

# EMIR: Calculation of counterparty risk by UCITS for cleared OTC derivatives

August 2014

**C L I F F O R D**  
**C H A N C E**



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# Introduction

The UCITS Directive allows UCITS to invest in both exchange traded derivatives (ETD) and over the counter (OTC) derivatives.

Both ETD and OTC derivatives are subject to eligibility criteria, which include counterparty eligibility criteria for OTC derivatives.

However, the UCITS Directive also imposes counterparty exposure limits on OTC derivatives (although there is also CESR guidance on exposure limits for ETDs not protected by client money or similar arrangements).

EMIR will impose obligations on UCITS to clear certain OTC derivatives transactions.

Clearing of OTC derivatives raises a number of issues for UCITS, in particular the need for UCITS to post significant initial and variation margin on centrally cleared OTC derivatives raises issues as to how the exposure limits should be applied to the resulting exposures.

ESMA published revised Q&A in December 2013 providing some guidance:

“When calculating the counterparty risk for exchange-traded derivatives and OTC transactions that are centrally cleared, UCITS should look at the clearing model used to determine the existence of counterparty risk and, if any, where the counterparty risk is located. When analysing the clearing model used, UCITS should have regard to the existence of segregation arrangements of the assets and the treatment of claims on these assets in the event of bankruptcy of the clearing member or central counterparty.”

ESMA has published a discussion paper on the calculation of counterparty risk by UCITS for OTC financial derivative transactions subject to clearing obligations (July 2014).

The deadline for comments is 22 October 2014. ESMA may recommend changes to the UCITS Directive as a result and these may also affect ETDs.

However, ESMA does not discuss how UCITS should address the issues for OTC derivatives arising under the UCITS Directive pending any amendments.

The discussion paper can be accessed at [www.esma.europa.eu/system/files/2014-esma-876.pdf](http://www.esma.europa.eu/system/files/2014-esma-876.pdf)

# Eligibility criteria

Art.50(1)(g) of the UCITS Directive limits the types of derivative instruments a UCITS may invest in, by setting eligibility criteria for both ETD and OTC derivatives.

## ETDs

- Must be dealt in on a regulated market, as defined in points (a), (b) or (c) of Art.50(1) of the UCITS Directive:
  - a regulated market as defined in point (14) of Art.4(1) of Directive 2004/39/EC [MiFID];
  - another regulated market in a Member State, which operates regularly and is recognised and open to the public; or
  - another regulated market in a third country, which operates regularly and is recognised and open to the public, provided that the choice of stock exchange or market has been approved by the competent authorities or is provided for in law, the fund rules or the instruments of incorporation of the investment company.
- The underlying must consist of instruments covered by Art.50(1) of the UCITS Directive or financial indices, interest rates, foreign exchange rates or currencies (as long as these form part of the UCITS' investment objectives, as stated in its fund rules or instruments of incorporation).

## OTC derivatives

- Counterparties must be institutions subject to prudential supervision and belonging to the categories approved by the competent authorities of the UCITS' home Member State (e.g. EU authorised credit institutions or investment firms and qualifying non-EU banks).
- The OTC derivatives must be subject to reliable and verifiable valuation on a daily basis and can be sold, liquidated or closed by an off-setting transaction at any time at their fair value at the UCITS' initiative.
- The underlying must consist of instruments covered by Art.50(1) of the UCITS Directive, or financial indices, interest rates, foreign exchange rates or currencies (so long as these form part of the UCITS' investment objectives, as stated in its fund rules or instruments of incorporation).

# Exposure limits

## OTC derivatives

**Art.52(1) of the UCITS Directive imposes counterparty risk exposure limits on OTC derivative transactions:**

“The risk exposure to a counterparty of the UCITS in an OTC derivative transaction shall not exceed either:

- 10% of its assets when the counterparty is a credit institution; or
- 5% of its assets, in other cases.”

## ETD

**The Guidelines on Risk Measurement and Calculation of Global Exposure and Counterparty Risk for UCITS (CESR/10-788) recommend that initial margin posted to, and variation margin receivable from, a broker relating to ETDs which are not protected by client money rules or other similar arrangements should also be taken into account for the calculation of counterparty risk for the purposes of Art.52(1) of the UCITS Directive.**

# Cleared OTC derivatives: issues for UCITS

The UCITS Directive was designed for bilateral OTC derivatives and did not envisage how it would apply to centrally cleared OTC derivatives.

**The boundary between ETD and OTC derivatives under the UCITS Directive is not the same as under EMIR.**

- Non-EU ETDs may be ETDs under the UCITS Directive, even if classified as OTC derivatives under EMIR because the non-EU market is not treated as “equivalent”.

**The UCITS Directive requires that counterparties on OTC derivatives meet certain eligibility criteria, but some of the possible counterparties may not meet the criteria.**

- Executing broker or market counterparties may be transaction counterparties (before trade given up for clearing).
- Clearing member as counterparty under principal clearing model, but non-EU clearing members may not meet eligibility criteria (affecting access to non-EU CCPs).
- Should CCP be treated as counterparty under agency clearing models (or where the UCITS has limited recourse against the clearing member if the CCP defaults)?
- Indirect clearing models may raise additional issues.

**The UCITS Directive requires that OTC derivatives can be sold, liquidated or offset at any time at their fair value at the UCITS’ initiative.**

- Clearing members for UCITS clients will need to be willing to make same commitment for cleared transactions.

**Existing ESMA guidance limits the ability of UCITS to reuse cash received as margin for OTC derivatives or through efficient portfolio management.**

- May affect willingness of UCITS to use cleared OTC derivatives (and uncleared OTC derivatives under proposed margin rules).

**Lack of clarity about how the exposure limits in the UCITS Directive should be applied in relation to cleared OTC derivatives.**

- Difficulty of identifying who the relevant counterparty is for the purpose of applying the limits.
- Exposures will be larger because UCITS will post initial margin as well as variation margin and it may not be possible to re-price contract to reduce margin levels.
- The UCITS Directive exposure limits seem inappropriate given the protections afforded to clients of clearing members under EMIR.

**The uncertainties have led ESMA to publish a discussion paper seeking stakeholders’ views on the appropriate way forward, including a possible recommendation to the Commission of a modification of the UCITS Directive.**

- However, ESMA’s discussion paper only focuses on the last of the above issues.



# ESMA discussion paper: direct clearing arrangements

The discussion paper does not address the way in which UCITS should take into account exposures to EU CCPs or non-EU CCPs recognised by ESMA when assessing their counterparty risk for centrally-cleared OTC transactions. ESMA indicates that such CCPs should be considered as market infrastructures with relatively low counterparty risk.

Instead, the discussion paper focuses on the impact of a default of a clearing member (CM) or of other clients of the CM on UCITS that enter into centrally-cleared OTC derivative transactions. In this context, ESMA focuses its analysis on the different types of segregation arrangements offered by CMs.

## Direct clearing arrangements

### Individual client segregation (EU CCP or recognised non-EU CCP)

- No counterparty risk to the CM or other clients of the CM (because of porting, direct return of liquidated positions, assets and positions legally and operationally separated from the assets and positions of other clients of the CM).
- Some exposure to market risk (if liquidated positions need to be re-established by the UCITS).

### Omnibus client segregation (EU CCP or recognised non-EU CCP)

- Higher counterparty risk to the CM and other clients of the CM than under individual client segregation (UCITS may not get its assets back and/or there may be substantial delay in the return of the assets).
- Proposal that exposure limits apply to the amount of collateral posted to the CM.

### Other types of segregation (EU CCP or recognised non-EU CCP)

- The impact of a CM default on the UCITS will depend on the nature of the CCP's segregation arrangements. The risks may be a combination of those presented by individual client segregation and omnibus client segregation. As such, some counterparty risk limits should be applied.

### Segregation arrangements with non-EU CCP outside the scope of EMIR

- These CCPs may not be subject to standards equivalent to those applicable to EU CCPs.
- OTC derivatives cleared through a non-EU CM with a non-EU CCP not recognised under EMIR should be treated as bilateral OTC derivatives and the 5% / 10% counterparty risk limits of Art.52(1) of the UCITS Directive should be applied in respect of the CM.

### ESMA also proposes that the same standards would be applied to ETDs as for OTC derivatives

- Currently, UCITS commonly rely on omnibus client segregation for ETDs but are not required to apply quantitative limits to counterparty risk if they are protected by client money or similar arrangements.
- Applying the proposed standards may have an adverse effect on the ability of UCITS to use ETDs unless individual segregation also available at reasonable cost.

# ESMA discussion paper: indirect clearing arrangements

## ESMA proposes corresponding treatment for indirect clearing arrangements

### **Recital 6 of Commission Delegated Regulation (EU) No 149/2013 under EMIR states that:**

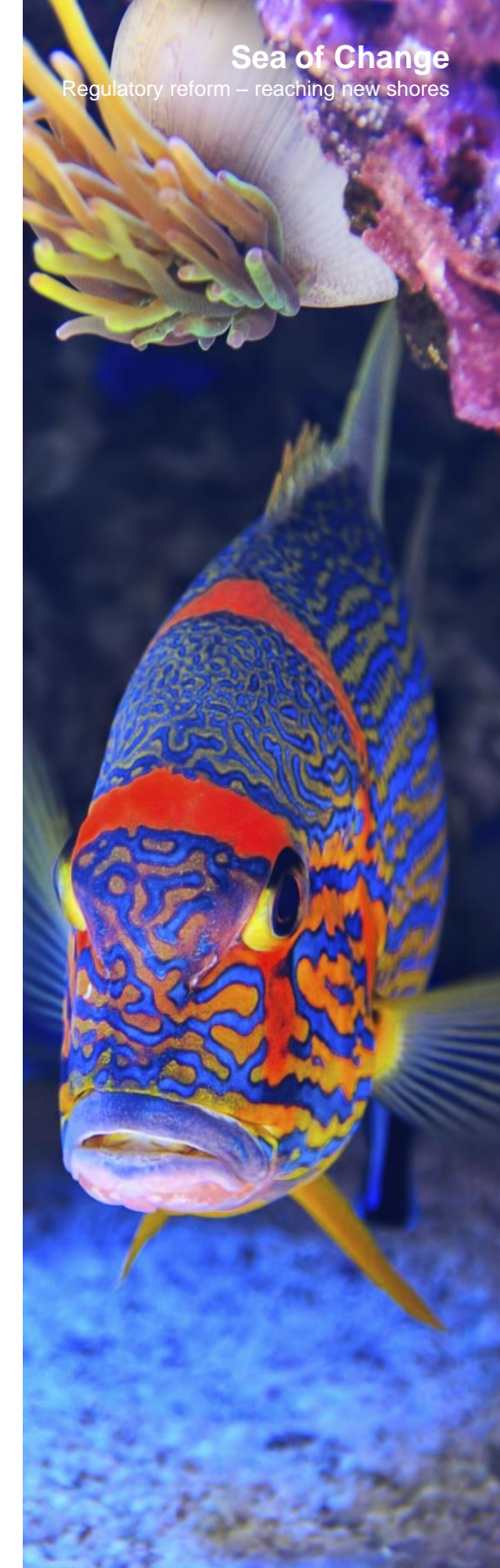
“indirect clearing arrangements should be established so as to ensure that indirect clients can obtain an equivalent level of protection as direct clients in a default scenario”.

### **ESMA therefore proposes to treat indirect clearing arrangements in an equivalent manner to direct clearing arrangements:**

- It proposes to apply the same counterparty risk exposure limits envisaged for the different segregation models in a direct clearing arrangement to indirect clearing arrangements.
- As with direct clearing arrangements, ESMA proposes to apply a higher risk exposure limit to indirect clearing arrangements which do not involve individual client segregation (in line with the one envisaged in Art.4(2)(b) of the EMIR Level 2 Regulation).

### **ESMA also proposes that similar standards would be applied to ETDs.**

- Currently, UCITS may use indirect clearing arrangements using omnibus accounts to access non-EU exchanges (as well as some EU exchanges).
- MiFIR is likely to require the offer of individual client segregation arrangements for ETDs in line with those applicable under EMIR (from 3 January 2017), although some non-EU ETDs may fall outside this requirement.
- However, it has been difficult to structure indirect clearing arrangements which comply with the standards set under EMIR.
- The combination of higher exposure limits and new standards for indirect clearing arrangements under MiFIR may limit the ability of UCITS to use some ETDs.





# Glossary

- **CCP:** central counterparty
- **Clearing obligation:** requirement to clear at a CCP all OTC derivative contracts pertaining to a class of OTC derivatives that has been declared subject to the clearing obligation in accordance with the procedure in Art.5(2) EMIR
- **CM:** clearing member as defined in Art.2(14) EMIR
- **Commission:** the European Commission
- **Derivative:** as defined in EMIR, i.e. a financial instrument as set out in points (4) to (10) Section C, Annex 1, MiFID, as implemented by the MiFID implementing regulation
- **EMIR:** the EU regulation on OTC derivatives, central counterparties and trade repositories
- **ESMA:** European Securities and Markets Authority
- **EU:** European Union
- **ETD:** exchange traded derivatives (i.e. under EMIR, derivatives executed on a regulated market or equivalent non-EU market)
- **Member State:** member state of the EU
- **MiFID:** the EU markets in financial instruments directive
- **MiFID2 and MiFIR:** the new EU directive and regulation replacing MiFID
- **OTC derivative:** over-the-counter derivative (defined in EMIR as a derivative executed outside a regulated market or equivalent non-EU market)
- **UCITS:** undertaking for collective investment in transferable securities as defined in Art.1(2) UCITS Directive
- **UCITS Directive:** the fourth directive on UCITS

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