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In Practice

Insolvency risks under the European Markets Infrastructure Regulation

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KEY POINTS

- The European Markets Infrastructure Regulation No. 648/2012 dated 4 July 2012 imposes a number of requirements on counterparties to derivative contracts, central counterparties and their clearing members and trade repositories. It introduced the obligation on central counterparties to clear certain classes of over-the-counter (OTC) derivatives under the EMIR framework.
- EMIR requires each central counterparty and its clearing members to offer its clients a choice between omnibus and individual client segregation of positions and collateral, in relation to cleared derivatives transactions and related accounts maintained at the central counterparty.
- Clearing members should review information provided by each EU and third country central counterparty regarding their segregation offerings, which should include further information on the legal and other implications of particular segregation models and applicable insolvency laws.
- In the current economic climate where the insolvency of all kinds of financial institutions is still a real risk, this exercise needs to be undertaken very carefully indeed.

BACKGROUND

The European Markets Infrastructure Regulation No. 648/2012 (EMIR) became effective on 16 August 2012. Many obligations under EMIR had to be further prescribed through regulatory technical standards which are developed by the European Securities and Markets Authority (ESMA).

After the recent authorisation of several EU domiciled central counterparties for the clearing of certain classes of OTC derivatives, it is appropriate for clearing members and their clients to consider insolvency risks that may arise in relation to clearing of their OTC transactions. The clearing obligations under EMIR involve an insolvency risk for both the central counterparty's clearing members and their clients (corporations or financial institutions, whether they are established inside or outside of the EU).

Notably, ESMA has published three consultation papers on the clearing obligation under EMIR, which have addressed for the first time which classes of OTC derivative contracts are subject to the mandatory clearing obligation. They were published as a result of the notifications received by ESMA that a number of central counterparties inside and outside of the EU have already been authorised to clear certain classes of OTC derivatives.

OTC derivatives contracts, which are subject to the clearing obligation under EMIR, must be cleared when they occur between the following counterparties:

- two financial counterparties (such as financial institutions, pension schemes and insurance companies);
- a financial counterparty and a non-financial counterparty which has exceeded certain clearing thresholds (calculated by reference to the aggregate value of trades);
- two non-financial counterparties (which have exceeded the clearing threshold); and
- counterparties established outside the EU in certain circumstances.

All parties need to observe their respective clearing obligations depending on certain thresholds and the type of OTC derivatives at issue. For example, the following OTC derivatives need to be cleared: interest rate derivatives; credit derivatives; commodity derivatives; equity derivatives; and foreign exchange derivatives.

Other classes of OTC derivatives could be included in the future:

- if there are more central counterparty authorisations;
- if there are authorised central counterparties that are expanding their product range; or
- if ESMA decides to use the "top-down method" to identify further contracts to be mandated for clearing.

RISKS RELATED TO CENTRAL COUNTERPARTY CLEARING MEMBER DEFAULT OR CENTRAL COUNTERPARTY DEFAULT

A major risk to a client of a clearing member is the risk of default upon insolvency of a clearing member or the central counterparty that it uses to clear its OTC derivative contracts. If a clearing member is declared to be in default by a central counterparty:

- that central counterparty may, at a request of the client of the clearing member, try to transfer the client's positions and assets to another clearing member (so called "porting"); or, if this cannot be achieved,
- that central counterparty will terminate the cleared derivative transactions relating to that client and will perform a close-out calculation, taking into account the value of those transactions and the proceeds of liquidating associated collateral.

In addition, a client of a clearing member also faces the risk that a central counterparty defaults. In this case, porting will not be available but transactions will be terminated and a close-out calculation will be performed.

ACCOUNT SEGREGATION REQUIREMENTS UNDER EMIR

One aspect of the protection of the clearing members and their client's assets is that EMIR does not allow the use of unsegregated accounts. Article 39 of EMIR provides that central counterparties and clearing members must offer both "individual client segregation" and "omnibus client segregation". Individual client segregation would mean that there will be no co-mingling of the clients' assets with the central counterparty's or clearing member's assets.

In Practice

Biog box
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Accordingly, ESMA's Questions and Answers dated 11 November 2013 (ESMA/2014/164), contain a clarification on whether central counterparties are further required to provide segregated accounts for indirect clients (meaning clients of central counterparties' clearing members). ESMA stated that central counterparties may, at the request of a clearing member, set up individually segregated accounts in which the positions and assets of their clients may be recorded, but the central counterparties have no obligation to do so. In this regard, it should further be noted that the provisions of Art 4 of EMIR and Art 2 of the Commission Delegated Regulation (EU) No 149/2013 on indirect clearing, apply only to OTC derivatives and not to all products (since they are subject to Art 4 of EMIR and their purpose is to meet the clearing obligation). Therefore EMIR requires:

Individual segregated accounts: the positions and collateral of a client of a clearing member must be recorded and booked in a certain client's account at the central counterparty. The accounts are protected on both a central counterparty insolvency default and a clearing member insolvency default from other clearing member or client accounts. For individual segregated accounts, EMIR requires that clearing members must transfer excess collateral received from the client to the central counterparties, to be recorded in the individual segregated account. For this purpose "excess collateral" means, in relation to an individual account, the amount of collateral that the clearing member requires the client to provide to it for positions in the individual account, over and above the amount required by the relevant central counterparty.

Omnibus segregated accounts: derivative positions and associated collateral of multiple clients of the clearing member must be booked and recorded in a single omnibus account at a central counterparty. If the central counterparty or the clearing member defaults, there is a high risk that losses associated with one client's positions and/or collateral may impact other clients. In particular, the positive value of one client's positions may be netted against the negative value of another client's positions. Ultimately, the default risk will depend on the type of omnibus account offered by the central counterparty and the clearing member. EMIR does not prescribe a single type of omnibus account, and different central counterparties may have different offerings, which potentially reduce some omnibus account risks that may otherwise exist.

Even so, ESMA regulatory guidance also emphasises that, while central counterparties might offer other levels of protection in addition to individual client segregation and omnibus client segregation (such as an omnibus gross margin client model), the omnibus client segregation is the minimum level of client protection to be used under EMIR.

RISK MANAGEMENT

There is a distinction to be made between the exposures of a central counterparty's clearing member and the exposures of a clearing member's client. With respect to a clearing member, the default risk relates on the one hand to the clearing member's exposures to a central counterparty and on the other hand its exposures to a client. With respect to a clearing member's clients, the default risk relates to the exposure to the central counterparty's clearing member and only indirectly to the central counterparty.

Clients of clearing members need to consider carefully the kind of offered protection and if such protection is sufficient for their risk management needs. Notably in this regard, an omnibus or individual segregated account at one central counterparty may have certain features which might distinguish it (sometimes fundamentally) from omnibus and individual segregated accounts at other central counterparties. In some cases, a central counterparty may offer more than one variety of omnibus or individual account. This can make choosing the appropriate account particularly challenging for clearing members and their clients. It is therefore most important that clearing members and their clients carefully review the information provided by central counterparties regarding the segregation models they offer and their related insolvency risks.

THIRD COUNTRY CLEARING MEMBERS AND THEIR CLIENTS

The references to clearing members in Art 39 are not limited to EU clearing members, such that all clearing members of an EU central counterparty are required to comply with the regulations. Similarly, the references to clients in Art 39 are not limited to EU domiciled clients of clearing members. EU central counterparties are expected to require all clearing members to comply with the relevant EMIR provisions and regulations. If a third country's insolvency regime applicable to a non-EU clearing member can limit the protection afforded by the omnibus client segregation or the individual client segregation, as set out in Arts 39 and 48, it is anticipated that the clearing member would offer its clients any available alternative to ensure that the protections afforded by the omnibus client segregation and the individual client segregation are not limited in an insolvency scenario. Such limitations may include, for example, the pooling of client accounts in a bankruptcy estate or exposing clients to the losses of others. Other possibilities of protection may include clearing solutions provided by an affiliate or other clearing member of the central counterparty.

For example, if clearing is to take place through a third country central counterparty, both the client and the clearing member should consider in particular the risks of the third country's insolvency regime not recognising segregation and the clearing member must disclose those risks in full to the client at the outset of the relationship, in accordance with both Arts 39(5) and 39(7).

CONCLUSION

From a client's viewpoint, individual segregated accounts offer the best protection on insolvency default as the client's assets are not consolidated with the assets of the insolvent clearing member or the assets of the insolvent clearing member's other clients. The main reason clients chose omnibus segregated accounts is they tend to be cheaper in terms of charges and costs. However, this is a situation where paying additional upfront charges may save considerably more money in the long run if an insolvency default occurs.

Ultimately, the new clearing regime is very complex and the insolvency regulations of relevant jurisdictions need to be considered by clearing members and their clients to protect their credit and asset exposure if OTC derivative transactions are cleared by central counterparties. ■