



ESRB opinion on ESMA report

on Central Clearing Solutions for Pension Scheme Arrangements

The General Board of the European Systemic Risk Board (ESRB) welcomes the report of the European Securities and Markets Authority (ESMA) entitled “Central Clearing Solutions for Pension Scheme Arrangements”. Under Article 85(2) of the European Market Infrastructure Regulation (EMIR), ESMA, in cooperation with the ESRB, is required to submit a report every twelve months on the potential central clearing solutions for pension scheme arrangements (PSAs). The ESRB appreciates that the deadline for producing this first report did not allow sufficient time for consultation and therefore welcomes the opportunity to provide ESMA with comments that may also be helpful for the second report due later this year. The ESRB also stands ready to revise its views once the new evidence from the consultation is made available.

The ESRB is responsible for the macroprudential oversight of the EU financial system and the prevention and mitigation of systemic risk. Given this mandate, our response takes a systemic risk perspective to focus on the analysis of the issues presented in the report and the solutions being considered. These can be summarised in three main points: the likelihood of PSAs accessing CCPs as direct members, the increased risk for central counterparties (CCPs) in intermediating repos, and solutions involving central bank access.

The ESRB believes it unlikely that PSAs will become direct clearing members of CCPs. The analysis in the ESMA report is predicated on the difficulties for PSAs to post variation margins in cash, especially during times of heightened market volatility. While the ESRB does not dispute the analysis, the impact is greatly reduced when the PSA accesses the CCP indirectly as a client. During the preparation of the ESRB’s 2020 report on mitigating the procyclicality of margins and haircuts in derivatives markets and securities financing transactions,¹ it became apparent that clearing members provide their clients with a wide suite of ancillary services on top of the core clearing services, including the funding of cash margins and collateral transformation services. In addition, clearing members also provide vital operational support in terms of technology to manage messaging systems and protocols, collateral, treasury planning and margin calls. These ancillary services are a vital component of the clearing service, as in many cases clients do not have the technical or operational capacity to replicate these

¹ https://www.esrb.europa.eu/pub/pdf/reports/esrb.report_200109_mitigating_procyclicality_margins_haircuts-0f3e9f9e48.en.pdf

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functionalities and become direct members.² To the best of the ESRB's knowledge, no PSA is a direct clearing member.³ The obstacles preventing direct membership go beyond the posting of cash margins, which PSAs are already required to do under the current EMIR framework in bilaterally cleared transactions⁴, relating instead to acquiring and supporting the technical capabilities to replicate the ancillary services mentioned above.⁵ Removing the obstacles to cash margins would not – in isolation – remove the other obstacles to direct membership. Nevertheless, the ESRB acknowledges that the client clearing model also entails certain risks, including for PSAs. Clients tend to rely on a small number of agents acting as clearing members, which gives rise to operational risk and concentration risk. Should the relationship cease for any reason, it would take time to form a relationship with another clearing member, and this could be costly. The client might lose access to the cleared derivatives market during this time. In addition, access to clearing members may not always be possible, as clearing members may have limited capacity, especially for clients with long-dated and unidirectional derivatives portfolios. However, the provisional assessment of the ESRB is that solutions involving client clearing or other forms of CCP access, like sponsored access, are more promising and less disruptive – and more widely beneficial to other users of derivatives beyond PSAs – than the ones requiring CCPs' risk management to be redesigned for the sole benefit of PSAs.

Clearing members are an important part of the clearing ecosystem, transforming risks for the benefit of both the CCP and the clients. By providing the aforementioned ancillary services, clearing members transform risks for the benefit of both the CCP and the clients. In particular, clearing members are responsible for all their accounts with the CCP, including their clients' accounts. This implies that they bridge liquidity issues by collecting margins from clients and absorb client delays and defaults so they do not immediately or directly impact the CCP. Solutions that envisage in-housing of these risks by the CCP, like suggesting that the CCP should provide repo facilities, would increase the non-core risks at CCP level, which in turn would reduce the resilience of the CCP in reliably delivering its core functions. Collateralised lending is a banking activity, which is regulated under the banking framework and is not addressed under the EMIR framework as a core CCP activity. The ESRB is strongly supportive of CCPs as standalone entities wholly focused on safeguarding financial stability by establishing a resilient central clearing architecture, which may only be achieved with dedicated risk management

² Except for large or sophisticated clients, who may have already have dedicated treasury or back office capabilities. However, it could still prove challenging to replicate all the functionalities provided to clients by clearing members.

³ This statement is limited to membership related to contracts mandated for clearing. There could be cases of direct or sponsored membership for non-mandated products, such as repos or exchange-traded derivatives. However, these would not be impacted by the exemption, and if verified would strengthen the case that it is technically possible for PSAs to post variation margin in cash.

⁴ The obligation to exchange collateral even in bilaterally cleared transactions effectively indicates that any entity which chooses to use derivatives in the conduct of its business should be sufficiently well equipped for that purpose, including in terms of being able to provide collateral when necessary.

⁵ Additionally, PSAs in some Member States do not have legal personality, which adds a further layer of legal complexity to possible direct membership.

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regulations. Forcing CCPs to commingle and expand the risks beyond those covered by EMIR would be detrimental to financial stability and not proportionate to the benefits which this proposal seeks to achieve.

The provision of central bank support is a decision reserved for central banks. While assuming that direct involvement is something that central banks could potentially independently explore, the ESRB would strongly advise against giving industry the impression that this is a viable option without the prior explicit consent and approval of central banks. There is a real risk of distracting market participants with options that are not feasible, which in turn would divert attention and resources from exploring other, more viable solutions. The ESRB is agnostic as to the role of central banks in providing liquidity support to PSAs for the purposes of clearing services. However, the ESRB wishes to highlight that PSAs clearing as clients would not require this type of direct support, as clearing members already have access to central bank facilities; and the need for direct support is in turn connected to the expectation that PSAs will become direct members. Also, the provision of direct central bank support would, just like direct membership, probably entail costs in terms of infrastructure and capabilities, which would make the case for direct membership and support even more unlikely for the vast majority of PSAs on economic and operational grounds.

In conclusion, the ESRB believes that the best way to remove obstacles for PSAs is to promote indirect clearing. The ESRB is fully supportive of the G20 Pittsburgh agenda. In particular, we recognise the benefits of centralised clearing of standardised OTC derivatives as an effective tool to mitigate the systemic risks arising from the web of credit exposures in the bilateral OTC market, which means supporting broad application of the clearing obligation. The establishment of a clearing obligation for liquid and standardised OTC derivatives markets is an essential component of this agenda, and exemptions from the clearing obligation could reduce the effectiveness in reducing systemic risk. The issues faced by PSAs, as detailed in the ESMA report, are in large part not specific to PSAs, being instead common to all less sophisticated or simply less active entities engaged in clearing, such as investment funds or insurance companies which do not, however, enjoy similarly preferential treatment under the EMIR framework. These entities overcome these problems by relying on the services provided by the clearing members, among other things. The ESRB believes that these services could be adapted to cater for the specificities of PSA needs.⁶ For this to happen, the regulatory requirement to centrally clear must finally come into force.

⁶ The ESRB is aware that a number of larger Dutch PSAs are currently clearing voluntarily across multiple clearing members. This seems to suggest that client clearing could be a viable solution. The ESRB is also aware of the risk of clearing members failing to provide adequate liquidity support to their clients, especially during stressed market conditions. However, these are not specific to PSAs and, in the ESRB's opinion, should not constitute per se the basis of a PSA-specific exemption. On the other hand, the ESRB is supportive of strengthening the regulatory framework around the provision of client clearing services, to also include safeguards in terms of stable and resilient provision of ancillary services and conditions, such as liquidity provision. These opinions are not the subject of this consultation, however, and were already communicated to ESMA during the consultation on client clearing services.