ISDA Safe, Efficient Markets

Costs and risks of an Active Account Requirement

Executive Summary

ISDA does not believe that clearing at UK Tier 2 CCPs poses unmitigated systemic risk. An active account requirement (AAR) would, however, significantly hamper the competitiveness of EU firms and be damaging to the overall derivatives market and to the Capital Markets Union (CMU), especially if the requirement is not adequately calibrated.

An AAR that mandates a certain amount of clearing to be in the EU, can be seen as a dial between zero (no change) to 100 (full location policy). The current architecture of the clearing market has been developed as an efficient equilibrium based on market forces and client choice. A full location policy on the other hand has been rejected by ESMA, in their assessment of UK Tier 2 CCPs (December 2021), because the risks and costs were too high.

We are often asked to propose ways to "make active accounts work". Mandating EU clearing participants (clearing members and their clients, including end users) to clear, especially if inadequately calibrated, in Europe will create costs and other competitive disadvantages that non-EU competitors will not have. There is a trade-off between mandating clearing in Europe and preserving the competitiveness of EU clearing participants. As the AAR dial is turned up, the cost and downsides increase with the amount of clearing that is mandated to occur on an EU CCP.

To support policymakers in making the decision about this trade-off, we provide detailed descriptions of the impact for EU based firms that comes with different steps towards mandating clearing in the EU. This paper builds on our "Technical Paper on Active Accounts"[1].

We note that the long list of costs and consequences of an AAR underline the requirement for a realistic and comprehensive cost/benefit analysis before any decisions are taken that could have a significant impact on the EU derivatives markets.

Baseline: Current market structure, no AAR

ISDA members believe that the current market equilibrium in terms of clearing location is the safest and most efficient for clearing participants (clearing members[2] and their clients). We do not share the view that there is a risk of "overreliance" that would need to be mitigated with forced relocation of transactions or trade flow. EMIR 2.2 strengthened the framework for third country CCPs to ensure that it was safe for EU firms to continue clearing on UK CCPs in light of Brexit. We acknowledge that there can be some further enhancements, for instance in the role of ESMA in relation to Tier 2 CCP recovery and resolution planning.

[1] https://www.isda.org/2022/10/24/technical-paper-on-active-accounts/

[2] We use the term clearing member, clearing broker and client clearing service provider (CCSP) interchangeably.

AAR without quantitative activity levels ("qualitative requirement")

We note that there is a determination of some EU policymakers to introduce at least an AAR without quantitative activity levels.

Potential design

There would be a requirement for firms in scope of the clearing obligation to keep active accounts for the derivatives contracts as set out in the proposed Article 7a of EMIR, but without a minimum proportion of transactions to be cleared on an EU CCP.

There might also be a requirement for clearing participants in scope to have at least a few transactions and daily variation margin exchange.

Benefits

From the point of view of proponents of AAR, this measure could be beneficial as some smaller firms might want to avoid the cost of duplicative accounts and use EU CCPs only, especially if these firms do not have multi-currency accounts. This requirement could also incentivise EU participants to increase voluntarily their clearing volumes at an EU CCP.

EU participants would have a theoretical fall-back for the relevant euro-denominated products specified in the proposed Article 7a in case there are issues with Tier 2 CCPs, albeit a fall-back account would only be helpful for some operational and technical issues and not be a credible alternative to a recovery and resolution framework and strong supervisory cooperation.

Risks

Introducing such a requirement could lead to an increase in operational risk, as firms have to implement the choice of CCPs in their processes and systems and transactions might be cleared at a UK CCP, especially if there are more manual processes involved because of the lack of Straight Through Processing (STP)[3]. This would also mean that portfolios are split, albeit to a limited extent.

[3] The ECB defines STP as "*The automated end-to-end processing of trades/payment transfers – including, where relevant, the automated completion of confirmation, matching, generation, clearing and settlement of orders*" (see https://www.bankingsupervision.europa.eu/services/glossary/html/glosss.en.html). The Principles for financial market infrastructures (see https://www.bis.org/cpmi/publ/d101a.pdf), Annex C, in point 3.12, offers the following definition: "*straight through processing (STP), that is, procedures that require trade data to be entered only once and then use those same data for all post-trade requirements related to settlement.*"

Costs

Costs will crystallise in particular for the buy-side and end-users, many of which do not yet have accounts at EU CCPs and which do not have a large volume of business that could cover the cost of setting up and maintaining additional accounts.

The Commission claims that opening an account at an EU CCP is virtually without costs. This might be the case if one was only looking at the direct cost of asking an existing clearing member to clear at an EU CCP in a net omnibus account. Clearing at another CCP in a net omnibus account will indeed not cause a lot of direct costs, albeit a net omnibus account provides the least amount of segregation and protection to the client. The Commission, however, did not consider any of the following indirect cost of setting up additional accounts:

Activity/cost	One-off / recurring	Size	Client	CCSP	CCP
Running a full due diligence on the new CCP	One-off	Medium	X		X
Running a full legal and regulatory analysis of clearing at the potential new CCPs to assess issues such as day-to-day compliance impacts, or the anticipated steps on the insolvency of the clearing broker or CCP and likely impacts on the porting of positions or return of client collateral.[4]	One-off[5]	Medium	X	X	
For any new CCP or clearing member, the due diligence and legal/regulatory analysis will then need to be monitored and updated to	Recurring	Medium	X	X	

[4] Using this latter point as just one example: clients have to assess the range of clearing account structures offered by CCPs (e.g. Individual Segregated Account (ISA) via a clearing member with Initial Margin (IM) held at CCP vs held by third party custodian vs the client entering a direct contract with the CCP) and how this is then impacted by CCP and clearing member jurisdiction. A significant number of clients might currently be clearing using only US Future Commission Merchants (FCM) under the US agency model, so will have to assess EU model clearing (principal to principal). Insolvency law differences, even between EU jurisdictions, can make this analysis complex and expensive.

[5] For any new CCP or clearing member, the points above will then need to be monitored and updated to account for: regulatory changes, contract updates, risk appetite changes, insolvency law changes, etc.

Activity/cost	One-off / recurring	Size	Client	CCSP	CCP
account for: regulatory changes, contract updates, risk appetite changes, insolvency law changes, etc.					
Where the client's existing clearing brokers do not support the relevant EU CCP, the client will also need to assess and chose two new clearing brokers, including due diligence, legal/regulatory analysis and contract negotiation. Clearing contracts are complex and expensive to negotiate, particularly for clients but also for clearing brokers. The new clearing broker will also have to run due diligence on the new client[6].	One-off	Medium (if a new broker needs to be found)	X	X	
Update documentation if required. This should be straightforward if the client already has a clearing agreement[7].	One-off[8]	Low	X	X	
Should the client require segregation at the new CCP, there is additional documentation and opening of accounts involved. Segregated accounts are	One-off	Medium	X	X	

[6] If the clearing broker is in the EU, please see also footnote 7.

[7] If the client does not have a clearing agreement, there are many more things to do, as e.g. specified for Clearing Members in RTS 6 to MiFID II or for Direct Electronic Access (DEA) providers in the same RTS (Commission Delegated Regulation (EU) 2017/589).
Furthermore, legal advice needs to be obtained, both at CSP and client side. While large firms might have in-house legal counsels, smaller firms might not. This might also be recurring, in case material changes to the agreements are made.

[8] This is recurring every few years as due to changes in the legislation, e.g. CCP RRR and FRANDT or if CCP rulebooks change in a way that influences the relationship between CSP/CM and client etc. Thus, the documentation needs to be reviewed regularly.

Activity/cost	One-off / recurring	Size	Client	CCSP	CCP
important if the client wants to have a chance to be ported to another clearing member in case of default of its clearing member. For the wider clearing system, a large amount of segregated account opening requests might cause a bottleneck at EU CCPs.					
Many counterparties opening accounts within a very short timeframe means that additional resources are needed especially at the CCP which will not only create a bottleneck but also drive costs for these EU counterparties.	One-off	Medium	X	X	
Adapt middleware, e.g. to be able to select CCPs at the point of trade, including related software licence costs if external software is used.[9]	One-off[10]	Medium	X		
Clear ongoing transactions to demonstrate that the account remains operational.	Recurring	Medium[11]	X	X	
Ensure liquidity sourcing, risk limits and capital are in place for initial and variation margin at EU CCPs, thereby making buy-side liquidity management less flexible and more complicated.	Recurring	Low	X		
Adapt/change/test working practices, procedures and	One-off	Low	X	X	

[9] This assumes they do not choose to clear only at an EU CCP going forward.
[10] In case software license costs are involved, there is also a recurring element.
[11] Depends on how often such transactions are required.

Activity/cost	One-off / recurring	Size	Client	CCSP	CCP
policies including the new accounts at EU CCPs.					
Implement a management process for what business the new EU CCPs are used.	One-off	Low	X	X	
Provide staff training and certification where applicable.	One-off and recurring	Medium	X	X	
Consider the potential impact on execution[12] clearing fees.	Recurring	Low/Medium[13]	X		
Large clearing members and asset managers will not only have to set up additional clearing relationships, but also copy these internally for a potentially large number of clients in scope of the requirements.	One-off	High	X	X	
Large asset managers will have to adapt their IT systems to allow for straight-though processing (STP) of transactions cleared at the new EU CCP. The EU CCP has to support STP on its side.	One-off	Medium	X		
Cost for additional reporting requirements (as currently envisaged in EMIR3), especially for clients and/or their asset managers. Dealers are already subject to a host of reporting requirements so find it relatively straight forward to generate an additional	One-off and recurring	Medium	X	X	

[12] Execution fees will be incurred if there is requirement to clear ongoing transactions to demonstrate that the account remains operational.
[13] Depends on the contractual relationship with the clearing member and the segregation model.

Activity/cost	One-off / recurring	Size	Client	CCSP	CCP
report, mostly because their reporting covers high volumes, so the relative cost (per report) is low. Clients have to build the required reporting functionality from zero to cover a relatively low amount of reporting, which is highly inefficient.					
Firms have to reconcile their books and record with the new CCP.	Recurring	Low	X	X	X
Firms have to manage direct connectivity to various bespoke CCP processes	Recurring	Low	X	X	X

Possible mitigation

By only requiring a qualitative AAR for firms above a specific threshold (EMIR 3.0 currently sets the threshold at the clearing requirement threshold), some firms would not be subject to the AAR, whereby partially mitigating the issues/costs set out above. Such threshold could however lead to distortions for firms whose exposures are around the threshold.

Supervisory issues

EMIR 3.0 proposes that firms subject to the AAR report their activities at an EU CCP to the EU CCP's authorities.

We understand this is for authorities to be able to supervise compliance with the AAR. We, however, doubt that authorities can supervise compliance of the long tail of small buy-side clients, for instance firms in phase 6 of the uncleared margin requirements.

AAR with minimum activity levels ("quantitative requirement")

Potential design

This is the currently proposed design in Article 7a of EMIR.

Benefits

From the point of view of proponents of AAR, such accounts with minimum activity levels will be able to force a defined quantum of euro-denominated derivatives business of EU market participants into EU CCPs.

Risks

Operational risk will increase significantly with an AAR with quantitative requirements, as all firms subject to the requirement will have to decide for each trade where it would be cleared.[14]

Given that we do not believe that clearing at Tier 2 CCPs creates systemic risk for the EU, we do not believe systemic risk will be reduced by an AAR. We do believe that there could be additional systemic risk:

- Global banks will intermediate between the global and the EU liquidity pool. The way the clearing obligation is designed (covering mostly banks and asset managers), client flow at EU CCPs will be directional. Banks intermediating between the EU CCPs and the global liquidity pool will therefore have equal directional portfolios. This will lead to higher liquidity risk for these banks, as in times of stress, they will be required to post margin intraday (large margin calls) with one CCP, while they will only receive margin from the other CCP the next day;
- Margin requirements will increase, as most firms will no longer benefit from netting of a larger, single portfolio on a single CCP rather than smaller, disparate portfolios on multiple CCPs. As margin the market price of risk, increased margin in the system means increased risk in the system;
- Supervisory fragmentation could mean that neither EU or UK authorities would have a full view of the market anymore.

Costs

The costs of AAR with quantitative requirements will be those of an AAR without quantitative requirement plus additional costs associated with the requirement to clear a portion of business on EU CCPs.

[14] Unless they decide to not use multiple CCP and clear only at EU CCPs. This could however mean a worse financial outcome, as the best prices might likely be in the larger global liquidity pool.

There will also be additional detrimental impacts and risks stemming from managing the quantitative requirements.

Bold in the table below indicates a change from the qualitative table above:

Activity/cost	**One-off / recurring**	**Size**	**Client**	**CCSP**	**CCP**
Running a full due diligence on the new CCP.	One-off	Medium	X		X
Running a full legal and regulatory analysis of clearing to the potential new CCPs to assess issues such as day-to-day compliance impacts, or the anticipated steps on the insolvency of the clearing broker or CCP and likely impacts on the porting of positions or return of client collateral.	One-off	Medium	X	X	
For any new CCP or clearing member, the due diligence and legal/regulatory analysis will then need to be monitored and updated to account for: regulatory changes, contract updates, risk appetite changes, insolvency law changes, etc.	Recurring	Medium	X	X	
Where the client's existing clearing brokers do not support the relevant EU CCP, the client will also need to assess and chose two new clearing brokers, including due diligence, legal/regulatory analysis and contract negotiation. Clearing contracts are complex and expensive to negotiate, particularly for clients but also for clearing brokers. The new clearing broker will also have to run due diligence on the new client[15].	One-off	Medium (if a new broker needs to be found)	X	X	
Update documentation if required. This should be straightforward if the client already has a clearing agreement[16].	One-off[17]	Low	X	X	

[15] If the clearing broker is in the EU, please see also footnote 16.

[16] If the client does not have a clearing agreement, there are many more things to do, as e.g. specified for CMs in RTS 6 to MiFID II or for Direct Electronic Access (DEA) providers in the same RTS (Commission Delegated Regulation (EU) 2017/589).
Furthermore, legal advice needs to be obtained, both at CSP and client side. - While large firms might have in-house legal counsels, smaller firms might not. This might also be recurring, in case of material changes to the agreements are made.

[17] This is recurring every few years as due to changes in the legislation, e.g. CCP RRR and FRANDT or if CCP rulebooks change in a way that influences the relationship between CCSP/CM and client etc. Thus, the documentation needs to be reviewed regularly.

Activity/cost	One-off / recurring	Size	Client	CCSP	CCP
Should the client require segregation at the new CCP, there is additional documentation and opening of accounts involved. Segregated accounts are important if the client wants to have a chance to be ported to another clearing member in case of default of its clearing member. For the wider clearing system, a large amount of segregated account opening requests might cause bottleneck at EU CCPs.	One-off	Medium	X	X	
Many counterparties opening accounts within a very short timeframe means that additional resources are needed especially at the CCP which will not only create a bottleneck but also drive costs for EU counterparties.	One-off	Medium	X	X	
Adapt middleware, e.g. to be able to select CCPs at the point of trade, including related software licence costs if external software is used.	One-off[18]	Medium	X		
Clear ongoing transactions.	Recurring	**High**	X	X	X
Ensure liquidity sourcing, risk limits and capital are in place for initial and variation margin at EU CCPs, thereby making buy-side liquidity management less flexible and more complicated.	Recurring	**High**	X		
Assess potential impacts on staffing.	Recurring	**Medium**	X		
Adapt/change/test working practices, procedures and policies including the new accounts at EU CCPs.	One-off	**Medium**	X		
Implement a management process for what business the new CCPs are used.	One-off	**Medium**	X	X	
Provide staff training and certification where applicable.	One-off	Medium	X	X	
Consider the potential impact on execution and clearing fees.	Recurring	**Medium-high**	X		
Large asset managers will not only have to set up additional clearing relationships, but also copy these internally for a potentially large	One-off	High	X		

[18] In case software license costs are involved, there is also a recurring element.

Activity/cost	One-off / recurring	Size	Client	CCSP	CCP
number of clients in scope of the requirements.					
Large asset managers will have to adapt their IT systems to allow for straight-though processing (STP) of transactions cleared at the new CCP. The EU CCP has to support STP on its side.	One-off	High	X	X	X
Firms have to reconcile their books and record with the new CCP.	Recurring	Low	X	X	X
Firms have to manage direct connectivity to various bespoke CCP processes	Recurring	Low	X	X	X

The introduction of quantitative requirements will cause additional costs / detrimental impacts for European clearing participants:

Activity/cost	One-off / recurring	Size	Client	CCSP	CCP
Implement processes and IT changes to support management of quantitative requirements. This likely requires changes to front-office systems that inform traders whether the firm is in compliance with minimum activity levels. For asset managers, this has to be done at the level of each client. If the client uses multiple managers, it would be exceptionally hard or impossible for asset managers to establish a real time feed of positions to allow the manager to adapt trading decisions to meet the relevant proportion requirement. Different asset managers cannot coordinate trading between each other for a range of competition,	One-off	High	X	X	

Activity/cost	One-off / recurring	Size	Client	CCSP	CCP
confidentiality and compliance reasons. The client or custodian would have to arrange some form of messaging, which would require a long lead time, add cost and, ultimately, would likely still give away sensitive data.					
Change how quotes to trading venues are streamed. Should a firm get near to the minimum activity levels, quotes for Tier-2 CCPs have to made worse or not be provided at all, leading to this firm not being competitive anymore.	Recurring	High	X	X	
EU clients will lose best execution and EU dealers could lose access to the global liquidity pool. If the EU cleared price is worse than is available at the non-EU CCP, EU dealers and clients will be forced to accept this worse pricing, while their third country competitors will have freedom to trade at the best available price.	Recurring	High	X	X	
EU market makers will have less access to the global liquidity pool to balance their trade flow. EU firms will have to buy expensive hedges from global firms (incurring at least the bid-ask spread), effectively leading to EU firms becoming regional distributors for global banks.	Recurring	High		X	
Loss of market making business with non-EU firms and EU firms that are not under the AAR.	Recurring	Depending on existing business	X	X	
Loss of client clearing business with non-EU firms and EU firms that are not under the AAR.	Recurring	Depending on existing business	X	X	

Activity/cost	One-off / recurring	Size	Client	CCSP	CCP
Loss of access to non-EU CCP for EU clearing members if the requirement to clear on EU CCPs means they can no longer effectively participate in non-EU CCP default management and thus no longer fulfil the non-EU CCP's membership requirements.	Recurring	Depending on existing business	X	X	
Potential worse prices in the EU liquidity pool, as neither market makers nor their clients can hedge themselves in the global liquidity pool.	Recurring	High	X	X	
Loss of netting possibilities due to fragmentation and thus smaller portfolios at EU CCPs.	Recurring	Medium	X	X	

Possible mitigation

The long list of costs and detrimental impacts make an AAR with quantitative requirements very damaging to EU market participants including end-users. Some of the costs for banks, especially the loss of business with non-EU firms could be mitigated by a market making exemption and a client clearing exemption. These exemptions would also be helpful for the buy-side and end-users, as market makers would have to ration business at Tier 2 CCPs to a much lesser extent. With an exemption, market makers could potentially also offer better prices to their clients. However, buy-side, end-users and banks' proprietary business can not avail themselves to similar exemptions and these exemptions therefore merely shift the pressure with a quantitative AAR to other participants in the market such as large EU pension funds and regulated funds (e.g. UCITS, AIFs), especially if there is a strict link between minimum activity levels and the substantial systemic importance of the clearing services in scope.

Supervision

The reporting and connected supervisory challenges associated with a qualitative AAR are amplified with a quantitative AAR as supervisors would have to monitor compliance with not only a requirement to have active accounts, but also to what extent these are used.

About ISDA

Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 1,000 member institutions from 79 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's website: www.isda.org. Follow us on Twitter, LinkedIn, Facebook and YouTube.