14 Dec 2018

Frank Odendall discusses access to centrally cleared repo markets for pension funds

Welcome to new solutions!

Pension funds play an important role both in the financial industry and for the daily life of pensioners in Europe. The aggregated assets across the EU28 are over Euro 5.2 trillion[1]. Regulatory changes, in particular the mandatory clearing of OTC IRS and the increase in capital requirements on banks, impose significant challenges to European pension funds. We spoke to Frank Odendall, Head of Buy-Side Repo Initiative at Eurex about these challenges and an interesting new solution for pension funds, asset managers and insurance companies.

Frank, what are main challenges?

The long-term nature of their liabilities requires pension funds to hedge interest rates and inflation risk. In particular, the relative lack of long-dated bond issuance in Europe by high quality issuers, e.g. governments, has driven many pension fund managers, especially in the UK, Netherlands and Denmark, to utilize standard interest rate and inflation-linked swaps for hedging. Traditionally, these swaps were not centrally-cleared and hence exposed the pension funds to counterparty and operational risks. The introduction of the Uncleared Margin Rules increases collateral requirements and adds further complexities as bilateral collateral schedules are not standardized typically. Central clearing of standardized OTC derivatives is a main pillar of EMIR and aims to reduce risks, improve market access and increase transparency.

What problems do pension funds fear due to regulatory requirements?

Whilst pension funds in general welcome central clearing, the requirement of central counterparties (CCPs) to meet the daily variation margin obligations in cash could create a challenge for pension funds, who are typically fully invested, in times of increasing interest rates. Essentially, they have three options, run a cash buffer, secure bilateral credit lines or access the un-cleared or cleared repo market. Holding significant cash balances typically diminishes investment returns and bilateral credit lines are very expensive on a continuous basis. Accessing the EUR 7.3 trillion[2] Pan-European repo market instead seems a natural choice. Nevertheless, based on historic experience e.g. during the Lehman crisis the bilateral repo market has not been very liquid during times of stress; furthermore, the additional capital and liquidity constraints on banks introduced have further reduced the available capacity.

How is the dealer-to-client repo market functioning?

As mentioned, repos are integral components and essential tools of the banking industry. In Europe, almost no dealer-to-client repos are centrally cleared. Therefore, they are based on a 1:1 credit relationship between individual borrowers and lenders and are typically governed by a specific legal agreement. That sounds easy and uncomplicated until you recognize that the large majority of dealer-to-client business is still executed via phone. Equally, negotiating the legal agreements is a lengthy process, sometimes taking up to 18 months. It is also limited in capacity, and not only because each bank has limited financing lines, but also because the time to trade and settle bilateral repos is often limited, given the fragmented and ageing settlement infrastructure. Meanwhile, many buy-side entities do not have the resources to assess and monitor the credit risk of a large number of counterparties. There is hardly anything scalable and nothing digital here. However, it doesn‘t have to be this way.

There seems to be a real dilemma? What solution do you suggest?

A potential solution to this problem comes from centrally cleared repo markets. Following the 2008 financial crisis, almost all interbank funding migrated from unsecured to secured, i.e. repos. Similar to OTC IRS, the large majority of interbank repo and approx. 70% of repo turnover overall is now centrally cleared[3] in Europe. Today, this market is dominated by commercial banks, but also sees participation by supranationals, government financing entities and central banks. In the US, more than 1,800 buy-side entities are already centrally clearing repo.

Today a number of buy-side entities already access Eurex`s centrally cleared repo market via Eurex Repo`s Select Invest offering. This model allows clients to invest cash securely via centrally-cleared reverse repos. In order to meet the aforementioned concerns by pension funds, Eurex recently expanded its offering: it now also permits buy-side clients as Select Finance participants to raise cash via our centrally-cleared repo markets.

What special advantages can pension funds and other buy-side entities expect from accessing Eurex`s centrally-cleared repo market?

We offer access to a complete new market segment, which until now had been closed to pension funds and other buy-side entities in Europe. This offer directly addresses the liquidity concerns and the regulatory challenges for pension funds. By accessing Eurex Repo’s liquid centrally-cleared repo markets they are able to invest cash securely or raise short-term funding utilizing more than 13,000 ISINs and trade with more than 140 Eurex Repo participants. This means access to 140 repo liquidity providers from commercial banks to central banks and government financing agencies all under one standardized legal agreement, with straight-through-processing and without the need of bilateral credit lines.

In addition, Eurex Clearing uniquely permits the combination of central clearing of repos and OTC IRS via its ISA Direct clearing services. This not only expands the number of repo liquidity providers significantly, but also offers additional operational, liquidity and safety advantages for both product lines, e.g. same cash account, re-use of repo collateral for initial margin or single clearing agreement.

Have you already seen reactions from pension funds?

Indeed! The first company clearly convinced by our offering is PGGM, the first pension fund manager to enable its clients to access the centrally-cleared repo market at Eurex Repo. With the increasing volumes in our derivatives clearing offering, we are optimistic that other European pension fund managers will seek access to our repo market place and manage their collateral requirements more efficiently.

Frank Odendall, Head of
Buy-Side Repo Initiative at Eurex

1) Baseline report on solutions for the posting of non-cash collateral to central counterparties by pension scheme arrangements by European Commission, 25 July 2014
2) See ICMA`s 35th survey of the European repo market for details which is available on https://www.icmagroup.org
3) See ICMA ERCC comment on ECB Money Market Survey on 28 February 2018

Further information

→ PGGM is the first pension fund manager to centrally clear repos at Eurex

→ Isa Direct