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The evolving use of swaps by pension schemes

The end of the European Market Infrastructure Regulation mandatory swaps clearing exemption for pension scheme arrangements (PSAs) is approaching. Susi de Verdelon, global head of LCH SwapClear, discusses the significance of the upcoming change for PSAs, and the implications for their clearing brokers and central counterparties

Pension scheme arrangements (PSAs) have been active traders in the swaps market for many years. What is changing for them next year?

Susi de Verdelon: Since the European Market Infrastructure Regulation (Emir) entered into force 10 years ago, PSAs have been exempt from the swaps clearing obligation that applies to most other financial firms. As reported on *Risk.net* in September this year, this exemption will expire on June 19, 2023.[1] While many pension schemes are already clearing voluntarily, those who had been taking advantage of the exemption will no longer have this choice. The exemption has permitted PSAs more time to adapt to the requirements of clearing, such as the use of cash for variation margin (VM).

Susi de Verdelon, LCH SwapClear

The Emir exemption states: "The clearing obligation should not apply to pension schemes until a suitable technical solution for the transfer of non-cash collateral as VM is developed by CCPs [central counterparties]." Has the market found solutions?

Susi de Verdelon: Over the years, *Risk.net* has covered the implications of bespoke credit support annexes (CSAs) for non-cash collateral and the difficulties in assigning values within them.[2] CCPs require consistent valuations for all contracts they clear, and collateral optionality challenges this. The importance of VM in cash for cleared swaps remains a core foundational principle. Through intense industry effort in the past 10 years, we believe the tools for the solution are now available, primarily via improvements in access to collateral transformation. This includes LCH RepoClear's sponsored clearing solutions.

Besides the cash VM question, were there other frictions between what PSAs wanted and what CCPs originally offered?

Susi de Verdelon: PSAs have been consistent in their requirements. They needed product scope to cover the bulk of their portfolios and had to be sure their collateral was suitably segregated. Previously, clearing for inflation swaps was a missing piece of the puzzle, but is now a well-established offering at LCH SwapClear. There are attractive netting benefits between nominal and inflation swaps positions, which help promote efficiency of resource allocation within PSA portfolios. Cleared inflation swaps have seen solid growth in light of recent macroeconomic developments too, with strong uptake among new clients, even beyond PSAs. Regarding collateral protection, the 'individual segregation' requirements of Emir were an important building block. CCPs have developed models that go beyond these minimum criteria and support PSA priorities, such as collateral velocity and optimisation.

There has been talk of PSAs joining CCPs as members. Is that a big part of future market structure?

Susi de Verdelon: CCP models reflect the market structure of the asset class in question. For cleared interest rate swaps, membership doesn't always provide the right balance of cost and benefits for PSAs when compared to intermediated access via client clearing brokers. Two integral features of swaps clearing membership can be challenging: the need to bid for potentially large swaps books in default scenarios, and the more general issue of loss mutualisation. PSAs vary greatly in size and, as such, membership has only ever been a consideration for the largest funds. That said, PSAs are already direct members of CCPs including LCH for other products, such as cleared repo under our new sponsored models.

Sticking with swaps, if PSAs are likely to access clearing as clients, does that mean we might run short of clearing broker capacity?

Susi de Verdelon: Initial margin (IM) is an effective measure of 'risk under management', and the IM associated with new PSA risk entering the cleared swaps ecosystem in the next couple of years could be material for clearing brokers and CCPs. Let's put this in perspective, however: cleared swaps IM has seen average annual growth of more than 30% year-on-year over the past 10 years. All else being equal, this translates to annual capacity of several hundred million euros in DV01 terms, which is in line with certain industry estimates of the potential incremental demand. Since the clearing obligation applies only to new swaps activity, I don't expect a step change the day after the exemption expires for PSAs.

Individual clearing brokers are no doubt actively preparing to support additional volumes. LCH provides its own innovative functionality, such as stress-loss margining to help balance sheet optimisation for clearing brokers. There are also industry initiatives looking into refinements of the European clearing model, which we will support as work progresses.

Can you update us on portability within the client clearing models?

Susi de Verdelon: Let's distinguish between two types of portability. What is called BAU [business as usual] portability is already an everyday occurrence within LCH SwapClear: customers regularly transfer positions and collateral within the system for a number of reasons, including optimisation or a change of clearing broker.

When it comes to 'default portability' – a scenario where the client has not transferred their portfolio prior to a clearing broker default and now wishes to do so – we are prepared: portfolio movements are fire-drilled regularly. In addition, account models, such as custodial segregation, further enhance porting likelihood.

I appreciate that PSAs will need to manage capacity across their clearing brokers, but keeping a clearing broker capacity buffer is probably akin to ensuring sufficient liquidity buffers.

Before we move off of swaps, does the recent turmoil in sterling rates markets have any implications for the PSA clearing exemption?

Susi de Verdelon: The recent market moves were unprecedented. Throughout the period, the cleared interest swaps markets operated effectively at LCH, and the member and client clearing brokers met all margin requirements. The key lessons are still emerging, but the careful management of leverage would seem to lie at the heart of the matter. Specifically, whether for cleared or bilateral swaps, the requirement for cash VM and the ability to generate cash reliably from holdings of high-quality liquid assets (HQLA) should be a real focus.

That seems like an opportune time to go back to your repo comments. How does repo relate to the PSA swaps clearing exemption?

Susi de Verdelon: PSAs have been consistently clear that they have large holdings of HQLA as part of their investment strategies. I think cleared repo is the connective tissue between their investment strategies and the swaps clearing requirement. PSAs can stick to the same allocation to HQLA as they had while exempt from clearing their swaps, thereby avoiding the yield drag associated with a higher allocation to cash.

Instead of posting the bonds under a bilateral CSA, PSAs can use their bonds via the cleared repo market to generate the cash to be posted to a CCP. The cleared repo market has the benefits of all cleared markets in this context, allowing more reliable access to liquidity in times of stress. Additionally, the new sponsored access models developed by CCPs have been designed with the buy side in mind, including PSAs. Indeed, PSAs have been among the earliest adopters of these models.

Does the end of the exemption mean PSAs need to run 100% cleared portfolios?

Susi de Verdelon: Based on conversations with PSAs, I anticipate that the bilateral market will continue to play a role in their activities. The clearing obligation only applies to new swaps businesses in relevant currencies and tenors. Therefore, it will take many years for existing bilateral positions to roll off, even with selective backloading. There are also non-cleared products, such as swaptions, which PSAs will continue to find useful. For these reasons, I expect the cleared and bilateral markets to work in harmony to support PSAs in the years to come.

[1] *Rebekah Tunstead (September 2022), European pension funds must start clearing next year – EC,* Risk.net, *www.risk.net/7954446*
[2] *Rebekah Tunstead (January 2022), Counterparties clash over 'dirty' CSAs,* Risk.net, *www.risk.net/7915476*

LCH SwapClear is here to partner with PSAs as they navigate the end of the Emir mandatory clearing exemption. Contact LCH SwapClear's specialist sales team or visit LCH SwapClear for further information.