054930/EU XXV. GP
Eingelangt am 05/02/15

Council of the
European Union

Brussels, 5 February 2015
(OR. en)

5923/15

EF 24
ECOFIN 67

COVER NOTE

From:	Secretary-General of the European Commission, signed by Mr Jordi AYET PUIGARNAU, Director
date of receipt:	3 February 2015
To:	Mr Uwe CORSEPIUS, Secretary-General of the Council of the European Union
No. Cion doc.:	COM(2015) 39 final
Subject:	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, assessing the progress and effort made by CCPs in developing technical solutions for the transfer by pension scheme arrangements of non cash collateral as variation margins, as well as the need for any measures to facilitate such solution

Delegations will find attached document COM(2015) 39 final.

Encl.: COM(2015) 39 final

www.parlament.gv.at

EUROPEAN
COMMISSION

Brussels, 3.2.2015
COM(2015) 39 final

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, assessing the progress and effort made by CCPs in developing technical solutions for the transfer by pension scheme arrangements of non cash collateral as variation margins, as well as the need for any measures to facilitate such solution

www.parlament.gv.at

1. INTRODUCTION

Regulation (EU) No 648/2012 on OTC derivatives, central counterparties and trade repositories (EMIR) was published in the Official Journal of the European Union (EU) on 27 July 2012, and entered into force on 16 August 2012.

Under EMIR, OTC derivatives that are standardised (i.e. that have met predefined eligibility criteria), including a high level of liquidity, will be subject to a mandatory central clearing obligation and must be cleared through central counterparties (CCPs).

CCPs are entities that interpose themselves between the two counterparties to a transaction and thus become the 'buyer to every seller', as well as the 'seller to every buyer'. As a counterparty to every position, the CCP bears counterparty credit risk in the event that one of its counterparties fails.

CCPs are designed to withstand the default of a clearing member or client principally through the use of frequent and conservative collateral – or 'margin' – requirements, calculated to cover any potential losses upon a default. CCPs accept only highly liquid assets, generally cash, as collateral to meet variation margin (VM) calls in order to allow for a rapid liquidation in the event of a default.

Pension Scheme Arrangements (PSAs)[i] in many Member States are active participants in the OTC derivatives markets. However, PSAs generally minimise their cash positions, instead holding higher yielding investments such as securities in order to ensure strong returns for their beneficiaries - retirees. The inability of CCPs to accept non-cash assets as collateral to meet VM calls means PSAs would need to generate cash on a short term basis either by borrowing cash or selling other assets in order to meet the CCP margin calls. This is not currently the case in the framework of bilateral relationships, where PSAs are able to post non-cash assets to their bilateral counterparties, to the extent that margin is required. Such a maintenance of cash reserves leads to high opportunity costs for PSA's because of the low level of interest that is earned on cash collateral. The costs of central clearing would therefore ultimately reduce the retirement income of the relevant pensioners if PSAs were required to post cash to meet VM calls.

The Commission, the Council and the Parliament therefore agreed a three-year temporary exemption from the clearing obligation for PSAs meeting certain criteria[ii], provided in Article 89(1) of EMIR. The exemption can be extended by up to a further three years in total. This transition period was explicitly provided for under EMIR in order to provide further time for CCPs to develop technical solutions for the transfer of non-cash collateral to meet VM calls.

www.parlament.gv.at

2. PURPOSE OF THE REPORT

In accordance with Article 85(2) of EMIR, the objective of this report is to present an assessment of the progress and effort made by CCPs in developing technical solutions for the transfer by PSAs of non-cash collateral as VM, as well as the need for any measures to facilitate such solution.

Article 85(2) of EMIR also provides that, if the Commission considers that the necessary effort to develop appropriate technical solutions has not been made by CCPs and that the adverse effect of centrally clearing derivative contracts on the retirement benefits of future pensioners remains unchanged, it shall be empowered to adopt delegated acts in accordance with Article 82 to extend the three-year period referred to in Article 89(1) once by two years and once by an additional one year.

In order to assess the current situation fully, the Commission ordered a baseline study on whether necessary efforts have been made by CCPs to develop appropriate technical solutions for the transfer of non-cash collateral as VM by PSAs. This baseline study also provided analysis of potential and alternative solutions. Finally the baseline study analysed the impact of removing the exemption in the absence of a solution, calculating the reduction in retirement income for the pensioner beneficiaries of the affected PSAs[iii].

In accordance with Article 85(2), the European Commission has consulted with the European Securities and Markets Authority and the European Insurance and Occupational Pensions Authority in the process of preparing this report.

3. EFFORTS BY CCPs

3.1. A PSA' "REPO" SERVICE

At this stage, only one CCP has demonstrated any notable effort to develop a solution for the posting of non-cash assets in order to meet VM calls.

The relevant CCP is actively developing a service (hereinafter 'the PSA repo service'[iv]) which could address PSAs' needs to use non-cash assets in order to meet the cash VM calls it requires.

The proposed service would allow a limited range of non-dealer market participants (including PSAs) to become members of its repurchase (repo) transaction trading and clearing service. Under a repo transaction, one party sells an asset (usually fixed-income securities) to another party and commits to repurchase the asset at an agreed price at a future date. The asset serves as collateral and mitigates the counterparty credit risk that the buyer has on the seller. Repos are therefore a means for PSAs to transform their existing non-cash assets into the cash that CCPs require to meet VM

www.parlament.gv.at

calls, whilst retaining ownership and – critically - investment returns of the assets long term. Under the proposed PSA repo service, PSAs would enter into repo transactions with other market participants of the trading service using the securities that it already holds in the ordinary course of its investments. These transactions would be executed on the CCP's repo trading platform and would automatically be cleared through its clearing service. The cash raised by the repo transactions could then be posted to the CCP to meet its VM calls. The repos themselves would be cleared through the CCP and therefore the PSA's counterparty credit risk on this transaction would be mitigated by the CCP.

This service would enable PSAs to execute repos whilst centralising the management of the positions at the CCP and mitigating any residual bilateral counterparty credit risk in the repo transactions by facing the CCP instead of the repo counterparty.

As the PSA repo service is still under development, certain important questions as to the viability of such a service remain at this stage. As detailed further below at section 4.3, it is considered that there may be insufficient capacity in the bilateral repo markets for PSAs to ensure the ability to source the cash needed to meet VM calls from the CCP in times of market stress. It must therefore be questioned whether cleared repo markets will develop to provide the extra capacity needed by PSAs. The ability of the bank providers of repo liquidity to remove bilateral risks from their transactions and to instead face the CCP may result in lower capital charges which could incentivise increased repo activity. However, other regulatory factors may influence the development of the repo markets in the short to medium term, including regulatory initiatives under Basel III as well as the proposed EU Financial Transaction Tax, and possible principles on mandatory haircutting of assets pursuant to the Financial Stability Board's Workstream on Securities Lending and Repos. It is possible that repo markets may become less attractive for liquidity providers and may therefore shrink as a result.

Further, the ability of all – or even the majority of - PSAs that have difficulty in meeting cash VM calls to utilise this service is questionable. This is because participants in the service will need to access the CCP under a special access membership agreement which would oblige the PSA to make contributions to a special default fund. The default fund would not be used to cover losses of other clearing members as with conventional membership agreements; it would be provided to cover only direct losses caused by the potential default of the PSA itself. It is therefore not exposed to losses caused by other clearing participants defaulting However it will involve a commitment of additional security upfront which may not be tolerable to all PSAs and their managers or trustees.

Finally, at this stage of development, the costs for PSAs of using the potential repo service are unknown. It is possible that the costs of entering into cleared repo transactions will be higher than the costs of entering into bilateral repo transactions.

This is because the PSA will have to maintain a default fund, as described above, as well as a clearing fee being attached to the transaction. There will also be implementation costs for the PSA to set up operational connections to the service, as well as legal agreements.

This potential service is still under development. It is planned to be launched in the first half of 2015. The Commission will continue to engage with the CCP in question and PSAs as the service comes to the market in order to assess its ability to serve the needs of PSAs.

The Commission will also explore with interest the ability of other CCPs to develop similar services.

As the proposed service is yet to be launched, the Commission has explored additional potential technical solutions in order to identify whether there are other measures which might be taken by CCPs in enabling PSAs to post non-cash assets to meet VM calls. These potential technical solutions are outlined below. The viability of each option is assessed, taking into account associated legal, commercial, policy and practical obstacles, associated risks, and any identifiable likely costs to PSAs.

The baseline study also explored whether alternative solutions may exist outside of the CCP infrastructure for PSAs to be able to centrally clear without negatively affecting retirement incomes. These alternative solutions are also outlined below, with an analysis of their viability.

Any resulting risks of the technical or alternative solutions must of course be balanced against the level of systemic risk mitigation that central clearing provides.

3.2. POTENTIAL ALTERNATIVE SOLUTIONS

(i) Collateral transformation by CCPs

This would entail a repo service offered by CCPs to PSAs in which the CCP would be the principal counterparty to the repo transaction, providing cash to the PSA in return for securities. In this sense, the core concept is comparable to the PSA repo service under development by the CCP outlined above. However, this potential solution does not assume the ability of the CCP to also create an offering for an organised repo trading platform and associated clearing service.

The relevant CCP would then need to execute a back-to-back repo with a third party concurrently in order to raise the cash. This third-party would be either a dealer bank in the repo market or a central bank.

It is questionable whether an arrangement in which the central bank is the only provider of liquidity for repo would be acceptable to that central bank therefore this

www.parlament.gv.at

discussion assumes a solution whereby the CCP expects to use the commercial banks in ‘normal’ conditions and only uses the central bank in adverse market scenarios.

Currently not all CCPs have routine access to central banks’ facilities. Certain EU CCPs currently have access to intra-day credit and, under defined conditions, to overnight credit. However, this access could not be suitable to implement a standard collateral transformation facility based on repo. To do so, CCPs would at least need access to overnight facilities or even to credit operations with longer maturities in order to avoid rolling over short-term repos on a daily basis. This would involve a change in practice between CCPs and central banks which central banks and their stakeholders would need to consider carefully.

This potential solution entails CCPs assuming an increased level of risk in terms of repo transaction volume and consequent exposure to counterparty and market risk. This in turn increases the systemic risk posed by CCPs.

Additional obstacles include the need for investment by the CCP in the necessary trading and treasury management capability as well as operational and legal changes – most notably in its default procedures where repo transactions with a defaulting clearing member may need to be liquidated at the same time as the affected OTC derivative portfolios.

(ii) Direct acceptance of non-cash assets with pass through to receivers of VM

Here the CCP would allow PSAs to post and receive VM in the form of non-cash assets that it is already holding, such as Government bonds. Those assets would then be passed through to the in-the-money counterparty to the transaction.

A CCP would have to offer for clearing two parallel sets of products with the same fundamental economic terms – one for which VM would be paid and received in cash and the other for which it would be posted and received in specified eligible securities. This would reduce market liquidity, with the probability of wider trading spreads and less flexibility in porting or liquidating the positions of a defaulting participant at the CCP. There would also be an inability for collateral calls to be netted across the two products.

Timely settlement is another principal obstacle to this option being made viable. Participants posting non-cash VM would have to be able to transfer the securities into the name of the CCP on the same day as the collateral call is made. However, this would be difficult to achieve in practice since same-day settlement is not standard practice at central securities depositories currently. A further difficulty is that securities can only be exchanged in transferable units. Since the VM amounts payable or receivable will be calculated by the CCP in monetary values the CCP would need to set a market convention for how these values are to be converted into the deliverable quantity of whatever security the VM payer chooses to post resulting in rounding differences and cash adjustments made between the CCP and the clearing members.

www.parlament.gv.at

Additionally costs amounting to several million euros would be incurred by CCPs, clearing members, Custodians, asset managers and PSAs in order to provide the necessary operational capabilities on this front.

In terms of legality, there is also doubt over whether passing securities through to the receiver of VM would meet some PSAs' requirement to keep control of their assets.

(iii) Acceptance of non-cash assets with security interest passed through to receivers of VM

The CCP would again allow PSAs to post VM in the form of securities, as under (ii).

However, instead of passing on the securities to the counterparties due to receive VM, the CCP would create a security interest over the posted securities, in favour of the VM receiver.

Under this solution, the assets posted to meet the VM call are not transferred to the VM receiver and so the risk in the contract is not actually settled. There simply exists a legal claim that will vary in value over time. In the event of default, the value of the claim would be uncertain until its liquidation. This additional risk would lead to the contract needing to be priced differently making it more expensive than regular cash settled contracts, and again creating a bifurcation of cleared products with less liquidity in the PSA tailored product.

Legal risk is also an obstacle to this solution, as security interests are not always subject to the same legal frameworks across the EU. This potentially leads to legal uncertainty as to what would happen in a default situation

(iv) Quad-party collateral for VM security interest

This is a variation of the previous solution in which the securities would be held with a custodian according to an agreement between itself, the PSA, the counterparty to the original transaction and the CCP.

This arrangement would enable PSAs to post non-cash assets as VM without needing to transform them into cash. Collateral would instead be provided in the form of a security interest in favour of the counterparty. The PSA would outsource its collateral management to a custodian in an arrangement formalised between the four parties involved - the PSA, the counterparty, the CCP and the Custodian. The solution would build on existing tri-party collateral management services.

This solution presents the same challenges as the previous solution in that it results in unsettled counterparty credit risk, which is counterintuitive to the function of VM and may cause concern for clearing members, counterparties and regulators.

www.parlament.gv.at

It would again create a bifurcation in products, with liquidity and netting complications.

(v) Collateral Transformation by Clearing Members

This first alternative to a technical solution at the CCP is the possibility for PSAs to raise cash by executing repo transactions with their clearing members, outside of the CCP's own infrastructure.

Clearing members of OTC derivatives CCPs generally belong to banking groups that are also active in the repo market. This means that clearing members are seemingly well placed to offer repo services to their PSA clients for this purpose without investing in new business operations. Such a service could also be provided to PSAs independently of their designated clearing brokers by a third party bank.

However the current size of the bilateral repo markets may have insufficient capacity to provide the cash that PSAs would need to meet their VM liabilities. In any case, repo lines would not be guaranteed by dealers and may be withdrawn in times of stress.

According to the findings of the baseline study (see, in particular, section 5.7.3), the repo market would however not be able to cope with the aggregate demand from PSAs seeking to fund in full cash VM calls due to a severe interest rate movement (e.g.100 basis points) and PSAs would, as a result, not have access to funding needed to meet VM calls if they were to rely on the bilateral repo market. This would result in unpaid margin calls putting PSAs into default and causing knock on effects across the markets.

Under this arrangement, the PSA's clearing broker would be exposed to the consequences of the default of the PSA in that it may be contractually obliged to meet VM calls on its PSA client's behalf. Clearing brokers are generally top-tier banks and so pose significant risk to the wider financial system.

(vi) Agency stock lending

Under a model of agency stock lending, the PSA would lend securities from its own portfolio to third parties and receive collateral in the form of cash from the borrower which could be used to meet VM calls.

Stock lending is already used by many PSAs through established operational and legal arrangements. However, the ability of the PSA to lend depends on the needs of other market participants to borrow the offered assets at any given time. Whether counterparties actually want to borrow stock and for what duration is outside the control of the PSAs. Stock lending cannot therefore be viewed as a reliable source of

funding. As with the arrangement above, this would have the potential to result in unpaid margin calls with the potential to lead to the default of the PSA's clearing broker.

(vii) Secured lending by non-financial entities

The baseline study identifies that many large corporate entities presently have large cash reserves that they may be looking to lend securely

This alternative option would involve the PSA posting securities under a repo transaction and receiving cash from the corporate entity as collateral against the repurchase, similar to the potential alternative solution outlined under (v).

There is currently no established market for secured corporate lending to PSAs so whilst conceptually corporates may have means to provide cash to PSAs in order to meet CCP VM calls, the capacity and volatility of such a market is impossible to assess. This alternative also raises questions as to whether the establishment of such a market would call for regulation, and the impact that this would have on costs and availability. It cannot therefore be deemed as a viable alternative option.

4. CONCLUSIONS

4.1. PROGRESS AND EFFORT MADE BY CCPS

It can be concluded that, with the exception of the proposed PSA repo service identified in section 3, no sufficient progress appears to have been made by CCPs in order to develop technical solutions for the transfer of non-cash collateral as VM. None of the infrastructure based potential alternative solutions analysed outlined under points (i) to (iv) of section 3.2 appear to be being pursued by any CCPs. It can be concluded that this is due to the obstacles that this report identifies. Nonetheless, CCPs should continue to consider ways in which the obstacles identified to the implementation of the potential alternative solutions could be overcome in practice.

The lack of progress in identifying and developing viable solutions may be attributable to the fact that those CCPs that have not developed solutions are currently not well placed to provide such services as they do not already operate any trading or clearing services in the repo markets that could be built on to facilitate collateral transformation. It can also be assumed that CCPs have focussed their resources over the past two to three years on bringing their services into compliance with the newly implemented requirements under EMIR, as well as other aspects of EU and international regulatory reforms.[v] Considerable resources have also been expended by CCPs on developing client clearing solutions generally, as clearing obligations under

www.parlament.gv.at

EMIR will extend to small and medium sized market participants (including PSAs) which are unable to clear directly as clearing members. The lack of efforts in developing technical solutions could therefore also be attributed to the fact that CCPs have been unable to prioritise new developments in this area.

4.2 MEASURES REQUIRED

The Commission will continue to monitor development of the repo-based service proposed by the relevant CCP, in order to assess whether this focus is maintained and the solution is implemented smoothly in 2015 as anticipated. The successful implementation of this proposed service will also depend on the continued cooperation of the potential PSA participants.

The Commission will also continue to engage with other EU CCPs clearing the relevant OTC derivative transactions (interest rate and/or inflation swaps) in order to assess whether similar solutions could be adopted by those CCPs. As identified above, this may depend on the ability of other CCPs to offer services in repo trading and clearing as well as OTC derivatives clearing. Nonetheless, the Commission strongly urges all EU CCPs, in cooperation with their clearing members and with PSAs, to continue their consideration of how the obstacles analysed in this report may be overcome to achieve clearing solutions that – either individually or in combination – could provide the necessary capacity for PSAs to centrally clear their OTC derivative transactions, with a lesser impact on their yields. An appropriate solution will enable PSAs to pursue their OTC derivatives activity without inhibitive cost whilst providing the benefits of central clearing to their counterparties and the wider financial system.

However, the Commission recognises that, in the absence of a solution, PSAs will ultimately be required to substitute securities for cash in order to maintain a sufficient cash buffer to meet potential VM calls, from August 2018 at the latest. It should also be considered that, though none of the potential alternative solutions seem to provide a comprehensively satisfactory solution for PSAs, a combination of collateral transformation may need to be utilised. The Commission would also encourage the industry to consider what longer term financing opportunities (such as covered bonds or asset backed securities) may be available to PSAs which, individually or in combination, could provide a sufficient source of funding with confidence, including in times of stress. It is recognised that such financing opportunities may be dependent on the ability of the PSA to maintain legal title and/or control over the securities being exchanged for cash and flexibility would therefore be required.

www.parlament.gv.at

4.3 POTENTIAL ADVERSE EFFECT OF CENTRALLY CLEARING DERIVATIVE CONTRACTS ON THE RETIREMENT BENEFITS OF FUTURE PENSIONERS

In the absence of an exemption from the clearing obligation being available, PSAs would be forced to hold cash reserves instead of higher yielding assets that they commonly hold, such as Government bonds. Continuing to hold non-cash assets and relying on the open repo markets on an ad-hoc basis does not provide sufficient certainty. As indicated in the baseline study, the main identifiable obstacle to doing so is the fact that the current repo bilateral repo markets do not appear to hold sufficient liquidity to withstand the needs of EU PSAs in stressed scenarios. This conclusion is based on analysis of the EU Government bond markets. The baseline study indicates that the aggregate VM call for a 100 basis point move would be €204–255 billion for EU PSAs. Of this, €98–123 billion (£82–103 billion) would relate to UK PSAs, and predominantly be linked to sterling assets, and €106–130 billion would relate to euro (and perhaps other currency) assets.

Even if PSAs were the only active participants in these markets, the total VM requirement for such a move would exceed the apparent daily capacity of the UK gilt repo markets and would likely exceed the relevant parts of the EU Government bond repo market — i.e. primarily that in German Government bonds (bunds). Repo liquidity does exist in other less liquid but still high grade securities although the markets for these instruments are much more susceptible to shrinkage in times of stress.

Holding cash reserves to cover potential market movements will reduce the overall yields earned on the investments made for the benefit of the pensioners belonging to the schemes, which may ultimately reduce the total amounts paid out by the PSAs as retirement income to those beneficiaries.

According to the baseline study, the costs of moving from bilateral collateralisation to posting cash VM with CCPs impact of requiring PSAs could consequently amount to a cumulated percentage reduction in retirement incomes of up to 3.1 per cent in the Netherlands and 2.3 per cent in the UK based over a 40 year period. The total expected impact on retirement incomes across the EU over 20-40 years would be up to 3.66%. This is directly attributable to the reduction in investment returns anticipated by being required to hold cash reserves instead of non-cash securities.

This is a significant impact which is likely to affect pensioners across the EU and can be considered disproportionate to the benefits served by requiring PSAs to clear at this stage. This conclusion takes into account the fact that transactions will in any case be required to be collateralised on a bilateral basis under the forthcoming bilateral margin requirements under Article 11(3) of EMIR, thereby mitigating the counterparty credit risk in transactions to which they are counterparty, both from the perspective of the banks and the PSAs.

www.parlament.gv.at

It is possible that PSAs at the higher end of the scale of this impact may choose not to hedge their liabilities in order to maintain current levels of retirement income for beneficiaries. This would create the risk of losses on investments as a result of unhedged market volatility which would equally lead to a reduction in retirement incomes.

However, it should be noted that, as the significant majority of standardised OTC derivative contracts move to central clearing, non-cleared contracts may become less liquid over time. This in itself would narrow the overall cost differential between cleared and non-cleared contracts in the future.

4.4 PROPOSAL FOR A DELEGATED ACT

The Commission considers that the necessary effort to develop appropriate technical solutions has not been made at this point in time and that the adverse effect of centrally clearing derivative contracts on the retirement benefits of future pensioners remains unchanged.

The Commission therefore intends to propose an extension of the three-year period referred to in Article 89(1) of EMIR by two years through means of a Delegated Act. The Commission shall continue to monitor the situation with regards to technical solutions for PSAs to post non-cash assets to meet CCP VM calls in order to assess whether this period should be extended by a further one year.

---

[i] As defined under Article 2(10) of EMIR.

[ii] Article 89(1) and (2) of EMIR, the exemption shall apply only to OTC derivatives that that are objectively measurable as reducing investment risks directly relating to the financial solvency of pension scheme arrangements and where the PSA encounters difficulties in meeting the VM requirements.

iii The baseline study will be made available on the European Commission website http://ec.europa.eu/internal_market/financial-markets/derivatives/index_en.htm#maincontentSec2

[iv] It should be noted that the service under development would not be limited to PSAs but may be offered to other market participants with similar needs.

[v] Several EU CCPs are authorised and operative in third country jurisdictions.

www.parlament.gv.at