Euro clearing – a balancing act

For the European Pension Fund community, 2023 brings about important changes as the European Commission sets out its position on the future of euro derivatives clearing activity within the EU, and the PSA mandatory clearing exemption comes to an end in June.

Christopher Page
FIC Derivatives & Repo Sales, Eurex

Regulatory outlook

The European Commission has set an objective to build a strong and attractive central clearing capacity in the EU through a combination of different policy measures that are under consultation. In December last year, it published its proposal to revise the clearing framework. With the so-called active account approach, the Commission aims to effectively rebalance relevant clearing activities to the EU to reduce systemic risks whilst still allowing for choice and flexibility to clear outside the EU. It, therefore, strikes a good balance between the regulatory objectives and market participants' competitiveness concerns.

As PSAs will be subject to the clearing obligation from June this year, they will likely also fall under the potential new active account requirement, once applicable, and need to clear a portion of their business in relevant products, including euro-denominated interest rate derivatives, in the EU in the future.

As the leading derivatives clearinghouse in the European Union, Eurex's ambition is to be the home of the euro yield curve. It has promoted market-driven solutions to EU regulators and has publicly advocated against harsher measures, such as an outright location policy, which could have wider financial stability implications and unintended consequences. Against this background, Eurex launched a Partnership Program in 2018 for euro OTC interest rate derivatives together with major market participants to build a liquid alternative clearing venue in the EU. Since then, Eurex has built a material market share and has established itself as a true and viable alternative.

In 2022, Eurex announced an additional incentive program to support buy-side clients starting to clear OTC interest rate derivatives positions in the EU. With this program, Eurex is not only further committing to support the broader European financial market autonomy aspirations but also supporting, at the same time, market participants to contribute and comply with these aspirations bringing more clearing of systemically relevant products into the EU while reducing reliance on systemically relevant third-country CCPs.

A primary reason for the PSA clearing exemption was the concern over sourcing cash for variation margin in times of stress if traditional liquidity sources cease to function. It has been deemed by ESMA and the European Commission that this situation has improved, with new, alternative liquidity sources available for the buy side. Eurex's repo services are a key development, with its pioneering ISA Direct offering, providing direct membership to cleared repo liquidity in the long-established inter-bank market at Eurex.

Lessons learned in 2022

As we moved into a new phase of the global interest rate cycle, with added geopolitical and inflationary stresses, 2022 was a year of marked change and volatility in the fixed income markets. We saw increased instability in long term euro swap rates which created a greater need for cash within the PSA community to meet margin calls on long term interest rate and inflation hedges.

Meanwhile, the fallout from the ill-fated UK mini budget caused turmoil in the UK Gilt market, putting severe stress on the UK Pension Fund system, as increasing Gilt yields prompted a huge sell-off to meet margin requirements on leveraged hedges related to LDI mandates. Although the Bank of England stepped in to halt the so-called 'doom loop' of rising Gilt yields, we continued to see volatility in yields shortly thereafter as the market viewed the BoE's bond-buying operations as too conservative.

While there are clear structural differences between the UK and European Pension Fund systems in relation to hedging and leverage, we observed increased volatility in euro rates throughout this crisis, once again generating a need for cash for some European PSAs. We can adequately assume that a higher frequency of market stress may be the new norm and we know that cleared repo markets provide proven resilience in these situations. We continue to encourage central banks to participate in cleared repo markets as a way of reducing the need for emergency liquidity programs, such as was seen in the Gilt market.

Eurex stands up to the challenges

Eurex continued its growth story in OTC interest rate derivatives, as 2022 and the beginning of 2023 saw a continued increase in notional outstanding and average daily volumes, coupled with a significant rise in members and clients onboarding. We observed comparable dealer spreads on Eurex as end clients continued to look for clearing opportunities within the EU. This further strengthens Eurex as the European clearing liquidity pool enabling the EU to achieve its policy objectives.

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Over this period, Eurex also posted substantial year-on-year volume growth in its repo services as the secured finance market grappled with the effects of ECB rate policy and continued collateral scarcity. Both the Single ISIN and GC Pooling markets once again proved to be robust liquidity sources when needed. ISA Direct repo volumes increased markedly in both cash investing and cash taking, demonstrating the viability of Eurex as a reliable tool for buy-side liquidity management. Repo rates available to the buy side on Eurex's repo trading platform continued to outperform those achievable in MMFs or the bilateral repo space, further addressing PSA concerns over best execution and pricing.

What next?

As we now look forward to the second half of 2023 and beyond, we understand an approach will be continued by the regulators to ensure relevant euro derivatives exposures are rebalanced, such that significantly more activity is happening within the EU.

As the active account requirement is yet to be agreed upon with the co-legislators in Brussels, it may appear as if there is ample time to get prepared. However, market participants, including PSAs, should be mindful of the prevailing risk of losing access to Tier 2 UK CCPs where the relevant products are currently predominantly cleared. The Commission has made it clear that there are no intentions to prolong the temporary equivalence for those CCPs again. In particular, if there is no meaningful progress in rebalancing, the Commission may not be in a position to reconsider its view. The Commission hence continues to encourage the industry to prepare for this scenario. Only with a clear outlook that risk exposure at Tier 2 UK CCPs will be reduced to the extent that they are no longer considered a risk to the EU's financial stability, regulatory concerns about granting UK CCPs permanent access to the EU market will be resolved.

Ultimately, an early rebalancing would likely ensure continued access to UK CCPs. This should be the preferable outcome for the market as it enables optimisation of euro clearing activities while addressing systemic risk concerns of EU regulators and central banks.

2022 showed us that regulatory change is a driving factor for all market participants, and we continue to encourage PSAs to ensure readiness for this new environment. The established and innovative Eurex offering across both OTC interest rate derivatives and repo is here to help PSAs meet these goals.

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