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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

The European Market Infrastructures Regulation¹ (EMIR) contains a temporary exemption from the central clearing obligation for entities operating Pension Scheme Arrangements (PSAs), in relation to certain types of over-the-counter (OTC) derivatives². The exemption has been extended several times since 2012³. Currently, it runs until 18 June 2022. The Commission may adopt a delegated act, extending the exemption for the last time until June 2023.

Requiring PSAs to clear OTC derivative contracts at a Central Clearing Party (CCP) could lead them to transform a significant amount of their assets for cash or other highly liquid assets, such as bank deposits, money market fund shares, repurchase agreements or credit lines, in order to be able to provide ‘margin’⁴ to CCPs. The obligation to clear and the associated requirement to provide margin⁵ relates in particular to the need to ensure sufficient cash for variation margin⁶ that needs to be covered regularly and at short notice. As such, there is a risk that prematurely requiring PSAs to clear OTC derivative contracts centrally may lead to PSAs divesting a significant proportion of their assets for cash to build up capital buffers in order to meet possible margin requirements of CCPs, thus reducing resources allocated to investment that generates income to cover future pensions. Nevertheless, the ultimate aim of the Regulation remains central clearing for PSAs as soon as possible.

¹ Regulation (EU) No 648/2012 on OTC derivatives, central counterparties and trade repositories.

² Pursuant to Art. 2(10) 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. Pursuant to Art. 89(1) EMIR, the exemption concerns OTC derivatives which are objectively measurable as reducing investment risks that directly relate to the financial solvency of PSAs.

³ The exemption has most recently been extended in May 2021 by means of Commission Delegated Regulation (EU) 2021/962 extending the transitional period referred to in Article 89(1), first subparagraph, of Regulation (EU) No 648/2012.

⁴ Margin is the collateral that an investor has to deposit. EMIR distinguishes between initial and variation margin. Initial margin is intended to cover current and potential future fluctuations in value.

⁵ Entities operating pension scheme arrangements, the primary purpose of which is to provide benefits upon retirement, usually in the form of payments for life, but also as payments made for a temporary period or as a lump sum, typically minimise their allocation to cash in order to maximise the efficiency and the return for their policy holders. See Regulation (EU) No 648/2012 on OTC derivatives, central counterparties and trade repositories, Recital 26.

⁶ Variation margin is collateral collected by a party regularly to reflect changes to the market value of an outstanding contract. Since variation margin calls have to be typically paid at short notice (e.g. overnight or even intra-day), the cash position plays a central role as cash is the most widely used instrument to meet these calls.

Article 85 (2) of EMIR requires the Commission to prepare annual reports assessing if viable technical solutions have been developed for the transfer by pension scheme arrangements of cash and non-cash collateral as variation margin and the need for measures to facilitate their uptake. This is the third Commission Report and it presents the progress made to date.

2. INPUT RECEIVED

Since the entry into force of EMIR REFIT on 17 June 2019⁷, work has been going on in various *fora* monitoring the progress towards central clearing by PSAs. Input has been received from the European Securities and Markets Authority (ESMA), European Banking Agency (EBA), European Insurance and Occupational Pensions Authority (EIOPA) and the European Systemic Risk Board (ESRB), as well as from market participants *via* the PSA expert group⁸. ESMA, in cooperation with EBA, EIOPA and the ESRB, submitted annual reports to the Commission assessing the issue, as required by EMIR. The first report⁹ was received by the Commission in April 2020. A second report¹⁰ was submitted to the Commission in December 2020¹¹. The latest¹² ESMA report was sent to the Commission in January 2022.

Taking into account the input received, the Commission has published two reports^{13,14} so far assessing the liquidity conditions as well as exploring various clearing arrangements for pension funds. These reports laid out the arguments relating to the subsequent prolongations of the exemption.¹⁵

In the report of January 2022, ESMA concluded that the description, analysis and findings detailed in the extensive second report were still valid. It considered unlikely that, despite the efforts of stakeholders and regulators, there is a unique solution to address PSAs concerns. Rather a mix of solutions facilitating access to liquidity or easing the pressure of carrying out clearing should be pursued. The focus of the latest report was therefore on assessing the level of operational readiness of PSAs to clear their OTC interest rate derivatives. ESMA concluded that PSAs are largely ready from an operational perspective, noting a mix of solutions available to PSAs, such that ESMA believed there was less reason to treat PSAs differently compared to other market participants. Furthermore, ESMA pointed out that the prolongation of the clearing exemption should be seen in the wider context of building

⁷ Regulation (EU) 2019/834 of the European Parliament and Council amending Regulation (EU) No 648/2012 as regards the clearing obligation, the suspension of the clearing obligation, the reporting requirements, the risk-mitigation techniques for OTC derivative contracts not cleared by a central counterparty, the registration and supervision of trade repositories and the requirements for trade repositories (EMIR REFIT).

⁸ As required by Art. 85(2) EMIR, 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.

⁹ Central clearing solutions for pension scheme arrangements, European Securities and Markets Authority, 2 April 2020, ESMA70-151-2823.

¹⁰ Report on the central clearing solutions for pension scheme arrangements (No.2), European Securities and Markets Authority, 17 December 2020, ESMA70-151-3248.

¹¹ Ibid. See Chapter 4 “Public Consultation” for details. The findings of the second report were supported by an extensive public consultation. It collected views from stakeholders, updated data on European PSAs’ portfolios and on the quantitative impact of moving their OTC derivative portfolios to central clearing.

¹² The clearing obligation for pension scheme arrangements, European Securities and Markets Authority, 25 January 2022, ESMA70-451-110.

¹³ COM (2020) 574 final.

¹⁴ COM (2021) 224 final.

¹⁵ The initial exemption was provided by EMIR until 16 August 2018, while EMIR Refit provided a further extension until June 2021, potentially to be extended by another year or two.

clearing capacity in the EU and increasing the attractiveness of EU CCPs, to which the end of this exemption can also contribute.

Nevertheless, according to ESMA, a number of operational considerations would justify granting PSAs more time before subjecting them to the clearing obligation. In particular, ESMA underlined that PSAs and the relevant market participants need time to finalise their clearing and collateral management arrangements. It also added that the Commission's decision must be communicated with sufficient notice allowing all affected parties to adapt their implementation plans. Taking the above into account, ESMA recommended a further prolongation of the clearing exemption until 19 June 2023.

Since the last Commission report in May 2021, the expert group on PSAs has met three times. Participants confirmed that PSAs are largely ready to clear, have clearing arrangements in place and clear some trades voluntarily. At the same time, PSAs underlined that the underlying issue of access to cash remains. To address this, in particular the cleared repo has been discussed by the expert group on PSAs as a potential liquidity solution. PSAs however noted that while this is a step in the right direction, over-reliance on the cleared repo market would leave them vulnerable to a residual liquidity risk in extreme market circumstances.

3. POLITICAL CONTEXT

The UK is a key hub for central clearing of derivatives and remains an important location for clearing by EU market players, which over the years have built up a significant amount of positions at the UK CCPs. Many EU PSAs currently have clearing arrangements both in the EU and the UK, but analysis shows that they tend to clear in larger proportions in the UK. In order to avoid financial stability risks for the EU, in September 2020 the Commission adopted a temporary equivalence decision covering the UK regulatory and supervisory framework for CCPs, running initially until June 2022¹⁶, and subsequently prolonged until 30 June 2025¹⁷. In the meantime, EU market participants were urged to reduce their exposures to the UK CCPs, as the extent of such exposures may make it challenging for EU authorities to manage financial stability in case of stress.

In January 2021, the Commission set up a working group including the ESAs, the ESRB, the ECB and the SSM to assess the opportunities and challenges of transferring derivatives clearing from the UK to the EU CCPs. The group also reached out to a range of stakeholders to collect views and input. The discussions in the group confirmed the risks for the EU stemming from the exposures to UK CCPs. Such risks were also highlighted in the assessment of systemic third-country CCPs carried out by the ESMA under the framework of EMIR 2.2¹⁸, finalised in December last year¹⁹.

¹⁶ Commission Implementing Decision (EU) 2020/1308 determining, for a limited period of time, that the regulatory framework applicable to central counterparties in the United Kingdom of Great Britain and Northern Ireland is equivalent, in accordance with Regulation (EU) No 648/2012 of the European Parliament and of the Council.

¹⁷ Commission implementing Decision (EU) 2022/174 determining, for a limited period of time, that the regulatory framework applicable to central counterparties in the United Kingdom of Great Britain and Northern Ireland is equivalent, in accordance with Regulation (EU) No 648/2012 of the European Parliament and of the Council.

¹⁸ Regulation (EU) 2019/2099 of the European Parliament and of the Council of 23 October 2019 amending Regulation (EU) No 648/2012 as regards the procedures and authorities involved for the authorisation of CCPs and requirements for the recognition of third-country CCPs, OJ L 322, 12.12.2019.

¹⁹ ESMA assessment report under Article 25(2c) of EMIR available at: <https://www.esma.europa.eu/press-news/esma-news/esma-publishes-results-its-assessment-systemically-important-uk-central>. ESMA found that the

Therefore, in order to support efficient and competitive clearing services, the Commission will come forward in the second half of 2022 with measures to make EU CCPs more attractive to market participants; by making the EU a more attractive and cost-efficient clearing hub and by strengthening the EU's supervisory framework for CCPs to better manage associated risks.

In this context, bringing an end to the PSA exemption could help develop the EU liquidity pool, potentially attracting further clearing in the EU.

4. EVOLUTION SINCE THE INITIAL COMMISSION REPORTS

The temporary exemption from the clearing obligation aimed to give PSAs and other relevant market participants sufficient time to differentiate sources of liquidity to cover variation margins needs and to develop operational capacity to handle clearing of large derivative portfolios.

4.1 Liquidity

The temporary clearing exemption for PSAs aims to mitigate the impact that the clearing obligation would have on their cash allocation. The most common reason for the use of OTC derivatives by PSAs is the insufficient number of issuances of long dated high-quality bonds, which restricts their ability to manage the interest rate risks adequately²⁰. This gives rise to concerns about the access to cash during periods of market stress²¹, when margin calls increase and PSAs compete with other market entities for liquidity.

Liquidity conditions for PSAs have evolved favourably since the onset of the EMIR obligation to centrally clear certain classes of OTC derivatives, even holding up well during recent periods of volatility. With the exception of March-April 2020, when daily variation margin calls were significantly higher than average flows normally observed²², PSAs have not faced liquidity problems related to margin calls. In March 2020, variation margin payments were large compared with the highly liquid asset held by pension funds and put some of them under liquidity strain²³. Nevertheless, pension funds were generally able to meet them²⁴.

During periods of market stress, the repo market can become an important source of liquidity for buy-side participants, including PSAs. In recent years, market participants have been active in accommodating PSAs and other entities in the repo clearing ecosystem. Eurex, the German CCP, set up a "direct access" model to facilitate access to clearing. This includes

Swapclear service provided by LCH Ltd for interest rate derivatives denominated in euro and Polish zloty and the credit default swap and short-term interest rate derivatives segments of ICE Clear Europe Ltd for products denominated in euro are of substantial systemic importance to the EU or one or more Member States.

²⁰ Report to the European Commission on the central clearing solutions for pension scheme arrangements (No.2), European Securities and Markets Authority, 17 December 2020, ESMA70-151-3248.

²¹ Significant fluctuations in variation margin in March 2020 illustrate this concern. Between 11 and 23 March 2020 European insurance corporations and pension funds (ICPF) had to pay additional EUR 50 billion in variation margin to their counterparties. More than 90% of this was posted by Dutch ICPFs, which have portfolios of exceptionally large size and duration. Source: "Interconnectedness of derivatives markets and money market funds through insurance corporations and pension funds", European Central Bank, Financial Stability Review, November 2020.

²² Review of margining practices – Consultative report, Bank for International Settlements, October 2021.

²³ "Interconnectedness of derivatives markets and money market funds through insurance corporations and pension funds", European Central Bank, November 2020.

²⁴ For instance, the overall variation margin posted by Dutch ICPFs in March 2020 reached around 77% of their highly liquid asset holdings, although this is likely to mask some heterogeneity. Source: "Interconnectedness of derivatives markets and money market funds through insurance corporations and pension funds", European Central Bank, Financial Stability Review, November 2020.

both repos and interest rate swaps. More recently, a second EU clearing house²⁵ opened a sponsored clearing repo model offering²⁶, adding more collateral transformation capacity. These models are expected to continue to mature over 2022 and 2023, leading to increased uptake by clearing sponsors and buy-side participants.

Despite this, PSAs continue to report concerns about their liquidity situation. Although liquidity has remained robust so far, it may tighten, especially in the market for general collateral²⁷, as monetary policy normalises²⁸ over the medium-term. According to PSAs, this could lead to them having to sell holdings such as equities, corporate bonds and government bonds. In such an environment, they would be selling in a declining market, and such asset sales could further exacerbate downward pressure on falling asset prices.

That being said, alternative sources of cash flow could become available. For instance, the extension of the TARGET2²⁹ and T2S³⁰ operating hours later this year could help ensure that funding transactions from EUR denominated repo facilities can be settled when margin calls arrive. Although these new access models appear more suited to the needs of large PSAs, they allow banks to release balance sheet capacity, potentially also to the benefit of smaller PSAs. PSAs however call for the introduction of a central bank link to the cleared repo platform, so as to allow central banks to intervene in the repo market and act as a provider of cash to pension funds (as well as other market participants) using cleared repos.

Nevertheless, it should be noted that neither ESMA in its three annual reports nor the PSA expert group indicated that at any point did liquidity conditions deteriorate to such an extent, even in spring 2020, so as to permanently threaten PSAs ability to meet margin calls. Similarly, clearing services for government bonds and repo transactions remained resilient and stable, unlike the liquidity experienced in the bilateral repo market. Even prior to central bank intervention, no money market funds³¹ suspended redemptions and the repo market continued to function, meaning the PSAs continued to be able to access liquidity. Nevertheless, in time of stress PSAs may indirectly benefit from central bank operations aiming to support vulnerable market segments, as was the case in March-April 2020 when the ECB provided lending facilities for banks to buy assets from money market funds or extending collateral to unsecured bank bonds³².

4.2 *Operational readiness to clear*

²⁵ [LCH RepoClear SA clears first euro repo by Sponsored Member](#), LCH Press Release, 10 December 2021

²⁶ These models allow buy-side firms to access clearing with the support of a bank (“clearing agent” or “sponsor”), which would typically facilitate margin payments and provide default fund contributions for transactions.

²⁷ General collateral is a set of security issues which trade in the repo market at the same or a very similar repo rate. These securities can therefore be substituted for one another without changing the repo much. Liquidity in the market for general collateral repo is key for PSAs.

²⁸ “Monetary policy in an uncertain world”, Speech by Ch. Lagarde, President of the European Central Bank, Frankfurt am Main, 17 March 2022

²⁹ TARGET2 is the real-time gross settlement system owned and operated by the Eurosystem. It settles payments related to the Eurosystem’s monetary policy operations, as well as bank-to-bank and commercial transactions.

³⁰ TARGET2-Securities (T2S) is a common platform on which securities and cash can be transferred between investors across Europe, using harmonised rules and practices. Currently 20 European countries use T2S.

³¹ A money market funds invest in liquid, short-term instruments (typically up to 1 year maturity). These funds offer investors low risk and the ability to draw down liquidity (disinvest) when needed.

³² “EU money market fund regulation – legislative review”, European Securities and Markets Authority, 26 March 2021, ESMA34-49-309

PSAs are largely ready to clear, meaning they have clearing arrangements in place and they clear some trades voluntarily. These findings are confirmed by ESMA's latest report which noted a high level of operational readiness of PSAs to clear³³.

ESMA's analysis indicates that around a third of PSAs clearing trades started to clear in the past year. There are however some differences between PSAs (some clearing the vast majority of their trades, some very little or none) and clearing activity seems to be concentrated (around 70% of the cleared notional is attributable to just 5 PSAs). In terms of percentage cleared, the analysis indicates that around 25% of notional (40% in trade count) traded by PSAs is cleared. However, while the three largest PSAs typically clear 25% on average but not more than 25%-30% of their trades, medium-sized and small PSAs clear from 0 to 100% of their trades.

The balance in clearing activity between Eurex and LCH Ltd for PSAs cleared swaps, in terms of overall cleared volume, is however in the same proportion as for the rest of the market, i.e. that LCH Ltd continues to have a dominant market share. In terms of clearing arrangements, the picture is different though. Looking at PSAs above the EUR 8 billion initial margin threshold, the analysis indicates similar percentages in terms of PSAs having at least a cleared trade at Eurex (76%) and a cleared trade at LCH Ltd (80%). 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. According to ESMA's calculations, 31 EU PSAs would be captured by the clearing obligation under EMIR, as they would be above the clearing thresholds³⁴. The vast majority of these PSAs (80%) have cleared at least one trade, but not necessarily their entire derivatives portfolio, and thus have some clearing arrangements in place. The development of the Commission's strategy on clearing, which will be presented later in 2022, aims to improve the attractiveness of clearing in the EU.

Lastly, it is important to highlight that despite their growing operational readiness, PSAs have expressed concerns about there being sufficient capacity to clear all their derivatives subject to the clearing obligation. They have indicated that increasing the clearing rate from the current levels might pose challenges in terms of clearing capacity limits caused by a limited number of clearing members or their potential clearing limits.

5. CONCLUSION

The current central clearing exemption expires on 18 June 2022. EMIR REFIT allows the Commission to extend this temporary exemption for the last time until 18 June 2023, were it to conclude that market participants need additional time to further develop and adopt appropriate technical solutions, and that the adverse effects of centrally clearing derivative contracts on the retirement incomes of pensions remain unchanged.

The Commission's analysis shows that liquidity conditions for PSAs continue to improve and a variety of models have sprung up to access central clearing or transform collateral. Although a single solution to the provision of margin to CCPs by PSAs in stressed market conditions has proved elusive, a range of instruments exists that should allow the pension funds to clear efficiently in different market conditions, including under stress.

³³ These findings were presented and discussed during the EC's expert group meeting on 14 December 2021, and participants who intervened confirmed seeing the same trends.

³⁴ EMIR Refit defined small financial counterparties as entities whose volume of activity in OTC derivatives markets is too low to pose an important systemic risk. These counterparties are exempted from the clearing obligation, but remain subject to the requirement to exchange collateral to mitigate any systemic risk. See EMIR Refit, recital 7 and Article 4(a).

In order to fully use the available solutions, EEA pension funds will need to strengthen their operational capacity to clear and manage liquidity and collateral. The analysis submitted by ESMA showed that the number of PSAs clearing continues to increase, but the level of readiness across the sector varies. Therefore, PSAs and their CCP clearing members would need additional time to finalise the arrangements necessary to clear all the contracts that are in scope. Time is also needed to address liquidity preparedness of PSAs as not all seem to have adequate liquidity management. Notably, national competent authorities in the Member States with larger PSA markets have indicated that supervisory initiatives have been set up to improve this situation³⁵. Lastly, the Commission's strategy on clearing will attract greater activity at EU-based clearing houses, providing PSA's with greater access to competitive and efficient clearing services.

In conclusion, since 2019, there has been substantial progress towards central clearing for PSAs, including some PSAs partially moving to central clearing on a voluntary basis. Nevertheless, further operational steps are needed. In particular, EU CCPs should use the allotted time to further develop their facilitated access and collateral transformation models, to increase their attractiveness to PSAs, in particular smaller ones, which seem currently to be more reluctant to clear. At the same time, pension funds should ensure that they possess sufficient organisational competences and capacities to handle clearing of their derivative portfolios. For these reasons, the Commission will prolong the clearing exemption for PSAs for a final year. From 19 June 2023, Pension Scheme Arrangements will be required under EMIR to clear.

³⁵ The clearing obligation for pension scheme arrangements, European Securities and Markets Authority, 25 January 2022, ESMA70-451-110, paragraph 26.