CLIENT NOTE

MORE CLARITY FOR PENSION FUNDS IN TRANSACTING WITH DERIVATIVES

OVERVIEW

The entry of global reputable pension fund managers to the Armenian financial landscape back in 2010 has significantly improved Armenia's integration into global sophisticated financial markets.

Particularly, two global asset managers: Amundi-ACBA (https://www.amundi-acba.am/en/About-us/Amundi-ACBA-Asset-Management) (with French roots) and C-Quadrat Ampega (with Austrian-German roots) (https://www.c-quadrat-ampega.am/) confidently walked into the Armenian market and established their shops.

Derivative instruments are considered to be one of the most sophisticated financial transactions. Many pension funds investing in various financial markets try to hedge their risks by entering into ISDA agreements. Thanks to the work by various stakeholders, Armenian pension funds can now do so as well. Find what was changed in this client note.

During the past few years, international financial institutions and financial intermediaries with global presence have shown great interest in transacting with both of these managers, especially with derivative instruments. To do so, the regulatory framework for entering into ISDA (International Swaps and Derivatives Associate www.isda.com) agreements had to be enhanced, to enable both the pension fund managers and their financial counterparts to confidently seal the deals.

Our law firm, being the only ISDA member in Armenia and one of the few in the region, embarked on working with the Central Bank of Armenia (the financial regulator) and other stakeholders, to enshrine the improvements in the Armenian regulatory framework. This work resulted in two important documents, which were adopted by the Central Bank Board this July. We have tried to summarize these regulatory developments in this note for our clients and the general public

The Central Bank of Armenia's Board has adopted **Regulation 10/32 "Types and Parties of Derivative Financial Instruments Entered into by Mandatory Pension Funds"** in its session on July 17, 2020. The Regulation permits investment of assets of mandatory pension funds in any type of derivative financial instruments stipulated in Article 3 of the Law on Securities Market for hedging purposes. An investment in derivative financial instruments shall be considered to be made for hedging purposes, if:

1) it is aimed at total or partial reduction of the risks associated with management of investments of the fund;
2) there is a direct link between the object of hedging (the risk) and the derivative instrument being used; and
3) such investment stems from the investment policy of the fund, including – it is associated with the assets of the fund or those assets, wherein the fund is planning making investments.

As to parties of derivative financial instruments entered into by mandatory pension funds, as such may act:

1) financial organizations licensed by the Central Bank of the Republic of Armenia;
2) international financial organizations. These organizations shall be subject to the threshold for banks established in Article 39 (5) of the Law on Funded Pensions;
3) foreign financial organizations possessing at least the following rankings:
- Standard and Poor's, group "BBB" BBB;
- Moody's, group "Baa" Baa3;
- Fitch, group "BBB" BBB.

At the same time, conclusion of derivative financial instruments between a mandatory pension fund and an international financial organization, which is not subject to licensing in or control by any state and has been established pursuant to an international treaty, shall not be considered as an investment made in a foreign state.

In addition to Regulation 10/32, with regard to derivative financial instruments concluded by mandatory pension funds, an **official clarification of Articles 39 (1) and (15) and 68 (5) of the Law on Funded Pensions** is has also been adopted by the Board of the Central Bank.

The main lines of interpretation embodied in the official clarification are the following:

- currency swaps entered into by pension funds for the purpose of hedging currency risks are to be considered as investments expressed in foreign currency and taken into account for calculation of thresholds of such investments pursuant to Article 39 (1) of the Law on Funded Pensions;
- for calculation of the threshold associated with derivative financial instruments concluded with one person, as required under Article 39 (15) of the Law on Funded Pensions, the mark to market value of the derivative financial instrument shall be taken into account, while for calculation of the threshold associated with all derivative financial instruments entered into by the pension fund the market value of the underlying asset shall be taken into account;
- the prohibition of pledge of assets of pension funds set out in Article 68 (5) of the Law on Funded Pensions does not mean that pension funds cannot enter into the Credit Support Annex of the Master Agreement of International Swaps and Derivatives Association.

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