EACH response to the ESMA First Report for Consultation "Central Clearing Solutions for Pension Scheme Arrangements"

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Introduction

The European Association of CCP Clearing Houses (EACH) represents the interests of Central Counterparties (CCPs) in Europe since 1992. CCPs are financial market infrastructures that significantly contribute to safer, more efficient and transparent global financial markets. EACH currently has 19 members from 15 different European countries. EACH is registered in the European Union Transparency Register with number 36897011311-96.

EACH appreciates the opportunity to provide feedback to the ESMA First Report for Consultation on Central Clearing Solutions for Pension Scheme Arrangements (hereinafter called "The consultation").

Section 4.1 – Why pension funds use derivatives

Q4: Do you think that PSAs fulfilling the clearing requirement would have significant consequences on their investment strategies, including any shift in their cash and non-cash asset allocation? Please elaborate on the reasons for your answer and provide numerical data supporting your answer where available.

EACH agrees with the description of the challenges faced by the PSAs, but would like to add that central clearing of Interest Rates Swaps (IRS) coupled with access to CCP cleared repo markets has the potential of providing other benefits to PSAs such as, for instance, increasing netting efficiency, decreasing capital requirements reducing risk, as well as reducing settlement fails.

Q5: Are there further considerations, other than investment strategies mentioned above, either driving or constraining the use of derivatives for PSAs?

EACH would like to highlight that one additional challenge for PSAs consists in clearing members' concentration, an aspect that could limit client clearing services. However, we note that gaining access to cleared repo facilities through direct or sponsored membership models addresses the concentration issue and provides the appropriate tools to turn non-cash into cash collateral for PSAs' further usage.

Section 4.2 – Why central clearing requirement to post variation margin in cash poses serious challenges for PSAs?

Q6: **Do you agree with the description of the challenges met by PSAs to post variation margin in cash? Please elaborate on the reasons for your answer.**

PSAs find it challenging to post variation margin (VM) in cash mainly due to the composition of their investment portfolio which consists mainly of high graded government bonds with long maturities.

While EACH agrees with the challenges met by PSAs to post VM in cash indicated in the consultation paper, EACH would like to reiterate that PSAs could mitigate these challenges by accessing centrally cleared repo markets.

EACH understands that PSAs are currently using clearing members to access CCPs for many reasons that go well beyond liquidity (e.g. having the technical operational infrastructure to access a CCP, participation to a default fund, etc.). This type of connectivity addresses the liquidity problem as they can use a clearing members' balance sheet capacity to satisfy their cash VM requirements. Additionally, sponsored clearing models can provide PSAs access to the repo market directly by getting sponsored into the service by a bank who acts as its sponsoring agent to enable them to turn non-cash into cash collateral for their VM purposes.

Section 5 – Exemption of clearing for PSAs

Q13: **Do you agree that the central clearing of OTC derivatives by PSAs by June 2023 at the latest is the ultimate aim? Do you agree that the entry into force of this requirement should be subject to regulatory and market developments enabling market participants to develop appropriate technical solutions within that period? Please elaborate on the reasons for your answer**.

As the operators of CCPs, EACH Members are indeed very well aware of the benefits brought by clearing services to financial stability namely, among others, the potential to reduce the counterparty credit risks that financial market participants face when they enter into transactions as well as contribute to improving efficiency in financial markets by providing multilateral netting of trades. EACH is therefore in favour of providing the right solutions for PSAs to benefit from the robust and efficient CCP clearing environment. However, we also recognize that the application of a requirement for PSAs to clear through CCPs should be preceded by a thorough analysis of the possible regulatory and market developments enabling market participants to develop appropriate technical solutions to be considered eligible for accessing clearing services.

In this context, we believe that the current exemption elapsing in June 2021 should allow sufficient time for PSAs and the broader industry to address these concerns and set up their clearing arrangements. While viable solutions to mitigate the challenges by PSAs described in the consultation paper have been developed since the exemption has been granted, the progress for adopting these solutions and ensuring readiness has been limited. Hence, a defined end date for clearing is important to ensure continued progress on the readiness process. Therefore, the possibility to extend the exemption by one year twice should only be used as a last resort.

This is due to the fact that a continued delay of the clearing obligation would have multiple downsides as:

- Repeated delays diminish on-going pressure for regulatory compliance, decrease efforts to genuinely find a working solution and most importantly, punish those who have been leading efforts to abide by the rules.

- Multiple exemptions to the clearing obligation diminish its efficiency and do not enable participants to reap the full benefits in terms of netting and margin efficiency, which are increased with an increased number of participants in the system.

Moreover, and perhaps most importantly, a further delay of clearing would mean that PSAs remain continuously exposed to counterparty credit risk. As the clearing obligation is a two-way street, PSAs are today exposed to the potential default of typically larger and more systemic counterparties. In addition, the continuous delay of the Uncleared Margin Rules (or bilateral margins) also means that most PSAs remain inappropriately collateralized in the uncleared space and therefore continuously underprice their risk exposure.

Therefore, we would like to reiterate that PSAs can mitigate the challenges on the cash management front by accessing the centrally cleared repo market via existing direct clearing access models. Some European PSAs already make use of direct clearing access models to access the liquid CCP cleared repo markets, as European centrally-cleared repo markets are of significant size and proved ample liquidity to market participants even in times of extreme market stress.

Q14: **In the hypothetical scenario where the exemption were to be made permanent, do you think that there would be a price handicap for less-liquid non-cleared contracts vis-à-vis the cleared alternatives? Can you provide estimates of the size of the price differential and the impact, also in terms of yield drag on PSA portfolios?**

We believe that if an exemption were to be made permanent, PSAs could be faced with lower risk weights for cleared trades with a CCP against higher risk weights in the uncleared market. Such differentiation in risk weights could have an impact on the underlying portfolios for the end users of PSAs if they are unable to access cleared markets.

Q15: **Under the new regime provided in EMIR Refit with respect to the scope of application of the clearing obligation and the calculation of the positions, do you expect to be or not subject to the clearing obligation once the clearing exemption has come to an end?**

As explained in our answer to Question 13, we encourage the application of the clearing obligations for OTC derivatives by PSAs in the near future, following a thorough assessment of the pension funds' needs and reality.

As part of the EMIR REFIT, EACH had acknowledged the introduction of a clearing threshold as an attempt to strike the right balance between financial stability considerations and the costs of setting up clearing arrangements for the smallest financial counterparties. In this light, EACH believes the smallest pension funds could therefore still be exempt, even after the clearing exemption for PSAs expires.

EACH also notes that EMIR REFIT specifies that ESMA has the power to periodically review the clearing thresholds to ensure proper risk management and monitor that these do not lead to a systematic underestimation of the positions of funds or a circumvention of the clearing obligation.

EACH is particularity concerned by the inconsistency of the aggregation level of the clearing threshold between group and fund levels under the current threshold methodology, which could have serious negative implications for the overall systemic risk and broader financial stability, as even significant funds could fall out of the scope leaving the clearing ecosystem unbalanced. The clearing ecosystem benefits from a healthy balance between "fixed payers" and "fixed receivers". The more of them that clear, the more they are likely to meet opposite trades, be able to net and build liquidity. Funds, including pension funds in particular, play a vital role in this context, as they typically seek directional and long-dated exposures. EACH understands that this is one of the reasons why other G20 jurisdictions have decided against allowing such broad and long-lasting exemptions.

Section 6 – Solutions explored so far to facilitate PSAs to centrally clear their OTC trades

Q16: **Do you agree with the pre-conditions for a workable solution as described in paragraph 51? Please elaborate on the reasons for your answer.**

Yes, EACH agrees with the pre-conditions for a workable solution as described in paragraph 51 of the consultation. As already mentioned, we are indeed in favour of a solution that takes into consideration the reality that pension funds need to face due to their nature and their purposes. We are in particular supportive, as explained in paragraph 51, of an option that "*is robust enough to be relied upon in both normal and stressed market conditions*" and would not expose CCPs and clearing members to unnecessary risks.

Regarding the posting of cash for the purpose of meeting variation margin calls, EACH Members agree with the analysis and conclusions included in section 6.1 of the consultation paper. We also would like to underline that it is not so much that CCPs would not accept VM in other forms than cash, but rather that the whole constructions of CCP's VM risk management would need to be changed, as clearing members would also need to accept types of collateral other than cash, and this would represent a major – and not easy to address – change to their processes as well as the risk management framework put in place by CCPs, with potential consequences in the robustness brought by CCPs to the market.

However, as outlined in our response to Q13, it is important to highlight that some workable solutions, such as the sponsoring clearing model, already exist and that the cleared repo market has proven its resilience and liquidity even in situations of extreme market volatility over the last 15 years.

Q17: Are there any other features that the solution should try and achieve?

To ensure a complete cost-benefits analysis, EACH believes that the costs for PSAs of centrally clearing should not be compared with today's situation where PSAs benefit also from exemptions in the uncleared space, but rather with a situation where all capital and margin requirements apply to PSAs in the bilateral space in line with the G20's incentives to clear.

Section 6.2 – Relying on the ancillary services of collateral transformation of clearing members

Q18: **Do you agree with the statement that no or few PSAs were onboarded with the status of clearing members, but instead clear as direct clients of a clearing member? Do you think that this situation may evolve in the coming years? Please elaborate on the reasons for your answer.**

Yes, EACH agrees with the statement that only a limited number of European PSAs are today a direct member of a CCP. However, EACH is of the view that there are good reasons to believe there would be a significant take up of PSAs, as direct CCP members via direct access or sponsored models as the pick-up of such models by the buy-side in the US has been significant.

However, we believe this process has been slower in the EU due to various regulatory reasons, namely the continued delay of PSA clearing obligation, but also the lack of incentives to clear (i.e. delay of phases V and VI for initial margin requirements in bilateral space but also lack of a consistent counterparty limits or capital requirement for the buy-side using CCPs). Please also refer to our answer to Question 21 for EACH's recommendations how to create regulatory incentives for the buy-side as well as clearing members to engage more actively in direct or sponsored access models.

Q19: **Do you agree that relying on collateral transformation services already offered by clearing members to their direct clients may be part of the solution? Please elaborate on the reasons for your answer.**

It is EACH Members' opinion that relying on collateral transformation services already offered by clearing members to their direct clients may be a robust and acceptable solution from the operational point of view. However, it is important to underline that such solution contains certain limitations, among which the leverage ratio and its impact on banks' balance sheets as described in the consultation paper.
As already mentioned, an alternative solution around leverage ratio may be direct access of PSAs to CCPs via a sponsored access of a general clearing member (GCM).

Q20: **To what extent has the constraint on the bank clearing members' capital requirements been eased and now allows for their role of collateral transformation to be better fulfilled?**

While – as specified in the consultation – the amendment of the Capital Requirement Regulation in May 2019[1] as well as the changes brought by the Basel Committee on Banking Supervision ('BCBS')[2] have changed the leverage ratio treatment of client cleared derivatives, such that to "*permit cash and non-cash forms of initial and variation margin received from a client to offset the replacement cost and potential future exposure for client cleared*

[1] OJ L 150, 7.6.2019, p. 1–225, Recital 12: "A leverage ratio should also not undermine the provision of central clearing services by institutions to clients. Therefore, the initial margin on centrally cleared derivative transactions received by institutions from their clients and that they pass on to central counterparties (CCPs), should be excluded from the total exposure measure."
[2] BCBS 'Leverage ratio treatment of client cleared derivatives' - June 2019

derivatives", such measures have only been recently implemented, and more time is necessary to assess whether this change has been successful.

Q21: **Do you think that modifying the calculation of the leverage ratio might have an impact on the offer on repo intermediation activities by banks and be a part of the solution? Please elaborate on the reasons for your answer.**

Yes, it is logical to expect that reducing the leverage ratio impact of a securities financing transaction may increase the availability of repo to PSAs. However, as an association representing risk managers, EACH is skeptical to any further changes to the leverage ratio as these could limit its function as a backstop to excessive leverage building.

Instead, EACH believes that other capital changes could be proposed to incentivize clearing for the buy-side and address existing regulatory barriers without building excessive leverage. The existing barriers that we note are the following:

- Counterparty limits of 15% per counterparty for EU MMFs and 20% for UCITS/AIFs do not include a specific treatment for central counterparties (though they are the buyer and seller to centrally cleared trades);
- Counterparty limits for UCITS/ AIFs do not recognize valid netting sets across products, i.e. counterparty exposures from derivatives and securities financing are calculated on a gross basis even if a valid netting agreement exists. In effect, UCITS are currently not allowed net exposures when using repo markets to raise cash to meet cash VM requirements from centrally cleared derivatives.
- UCITS/AIFs that have received collateral via title transfer in a SFT are prohibited to pledge back this collateral to the provider, even if the collateral is held bankruptcy remote from the initial collateral provider;
- Insurers or pension funds which are direct members of the CCP are not allowed under Solvency II to apply the same preferential risk weights afforded to clearing members under CRR II.

The cumulative impact of these regulatory barriers has acted as a disincentive in the uptake of clearing for SFT markets by the buy-side.

Q22: **Can you elaborate on issues you have encountered, or risks you perceive, in relying of clearing members to provide collateral transformation services, including transformation into cash to meet variation margin requirements? Is this a service that is available to you? If not, what are the obstacles?**

EACH would like to point to the overall resilience of the European repo markets, even during the recent peaks of uncertainty and strain on financial markets. According to the ICMA European Repo and Collateral Council (ERCC) April 2020 Report[3] which states that "*the European repo market, for the most part, has 'held up well' during the market turbulence stemming from the global COVID-19 pandemic*". In particular, CCP cleared repo markets were resilient as shown in the day-by day analysis.

[3] https://www.icmagroup.org/assets/documents/Regulatory/Repo/The-European-repo-market-and-the-COVID-19-crisis-April-2020-210420.pdf

Section 6.3 – The market-based repo solution

Q23: **What is your view on solutions based on collateral transformation via the repo market? Do you think that initiatives on collateral transformation solutions via the repo market constitute one possible solution? What other solutions are worth exploring?**

EACH is of the opinion that a collateral transformation via the repo market could be a suitable and sustainable solution for PSAs. Repo markets in the EU are deep liquid markets which have admirably weathered multiple crises (e.g. Great Financial Crisis, Euro sovereign debt crisis, Covid-19).

As per the ICMA/ERCC April 2020 Report, buy-side firm have been successful in managing their liquidity through the early part of March by offsetting fund outflows with positive margin inflows. EACH believes that any potential bottleneck effects via clearing members could be successfully addressed via direct access or sponsored models to facilitate these processes.

EACH believes that this solution does not need to be dependent on the one of PSAs' access to central banks' liquidity in times of market stress as described in section 6.4 of the consultation paper.

Q24: **Do you think that the repo market is suitable for PSAs' needs? If not, what are the impediments for PSAs to access the repo market? Please elaborate on the reasons for your answer, specifying if these are related to cost, operational complexities or regulatory constraints.**

Yes, given the depth and liquidity of EU cleared repo markets, EACH believes they are suitable to help PSAs with their liquidity needs. Even in times of stress, EU cleared repo markets have been particularly resilient and supported other types of financial counterparties to perform their VM payment smoothly.

Q26: **Do you think that PSAs fulfilling their liquidity needs via the repo market will have strong implications on this market's liquidity and procyclicality? Can you provide quantification of the risk of the likelihood of a failure of market-based repo solutions to meet PSAs' needs? Under which conditions?**

As per our previous response, EACH believes that the 13 last years have been rich of 'live tests' which have tested the liquidity of EU centrally-cleared repo markets with major destabilizing events such as the Lehman Brothers collapse, the Brexit referendum or most recently the Covid-19 crisis. Instead of shrinking, EU cleared repo markets act as safe-havens and usually witness an increase of volumes in times of crisis. Based on the experience, EACH concludes there is little reason to believe such markets would be subject to liquidity squeezes or have pro-cyclical repercussions.

Section 6.4 – Access to alternative emergency liquidity arrangements

Q27: **Do you think that there is agreement or evidence that the impact of the limitations of the solutions explored so far would be such that there is a need for devising and**

developing some form of emergency liquidity tools? If so, under which scenarios and how could such tools actionably and realistically be deployed?

It is EACH's opinion that the discussion on whether or not to develop emergency liquidity tools should occur only at central banks' level.

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