European Securities and Markets Authority

The Chair

25 January 2022
ESMA70-451-110

Ms. Mairead McGuinness
Commissioner for Financial Services, Financial Stability and the Capital Markets Union
European Commission
Rue de la Loi / Wetstraat 200
1049 Brussels
Belgium

Ref: Clearing obligation for pension scheme arrangements

Dear Ms McGuinness, Dear Mairead,

The European Markets and Infrastructure Regulation (EMIR) [1] requires the European Securities and Markets Authority (ESMA), in cooperation with the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA) and the European Systemic Risk Board (ESRB), to prepare every twelve months a report on the solutions for pension scheme arrangements (PSA) to clear their OTC derivative transactions.

The description, analysis and findings detailed in the extensive report that ESMA sent you a year ago on 17 December 2020[2] are still valid today. The focus of ESMA's efforts following that last report have thus been on assessing further the situation a year later, in particular the level of operational readiness of PSAs to clear their OTC interest rate derivatives and the considerations that should be taken into account for deciding when the clearing obligation should start applying to PSAs, which are described in annex. In line with the mandate, the EBA, EIOPA and the ESRB have provided input, which has been taken into account in this letter and its annex.

---

[1] Regulation (EU) 648/2012 (EMIR)
[2] Link to the ESMA report: ESMA Report to the European Commission - Central Clearing Obligations for Pension Scheme Arrangements - No 2 (europa.eu)

The conclusion of this assessment is that PSAs are largely operationally ready. While ESMA is supportive of continuing efforts to improve further PSAs' ability to source cash to meet variation margin calls in all possible scenarios, in particular in stressed market conditions, a mix of solutions is available to PSAs, including sponsored cleared repo models, such that there are less reasons to treat PSAs differently than other funds. ESMA is thus of the view that the exemption first introduced in 2012 and that was meant to be temporary, should stop. In other words, the clearing obligation should start applying to PSAs.

However, as developed in the annex, there are a number of considerations that would justify providing sufficient time before the clearing obligation would start applying to PSAs. In particular, PSAs and the relevant market participants need sufficient time to finalise their clearing and collateral management arrangements in order to absorb the important additional cleared volume corresponding to PSAs' OTC interest rate derivative trading activity that is not yet voluntarily cleared. In addition, the start of the clearing obligation for PSAs should be considered in the context of the broader plan to build clearing capacity in the EU and reduce reliance on UK CCPs, to which the end of this exemption can also contribute.

With this letter, ESMA would thus like to express its view that the clearing obligation should start applying to PSAs and would also like to highlight the various considerations that the European Commission should take into account in determining an appropriate timing for when this obligation would start. In particular, taking all of the above into account, and provided that this date would fit with the broader EU clearing strategy, ESMA would recommend a final one-year extension of the exemption to start applying the clearing obligation to PSAs on 19 June 2023. ESMA is also of the opinion that the decision from the European Commission should be communicated with sufficient lead time for PSAs and the relevant market participants to adapt their implementation plans accordingly.

In case you have any questions or comments regarding this letter or its annex, please contact me or Fabrizio Planta, Head of the Markets and Data Reporting Department.

Yours sincerely,

Verena Ross

CC: Mr John Berrigan, Director General, DG Financial Stability, Financial Services and Capital Markets Union, European Commission

Annex – The clearing obligation for PSAs

I – Introduction

1. PSAs have been benefitting from a temporary exemption from the clearing obligation since the inception of EMIR in 2012. This temporary exemption has been renewed a number of times (by the European Commission (EC) in accordance with EMIR, but as well via EMIR Refit in 2019) and is currently running until 18 June 2022. Under the current version of EMIR, the EC has the possibility to extend it by one year only one last time, meaning that the exemption could potentially run up until June 2023.

2. The temporary exemption was introduced in EMIR to allow time to find viable technical solutions to enable PSAs to clear their OTC derivatives in view of the challenges they can face in meeting CCPs' cash variation margin calls.

3. ESMA published a report on this issue in December 2020[3]. The report analysed the situation in detail, indicated that there was no silver bullet to address PSAs concerns but that instead, a mix of solutions should allow PSAs to clear their OTC derivatives. In addition, the report recommended at the time to extend the temporary exemption from June 2021 to June 2022 to allow sufficient time for involved parties to prepare and make all the efforts possible to avoid extending this exemption further.

4. The content of the December 2020 report is still relevant today, while some of these efforts did materialise since its publication, notably PSAs appear now as being largely operationally ready to clear as discussed further down in this annex. In addition, it should also be mentioned that a second EU CCP (LCH SA, the first one was Eurex[4]) has gone live with a sponsored clearing repo model offering[5], thus adding more collateral transformation capacity and broadening the tools available to PSAs to source cash to meet variation margin calls for their cleared OTC interest rate derivative trades.

5. After the EC had provided the one-year extension (which meant the exemption was extended from June 2021 to June 2022), ESMA started to rediscuss this issue. The objective of these discussions was to assess any further developments since the publication of the December 2020 report in order to express an up-to-date view on whether the exemption should stop or be prolonged. This is also in line with EMIR which mandates ESMA to provide its technical input on this issue every year by December until the exemption is stopped.

[3] ESMA RECOMMENDS MORE TIME TO IMPLEMENT A MIX OF SOLUTIONS FOR PSAS TO CLEAR (europa.eu)
[4] Whitepaper Direct Access Repo Clearing Models (eurex.com)
[5] LCH RepoClear SA clears first euro repo by Sponsored Member | LCH Group

6. One key aspect that came up during these discussions was the important link of the clearing obligation for PSAs with the work and discussions undertaken to build EU clearing capacity and to reduce reliance on UK CCPs. As a result, instead of targeting December 2021 to finalise ESMA's technical input to the EC on the PSA issue, ESMA has finalised it in January 2022 in order to take into account the announcement from the Commission on 10 November 2021[6] on central clearing and ESMA's decision on the tiering exercise regarding UK CCPs at the 15 December 2021 ESMA Board meeting.

II - Operational readiness

7. In June 2021, representatives from PSAs had indicated during the EC's expert group meeting that PSAs are largely operationally ready to clear, meaning that they have clearing arrangements in place and that they clear some trades voluntarily. ESMA followed up on these comments to try and have a better understanding on the level of readiness of PSAs more broadly.

8. ESMA thus ran a survey over the summer of 2021 with the NCAs of the three key Member States for PSAs in the EU (DK, IE and NL) as well as with the two most important CCPs for OTC interest rate derivatives clearing (Eurex and LCH Ltd) in order to have more details on the level of PSAs' operational readiness to clear. ESMA discussed the results which were in line with the comments from PSAs representatives. However, some of this data was caveated by respondents for several reasons, such as relying on a number of assumptions, having a partial view, etc. so this data is not reproduced in this annex and was only used to discuss and to provide further insight to regulators on the level of operational readiness of PSAs.

9. In parallel, ESMA also ran its own analysis based primarily on EMIR TR data during the summer of 2021, and this analysis alone gives a sufficient level of information to provide some clarity on the situation. ESMA's analysis allowed to have a horizontal and comparable view on the level of readiness across PSAs, Member States and CCPs.

10. In the end, ESMA's analysis of the EMIR TR data did confirm that PSAs were operationally ready in the vast majority of cases. Here are below the key findings from the EMIR TR data analysis[7]:

---

[6] Commissioner McGuinness way forward for central clearing (europa.eu)

[7] ESMA's analysis is based on an EMIR trade state data extraction from June 2021.
ESMA used a first filter, the corporate sector of the reporting counterparty ('O') to identify PSAs. O stands for 'Institution for occupational retirement provision'. However, there's a large variability on how counterparties classify themselves into sectors.
In addition, ESMA used its Entity Information System (EIS), which connects within a central database the most essential information on entities based on Legal Entity Identifiers (LEIs). It collects information from various sources to create a "business card" with basic information on an entity. Sources contain, among others, GLEIF, ECB RIAD, EBA, EIOPA. It is designed to detect conflicting information on the same entity across different sources and take actions to resolve those conflicts.

11. ESMA identified 266 PSAs in the data that ESMA has access to, with 123 PSAs reporting at least one cleared OTC derivative trade. However, the activity in terms of volume is dominated by about a dozen PSAs (and the top 3-5 in particular), who account for the majority of the trading activity in OTC derivatives by PSAs.

12. NL has the largest PSA market and many of the largest PSAs are located there, followed by DK and IE (ESMA's analysis also indicates that the SE market has a comparable size but with mainly smaller PSAs).

13. Looking at PSAs with an aggregate position in OTC derivatives (across asset classes) above EUR 8 billion could be informative of where these PSAs might stand vis-à-vis the IM Phase 6 threshold. Although the calculation in ESMA's analysis is not the exact calculation to be done under EMIR to check whether a counterparty may breach the IM Phase 6 threshold, this is still an interesting proxy to have an estimate of possible PSAs in scope. This metric was looked into by ESMA as PSAs that have come under phase 5 or that would come under phase 6 of the margin rules would have further incentives to clear regardless of any decisions with regards to the clearing obligation. In the analysis, ESMA identifies that there are around 25 of them. The vast majority of these PSAs (84%) have one or more cleared trades (we mean that 84% of these PSAs have at least one cleared trade, not to be understood as these PSAs clearing 84% of their trades) and thus have clearing arrangements in place (and potentially more, as accounts onboarded but not being used do not appear in the EMIR TR data).

14. Looking at the number of PSAs with an aggregate position above 3 billion in OTC interest rate derivatives and/or above 1 billion in OTC credit derivatives, 1 billion in OTC equity derivatives, 3 billion in OTC FX derivatives and/or 3 billion in OTC commodity derivatives, could be informative of where they might stand vis-à-vis the clearing thresholds. Although the calculation in ESMA's analysis is not the exact calculation to be done under EMIR to check whether a counterparty may breach the clearing thresholds, this is still an interesting proxy to have an estimate of possible PSAs in scope. This metric was looked into by ESMA as PSAs that would exceed the clearing thresholds would be the ones captured by the end of the exemption from the clearing obligation. After filtering out those PSAs that breach one or more clearing thresholds but do not have OTC interest rate derivatives (for example a PSA breaching the 1 billion level in equity derivatives but not trading interest rate derivatives would not be impacted by the overall question of the exemption from the clearing obligation), then under ESMA's analysis this number would amount to around 31

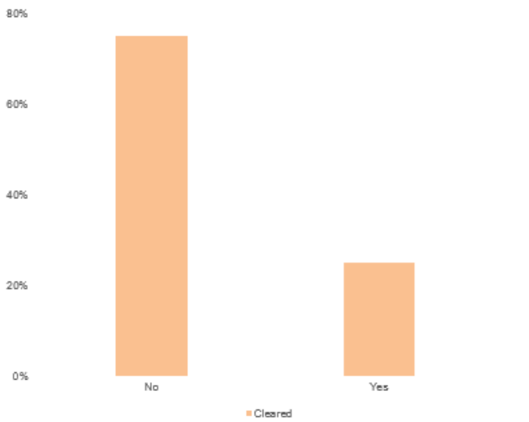
For the final selection of counterparties identified as PSAs, ESMA captured entities with records referencing EMIR's sector 'O' or classified as 'Pensions' in EIS. The main difference between the two is that some EIS Pensions report to EMIR with sectors F (investment firms) or 11 (financial and insurance). In the end, only 172 out of 1139 EIS pensions appear in EMIR. Combining both Sector 'O' and EIS pensions, 266 different counterparties appeared in EMIR. This variability in how entities use sector O or other sectors such as 'investment firms', sometimes using different sectors for different trades, inevitably affects the numbers presented in this document, but based on various discussions they seem to still allow giving the high level picture in terms of trends and key findings.
Lastly, it should be noted that additional filtering included outlier removal, which might affect comparisons with other analysis.

PSAs (this time including IE in the group with one PSA). Here as well, the vast majority of these PSAs (80%) have one or more cleared trades and thus have clearing arrangements in place.

15. In terms of clearing activity, the data indicates that several hundreds of billion have been (voluntarily) cleared, and that the same concentration as described in point a) exists for cleared trades (around 70% of the cleared notional is attributable to just 5 PSAs). In terms of trends, ESMA's analysis indicates that around a third of PSAs currently having cleared trades have started to enter into such cleared trades over the past year (although this number relies on a number of assumptions given that trade state data is being used and it is difficult to compare it across two dates, although the number might not be exact it is safe to say there was an increased number of PSAs clearing some trades). And in terms of percentage cleared, the analysis indicates that around 25% of notional (40% in trade count) traded by PSAs is cleared. There are obviously some differences between PSAs (some clearing the vast majority of their trades, some very little or none), for instance, data showed that the three largest PSAs typically clear 25% on average but not more than 25-30% of their trades, whereas the voluntarily clearing rate of medium-sized and small PSAs can vary from 0 to 100% of their trades[8]. Yet this is a rather informative average across PSAs (which number is also consistent with what was reported in the December 2020 Report) in the sense that many of these PSAs of a certain size do appear to clear some trades, but in most cases not the majority of their trades.

Notional amounts by clearing status

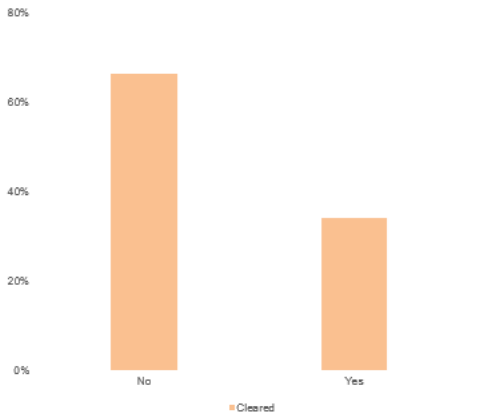
About a quarter of the notional is cleared



Note: Notional amounts of cleared and un-cleared trades, as share of total. Notional that appears as not cleared includes non-clearable trades. Extraction date: 11/06/2021.

Trades by clearing status

Almost 40% of the trades are cleared

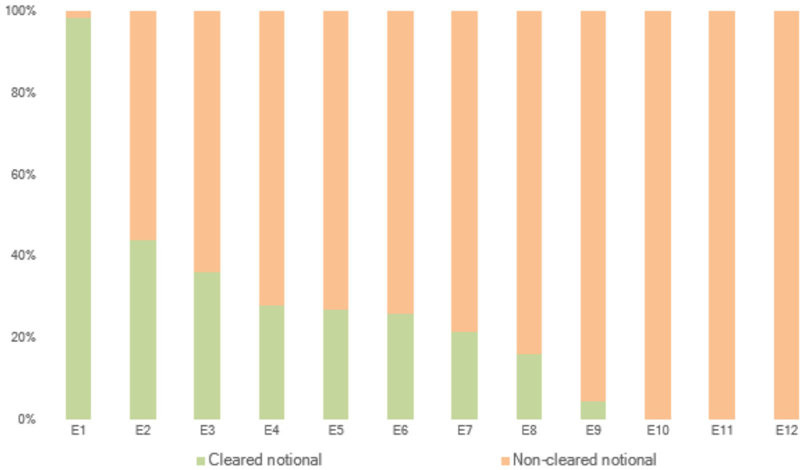


Note: Number of cleared and un-cleared trades, as share of total. Trades that appear as not cleared include non-clearable trades. Extraction date: 11/06/2021.
Sources: TRs, ESMA

[8] Depending on the sample of PSAs considered and the methodology used to select these (filtering OTC exposure, certain reported sectors, size, etc.), the numbers of PSAs clearing can vary a little. For instance, it appears that all the biggest Danish PSAs surveyed do clear to some extent when they have OTC IRS exposure, but when considering a larger and different sample then the EMIR TR data indicates that some smaller ones may not. However, the overall picture remains that the vast majority of the biggest PSAs in the EU do have some clearing arrangements in place.

Share of notional amounts by entity and clearing status

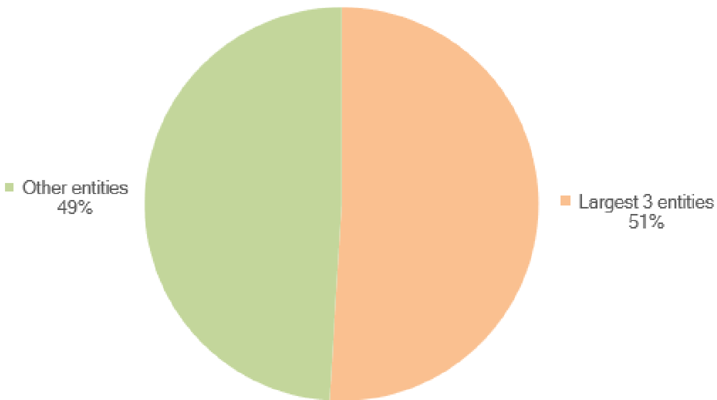
Different clearing patterns across selected entities



Note: Shares of notional amounts by clear status for selected 12 largest entities, ranked by percentage of voluntary cleared amounts (i.e., E1 is not the largest of the top 12 entities but the one clearing the most on a voluntary basis in terms of percentage of its own portfolio). E1, E2, etc. stands for Entity 1, Entity 2, etc.

Share of cleared notional by the largest entities

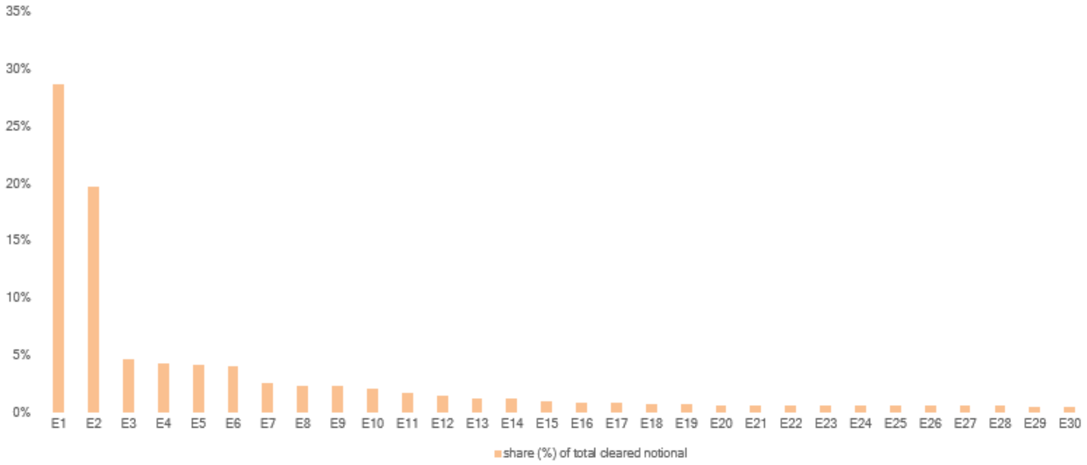
Top 3 entities clear on average 25% of their respective portfolios but account for around half of the cleared volume in notional terms



Note: Shares of total voluntary clearing split by whether it is coming from the largest 3 entities or not. Average voluntary clearing of the largest 3 entities amounts to 25% of their own portfolios.
Sources: TRs, ESMA

Cleared notional amounts by entity as share of total cleared notional

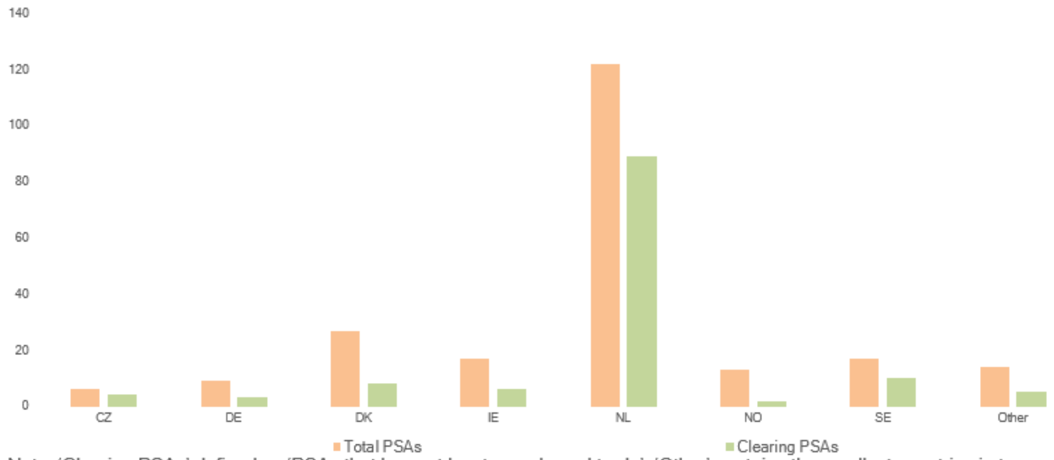
5 entities responsible for 60% of the cleared notional



Note: Cleared notional amount by entity divided by total cleared notional. Total cleared notional computed as in 'Chart 1: Notional amounts by clearing status'. E1, E2, etc., stands for Entity 1, Entity 2, etc. Only 30 largest entities displayed.
Sources: TRs, ESMA

Total and clearing PSAs by country

Almost half of the selected PSAs clear



Note: 'Clearing PSAs' defined as 'PSAs that have at least one cleared trade'. 'Other' contains the smallest countries in terms of number of PSAs. Extraction date 11/06/21.
Sources: TRs, ESMA

16. The clearing activity between Eurex and LCH Ltd for PSAs' cleared swaps, not in terms of clearing arrangements, but in terms of overall cleared volume, is in the same proportion as for the rest of the market, i.e. that LCH Ltd has a very dominant market share. However, in terms of clearing arrangements, the picture is a bit different. When looking at PSAs above the 8 billion threshold the analysis indicates similar percentages in terms of PSAs having

at least a cleared trade at Eurex (80%) and PSAs having at least a cleared trade at LCH Ltd (76%). This would mean that the vast majority of the larger PSAs, the ones most likely affected by the requirement to clear, have arrangements in place to clear at either CCP, whereas they are currently clearing in larger proportions where the broader market is also clearing in larger proportions.

Cleared notional by CCP

Concentrated in two entities

Note: Total cleared notional amount by CCP. Date of extraction: 11/06/21.
Sources: TRs, ESMA

Cleared trades by CCP

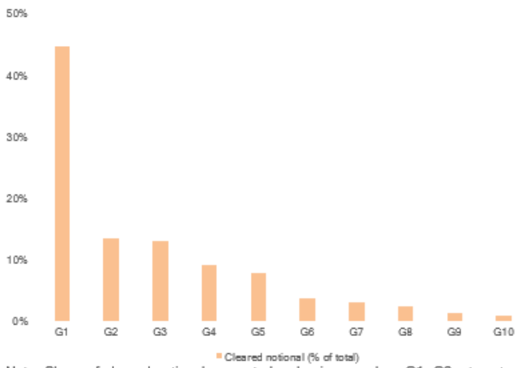
Concentrated in three entities

Note: Number of cleared trades by CCP. Date of extraction: 11/06/21.
Sources: TRs, ESMA

17. There are a dozen clearing members that are clearing trades for these PSAs (a very similar list as for other segments of OTC derivative clients that clear). In fact, these are most of the big OTC derivative dealers and clearing brokers, with 5 of them clearing in much bigger proportions in terms of trade count and notional of PSA trades, and one in particular in terms of notional.

Notional amounts by clearing member

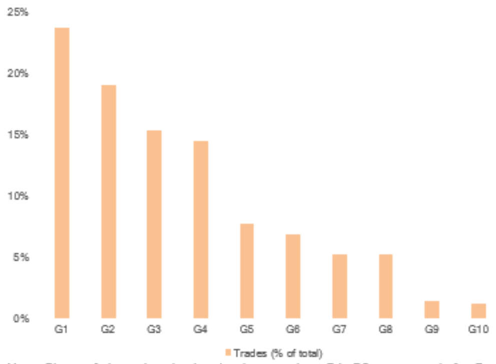
Five groups responsible for most notional



Note: Share of cleared notional amounts by clearing member. G1, G2, etc., stands for Group 1, Group 2, etc. Extraction date 11/06/21.
Sources: TRs, ESMA

Trades by clearing member

Number of trades more homogeneous



Note: Share of cleared trades by clearing member. G1, G2, etc., stands for Group 1, Group 2, etc. Extraction date 11/06/2021.
Sources: TRs, ESMA

18. As a result, all these elements point to a very high level of operational readiness of PSAs to clear their OTC interest rate derivatives, which confirms what the representatives of PSAs indicated during the EC's Expert Group meeting in June 2021.

19. It should be noted though that there could be a difference in terms of readiness between clearing at Eurex or at LCH Ltd. First of all, as EMIR TR data does not capture dormant accounts that have been onboarded but are not being used yet, and secondly because there is a large difference in terms of volume cleared between the two CCPs.

20. Furthermore, it should be mentioned that these findings were presented and discussed during the EC's expert group meeting taking place on 14 December 2021, and participants who intervened confirmed seeing the same trends. So, once again, PSA representatives reiterated their comment of being largely operationally ready.

21. Yet, the question of whether to stop or extend the exemption, or put it differently the question of the timing of the end of the exemption, is not only linked to the operational readiness of PSAs but it is also linked to other aspects that are discussed in the next section of the annex.

III - Other considerations

22. First of all, operational readiness does not necessarily mean that PSAs feel confident that there will always be sufficient capacity to clear all their derivatives subject to the clearing obligation. PSAs have indicated that increasing the clearing rate of these derivatives from 25% cleared voluntarily on average to the full clearing obligation might pose challenges in terms of clearing capacity limits due to a concentration of clearing members, clearing member potential limits in view of PSAs large and directional portfolios, etc. Moreover, PSAs have also expressed strong concerns on whether they will always be able to source the necessary amount of cash on a timely basis to meet the CCP variation margin calls (such as a potential repo market dry-out). For this last aspect, the concern is mainly with regards to the scenario of stressed market conditions. During the EC's expert group meeting taking place on 14 December 2021, PSAs mentioned that in order to have more confidence in being able to clear they would want more reassurance or means on their ability to source cash (banks providing further liquidity, central banks' support of money markets during stressed times, more clearing agents available for sponsored cleared repos and for these markets to mature further, etc.).

23. Secondly, ESMA has also discussed the fact that the decision with regards to PSAs needs to be articulated with the broader question on the approach for central clearing in the EU and the reduction of reliance on UK CCPs. With the EC announcement from 10 November 2021 further clarity has been provided on the next steps with regards to EU central clearing. Furthermore, ESMA's decision regarding the tiering exercise of UK CCPs taken at the December 2021 ESMA Board meeting goes in the same direction. ESMA has taken these

two announcements into account when finalising a position regarding PSAs, in order to ensure some consistency between the two topics. For instance, the EC could consider the end of the PSAs exemption as one of the milestones in the plan to build EU clearing capacity, as it might contribute to bring client liquidity to the EU which could then in turn attract further buy-side activity to EU CCPs.

24. Thirdly, there are other factors that the EC could take into account in deciding the timing from when the clearing obligation would start applying to PSAs. The first factor is the phase-in of the bilateral margin requirements, more specifically the requirement to exchange initial margin (IM) on non-cleared derivative trades, as counterparties above the EUR 8 billion threshold will be subject to the requirement to exchange IM as per 1 September 2022. As mentioned earlier in this annex, this requirement will add a further incentive for PSAs (those caught by this threshold) to clear their trades, such that this milestone will contribute to the further increase in the volume of PSAs' cleared derivatives.

25. The second factor is with regards to the operating hours of TARGET2 and T2S, which are foreseen to be extended within the context of the consolidation of TARGET2 and T2S. This consolidation is foreseen by November 2022. Currently, clearing members and clients are subject to USD cash calls, even for their EUR positions in EU CCPs, because of the early closing time of TARGET2. Extending the operating hours could contribute to the attractiveness of clearing in the EU. Besides, extending this window beyond the moment of end of day margin calls is likely to improve the accessibility of EUR-denominated repo facilities for pension funds, as well as the use of EUR for cash calls related to their IRD positions. Having the extended window for TARGET2 in place would help ensure that EUR denominated repo facilities are available when margin calls arrive and increase PSAs' clearing activities at EU CCPs, in line with the EU's objective of making EUR clearing less reliant on UK CCPs.

26. The third factor is the need for sufficient time for the implementation of the EC decision for when the clearing obligation should start to apply. First of all, as explained earlier in the annex, PSAs have only cleared a portion of their portfolio on average, such that PSAs and their clearing members would need some time to finalise the arrangements necessary to clear all the contracts in scope of the clearing obligation for all the PSAs that are also in scope of the clearing obligation and to absorb this important increase in cleared volumes. Secondly, some time is also needed to address liquidity preparedness of PSAs. Institutions that will be subject to mandatory clearing should actively manage their collateral. As of yet, it appears that some of the PSAs subject to the clearing thresholds would need to make additional adjustments to their liquidity management in order to be ready to clear all the volume of contracts that would fall under the clearing obligation. NCAs from the Member States with larger PSA markets have indicated that supervisory initiatives have been set up to improve this situation.

27. ESMA is of the view that these elements are important to take into account by the EC when finalising their decision on when the clearing obligation should start.

IV - Way forward

28. In summary, PSAs are largely operationally ready and a number of solutions (as described in the December 2020 report) exist and provide them with a toolbox to source cash and clear their trades. It should also be mentioned that ESMA supports the ongoing efforts led by the EC with its Expert Group aiming to improve even further the conditions to source cash. And taking all the above into account, ESMA is of the view that the exemption should end.

29. The exemption introduced in EMIR in 2012 and renewed a number of times since then was meant to be temporary, and by now there are less reasons to treat PSAs differently to other funds.

30. Although ESMA is of the view that the exemption should end, ESMA is also raising to the attention of the EC the fact that providing sufficient implementation time should be considered when finalising the decision on the date from when the clearing obligation would start applying to PSAs. The length of this implementation time should take into account the considerations described in section III. ESMA recommends a final one-year extension of the exemption in order to start applying the clearing obligation to PSAs on 19 June 2023.

31. Furthermore, it should be noted that ESMA has consulted the EBA, EIOPA and the ESRB on this topic and has shared with them the results of its study on the level of operational readiness of PSAs to clear their OTC derivatives. The EBA, EIOPA and the ESRB have agreed with ESMA's position that the exemption was meant to be temporary and that it should come to an end. In addition, the same other considerations than the operational readiness, as described in section III of this annex, and that are important to take into account when deciding on the length of the implementation period with regards to the clearing obligation start date, have also been raised and discussed by EBA, EIOPA and the ESRB. The ESRB also recalled its previous advice on the subject according to which the exemption is raising financial stability issues leaving a big portion of the market uncleared for entities facing similar challenges as other funds. The EBA, EIOPA and ESRB's respective input has thus also been taken into account by ESMA in finalising this document and ESMA's position.