

The Changing Landscape

OTC Derivatives Collateral Management for Institutional Investors

AUGUST 2011

Amongst other harsh lessons, the financial crisis highlighted the importance of counterparty credit risk. The subsequent industry-led period of reform proposals looks poised to impact OTC market and buy-side participants dramatically.

J.P. Morgan hosted a Derivatives Collateral Management (DCM) Roundtable in late Spring in Amsterdam, to tackle concerns around the reform proposals and to provide an overview of the clearing requirement detailed in the European Market Infrastructure Regulation (EMIR).

Industry guidance from International Swaps and Derivatives Association (ISDA) has also focused on buy-side institutions covering a range of collateral management best practices such as robust portfolio reconciliation through to standardisation of electronic margin calls to ensure collateral management processes are in place to improve efficiencies and address the issue of risk in the OTC marketplace. Substantial investment is required to implement best practice and to keep up to date with the raft of regulatory reforms. Outsourcing collateral management can maximise the efficiency of collateral deployment and help to improve counterparty risk management process.

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Introduction

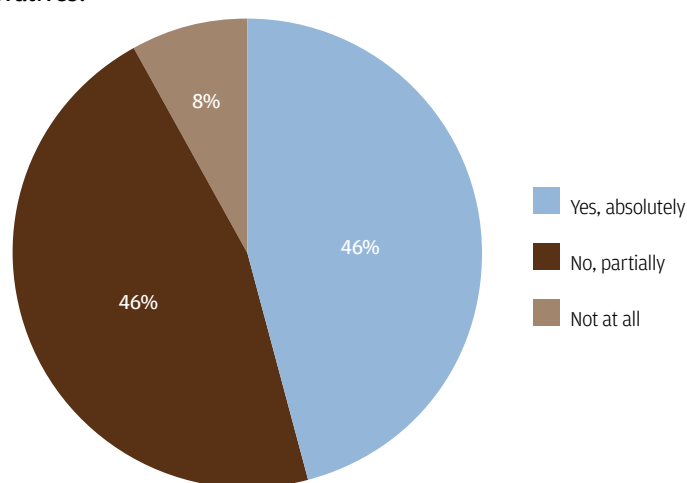
We welcomed around eighty attendees – including representatives from investment managers, pension funds, consultants, fiduciary managers, industry bodies and government – from the UK and the Netherlands to our Roundtable event. This forum was the second in a series of events hosted for the Dutch market as part of J.P. Morgan's thought leadership programme. Its theme had been inspired by discussions at the inaugural event, the Pensions Roundtable – Managing the Changing Business Environment, last year in Amsterdam.

Survey Results and Key Discussion Themes

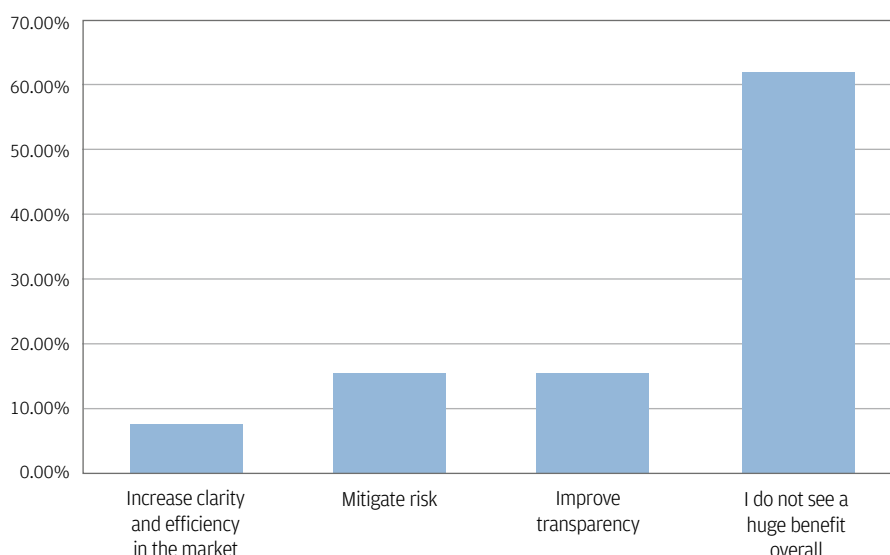
The agenda for the afternoon event included an overview of regulatory and market updates followed by a panel discussion which gave the audience an opportunity to hear all of the views from our buy-side participants and their consultants. We also included time to canvas audience opinion on the subjects tackled by our pre-eminent speakers. We report on the results of our survey below, along with insights from the discussions of the day.

The responses to the survey represent a cross section of buy-side clients. As such, they give a good sense of general expectations relating to the future landscape of the OTC market and the level of concern around the proposed changes. We have found not only from the survey conducted but from ongoing conversations with our clients and prospects that the overwhelming response to the mandatory clearing of OTC products raises a number of potential concerns.

Are you aware of the future structural changes with regards to CCPs for OTC derivatives?

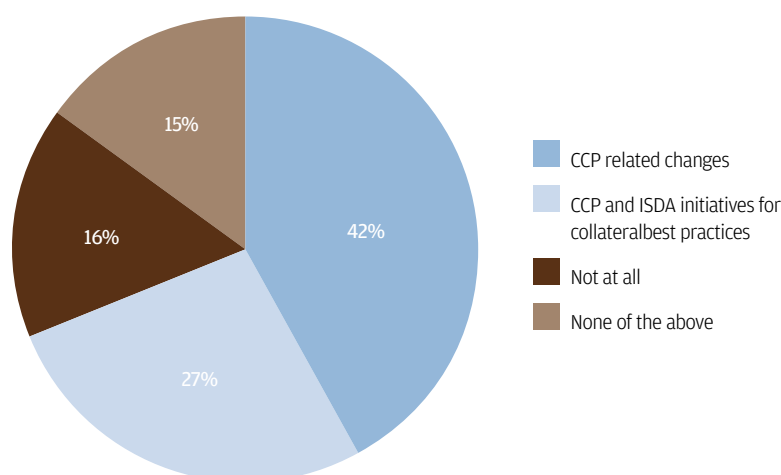


If Yes, do you think these changes will:

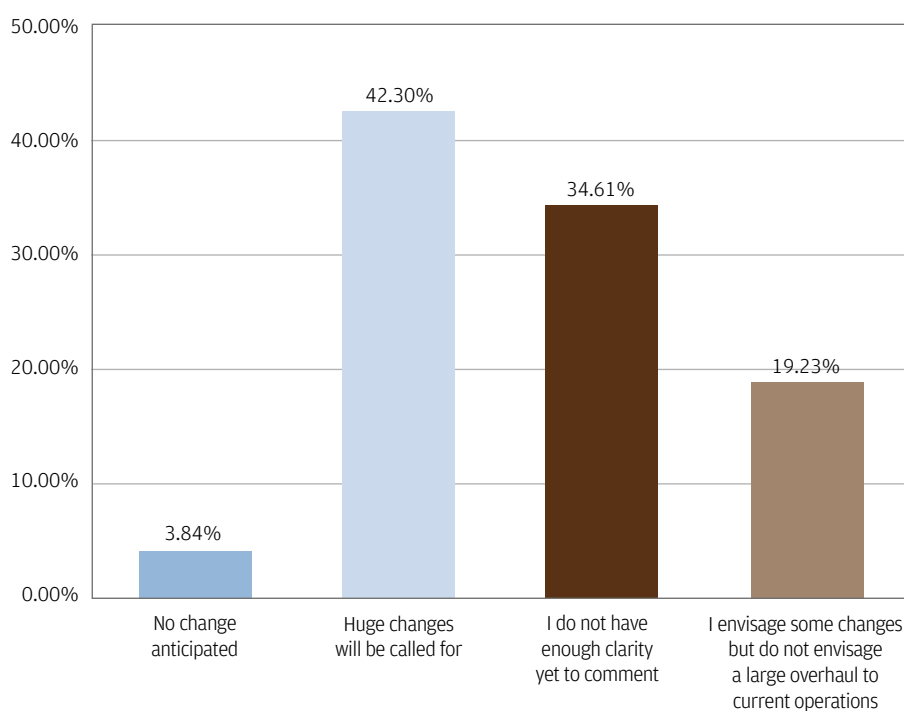


The majority of respondents did not believe the new regulations will be of overall benefit. Discussion on the day revealed that this is largely due to concerns around the introduction of initial margin for OTC contracts and conservative collateral eligibility within a centrally-cleared model. Another key issue is that variation margin will take the form of cash only, which is being vigorously pursued by the Dutch pension funds as one of their reasons to continue to lobby for an exemption.

In relation to Collateral Management, are you up to date and aware of:



Do you think central clearing will affect internal operations such as Risk Management and reporting?

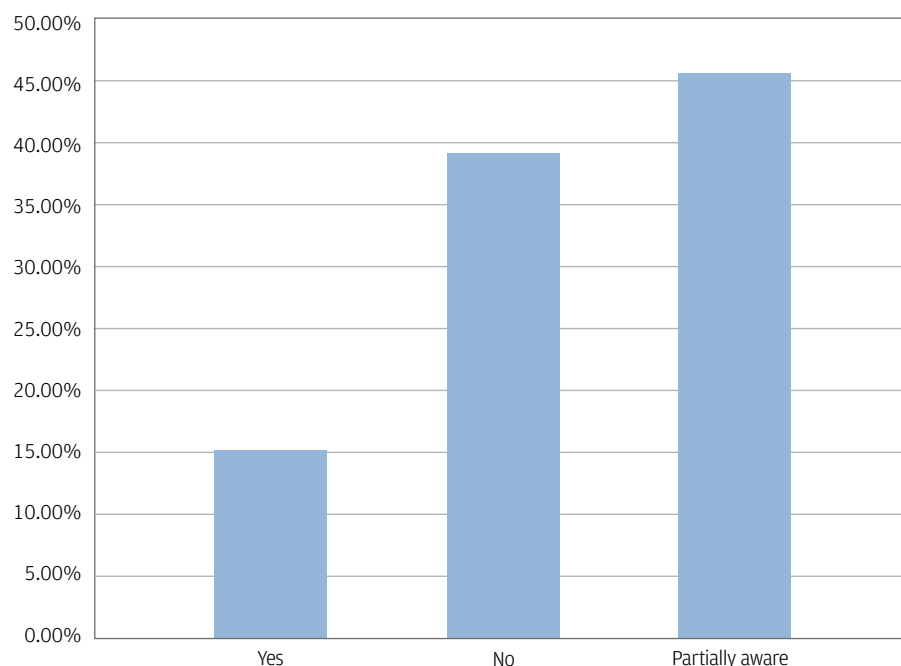


Over 40% of respondents believed central clearing will affect internal operations, such as risk management and reporting. Comments from the speakers and audience revealed that they also anticipate increased overheads due to administering and validating daily margin calls with multiple clearing brokers, and the bifurcation of exposure and operational effort across different venues – i.e. bilateral versus CCP-cleared venues. The latest proposal makes it look likely that European pensions funds will be exempt from central clearing for four years after EMIR comes into force, which is expected to be late 2012 or even early to mid 2013. In the meantime, regulators are said to be making efforts to develop a technical solution for the transfer of non-cash collateral as variation margin to CCPs.

Another area of concern related to the regulatory agencies charged with implementing Dodd Frank.

These have already impacted the marketplace by issuing so many regulatory proposals in so short a period of time, with palpable dissent between the two main regulators, U.S. Securities and Exchange Commission (SEC) and Commodity Futures Trading Commission (CFTC).

Do you understand the main difference between Dodd Frank and EMIR current proposals?



Following on from this buy-side participants are still unclear as to how Dodd-Frank will differ from EMIR, given the later date set for implementation within Europe.

Much of the panel discussion reflected the audience's major concern and that of many of our Dutch clients that European pension funds ought to be exempted from proposed regulation which would disproportionately impact their business. If pension funds are forced to clear their swaps they will be required to hand over cash collateral to a clearing house. This includes upfront margin which is generally about 2% of the value of the contract (and could be significantly higher depending on the trade undertaken) and a daily variation margin, which would be cash only. Clearing houses would also charge pension schemes a fee based on the amount of collateral they have posted. The costs will have a significant impact on pension funds. In order to generate cash for variation margin, pension schemes may have to sell government bonds in return for cash and this would reduce their investment returns.

What was abundantly clear, underpinning all sentiment expressed on the day, was that rushing to meet deadlines without adequate analysis and market feedback would result in a fragmented regulatory structure and uncertainty within the market as a whole.

Our aim is for our thought leadership programme to continue in this vein, and we look forward to welcoming you to other events and forums throughout the year. The next one in the series is the 2011 Dutch Forum, Risk Management – Best Practice on Tuesday 11 October, 2011. We hope you will join us.

I found the roundtable event to be very useful as it provided both a regulatory update and valuable insights from practical case studies tailored specifically to the pensions industry.

Sabine Frehen, Head of Derivatives Services and Collateral Management, Aegon N.V.

About J.P. Morgan Worldwide Securities Services

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