Pension funds should benefit from a further two year exemption from central clearing requirements

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The European Commission has today published a report that recommends granting pension funds a two-year exemption from central clearing requirements for their over-the-counter (OTC) derivative transactions. The report, which is based on an extensive study requested by the European Commission, concludes that central counterparties (CCPs) need this time to find solutions for pension funds. At the same time, the report encourages CCPs to continue working on finding technical solutions in this important matter. Ultimately, the objective is that pension scheme arrangements (PSAs) should use central clearing for their derivatives transactions, as is the case for other financial institutions. This is also imperative for financial stability.

Under current arrangements, PSAs – which encompass all categories of pension funds – would have to source cash for central clearing. Given that PSAs hold neither significant amounts of cash nor highly liquid assets, imposing such a requirement on them would require very far-reaching and costly changes to their business model which could ultimately affect pensioners’ income.

EU Commissioner for Financial Stability, Financial Services and Capital Markets Union, Jonathan Hill said: “Today’s report sets out a number of potential ways to facilitate central clearing for pension funds. But none of them is straightforward and it is sensible to take more time to develop a solution which is proportionate.”

CCPs collect collateral, or ‘margin’, from their participants to cover the potential losses in the event of a counterparty default. CCPs accept only highly liquid assets, generally cash, to meet these margin calls. This allows rapid liquidation in case of a default so that the CCP can maintain business as usual.

In many Member States, PSAs use over-the-counter derivative transactions (i.e. derivatives that trade through a dealer network rather than through a centralised exchange) to hedge long-term interest rate and inflation risks. However, PSAs generally do not hold cash and instead invest in higher yielding and longer term assets such as bonds to enhance returns for pensioners. A requirement to source cash for central clearing could therefore ultimately reduce pensioners’ retirement income, the report concludes.

Recent estimates show that the costs for obliging pensions funds to clear their OTC derivative portfolios would range from € 2.3 billion to € 2.9 billion annually and the expected impact could be up to 3.66% over 20-40 years on retirement incomes across the EU.

In line with the Commission’s legal mandate under the European Market Infrastructure Regulation (EMIR) (Article 85(2)), the report also assesses possible alternative solutions for the posting of non-cash assets by PSAs.

Current EU law provides for a temporary exemption from the clearing obligation for certain contracts. The exemption is set to expire in August 2015. Today’s report recommends extending it for another two years. This extension would take the form of a delegated act that would need to be adopted by the College of Commissioners.

BACKGROUND:

The EMIR Regulation, which entered into force on 16 August 2012, is designed to improve the stability of the over-the-counter (OTC) derivative markets throughout the EU. The Regulation requires standard derivative contracts to be cleared through central counterparties (CCPs) and establishes stringent organisational, business conduct and prudential requirements for these CCPs. It has also introduced an obligation to report derivative contracts to trade repositories. The Regulation, directly applicable and enforceable throughout the EU, will considerably increase financial stability and safety by preventing the situation where a collapse of one financial firm can cause the collapse of other financial firms.

A specific exemption in the Regulation states that ‘pension scheme arrangements’ are exempt from the clearing obligation of certain derivatives until August 2015.

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