PensionsEurope input to the European Commission consultation on the review of the central clearing framework in the EU

March 2022

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General remarks

As the European umbrella organisation representing pensions in Europe, we welcome the European Commission consultation on the review of the central clearing framework in the EU.

For many the European Pension Scheme Arrangements (PSAs), an integral part of their investment approach is to use over-the-counter (OTC) derivatives to manage their financial solvency risk as their liabilities are often long-dated, one-directional and linked to interest rates and/or inflation. PSAs use these derivatives to reduce the risk of retirees not receiving pension income. Prudent risk management is encouraged by regulators and reduces the burden on PSAs' corporate (or other) sponsors. PSAs also invest in high-quality European government bonds to hedge their (euro) liability risks, but their ability to hedge such risks completely with these bonds is limited as the amount of bonds that can be used to match long-dated liabilities is unavailable in the capital markets. Derivatives have the advantage of being available, and for longer maturities. Moreover, they can also be tailored to match the dates of PSAs' liabilities more accurately, which is not generally possible with government bonds. Furthermore, derivatives (such as interest rate swaps) are also the best matching asset for PSAs, as their pension liabilities are discounted using swap rates. Finally, they also may manage currency risk through derivatives.

It is important to note that Article 19.1(e) of the IORP II Directive (2016/2341/EC) stipulates that "investment in derivative instruments shall be possible insofar as such instruments contribute to a reduction in investment risks or facilitate efficient portfolio management".

The main concerns to PSAs to fully switch to clear only with the EU CCPs include the costs related to switching exposures and transition risks. Switching exposures can be costly, as the exposures in UK CCPs have different market values than in the EU CCPs. PSAs need to bear this transition risk when transferring exposure from UK CCPs to EU CCPs, and there are also fixed operational costs in doing transitions. Many PSAs are also worried that there is still no liquid market for interest rate swaps (IRS) in small currencies and other currencies denominated derivatives outside the UK. These derivatives are important for PSAs to manage interest rate risk and other risks, which are mainly in Member States outside the Eurozone.

PSAs have extensive interest rate swap portfolios, and they manage these portfolios mainly for the purpose to mitigate interest rate risks arising from their long-term pension obligations (ca. 20 years on average) to plan members. These derivative portfolios are one directional and long duration in nature. PSAs in Europe have an exemption to clearing until 18 June 2022 cause of the liquidity risks arising from margin calls for cleared transactions. The key challenge for PSAs is the need to post variation margin in cash in case of market stress when they may be required by CCPs to post significant amounts of variation margin. We remain supportive of the intention to clear all derivatives possible. However, **as <u>no solution</u> is found yet for the liquidity risks, we agree with the recent ESMA advice**

(of 25 January 2022) to the Commission that an extension of PSAs' exemption from clearing obligation until 19 June 2023 is still needed to have enough time to find the solution.

Simultaneously, several leading investment banks do have proposed liquidity arrangements to PSAs as a solution to their liquidity risk (large variation margin calls). However, these arrangements tend to be complex, expensive, and only for limited capacity. Most importantly, they are much smaller than the demand from PSAs. Furthermore, we do not believe they really work during times of stress when PSAs need them. This holds true also for PSAs that are not directly or legally affected because the advantage of a clearing exemption does not "reach them" if the collateral management is done via an (100% self-owned) investment vehicles or investment funds. **The best way forward is a structural solution, involving central bank liquidity. Central clearing houses in Europe would suffice to provide (indirect) central bank liquidity utilizing their cleared repo platform.**

Therefore, <u>the solution would be that the European central clearing houses could provide central bank liquidity to PSAs in times of stress to convert high quality government bonds into cash</u>. From a risk management perspective, **the European clearing houses would become then the superior platform to clear derivatives transactions for PSAs**. Currently UK clearing houses and EU clearing houses are similar from a risk management perspective. We are not asking for direct liquidity, just mere (temporary) collateral transformation of (European) government bonds into cash (which are better match for pension funds liabilities than cash). **We are looking forward to continuing good and constructive dialogue with policymakers to structure this to address any concerns central banks may have.**

Furthermore, we think liquidity arrangements (including central bank liquidity) through clearing member or any commercial banks instead of clearing houses will not solve our liquidity issue. The main problem for banks is that necessary liquidity flows, due to large variation margin calls, in times of crisis from some non-banking financial entities, like PSAs, have become too large.

In its recent advice (of 25 January 2022) to the Commission, ESMA also stated that PSAs' exemption from clearing obligation should not be extended beyond 19 June 2023. **When applying the PSAs' exemption according to ESMA's proposed timeline the need for a solution for PSAs becomes urgent.** The proposed solution for PSAs (as described above) involving (indirect) central bank liquidity will help the clearing market on the European mainland and the financial markets in times of stress.

In our answers below, we have particularly focused on the questions which we have found the most relevant to us (and on top of our answers, we have also included the page numbers and the questions).

Answers to specific questions

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Question 1. In the sections below, throughout this document, a range of possible options are presented which could support enhancing the attractiveness of clearing at EU CCPs, thus reducing reliance of EU participants on Tier 2 third-country CCPs, focusing on both the supply side and the demand side of clearing services. Please indicate which ones are the most effective in your view in contributing to the objectives (1 most effective):

Broadening the scope of clearing participants	**2**
Broadening the scope of products cleared	**2**
Higher capital requirements in CRR for exposures to Tier 2 CCPs	**4**
Exposure reduction targets toward specific Tier 2 CCPs	**4**
Macroprudential tools	**3**
Macroprudential tools	**4**
Active account with an EU CCP	**3**
Hedge accounting rules	**3**
Use of posttrade risk reduction services	**3**
Measures to expand the services by EU CCPs	**2**
Payment and settlement arrangements for central clearing	**3**
Enhancing funding and liquidity management conditions	**1**
Interoperability	**3**
Other: Central bank liquidity in times of crisis	**1**

Please specify to what other option(s) you refer in your answer to question 1:

Central bank liquidity in times of crisis
The past years several leading investment banks do have proposed liquidity arrangements as a solution to PSAs' liquidity risks from central clearing. These arrangements include offsetting cash flows and semi-committed repo arrangements. Unfortunately, these arrangements have one common denominator: **they are too complex and expensive.** Moreover, we don't believe they work during times of stress. We believe there need to be **a structural solution to our liquidity risks, involving central bank liquidity to enhance the attractiveness of clearing at EU CCPs.**

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Question 1. What measures (legislative or non-legislative) do you think would be useful in order to make clearing in the EU more attractive for PSAs?

- In order to make clearing in the EU more attractive for PSAs, we believe that European central clearing houses (CCPs) or any other special entity should provide central bank liquidity to PSAs

in times of stress. This can be achieved through conversion of high-quality government bonds into cash. Most likely the cleared repo platform can be used to this end.

- From a risk management perspective, the European clearing houses would become then the superior platform for clearing derivatives transactions for (European) PSAs. Currently UK clearing houses and EU clearing houses are from a risk management perspective similar.
- In addition, there should be sufficient (automatic) porting mechanisms in place for porting between and among normal and sponsored ISA accounts.

Question 2. How could the current offer by EU CCPs, including the direct /sponsored access models which were designed to also specifically address central clearing issues for PSAs, be further improved and/or facilitated?

- To improve the direct /sponsored access models we see four main areas that need attention:
  1. Increase clearing capacity:
     Sponsored/direct access models should be aimed to decrease systemic risk and designed to free up clearing capacity/balance sheet relief at clearing member banks.
  2. Standardisation:
     Standardisation of legal documentation and IT onboarding procedures will help greatly in usage of sponsored/direct access models.
  3. No introduction of new risks:
     Sponsored/direct access models and sponsored access models should not give the obligation to participate in a default process (i.e contribution to default fund, required participation in the auction process of defaulting clearing member book) in any circumstance. This kind of obligation is not allowed for the Dutch PSAs, for instance. PSAs can by law not guarantee external entities.
  4. Synergy advancements:
     Sponsored/direct models should offer synergy; advantages regarding provided collateral across product types. Also, different types of collateral and lower multipliers on initial margin compared to other clearing models will be of great benefit to promote these models and enhance clearing market access.

Question 6. (For PSAs) Do you currently actively clear derivatives at more than one CCP? Yes No Don't know / no opinion / not applicable

- Yes, currently some PSAs are actively clearing derivatives at more than one CCP (for instance at Eurex and LCH), while some others only at one CCP.

Question 6.1 Please specify at which CCPs you currently actively clear derivatives:

- Some PSAs are actively clearing on the central clearing house EUREX. Since the European Commission announced that it desires to onshore euro-denominated clearing activity some of them have decided to clear interest rate swaps on EUREX. However, they do hold several (legacy) positions of interest rate swaps on LCH.

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Question 7: According to your estimation, what amount of Union currency denominated OTC derivatives will be brought to clearing once PSAs become subject to the clearing obligation. What amounts could be brought to clearing in the EU?

- After the exemption expires for the PSAs in, let say June 2023, there is a possibility to clear all derivatives onshore in the EU. However, to realize this the liquidity issues, due to large variation margin (VM) calls in cash PSA face needs to be resolved. We are convinced that only through involving central bank liquidity in times of stress this issue can be resolved. In addition, there should be sufficient (automatic) porting mechanisms in place for porting between and among normal and sponsored ISA accounts.
- Furthermore, due to the introduction of bilateral initial margin, some PSAs are clearing all derivatives that are in scope for the Uncleared Margin Rules (UMR). We believe that in the future also PSAs that are currently out of scope of the bilateral initial margin requirements will start clearing.

Question 1. How do you usually approach a CCP for clearing your cash, derivatives and/or repo contracts?

While we have not done any mapping exercise on this question, we are aware that at least some PSAs are approaching a CCP in the following way:

- PSAs approach a CCP for derivatives via a clearing member (Over-The-Counter and Exchange Traded (Futures) Derivatives)
- PSAs approach a CCP for (reverse) repurchase agreements through a sponsored access model (EUREX ISA Direct)

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Question 3. Do you currently clear at a CCP only derivatives subject to the clearing obligation under EMIR or also other types of derivatives?

- PSAs are currently exempt from the clearing obligation, however some of them already voluntarily clear interest rate derivatives and repurchase agreements.

Question 3.1 Please specify whether these other derivatives are OTC or ETD (or both)

- These derivatives are over the counter and exchange traded.

Question 5. How would you describe your client clearing relationship with a clearing member:
a) in terms of offer of client clearing services, is it easy for you to find a clearing member to access a CCP?

- Yes.
  Explanation: It's easy to find a clearing member to clear your positions if your portfolio size/composition is of interest to clearing members. We do think for smaller PSAs it is very difficult to find a clearing member on their own. They should approach a clearing member together with a big PSA (umbrella construction).

b) Is it expensive? Yes

c) Is it/would it be more difficult/expensive for you to find a clearing member to access an EU CCP?

- No
  Explanation:
  Under the EMIR defined ISA/OSA account structure, its relatively easy to access an EU CCP. For the sponsored models it is more complex and difficult to access an EU CCP. Therefore, we also outlined areas of improvement regarding sponsored access models under question 1 of this consultation.

Question 5.1 Please explain your response to question 5 and provide, where possible, quantitative evidence and examples, including where possible an estimate of the costs under Q5 b) and c):

- The main cost is a cash drag caused by a necessary cash buffer for the cleared derivative positions. The main reason for the cash buffer is that the value change of the cleared derivative positions must be met in cash daily. This cash buffer PSAs would have invested normally in their investment portfolio. Since for bilateral OTC derivative positions PSAs can exchange non-cash variation margin in the form of highly liquid assets (such as government bonds), no cash buffer is necessary and therefore its structurally cheaper.

Question 6. Do you select where to clear or do you rely on the advice of your clearing member?

- PSAs do not rely on advice of clearing members. Currently they have limited options to clear; some PSAs actively clear at Eurex and hold legacy positions elsewhere.

Question 6.1 What considerations are relevant in your choices where to clear?

- PSAs hold long-dated interest rate derivatives to match pension obligations and therefore they have a significant net interest rate exposure to manage. When the European Commission announced they want to strengthen the clearing capacity in Europe some PSAs decided to tailor their clearing activity from London towards Eurex.

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Question 12. Collateral transformation services provided by banks are often used by clients to meet liquidity needs related to margin calls. How do you consider the treatment of repos/reverse repos under the Capital Requirements Regulation: do you think there is room for better encouraging banks to provide collateral transformation services to their clients which clear in the EU?

- PSAs don't believe they can rely on banks for collateral transformation services in times of stress. This is an important reason why central bank liquidity is needed in times of stress to solve the liquidity issues arising from large variation margin calls for PSAs.

<u>**Page 66 (Level playing field):**</u>

Question 1: EMIR applies to entities established and authorised in the EU. As a consequence any requirement to clear partially or totally in EU CCPs could create an un-level playing field where non-EU market participants would continue to have access to third-country CCPs for all of their transactions, e.g. for the clearing of euro-denominated OTC derivatives while EU market participants would be restricted to using EU CCPs. Some stakeholders argue that this could lead to two pools of liquidity serving different interests, one being very local inside the Union and a more international and potentially more liquid one abroad. Furthermore, they argue that those EU market participants that would not be subject to specific requirements to clear inside the Union could choose to continue clearing outside. How in your view could this issue be avoided? Please explain your answer providing, where possible, quantitative evidence and examples including on potential costs and benefits:

- From a buy side perspective EU-clearing has the advantage that settlement can take place at a time where all markets are open. In general, the more clearing market participants, the better it is, as having more clearing participants will make it worthwhile for clearing members to offer relevant services. This will – in theory – promote competition and thus induce a positive development where clearing in the EU becomes advantageous for the buy side.
- In general, the more there are OTC-derivate types that can be cleared, the better it is, as we believe that clearing helps to reduce risks in the financial system. Clearing more derivative types can be also a way to make it worthwhile for more clearing members to offer relevant services, thus contributing to enhance competition. From a buy side perspective, it is of great importance that the costs associated with clearing in the EU are kept at a low level. Higher costs compared to non-EU clearing will seriously reduce the incentives to move more clearing into the EU. For this reason, it is of great importance to promote competition (as mentioned also earlier). It is also important that EU regulatory rules do not require EU-based clearing members to maintain higher costs compared to non-EU clearing members.
- In line with the above, we believe it should be the aim to ensure a level playing field between EU and non-EU clearing members.
- We do not support any rules mandating EU-based PSAs to clear with EU-based clearing members or CCPs. The free flow of capital – into and out of the EU – is of major importance to PSAs, credit institutions, and listed and unlisted undertakings etc. Introducing mandatory

EU clearing would effectively limit competition and thus limit the incentives for EU-based clearing members and CCPs to constantly optimize their business and remain competitive.

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Question 3. With specific reference to question 2, how could end clients which are not subject to the CRR be incentivised? Please explain your answer providing, where possible, quantitative evidence and examples including on potential costs and benefits:

- Regarding capital requirements (in the CRR), in general we believe that they should be as small as possible and reflect the actual risk pertaining to assets and liabilities. Thus, we are generally in favor of lowering capital requirements when this is commensurate with the observed level of risk. We oppose to use capital requirements as a lever per se to obtain politically desirable objectives.

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Question 1. Is the current range of options for funding, liquidity, collateral safekeeping/management, investment sufficient to support the growth of EU based clearing?

- One of our main concerns regarding growth of EU based clearing is that clearing members sometimes ask significant additional collateral amounts (they apply so called "multipliers" on requested initial margin). In some cases, this multiplier is 2.5 times the initial margin normally requested (for example: Clearing House Initial Margin is 100 euro / Clearing Member Initial Margin is 250 euro).
  During contract negotiations we discovered these multipliers are difficult to negotiate. Also, there are clearing members that are able to demand, during market stress, that the initial margin (including the additional collateral amount) must be posted (partially) in cash, instead of non-cash collateral (for example government bonds).

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Question 1. Do you agree that giving a stronger role to EU-level supervision could simplify and accelerate procedures, remove legal uncertainties and possible dual or conflicting instructions, ensure coherent application of EU Regulations, facilitate the coordination with third country supervisory authorities and create a level playing field between EU CCPs?

- Neutral. We believe that the supervision with CCPs should be robust and aligned across Europe and with a view to ensure level playing field both within EU and in comparison, with non-EU clearing members and CCPs. To promote PSAs' clearing – both inside and outside the EU, there must be assurance around the transformation of HQLA assets to cash for VM settlement. Obtaining certainty that EU central banks will support repo markets in times of market stress could be a very serious competitive advantage for EU based clearing.

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About PensionsEurope

PensionsEurope represents national associations of pension funds and similar institutions for workplace and other funded pensions. Some members operate purely individual pension schemes. PensionsEurope has **25 member associations** in 18 EU Member States and 4 other European countries[1].

PensionsEurope member organisations cover different types of workplace pensions for over **110 million people.** Through its Member Associations PensionsEurope represents **€ 5 trillion of assets** managed for future pension payments. In addition, many members of PensionsEurope also cover personal pensions, which are connected with an employment relation.

PensionsEurope also has **19 Corporate and Supporter Members** which are various service providers and stakeholders that work with IORPs.

PensionsEurope has established a **Central & Eastern European Countries Forum (CEEC Forum)** to discuss issues common to pension systems in that region.

PensionsEurope has established a **Multinational Advisory Group (MAG)** which delivers advice on pension issues to PensionsEurope. It provides a collective voice and information sharing for the expertise and opinions of multinationals.

What PensionsEurope stands for

- A regulatory environment encouraging workplace pension membership;
- Ensure that more and more Europeans can benefit from an adequate income in retirement;
- Policies which will enable sufficient contributions and good returns.

Our members offer

- Economies of scale in governance, administration and asset management;
- Risk pooling and often intergenerational risk-sharing;
- Often "not-for-profit" and some/all of the costs are borne by the employer;
- Members of workplace pension schemes often benefit from a contribution paid by the employer;
- Wide-scale coverage due to mandatory participation, sector-wide participation based on collective agreements and soft-compulsion elements such as auto-enrolment;
- Good governance and alignment of interest due to participation of the main stakeholders.

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[1] EU Member States: Austria, Belgium, Bulgaria, Croatia, Denmark, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Luxembourg, Netherlands, Portugal, Romania, Spain, Sweden. Non-EU Member States: Iceland, Norway, Switzerland, UK.