ISDA Safe, Efficient Markets

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Individual Client Segregation and Central Counterparty ("CCP") Default Fund Sizing

Dear Edwin

Thank you for meeting with us on 6 March 2013 in relation to CCP risk issues. We are grateful for your and your team's engagement with us, and appreciate the Bank of England's work on various CCP risk topics.

This letter summarises the views of the ISDA Risk and Margin Regulatory Implementation Committee on two issues:

(i) the lack of certainty around the meaning of "individual client segregation" under Article 39(3) of the European Market Infrastructure Regulation ("EMIR"). Please note that this letter is being sent in conjunction with an industry-wide effort, led by the Futures and Options Association ("FOA") and supported by ISDA, to engage with the European Securities and Markets Authority ("ESMA") on this issue; and

(ii) CCP default fund ("DF") sizing.

Individual Client Segregation

Statement of issue

We are concerned that the meaning of "individual client segregation" under Article 39(3) of EMIR lacks certainty. In particular, we wish to confirm that individual client segregation does not in every case require full asset segregation (in other words, for assets to be held in separate accounts at both Clearing Member ("CM") and CCP level). We have received unconfirmed reports that some European Union ("EU") regulators consider that individual client segregation does require full asset segregation and that a "value" segregation model should not be considered compliant with Article 39(3). In our view, Article 39(3) should be

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interpreted so as to allow CMs' clients to be offered a choice among individual client segregation models.

Reasons Article 39(3) should be read as allowing for choice among individual segregation models

At the outset, we would like to highlight the importance of delivering choice of cost-effective individually segregated account structures. Due to the uncertainties surrounding the interpretation of Articles 39 and 48 such cost effective structures cannot be developed and offered with certainty. We consider that prohibiting choice among individual client segregation models would give rise to a number of risks, including:

(i) banks and agents that provide services to CMs may be reluctant to provide the additional accounts required to support a CM with numerous individually physically segregated clients;

(ii) operational risk, generated by increased transaction volumes and reconciliation issues;

(iii) increased risk to CMs' solvency as their obligations to cover funding timing differentials increase; and

(iv) the high costs associated with individual physical segregation may increase risk by forcing medium sized clients to opt for lesser levels of segregation than they would have selected had choice, including "books and records attribution" (described in more detail below), been available.

Further, we consider the text of EMIR supports our view. "Individual client segregation" under Article 39(3) of EMIR does not on its face mandate full asset segregation as the only, or the minimum, model to achieve the standard of protection required to satisfy the regulation. Nor is there anything in the EMIR text suggesting that particular collateral assets must be held in separate accounts attributable to individual clients throughout the clearing process at both CM and CCP level. In particular, the references to "assets" in Articles 39 and 48 do not specify the particular assets of clients. We consider that the term "assets" in this context means value (that is, a claim, or a liability owed), which would be consistent with the definition of "equivalent collateral" under the Financial Collateral Directive, particularly in relation to intangible assets.

Advantages of specific individual segregation models

We consider that a value-based segregation model combined with "books and records attribution" should be considered to fall within the meaning of "individual client segregation" in Article 39(3). Books and records attribution would permit CCPs and CMs to operate a single collateral account for the collateral of all 'individual clients", as long as each CCP and CM is able to identify, distinguish and attribute to each client account *in its own books and records* the values of those assets posted to it.

The principal to principal models of EU CCPs are typically underpinned by transfer of title to collateral, which means that clients do not own assets that a CM has placed with a CCP. Indeed, the collateral posted by a CM to a CCP may differ from the collateral that the client

has posted to the CM for the back to back transaction, unless the CCP in question has mandated a full collateral pass-through model.[1] This collateral transformation process is generally provided as a service to the client, to enable them to reduce their operational effort and costs, or to employ a wider range of collateral than is eligible to use at CCPs. As a result, it is simpler to apportion between the required collateral level and any excess under the "value" model. Accordingly, porting following CM default is simplified.

Both a pure value-based model (such as the US Legally Segregated Operationally Commingled ("LSOC") model) and a value model combined with "books and records attribution" would be advantageous in instances where a CCP is required to liquidate client or CM assets. A model that requires full asset segregation must make it possible for assets to be ported, including in the context of a CM default. Prior to porting assets for trades in which a client is "out of the money", a CCP would need first to satisfy variation margin ("VM") claims on those trades. This would require the CCP to liquidate client assets, with the client having no control over which assets are liquidated. A"books and records attribution" model would allow clients to have a claim to the value of the specific asset attributed to their positions. The "value" model would also facilitate the process where a CCP is required to liquidate some or all client collateral to mitigate diminution in value following the point of default. In this context, different benefits would accrue for clients in seeking to protect their assets depending on the segregation model that they elected and thus there is merit in offering a choice among segregation models, rather than a single prescribed model. It is also important to acknowledge that in the event of a CM default, the pressure on a CCP to manage the default in an orderly manner, and preserve the value of clients' assets as effectively as possible, is highly likely to result in the CCP liquidating those assets in order to reduce volatility.

Finally, in our view, offering clients a choice among individual client segregation models would assist in avoiding cross-jurisdictional inconsistencies. A minimum standard of full asset segregation in the EU is inconsistent with the LSOC model. There will be consequent Article 25 non-EU CCP recognition obstacles if a value-based model is not deemed sufficient for individual segregation. In addition, CCPs in the US, for example, CME will be subject to Dodd-Frank requirements rather than having to comply with EMIR. Accordingly, CME in the US will continue to be able to offer LSOC to their clients, whereas EU authorised CCPs would be forced into a full physical segregation model. Given the US LSOC model would be cheaper, there is a risk of a flight of clearing from the EU to US CCPs, outside the purview and control of ESMA.

Further, were Article 39(3) to require full asset segregation only, (whether by "asset tagging" in separate accounts at CM and CCP level or by full physical quad party segregation), CCPs and CMs would be required to build significant infrastructure, which could delay the EU's ability to meet mandatory clearing obligation deadlines and would result in significant cost increases, for example, signing up to custodians, developing systems to interface with custodian systems, CM funding costs and ongoing custody fees. Such costs would be likely to delay the provision of individual client segregation, and would ultimately be passed to all clients who opt for individual client segregation.

[1] Even under this model, title is transferred and the CM's cash account is initially debited, with subsequent asset substitution taking place (possibly by asset tagging or multiparty custodian arrangements).

Proposed solution

Accordingly, in our view, clients should be offered a choice among individual client segregation models, with full disclosure of the risks and costs of each model. This will mean that individual segregation is affordable for clients other than the very largest market participants and we consider this is desirable. Accordingly, compliant models should include, but not be limited to, the "value" model (as currently provided by, for example, LCH.Clearnet Ltd, CME Clearing Europe and ICE Clear Europe), segregation by value combined with asset attribution, full segregation by "asset tagging" in separate accounts at both CM and CCP level, and full physical quad party segregation with a third party custodian. This would mean that clients would have the option of a range of client clearing model that meet their segregation needs taking into consideration (for both CMs and clients):

(i) infrastructure requirements, operational timing and costs;

(ii) on-boarding, documentation and operational scalability; and

(iii)collateral management and settlement risk, including in relation to substitutions.

We would be grateful if the Bank of England could indicate whether you agree with our view that "individual client segregation" under Article 39(3) of EMIR does not necessarily require full asset segregation, but rather contemplates individual segregation based upon one or more of the models outlined above. We consider that this issue merits discussion with ESMA and, as noted, support the industry-wide effort, led by the FOA to engage with ESMA on this issue and relevant competent authorities, including the AMF and BaFin. We seek clarification as soon as possible given that CCPs and CMs are currently building their clearing models for authorisation or recognition under EMIR (in the case of CCPs) and in order to provide clearing services to clients in accordance with EMIR (in the case of CCPs and CMs). Clients will subsequently face tight systems development timelines too.

DF sizing

Statement of issue

As you know, the size of a CCP's DF is based on the risk the CCP faces following a CM default where the CM's initial margin ("IM") is insufficient to cover losses incurred while the CCP closes out its portfolio. EMIR sets minimum standards for the size of a DF[2]. However, there is ambiguity on how EMIR's sizing requirements apply in respect of clients, especially due to the impact of new client segregation models.

Under traditional client omnibus models, a typical CM would present two sources of risk to the CCP: its house account and its client account. In the case of a CM default, house positions, together with any client positions that are not ported, would be auctioned or closed out with any losses beyond the IM being borne on a net basis by the DF and the CCP's own funds. Enhanced client segregation constructs ring fence non-defaulting clients' IM assets and prevent a CCP from using them to absorb losses in the event of a CM or client default.

[2] EMIR requires CCPs to have aggregate financial resources to cover the credit risk of the default of the largest two CMs (Article 43 (2)). By itself, the DF has to cover 1 or 2nd and 3rd largest CMs (Article 42).

Other segregation constructs have been developed that purport to protect non-defaulting clients' IM and VM.

As a result, a CM that offers its clients enhanced segregation would present multiple sources of new risk to the CCP. In calculating the necessary size of its DF, a CCP would need to take into account the possibility of individual clients defaulting, since non-defaulting clients' IM and/or VM could not be used to cover a defaulting client's residual losses. Moreover, the client by client close out for non-porting clients could take much longer and be more expensive. This scenario would require greater DF contributions from CMs in order to maintain existing levels of protection for cleared contracts. In turn, CMs would need to finance additional contributions, as well as regulatory capital, against DF contributions. This would affect the cost of clearing for clients, which pay fees to their CM to offset DF costs, and CCPs' default management plan fees. Preliminary estimates of this cost render central clearing uneconomic for many clients.

Key considerations in DF sizing calculations

Calculating an appropriate DF size depends on CCP default management processes and how those processes treat the non-defaulting clients of a defaulting CM. In our view, it is important that a CCP that is unable to avoid liquidating client positions does so:

(i) as efficiently as possible - in particular, not client by client and not position by position; and

(ii) in respect of as few customer positions as possible.

Crucially, we do not consider that a CCP should take on contingent client risk in a double default scenario. This would fundamentally redefine the risk characteristics of a CCP, and the supervision required of clearing services. That is, in our view, the credit intermediation provided by CMs to the CCP adds to the resilience of the financial system.

Reasons clients with "highly likely" portability should be excluded from DF sizing calculations

CMs already actively encourage their cleared OTC derivatives clients to enter into "highly likely" portability arrangements. Uncertainty surrounds the meaning of this term. We consider that "highly likely" portability means that clients are on-boarded with at least one secondary CM. For Regulated Clients, the "highly likely" portability standard is a necessary condition to receiving a favourable risk weight on a trade exposure to a Qualifying CCP.

We consider that clients with "highly likely" portability arrangements should be excluded from the DF sizing calculation. The rationale is that in the event that their CM defaults, those clients' transactions and margin would be ported to the back-up CM, which would be relied upon to make the required payments. The CCP would not be required to close them out and absorb any losses associated with that process. To cover a scenario where the CM and a client with "highly likely" portability arrangements default at the same time, the uncovered risk of the largest such client could be included in the DF sizing calculation.

Of course, certain clients seek a higher degree of porting certainty than a "highly likely" portability standard. However, the complexity and cost of such arrangements should not be underestimated. Certainly, such bespoke solutions should not be a minimum requirement for the purposes of DF sizing. CMs can be expected to be suitably conservative in providing porting services on a guaranteed basis, given they will themselves be acting as secondary CMs in respect of other clients. They will thus be required to implement structural risk management measures necessary to control the contingent risk, exposure and capital implications of acting as 2nd guarantors.

Other porting models, such as a back-up administrator/payments CM, or a client becoming a CM for some time without contributing to the DF, disintermediate CMs as credit risk managers. Instead, they require the CCP to hold the contingent client risk. It is unlikely that this was the G20's intention.

Advantages of joint management processes

Clients that do not have porting arrangements, irrespective of the segregation model, could be dealt with on a joint management process that is acceptable to clients and approved by regulators. [3] A joint management process might require non-defaulting clients without "highly likely" portability either to be ported in bulk to CM(s) that are prepared to accept them, or closed out via a joint management process in which segregated clients' IM and VM (to the point of non-transferability) are preserved. Allowing CCPs to manage clients on a joint basis has risk management benefits beyond the DF size itself, including:

(i) The speed at which a defaulting CM's portfolio can be closed out and the CCP re-balanced. The timeliness of a CCP's default management plan is important for financial stability.

(ii) The costs of the CCP default management plan. Separately closing out non-defaulting clients that do not have "highly likely" portability would be much more expensive. First, more traders would be required in order to manage the number of accounts to be closed out. (This might pose practical difficulties where a CM has defaulted.) Second, if clients were not able to hedge each other at all, the CCP would incur significant frictional costs entering the market to acquire such hedges.

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[3] There are broadly two categories of client segregation model known to EMIR and it is possible to further differentiate within the "individual client segregation" category (that is, we are able, under EMIR, to split the client universe of a CM into:

A. *Omnibus clients* (irrespective of whether net or gross).
B. *Individually segregated clients*
    a. With 2nd guarantor (which would assume the risk from closing out the client's positions in a double default scenario).
    b. With executed guaranteed porting agreement by a 2nd CM (who is legally committed to assume the client's assets and positions as long as the client hasn't defaulted).
    c. With a "back-up" CM or other solutions - meaning it is "highly likely" that the client's positions will continue to be transacted through the CCP if the CM defaults, and that the client's collateral is protected from losses.
    d. Neither of the above.

We consider that, solely for the purpose of calculating the required DF size, CCPs should be allowed to disregard clients of type B1, B2, and B3 on the justifications provided above, and that CCPs should also be allowed to model the close-out of clients of type A and B4 in a single-default management process.

We support client positions being default managed by the CCP because we consider it would enable predictable and timely default management.

Proposed solution

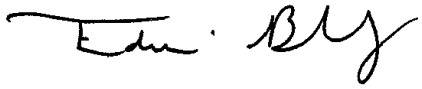
Accordingly, we consider that the DF sizing calculation for clients should:

(i) exclude clients with "highly likely" portability arrangements in place,[4] other than the client with the largest uncovered risk; and

(ii) reflect the fact that the remaining clients, which do not have "highly likely" portability arrangements in place, are dealt with on an approved joint management basis and thus calculate on a net basis.

Please contact the undersigned should you require further information.

Yours sincerely,



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[4] Page 13, paragraph 112(b) of BCBS 206 requires arrangements that are "highly likely" to ensure an institution's trades will be taken over by another CM in the event a bank's CM defaults or becomes insolvent. In previous iterations of the proposals such portability arrangements have had to be "guaranteed" or "assured". This change was made due to prudential concerns regarding "guaranteed" portability.