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| 02 April 2020 |

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| Response form for the Consultation Paper on central clearing solutions for pension scheme  arrangements (EMIR Article 85(2)) |
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| Date: 02 April 2020 |

Responding to this paper

ESMA invites responses to the questions set out in Annex II of the First Report with Consultation on Central Clearing Solutions for Pension Scheme Arrangements that ESMA drafted under Article 85(2) of the Regulation (EU) No 648/2012 of the European Parliament and Council on OTC derivatives, central counterparties and trade repositories (EMIR, as amended by Refit).

Responses are most helpful if they:

* respond to the question stated;
* contain a clear rationale; and
* describe any alternatives ESMA should consider.

ESMA will consider all responses received by 15 June 2020.

Instructions

In order to facilitate analysis of responses to the Consultation Paper, respondents are requested to follow the below steps when preparing and submitting their response:

* Insert your responses to the questions in the Consultation Paper in the present response form.
* Please do not remove tags of the type <ESMA\_QUESTION\_CCSPSA\_1>. Your response to each question has to be framed by the two tags corresponding to the question.
* If you do not wish to respond to a given question, please do not delete it but simply leave the text “TYPE YOUR TEXT HERE” between the tags.
* When you have drafted your response, name your response form according to the following convention: ESMA\_CCSPSA\_nameofrespondent\_RESPONSEFORM. For example, for a respondent named ABCD, the response form would be entitled ESMA\_CCSPSA\_ABCD\_RESPONSEFORM.
* Upload the form containing your responses, in Word format, to ESMA’s website ([www.esma.europa.eu](http://www.esma.europa.eu) under the heading “Your input – Open consultations” 🡪 “Consultation on central clearing solutions for pension scheme arrangements”).

Publication of responses

All contributions received will be published following the close of the consultation, unless you request otherwise. Please clearly indicate by ticking the appropriate checkbox on the website submission page if you do not wish your contribution to be publicly disclosed. A confidential response may be requested from us in accordance with ESMA’s rules on access to documents. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by ESMA’s Board of Appeal and the European Ombudsman.

Data protection

Information on data protection can be found at [www.esma.europa.eu](http://www.esma.europa.eu) under the heading “Data protection”.

Who should read the Consultation Paper

All interested stakeholders are invited to respond to this consultation paper. In particular, responses are sought from market participants, pension funds, banks, CCPs, central banks, authorities and trade associations of financial market participants.

# General information about respondent

|  |  |
| --- | --- |
| Name of the company / organisation | ABN AMRO Clearing Bank N.V. |
| Activity | Banking sector |
| Are you representing an association? |  |
| Country/Region | Netherlands |

# Introduction

Please make your introductory comments below, if any:

<ESMA\_COMMENT\_CCSPSA\_1>

TYPE YOUR TEXT HERE

<ESMA\_COMMENT\_CCSPSA\_1>

1. : Do you agree with the description made of the portfolios of EU pension funds as well as their use of derivatives? In particular, do you agree that PSAs use derivatives to build synthetic long-dated positions in order to overcome the availability of suitable sovereign or corporate bonds alternatives? Please elaborate on the reasons for your answer.

<ESMA\_QUESTION\_CCSPSA\_1>

TYPE YOUR TEXT HERE

<ESMA\_QUESTION\_CCSPSA\_1>

1. : Do you have any data with respect to the structure of PSAs’ portfolios? In particular regarding the duration gap which derivative strategies are designed to address?

<ESMA\_QUESTION\_CCSPSA\_2>

TYPE YOUR TEXT HERE

<ESMA\_QUESTION\_CCSPSA\_2>

1. : Do you have any data on the volume and nature of the activity of PSAs in cleared and non-cleared OTC derivatives markets, within each asset class, and any related systemic risk they might pose to the financial system? What portion of non-cleared derivatives would be replaceable by cleared products if the impediments to clearing were removed?

<ESMA\_QUESTION\_CCSPSA\_3>

TYPE YOUR TEXT HERE

<ESMA\_QUESTION\_CCSPSA\_3>

1. : Do you think that PSAs fulfilling the clearing requirement would have significant consequences on their investment strategies, including any shift in their cash and non-cash asset allocation? Please elaborate on the reasons for your answer and provide numerical data supporting your answer where available.

<ESMA\_QUESTION\_CCSPSA\_4>

TYPE YOUR TEXT HERE

<ESMA\_QUESTION\_CCSPSA\_4>

1. : Are there further considerations, other than investment strategies mentioned above, either driving or constraining the use of derivatives for PSAs?

<ESMA\_QUESTION\_CCSPSA\_5>

TYPE YOUR TEXT HERE

<ESMA\_QUESTION\_CCSPSA\_5>

1. : Do you agree with the description of the challenges met by PSAs to post variation margin in cash? Please elaborate on the reasons for your answer.

<ESMA\_QUESTION\_CCSPSA\_6>

TYPE YOUR TEXT HERE

<ESMA\_QUESTION\_CCSPSA\_6>

1. : Do you have any data with respect to the value and/or share of cash holdings in PSAs’ portfolios? Can you provide estimates of how much those would need to be increased to service cash variation margin calls?

<ESMA\_QUESTION\_CCSPSA\_7>

TYPE YOUR TEXT HERE

<ESMA\_QUESTION\_CCSPSA\_7>

1. : Do you have any data with respect to estimated changes in variation margin for your outstanding contracts for a +/- 1% parallel shift in the yield curve for: a) cash VM of centrally cleared contracts, b) cash VM for OTC contracts, c) bonds VM for OTC contracts, and d) for all your outstanding contracts?

<ESMA\_QUESTION\_CCSPSA\_8>

TYPE YOUR TEXT HERE

<ESMA\_QUESTION\_CCSPSA\_8>

1. : Can you provide data on the prevalence of acceptance of non-cash collateral in the context of bilateral OTC trades? And conversely on the limitations imposed by counterparties to post initial margins in the form of cash?

<ESMA\_QUESTION\_CCSPSA\_9>

TYPE YOUR TEXT HERE

<ESMA\_QUESTION\_CCSPSA\_9>

1. : Can you provide data on the size of the yield drag from holding cash buffers to service variation margin calls in cash? Possibly differentiating between drag from under-investment and costs of funding temporary high liquidity demands?

<ESMA\_QUESTION\_CCSPSA\_10>

TYPE YOUR TEXT HERE

<ESMA\_QUESTION\_CCSPSA\_10>

1. : Are you (or are you aware of) a PSA which is a direct clearing member to a CCP? How have you addressed the issues regarding the posting of cash VM?

<ESMA\_QUESTION\_CCSPSA\_11>

TYPE YOUR TEXT HERE

<ESMA\_QUESTION\_CCSPSA\_11>

1. : Can you indicate whether you have considered becoming a direct clearing member to a CCP for the purpose of clearing mandated contracts? If not, what were the reasons against becoming a direct member? Specifically, were there other considerations beyond the issue of cash variation margins?

<ESMA\_QUESTION\_CCSPSA\_12>

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<ESMA\_QUESTION\_CCSPSA\_12>

1. : Do you agree that the central clearing of OTC derivatives by PSAs by June 2023 at the latest is the ultimate aim? Do you agree that the entry into force of this requirement should be subject to regulatory and market developments enabling market participants to develop appropriate technical solutions within that period? Please elaborate on the reasons for your answer.

<ESMA\_QUESTION\_CCSPSA\_13>

Yes, ABN AMRO Clearing believes that central clearing of OTC derivatives should be mandatory by June 2023, including Pension Scheme Arrangements (PSAs). Central clearing has been key in the reduction of risk in the financial sector in the aftermath of the financial crisis and remains a cornerstone of safe and transparent markets.

We agree that the entry into force of this requirement should be subject to regulatory and market improvements enabling market participants to develop appropriate technical solutions within this period. We, would like to emphasize that at present the following constraints hinder both clearing members and PSAs to support the clearing obligation for PSAs:

* Balance sheets impact on clearing members
* Regulatory liquidity constraints of clearing members
* Constrains for clearing members to continuously access central bank liquidity facilities
* PSAs are required to keep too much cash buffers (liquid resources) available to meet CCP VM calls, resulting in increased credit risk on banks to store cash and reduced investment performance.

<ESMA\_QUESTION\_CCSPSA\_13>

1. : In the hypothetical scenario where the exemption were to be made permanent, do you think that there would be a price handicap for less-liquid non-cleared contracts vis-à-vis the cleared alternatives? Can you provide estimates of the size of the price differential and the impact, also in terms of yield drag on PSA portfolios?

<ESMA\_QUESTION\_CCSPSA\_14>

We need to be aware and it should be noted that a permanent exemption will continue to undermine the resilience of our financial system. Although interest rates markets may continue to be at these low levels, one should foresee that Central Bank monetary policies may lead to significant changes of low interest market rates, leading to significant shocks for interest rates derivatives markets i.e. collateral obligations.

Banks will be required to hold more capital for bilateral OTC derivatives with a long duration compared to centrally cleared derivatives. Holding more capital results in higher costs and therefore a higher price for the bilateral OTC derivatives.

<ESMA\_QUESTION\_CCSPSA\_14>

1. : Under the new regime provided in EMIR Refit with respect to the scope of application of the clearing obligation and the calculation of the positions, do you expect to be or not subject to the clearing obligation once the clearing exemption has come to an end?

<ESMA\_QUESTION\_CCSPSA\_15>

TYPE YOUR TEXT HERE

<ESMA\_QUESTION\_CCSPSA\_15>

1. : Do you agree with the pre-conditions for a workable solution as described in paragraph 51? Please elaborate on the reasons for your answer.

<ESMA\_QUESTION\_CCSPSA\_16>

Yes, we agree with the pre-conditions. Especially the fact that the solutions should function properly in stressed market conditions. As a pre-condition to the mandatory clearing for PSA’s, the resilience of the clearing setup and collateral related requirements to clearing must be sufficiently robust and should not impose disproportionate costs for PSAs. See also response to Q13.

<ESMA\_QUESTION\_CCSPSA\_16>

1. : Are there any other features that the solution should try and achieve?

<ESMA\_QUESTION\_CCSPSA\_17>

We are of the opinion that repo is an important instrument to generate the required liquid assets (cash), but cannot be fully relied upon under all market circumstances. Therefore, we believe that the solution should be robust enough to weather difficult market circumstances i.e. there should be a safety net / lender of last resort to address extreme drops in repo market liquidity. Intermediation of clearing member banks will remain necessary and further exploration is needed to provide clearing members with adequate (regulatory) tools to provide collateral services to PSAs.

<ESMA\_QUESTION\_CCSPSA\_17>

1. : Do you agree with the statement that no or few PSAs were onboarded with the status of clearing members, but instead clear as direct clients of a clearing member? Do you think that this situation may evolve in the coming years? Please elaborate on the reasons for your answer.

<ESMA\_QUESTION\_CCSPSA\_18>

Yes, we agree with the statement that limited to none were on-boarded with the status of clearing member. This situation is not likely to change in the coming years. For a number of reasons direct membership seems to be too much of a challenge for many PSA’s, such as operational capabilities, meeting morning and intra-day margin call obligations and meeting CCPs’ default fund participation requirements and default fund contributions. Also most PSA won’t be able to participate in mandatory default auctions.

We believe that a hybrid setup in which the PSA enters into a direct relationship with the CCP and in which the clearing member acts as agent or sponsor on behalf of the PSA will receive more interest in the market.

<ESMA\_QUESTION\_CCSPSA\_18>

1. : Do you agree that relying on collateral transformation services already offered by clearing members to their direct clients may be part of the solution? Please elaborate on the reasons for your answer.

<ESMA\_QUESTION\_CCSPSA\_19>

TYPE YOUR TEXT HERE

<ESMA\_QUESTION\_CCSPSA\_19>

1. : To what extent has the constraint on the bank clearing members’ capital requirements been eased and now allows for their role of collateral transformation to be better fulfilled?

<ESMA\_QUESTION\_CCSPSA\_20>

In general, the way the leverage ratio was originally designed made it less convenient for banks to provide client clearing services, because margins posted by clients could not be used to offset the amount of the exposure (which would feed into the denominator of the ratio).

The amendment of the Capital Requirement Regulation (CRR-II) has changed the leverage ratio treatment for client cleared derivatives such to ‘permit cash and non-cash forms of initial and variation margin received from a client to offset the replacement cost and potential future exposure for client cleared derivatives’. This amendment will help make central clearing more economic in terms of capital requirements. We believe that further adjustments to the leverage ratio framework would leave more room for clearing members to provide collateral transformation services. <ESMA\_QUESTION\_CCSPSA\_20>

1. : Do you think that modifying the calculation of the leverage ratio might have an impact on the offer on repo intermediation activities by banks and be a part of the solution? Please elaborate on the reasons for your answer.

<ESMA\_QUESTION\_CCSPSA\_21>

Yes, we think so. An improved calibration of the leverage ratio framework leaves more room to conduct collateral transformation services that may require less capital. A more favourable capital treatment for repo/reverse repo would certainly be supportive to stimulate repo intermediation by banks and clearing agents. Also, one could consider establishing a new exposure class for pension funds, which could lower risk weights for these exposures significantly, improving alignment with the actual risks these exposures pose to clearing banks.

<ESMA\_QUESTION\_CCSPSA\_21>

1. : Can you elaborate on issues you have encountered, or risks you perceive, in relying of clearing members to provide collateral transformation services, including transformation into cash to meet variation margin requirements? Is this a service that is available to you? If not, what are the obstacles?

<ESMA\_QUESTION\_CCSPSA\_22>

See comments on Q23.

<ESMA\_QUESTION\_CCSPSA\_22>

1. : What is your view on solutions based on collateral transformation via the repo market? Do you think that initiatives on collateral transformation solutions via the repo market constitute one possible solution? What other solutions are worth exploring?

<ESMA\_QUESTION\_CCSPSA\_23>

We believe collateral transformation through the repo market could be the solution, although current available liquidity\* in this market may not yet be sufficient. In addition, we believe that settlement timings of the (cleared) repo market should be aligned with the timing of the variation margin settlement (as described below).

To ensure PSAs have sufficient cash available to satisfy their variation margin obligating, PSAs should raise cash in a repo transaction for a longer duration (term they would require to replace the cash need in an alternative way, for example by selling assets e.g. 1 week) and place excess cash not needed for VM via a shorter duration reverse repo (overnight). This way they will always have the certainty of having sufficient cash available for future needs.

The centrally cleared repo market at e.g. Eurex Clearing may currently not be large enough to support the cash requirements by large PSAs from the Netherlands or Denmark. In March 2020 the combined outstanding balance in Special Repo and General Collateral (GC) Baskets was roughly 130 billion Euros. As of this moment there are 143 participants from 18 countries connected to Special Repo and GC Baskets. These participants vary from banks to corporates. PSAs could find a natural cash liquidity match in corporates as Banks are moving out of (centrally cleared) repo by month-, quarterly, semi-annual, year-ends due to balance sheet constraints. Corporates on the other hand prefer to post larger amounts of cash around those periods for other reasons.

To ensure sufficient liquidity in the repo instrument one should consider for central banks to play a role as a lender of last resort, providing cash liquidity to the repo market in periods of significant stress or perhaps even directly to PSAs in a collateral (intraday) facility, due to PSAs’ directional and large exposures.

Other solutions could be considered using securities financing / securities lending instruments, but we believe current market liquidity in cleared SF on CCPs are low, leaving only bilateral SF trades to be of use here.

The challenge for PSAs to clear derivatives through a CCP is that they do not have large cash buffers available to satisfy margin calls by CCPs. Following types of margin calls are to be paid when clearing through CCP next to the contribution to the default fund (which will be covered by the PSAs clearing member/agent):

1. Initial Margin call: to cover future exposures on open positions
2. Variation Margin call: to pay daily variation in the value of the positions

Both can be triggered daily and are settled early in the morning based on the exposures end of day of the day before and can be triggered intraday as soon as CCP thresholds are hit, so that exposure is covered till next daily settlement of the daily margin call.

In our view, the best solution to cover the intraday margin calls of the CCPs is to allow the possibility to cover this with non-cash eligible collateral. The collateral does not have to be paid out to other CCP participants by the CCP as returning initial or variation margin on happens with the daily margin call settlement cycle. The non-cash collateral only covers the exposure risen above the accepted 1-day threshold level, to ensure the standard daily call can be met the next morning.

As initial margin calls are allowed to be covered with non-cash collateral as well, it’s not paid to another CCP participant, but acts as buffer for future exposure for the CCP, initial margin calls do not cause an issue for the PSAs either to clear through CCP.

Variation margin, however, can only be paid in cash, as it needs to be paid onwards to the receiving participant of the CCP. We do not believe pledging non-cash collateral will be an effective solution. The receiving participant would not have any certainty on when it will receive the actual liquidity on the back of this variation margin and this liquidity might be required to satisfy other obligation. In short, it might, in extreme circumstances, become an everlasting position never to be turned into cash liquidity.

This leaves the cash liquidity issue with the settlement of the daily variation margin. As PSAs generally have sufficient non-cash assets available, the key challenge is to timely transform these assets into cash. Transformation via a repo contract has been used in multiple markets for many years. The challenge to use this instrument to solve the cash PSAs need to satisfy the VM call, lays in the timing of the settlement of the variation margin versus the settlement of the repo, as most repo contracts settle during the day, while VM is called in the early morning.

To solve this timing mismatch the processing of the variation margin settlement and the settlement of the repo instrument need to be aligned. We see three possible solutions, using the repo instrument:

1. Create a repo instrument that settles at the time the variation margin needs to be paid.

This solution is being looked at by multiple CCPs. Eurex has developed a GC pooling product that settles at the same time as the variation margin calls for the IRS instrument. Big advantage of such a product is that if repo and derivatives are traded at the same platform it ensures settlement on the variation margin; potentially these cash flow settlements could even be netted. Trading the two products on different CCPs or even the repo bilateral, will create operational and settlement risk and it will be difficult to ensure timely payments of the variation margin. Although this is a very promising option, it is difficult to predict whether there will be enough liquidity in the IRS instruments.

1. Adjust the settlement timing of the variation margin to the settlement timing of the repo instrument and allow the exposure to be covered with non-cash collateral in between.

The advantage of this option is that PSAs will have access to more liquidity in the repo market and will be more likely to cover the full potential cash need of the PSAs. The disadvantage of this solution is that the intraday timing gap will need to be covered with non-cash collateral, locking up additional available collateral. Operational and settlement risks do remain relatively high with this set up.

1. Develop cash liquidity solutions to transform non-cash collateral intraday between the timing of the settlements of both.

This solution can be used with the current settlement timing, bridging the time between the settlement of the variation margin and the settlement of the repo, but it requires an intraday cash liquidity provider that is committed to provide the cash liquidity. The commitment to providing the intraday cash will be costly and will bring the same settlement and operational risks as the second solution. The repo product still needs to be in place to allow for the return of the intraday financed variation margin, which will lock up additional non-cash collateral.

\*Repo traded volumes on Eurex can be found here: GC Pooling. Source: <https://www.eurexrepo.com/repo-en/info-center/statistics> & Special repo. Source: <https://www.eurexrepo.com/repo-en/info-center/statistics/Statistics-23890?frag=245182>.

<ESMA\_QUESTION\_CCSPSA\_23>

1. : Do you think that the repo market is suitable for PSAs’ needs? If not, what are the impediments for PSAs to access the repo market? Please elaborate on the reasons for your answer, specifying if these are related to cost, operational complexities or regulatory constraints.

<ESMA\_QUESTION\_CCSPSA\_24>

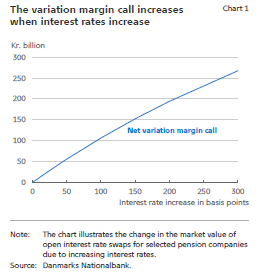
We do believe servicing access for PSAs to the repo markets will have a positive impact on the reduction of the liquidity challenges to support the CCP OTC derivatives markets. We are actually developing solutions to service our clients in this. If this will solve the total liquidity issue for PSAs clearing OTC derivatives, remains to be uncertain due to reason mentions above (see Q23). We are confident it could help at least covering a part of the liquidity constrains.

<ESMA\_QUESTION\_CCSPSA\_24>

1. : Do you have any data with respect to PSAs’ potential liquidity demand in business-as-usual? Also, do you have any data with respect to PSAs’ maximum liquidity needs in stressed market conditions?

<ESMA\_QUESTION\_CCSPSA\_25>

Danmarks Nationalbank published a study in November 2019 where they have assessed the liquidity need for PSAs in the event interest rate rises. The chart below is showing the amount Danish Krone, which needs to be funded on basis point shifts. Please note that there are no recent similar studies performed by any Dutch agency, however since the Danish and Dutch markets look similar we can safely assume this will hold also on the Dutch market.



In analyzing current IRS cleared positions for stressing cash liquidity, we find that a 20% additional buffer of the initial margin amount should cover the day to day delta for VM or intraday IM. Stress testing showed that a buffer of up to 50% is needed for extreme interest movements. These are average numbers and can differ on individual level depending on the portfolio cleared.

<ESMA\_QUESTION\_CCSPSA\_25>

1. : Do you think that PSAs fulfilling their liquidity needs via the repo market will have strong implications on this market’s liquidity and procyclicality? Can you provide quantification of the risk of the likelihood of a failure of market-based repo solutions to meet PSAs’ needs? Under which conditions?

<ESMA\_QUESTION\_CCSPSA\_26>

It will be hard for PSAs to find liquidity around month- and quarter-ending because banks retreat from the repo market due to balance sheet and capital ratio constraints. Detailed information about this behavior of credit institutions can be found on Clarus: <https://www.clarusft.com/the-gsib-framework-and-window-dressing/>.

This is also the reason that PSAs should require the cash in advance of a VM call on a potential (stress) outflow. Requiring the cash when the VM call already took place will not be a solution, as liquidity will not be sufficient and an intraday time gap on the settlement will still leave an intraday liquidity gap. Pre-arranging the cash in a termed repo on a continuous basis by PSAs will impact availability and pricing in the Repo market. Consequently, higher pricing could also make more liquidity available.

To ensure failure of the repo market is avoided, it should be considered to have central banks supporting liquidity in stressed repo markets (as discussed in Q23). Also, a more favourable capital treatment for repo/reverse repo would certainly be supportive to stimulate repo intermediation by banks and clearing agents.

For interest rate derivatives high volatility can be expected when central banks increase or decrease interest rates which therefore may cause large margin calls in the foreseeable future. At the same time central bank interest rates changes will also have its effect on repo pricing and potentially on the liquidity available for the repo instrument moving procyclical with the interest rate derivatives. With an increase of central bank interest rates, central banks can be expected to be looking at tapering market liquidity (which we’ve seen happening in the US after the financial crisis). This could be in conflict with the liquidity required to cover increased margin requirements for CCP cleared interest rate derivatives, at least in the next couple of days after the interest rate move.

<ESMA\_QUESTION\_CCSPSA\_26>

1. : Do you think that there is agreement or evidence that the impact of the limitations of the solutions explored so far would be such that there is a need for devising and developing some form of emergency liquidity tools? If so, under which scenarios and how could such tools actionably and realistically be deployed?

<ESMA\_QUESTION\_CCSPSA\_27>

Having emergency liquidity tools in place will be needed, as repo markets are not always liquid enough (see recent US repo market move) to cover the need for cash liquidity for the PSAs. Rather to open a window to the central banks for PSAs to mitigate this risk, we prefer central banks to have efficient liquidity providing instruments set up to support liquidity in the repo market.

<ESMA\_QUESTION\_CCSPSA\_27>

1. : In the hypothetical scenario where central banks extended liquidity support to PSAs, can you provide estimates of the costs, also in terms of infrastructure, ancillary requirements, and regulatory obligations that this option would entail? Can you express the cost in term of yield drag on PSAs performance, especially vis-à-vis the null option of increasing cash allocation in PSAs’ investment portfolios?

<ESMA\_QUESTION\_CCSPSA\_28>

TYPE YOUR TEXT HERE

<ESMA\_QUESTION\_CCSPSA\_28>

1. : What type / form of emergency liquidity tools do you think could be deployed? And whom should they be accessible to? In particular, is there any tool other that central bank liquidity that you would recommend to ESMA to consider?

<ESMA\_QUESTION\_CCSPSA\_29>

See comments on Q23 and Q27.

<ESMA\_QUESTION\_CCSPSA\_29>