfy a counterparty default is the collateral posted by one of the pension funds. Unless pension funds are exempt from mandatory clearing, they will have to assume a portion of the redistributed aggregate risk of all counterparties using the central counterparty. Therefore, including pension funds in the proposed regulation would not reduce overall systemic risk and could unfairly allocate risk to pension funds and their beneficiaries.

Regulators and market participants recognize that the additional demand for near cash collateral will result in a general liquidity squeeze, particularly in the shorter term. In the longer term, the potential impact of a general greater need for high quality liquid collateral is uncertain but is likely to negatively impact pension funds' ability to optimally manage their portfolios to meet targeted returns.

In our view the increased costs to pension funds and the reallocation of risk that result from central counterparty clearing necessitate an exemption for OTPP and other pension funds from mandatory clearing.

<u>International Harmonization</u>

The CSA states in Consultation Paper 91-406 that it is working with foreign regulators to develop Canadian rules based upon international standards.[23] It recognizes that most OTC derivatives transactions involving Canadian market participants involve a foreign counterparty. This preponderance of international transactions holds true for OTPP, which for example, owns approximately four times as much in asset value in Non-Canadian equities as it does in Canadian equities. As a result, the majority of its OTC derivatives transactions will involve a counterparty regulated by the laws of another country.

As stated in Consultation Paper 91-406, it is "crucial that rules be developed for the Canadian market that accord with international practice to ensure that Canadian market participants have full access to international markets and are regulated in accordance with

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22 *Supra* note 8.
23 *Ibid*, at 4.

international principles".[24] Bearing this in mind, we encourage the CSA to find guidance in the European Market Infrastructure Regulation ("EMIR"), due to come into effect in April 2013. EMIR, which will govern European OTC derivatives trading, specifically exempts pension funds from mandatory clearing. We suggest that many of the concerns that led to the EMIR exemption are also directly applicable in Canada. We acknowledge that the exemption for pension schemes under EMIR is only temporary. However, the exemption adds support for our argument that Canadian pension funds, like European pension schemes, do not pose material credit risk and, therefore, do not create or increase systemic risk.

Conclusion

We are strongly in favour of regulation that is pragmatically tailored to meeting the objectives set out in Consultation Paper 91-406 and the earlier consultation papers released by the CSA. In particular, OTPP supports recommendations made by the CSA for greater transparency, surveillance and reporting in respect of derivatives positions. However, we believe the CSA should give serious consideration to an exemption from central clearing for pension funds. The costs of any regulatory regime should be proportionate to the potential harm that could result from failing to impose such regulation. As outlined above, mandating central clearing for pensions is inconsequential in achieving the objective of mitigating systemic risk and will result in pension funds bearing a disproportionate portion of the costs of such regulation. The higher costs associated with derivatives trading under a mandatory clearing regime could result in some pension funds electing to leave risks un-hedged or could lead to the need for higher contributions and lower payments to pension beneficiaries. Either result is unsatisfactory and in our view, results in undue harm to pension funds and possibly the economy as a whole. As such, we respectfully submit that OTPP and other pension funds be exempt from mandatory clearing of their OTC derivatives transactions.

Yours very truly,

Gregory O'Donohue
Legal Counsel, Derivatives
Ontario Teachers' Pension Plan Board

[24] *Ibid.*