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REPORT FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT AND THE COUNCIL

under Article 85(2) of Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories, as amended by Regulation (EU) No 834/2019, assessing whether viable technical solutions have been developed for the transfer by pension scheme arrangements of cash and non-cash collateral as variation margins and the need for any measures to facilitate those viable technical solutions

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1. INTRODUCTION

Regulation (EU) No. 648/2012 (the European Market Infrastructures Regulation, EMIR) provides for a temporary exemption from the central clearing obligation for entities operating pension scheme arrangements (PSAs), in relation to certain types of OTC derivatives[1]. The temporary exemption is intended to take into account the specific features of the business model of such entities and the impact mandatory clearing could have on pensions: entities operating pension scheme arrangements typically minimise their allocation to cash in order to maximise the returns for their policy holders. Hence, there is a risk that requiring PSAs to clear OTC derivative contracts centrally may lead to PSAs divesting a significant proportion of their assets for cash in order for them to meet the margin requirements of CCPs, with a potential negative impact on the retirement income of pensioners. The temporary exemption is intended to provide time for PSAs, central counterparties (CCPs) and clearing members to find a viable technical solution, which would allow PSAs to clear centrally at CCPs while avoiding materially adverse effects on pensioners' income.

EMIR Refit, which entered into force in June 2019, extended the exemption until June 2021, with further potential extensions through Commission delegated acts twice, each time by one year maximum. The ultimate aim of the Regulation, however, remains central clearing for PSAs as soon as possible. CCPs, clearing members and PSAs are required to do their utmost to contribute to the development of viable solutions.

As required under EMIR Refit, the European Commission set up an expert group including representatives of CCPs, clearing members, PSAs and other relevant parties, so as to monitor their efforts and assess the progress made towards finding viable technical solutions. The expert group, which also includes representatives of central banks, European Securities and Markets Authority (ESMA) and European Insurance

[1] Under EMIR, PSAs include Institutions for Occupational Retirement Provisions (IORPs) as defined under Art. 6(a) of Directive 2003/41/EC, the occupational retirement provision businesses of institutions under Art. 3 of that Directive, the occupational retirement provision of insurance undertakings covered by Directive 2002/83/EC (under certain circumstances), as well as other authorised and supervised entities or arrangements operating on a national basis whose primary purpose is to provide retirement benefits. The exemption concerns OTC derivatives which are objectively measurable as reducing investment risks that directly relate to the financial solvency of PSAs. It also applies to entities established to provide compensation to members of such arrangements in case of default, and PSAs which encounter difficulties in meeting the variation margin requirements (Art. 89 EMIR).

and Occupational Pensions Authority (EIOPA), met in October 2019 and in April and November 2020.

Article 85 of EMIR Refit requires the Commission to prepare yearly reports until the final extension of the exemption, assessing whether viable technical solutions have been developed for the transfer by PSAs of cash and non-cash collateral as variation margins and the need for any measures to facilitate those viable technical solutions. The Regulation also establishes that ESMA, in cooperation with European Banking Authority (EBA), EIOPA and the ESRB, shall submit annual reports to the Commission assessing the issue.

ESMA delivered a first report to the Commission in April 2020. A first Commission Report[2], issued in September 2020, included a comprehensive analysis of the issues surrounding central clearing by PSAs.

ESMA held a public consultation from April to June 2020 to gather a broad range of views and data on the topic. The results of the public consultation were included in ESMA's second report to the Commission in December 2020, which was prepared in cooperation with the EBA, EIOPA and the ESRB.

This is the second Commission Report under Article 85 of EMIR Refit. It presents the progress made, based on the discussions held in the Commission expert group and on the input provided by the ESAs and the ESRB through their reporting to the European Commission.

2. CONTEXT

The PSA landscape in the EU is diversified. The largest PSA markets in the EU are to be found in the Netherlands, with an average ratio of assets to GDP of 173.3%, and in Denmark, with a ratio of 198.6% - according to end-2018 data[3]. Ireland also has similar schemes in place. According to data provided by ESMA[4], Dutch PSAs accounted for 70-80% of the notional amount of derivatives of all EU pension funds as of end-March 2020. PSAs largely use derivatives to hedge their liabilities from a number of risks.

The first Commission Report took stock of the situation with respect to PSA central clearing. It illustrated that, as emerged from the discussions within the Commission expert group, the need to post variation margin in cash can be problematic for PSAs particularly in stressed market conditions, when variation margin calls by CCPs can be significant. In recent times, some pension funds have started clearing centrally part of their derivatives portfolio on a voluntary basis, typically as clients of clearing members.

2 "Report from the Commission assessing whether viable technical solutions have been developed for the transfer by pension scheme arrangement of cash and non-cash collateral as variation margins and the need for any measures to facilitate those viable technical solution", COM (2020) 574 final.

3 ESMA, "First Report for consultation – Central Clearing Solutions for Pension Scheme Arrangements", April 2020.

4 ESMA, "Report to the European Commission – Report on the Central Clearing Solutions for Pension Scheme Arrangements (No. 2)", December 2020.

Some of them also started using solutions designed by certain CCPs[5] to facilitate central clearing by PSAs, namely so-called "facilitated" access models to their cleared repo platforms. Such models should improve PSAs' capacity to resort to the repo market for their liquidity needs[6]. The move towards central clearing has also been increasing overtime due to requirements applicable to bilateral trades, which are expected to increase the liquidity available in the central clearing space vis-à-vis the bilateral one[7].

The Report also highlighted the difficulties which PSAs may face in accessing the repo market to source liquidity in times of stress, which may be also linked to the fact that clearing members are not always willing or able to provide collateral transformation services to PSAs in stressed market conditions.

3. MAIN OUTCOMES OF ESMA'S PUBLIC CONSULTATION AND FURTHER DISCUSSIONS WITH STAKEHOLDERS

3.1 Outcomes of ESMA's public consultation

The outcomes of the public consultation held by ESMA broadly confirmed the overall analysis included in the first Commission Report and provided additional opportunity to complement the findings with further quantitative data. ESMA received responses[8] from a broad range of stakeholders, including among others asset managers (which have PSAs as their clients), trade associations, central counterparties. The range of stakeholders who replied to the consultation was diverse, enabling the collection of a wide range of views on different aspects of the possible solutions. According to ESMA's analysis, consultation responses confirm that a large majority of stakeholders are looking forward to a situation in which PSAs would be able to clear centrally and that a majority of PSAs do want to clear.

The consultation confirmed that some PSAs are already voluntarily clearing a part of their portfolio, including in order to avoid being caught under the rules on initial margins for bilateral trades. They do so as clients of clearing members. In certain cases, PSAs also make use of facilitated access to the cleared repo markets offered by certain CCPs. According to data reported to ESMA by the Dutch National Bank[9], the clearing rates for Euribor and Libor interest rate swaps (IRS) for the Dutch pension funds in the third quarter of 2020 amounted to 22% on average for large pension funds (ranging

5 In the EU, Eurex Clearing has established such a model, possibly also together with "facilitated access" to the cleared OTC market. To the Commission best knowledge, LCH SA is also in the process of developing a "facilitated access" solution. See COM (2020) 574 final.

6 A repurchase agreement ("repo") is an agreement to sell securities at a given price combined with an agreement to repurchase those securities at an agreed price at a later date. The repo market brings together firms which provide collateral in exchange for cash and firms which provide cash in exchange for collateral.

7 ESMA, "Report to the European Commission - Report on the Central Clearing Solutions for Pension Scheme Arrangements (No. 2)" , December 2020.

8 ESMA received 19 individual or trade association responses, including 2 confidential ones, and 1 joint response from 10 stakeholders from the pension fund industry.

9 Based on EMIR reporting data.

from 3 to 26%), 25% on average for middle-large pension funds (ranging from 0 to 46%) and 37% on average for small pension funds (ranging from 0 to 100%). The data shows broad variability across firms. In Denmark, according to analysis by the Danmarks Nationalbank, Danish PSAs clear at a CCP approximately 42% of their interest rate derivatives – also with considerable variability across firms.

PSAs find benefits in central clearing, irrespective of the upcoming obligation to do so. According to ESMA, as the main advantage they quote liquidity which characterises cleared products, execution efficiencies and other cost considerations. Some respondents to the public consultation indicated that already now PSAs experience a difference in cost between bilateral and centrally cleared contracts. They reported that executing a bilateral 30-year IRS with a 50-million nominal amount can have a marginally higher cost than executing a centrally cleared 30-year IRS, and that unwinding the former can be more expensive.

The consultation also confirmed that the main challenge with respect to central clearing for PSAs is the issue of the cash variation margin. Other challenges which have been mentioned include the cost of clearing, which would be linked to the amount of capital banks are required to hold vis-à-vis client positions under the bank capital rules; the possibility for clearing members to terminate the contracts with their clients at a short notice[10] and the issues PSAs may encounter if their large positions needed to be ported to another clearing member. It is to be noted, however, that in the bilateral clearing space PSAs may also be exposed to the default of their trading counterparties.

Overall, participants to the consultation agree that the solution to the issue of PSAs central clearing should strike the right balance between the objectives of financial system resilience and not imposing disproportionate costs to pensioners, and should be able to work in both normal and stressed market conditions.

3.2 Potential impacts of migration towards mandatory central clearing

The quantitative information collected by ESMA through the public consultation provides an overview of the potential impact of central clearing for PSAs in terms of: i) initial margin; ii) cash allocation; iii) yield drag; and iv) liquidity impacts in case of stress.

i) Impact on initial margin

According to a 2018 study by ISDA and PensionsEurope, a clearing mandate capturing Dutch and Danish pension funds would increase cleared initial margin (IM) by approximately EUR 7.4 billion if only new trades had to be cleared, by EUR 26 billion if 50% of the back-book were to be cleared, and by EUR 44 billion if all the back-book were to be cleared[11].

10 Client clearing contracts often contain a 90-day termination notice clause.
11 PensionsEurope and ISDA, "Potential demand for clearing by EU pension funds", 2018.

Furthermore, large PSAs could be assessed as large risk contributors by CCPs, as they often carry one-directional swap positions. One of them reported to ESMA that its additional liquidity add-ons on initial margin could be so significant that it could consider setting a ceiling on the number of swaps it would be able to clear[12].

ii) Impact on cash allocations

The expiry of the central clearing exemption could oblige PSAs to set aside cash to allow them to handle potential margin calls. In case of derivative exposures, this reduces counterparty credit risk, but simultaneously increases liquidity risk. In the prevailing low-yield environment, holdings of cash and other liquid assets have become increasingly costly. In the case of investment funds, this has incentivised them to reduce such holdings[13]. The public consultation indicated that while some pension funds hold approximately 2% of assets in cash, others have a zero strategic allocation to cash. ESMA's report, based on response to the public consultation, shows that if a PSA wanted to be able to meet 99.8% of variation margin calls, and assuming that 30% of its cash allocation is available on a one-day horizon, it would need to allocate 7.8% of its assets to a cash portfolio. This amount would rise to 10.9% should it want to be able to meet 99.95% of variation margin calls, and would decline to 5.3% should it want to be able to meet 99% of the calls.

iii) Potential reduction in returns

An extra allocation to cash by PSAs to meet potential margin calls would mean a reduction on annual returns. The ESMA report suggests that should a PSA have to allocate 5% - 10% of its investment portfolio to cash, the resulting reduction in annual returns could be approximately 0.17% - 0.33% annually in the current low interest rate environment (with returns around 3.17%)[14]. If historical returns are considered instead (around 6% for the Dutch pension sector over the last 15 years, according to OECD data), the reduction would be in the range of 0.3-0.6%.

Other asset managers responding to the consultation reported that their PSA clients already hold a sizeable cash buffer and as such the costs for them of funding temporarily high liquidity demands would be very low.

In this regard, it should also be kept in mind that pension funds are likely to face a prolonged period of low returns and may find it difficult to match historic returns. Even if recent monetary policy action by central banks have reversed significant asset price declines, pension funds are likely to face lower interest rates over the medium- to long-term. The challenge will be to match historic returns in a potentially volatile, low interest rate environment. In such a scenario, even moderate yield drag may unfavourably impact on returns for pensioners. For instance, ECB analysis[15] shows that

12 ESMA, "Report to the European Commission - Report on the Central Clearing Solutions for Pension Scheme Arrangements (No. 2)", December 2020.
13 ECB, "Financial Stability Review", May 2020.
14 From responses to ESMA's consultation.
15 ECB, "Financial Stability Review", May 2020.

in the case of insurers should the current interest rate environment continue, average coupon income is projected to decline from 2.8% in 2019 to 1.7% in 2030, as securities that yield higher returns mature. Guaranteed rates are also estimated to decline.

iv) Liquidity impact in case of stress

The liquidity needs of PSAs to meet variation margin under a stress scenario based on a 1% shift in rates was discussed in the first Report by the Commission[16], which reported data from an Economic and Bourse Consult study of 2014 and recent Eurosystem analyses on the issue[17]. An increase in interest rates would trigger CCP variation margin calls on pension funds' interest rate swap portfolios. Using Dutch pension funds as an example (they hold around 89% of IRSs of euro-area pension funds, according to data available to the Eurosystem), the Eurosystem simulated the impact of a one-day +100 basis point parallel shift in the yield curve. Under the simulated stress scenario, variation margin calls on interest rate swaps held by Dutch pension funds could be between EUR 36 billion and EUR 47 billion, resulting in an aggregate cash shortfall of EUR 6 billion to EUR 15 billion (for the whole euro-area pension funds, this could amount up to EUR 17 billion). At the upper bound estimate, 55% of Dutch pension funds would not have sufficient cash to cover their variation margin calls. The shortfall would be concentrated within a small number of funds with relatively low variation margin payments.

Responses to ESMA's public consultation in this regard show that, under a scenario of 100 basis point shift in rates, the cash variation margin requirement would amount to circa EUR 95bn across Dutch, Danish and Irish PSAs using swaps.

During the recent Covid 19 market turmoil, the daily variation margin calls on funds' derivative exposures rose fivefold[18]. Using investment funds as an example and based on the partial reporting of variation margin in EMIR data, the daily variation margin calls on euro area funds increased from around EUR 2 billion in the first half of February 2020 to over EUR 10 billion in the week beginning 16 March 2020. The highest increase – by around 6.5 times – was reported on portfolios composed of equity derivatives, followed by interest rate derivatives (fivefold increase) - which are the ones PSAs most typically hold - and currency (fourfold increase) portfolios. There is evidence that to meet margin calls, some euro area insurers and pension funds liquidated shares held in money market funds.

It seems a substantial number of euro area investment funds have faced liquidity strains from the high margin calls, but they were generally able to meet them[19]. The interest rates cuts and bond buying programmes from central banks contributed to insulating

16 COM(2020) 574 final of 23rd September 2020.
17 ECB, "Financial Stability Review", May 2020.
18 ECB, "Financial Stability Review", May 2020.
19 ECB, "Financial Stability Review", May 2020.

market participants, including pension funds, from some of the worst potential impacts of the crisis. Furthermore, it seems funds could raise cash during the turmoil by engaging in repo transactions, selling assets (e.g. money market fund shares) or drawing on credit lines. However, as illustrated in the first Commission report, strains were reported in accessing liquidity for pension funds.

In the analysis above, assuming PSAs could source their additional cash needs under the designed stress scenario via the repo market, the liquidity needs of euro-area PSAs would remain small as compared to the amount of reverse repo transactions outstanding (a proxy for the size of the European repo market). Outstanding reverse repo transactions in December 2019 amounted to about EUR 1.9 trillion. Assuming that the borrowing needs of other Euro area PSAs are similar to those of Dutch PSAs, the cash borrowing needs for all Euro area PSAs would be likely to remain below 2% of the overall outstanding reverse repo transactions[20].

According to ESMA, and as also reported by ICMA[21], the EU repo market, for the most part, held up well during the Covid-19 market turmoil. Nevertheless, repo markets faced some adverse conditions at the height of the crisis in February/ March, as demand for repo increased and the dealers capacity to intermediate that demand was relatively constrained[22]. This may have limited the ability of many firms to access the repo market, which was needed to manage intraday liquidity and collaterals. According to some sources, an illiquid money market impaired the intermediation of liquidity from banks to non-banks[23]. Overall, as reported by ESMA, the cleared repo markets operated efficiently and effectively throughout the crisis, providing continued access to derivative products – even if not without spikes in margin calls.

Going forward, repo markets are likely to continue playing a central role in meeting the central clearing challenge; however, pension fund participation in repo markets in Europe remains muted, especially when compared to the US[24].

3.3 Initiatives proposed in the public consultation

In order to promote progress towards central clearing for PSAs, respondents to the public consultation proposed some initiatives, as illustrated in ESMA's report. Such initiatives mostly aim at improving the solutions currently used by PSAs to clear centrally, that is client clearing and CCPs' facilitated access models. These are emerging as the two axes around which the next steps of this work should focus.

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20 COM(2020) 574 final of 23rd September 2020.

21 International Capital Market Association, "The European repo market and the Covid-19 crisis", April 2020.

22 International Capital Market Association, "The European repo market and the Covid-19 crisis", April 2020.

23 D'Avernas, A., Vandeweyer, Q. and Darracq Pariès, M. (2020), "Unconventional monetary policy and funding liquidity risk", Working Paper Series No 2350.

24 Eurex, "Derivatives markets after the Covid-19 crisis - A review of the Digital Derivatives Forum", 2020.

As for client clearing, input included in ESMA's report and discussions within the Commission expert group show that enhancing clearing members' capacity to provide collateral transformation services to their direct clients would be beneficial to improve PSAs' access to liquidity when needed. Banks are well positioned to facilitate collateral transformation and have been doing this for a long time.

As indicated in ESMA's report, banks pointed to some constraints which make it harder for them and for PSAs to support the clearing obligation for PSAs: these relate in particular to the leverage ratio, risk-weighted assets, funding. In particular, as illustrated in ESMA's report based on the public consultation, a more favourable capital treatment for repos/reverse repos would help stimulate repo activity.

As for facilitated access models offered by CCPs, such modes are already being used by some large PSAs to access the cleared repo market. According to CCPs participating in the public consultation, such a solution would require a clear signal by regulators, via regulatory amendments and a clear end-date for the PSA clearing exemption, for such a solution to be more broadly adopted. Some asset managers with large PSAs as clients reported that these types of models are an encouraging avenue, and some respondents pointed to the reliability of EU cleared repo markets over the years in terms of available liquidity, also in times of stress. Some further operational improvements could be brought to such CCP solutions in order to better meet the needs of PSAs: on the CCP side, it emerged from the consultation that further improvements could be envisaged.

A number of regulatory measures were thus proposed by the respondents to the consultation. In particular, the following proposals from stakeholders are mentioned in ESMA's report:

- A more favourable treatment of repos/reverse repos in the context of the leverage ratio;
- A re-calibrated methodology for the calculation of the leverage ratio, so as to avoid window-dressing by banks at specific reporting deadlines during the year[25];
- Consider establishing a specific category of exposures to pension funds, with reduced risk weights (better reflecting their high creditworthiness);
- Address specifically the role of clearing agents (the banks which allow PSAs to access CCPs in the context of the facilitated access models) in banking regulation;
- Under Solvency II, consider granting to PSAs and insurance companies which are direct members of a CCP in the context of facilitated access models the same preferential treatment which is available for clearing members under the CRR;
- Other regulatory changes concerning UCITS and AIFs, with the aim of encouraging central clearing for the buy side.

In addition, the ESRB made proposals to enhance the liquidity risk framework including for PSAs, also by establishing a specific liquidity buffer in certain cases.

25 In this regard, it is to be noted that the Basel Committee on Banking Supervision and EU authorities recently took action to tackle this issue, by enhancing leverage ratio disclosure requirements. These provisions will be applied by EU banks from June 2021.

4. CONCLUSION

According to EMIR Refit, the central clearing exemption expires in June 2021 and may be extended by the European Commission twice, by means of delegated acts, by one year each time.

The European Commission's overall analysis of the main issues surrounding PSAs' central clearing as outlined in the first Report issued in September 2020 are broadly confirmed by the results of ESMA's public consultation. That consultation also provided some further quantitative insights.

There has been progress in the last years towards central clearing for PSAs, and indeed, as outlined, PSAs are partially moving towards central clearing on a voluntary basis. This is also the outcome of various regulatory and market forces.

Nevertheless, in order to progress further towards a sustainable central clearing landscape for PSAs, the Commission is of the view that extending the PSA exemption would be needed for several reasons. First, it would offer the possibility to bring further refinements to CCPs' facilitated access models. Second, it would allow a more in-depth assessment of the appropriateness and feasibility of introducing any potential regulatory changes which could support a mandatory central clearing solution. Third, it would allow alternative solutions to mature as money markets could still be volatile as the economic fallout from the Covid-19 pandemic unfolds. Letting the clearing obligation exemption for PSAs expire in June 2021 seems premature, in particular as concerns may still arise over the availability of liquidity in the system to meet the demand for variation margin. Finally, an extension is in line with the advice provided by ESMA, in co-operation with EBA, EIOPA and the ESRB.

The Commission is therefore proposing to adopt a delegated act which would extend the central clearing exemption until June 2022.

In the coming months, DG FISMA will continue to explore and assess in more depth the different solutions and proposals brought forward by industry stakeholders, in cooperation with the dedicated expert group and the relevant Commission Services.