A well-founded pension fund uptake in central clearing

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Pension funds play an important role in the financial industry and the lives of European pensioners. Regulatory changes such as the mandatory clearing of over-the-counter financial instruments (OTC IRS) and the increase in capital requirements for banks pose major challenges for European pension funds.

Due to the long-term nature of their liabilities, pension funds must hedge against interest rate and inflation risks. Notably, the lack of long-dated bonds in Europe issued by high-quality issuers, such as governments, has led many pension funds to use standard interest rates and inflation swaps for hedging. However, historically these swaps were not centrally cleared, and pension funds were exposed to multiple counterparty and operational risks.

Regulators' plans for an enforced transition to a cleared model have been delayed since 2012, primarily stemming from the perceived inability to raise cash to fund variation margin calls.

In January 2022, ESMA determined that PSAs are largely operationally ready and that a mix of repo models, including cleared repo, are available. In a letter to Commissioner McGuinness, ESMA proposed that the clearing obligation should also apply to pension funds and exempt them one final time until 19 July 2023.

Minimise risk. Maximise opportunity.

In today's bilateral model, pension funds face many different counterparties across their OTC derivative portfolios. Often very advantageous one-sided CSAs are in place, and as fixed receivers, some pension funds hold a healthy stock of deep-in-the-money swaps. Moving to a cleared derivative model presents complexities that need careful consideration.

One such consideration is how best to manage the clearing model in terms of required clearing brokers. This requires careful balancing with the allocation of risk across interest rate and inflation exposure to the extent that gross notional measurements are reduced to a minimum where possible. The lower the margin impact of a client's portfolio on the balance sheet of their clearing brokers, the lower the associated costs.

Another consideration is to which extent existing bilateral inventory is introduced to the cleared environment. At Eurex, we have seen evidence of clients backloading portfolios as partial offsets to newly cleared derivatives to take advantage of lower margin requirements and the associated funding costs.

Pension funds are already taking advantage of central clearing

Despite the delay in implementing the clearing mandate for PSAs, 2021 saw significant growth in our OTC derivatives clearing services within this client segment. The number of active pension funds increased by more than 150 percent. At year-end, the notional outstanding was more than 250 percent higher than in December 2020. These statistics demonstrate impressive growth, evidencing the advantages of a cleared derivative model over a complex bilateral model that incorporates multiple counterparty risk exposures and operational and technological processes.

Therefore, we recommend the Eurex ISA Direct model for OTC for pension fund clients looking to finance their cleared derivative exposures through a single collateral pool. Clients adopting this model today enjoy access to a broader scope of collateral, superior asset protection and enhanced portability in the event of a default. This proposition becomes even more powerful when combined with ISA Direct for repo.

Shortcomings of bilateral repo

While pension funds generally welcome central clearing, in times of rising interest rates, the requirement for CCPs to meet daily variation margin obligations in cash could pose a challenge for pension funds, which are typically fully invested. They generally have three main options: holding a cash buffer, securing bilateral credit lines, or accessing the repo market. Holding substantial cash balances usually reduces investment returns, and bilateral credit lines are expensive in the long run. Accessing the EUR 7.3 trillion pan-European repo market seems a natural choice. Nevertheless, experience has shown that the bilateral repo market is not very liquid in stressful situations. Moreover, banks' additional capital and liquidity constraints have further reduced the available capacity.

Most of the business between dealers and pension fund clients is conducted bilaterally in a highly manual, centrally cleared approach. Negotiating legal agreements can be a lengthy process. Dealer banks' capacity is limited because each bank has limited funding lines. The fragmented settlement infrastructure often restricts the time to trade and settle bilateral repos. At the same time, many buy-side firms do not have the resources to assess and monitor the credit risk of a large number of counterparties. There is hardly anything scalable or digital here. But this does not have to be the case.

> **"Many buy-side firms do not have the resources to assess and monitor the credit risk of a large number of counterparties."**

Optimise collateral and funding with Eurex's cleared repo solutions

Centrally cleared repo markets offer a possible solution to this problem. After the 2008 financial crisis, almost all interbank funding was switched from unsecured to secured repos. Today, most interbank repo transactions and about 70 percent of total repo turnover in Europe are centrally cleared. While commercial banks drive the most significant portion of the activity, supra-nationals, government treasuries and central banks remain important stakeholders. Since 2008, cleared repo markets have consistently stood up in times of stress as a reliable liquidity source and a more robust alternative than the bilateral repo market.

While repo transactions are already centrally cleared by more than 1,900 buy-side firms in the US, the cleared banks-to-client segment in Europe is just starting to expand. In the meantime, multiple buy-side firms already have access to Eurex's centrally cleared repo market via its ISA Direct access model. This model allows clients to invest and raise cash safely via centrally cleared reverse repos, addressing pension funds' concerns to a large degree.

Having access to Eurex's liquid and centrally cleared repo markets enables pension funds to safely invest cash or raise short-term funding using 13,000 ISINs and trade with over 150 Eurex Repo trading participants. This means access to 150+ repo liquidity providers, from commercial banks to central banks to sovereign funding agencies, all under a standardised legal agreement, with straight-through processing and no need for bilateral credit lines.

The benefits of centrally cleared swaps and repo combined

Eurex uniquely enables the combination of central clearing of repos and OTC IRS through its ISA Direct model. This significantly expands the number of repo liquidity providers for the buy-side and offers additional operational, liquidity and collateral management efficiencies through the integration of both product lines.

Eurex Clearing is the only EU-based CCP providing future-proof clearing services with access to liquidity in Euro-ETDs, OTC IRDs and repo under a single legal, risk and collateral authority.