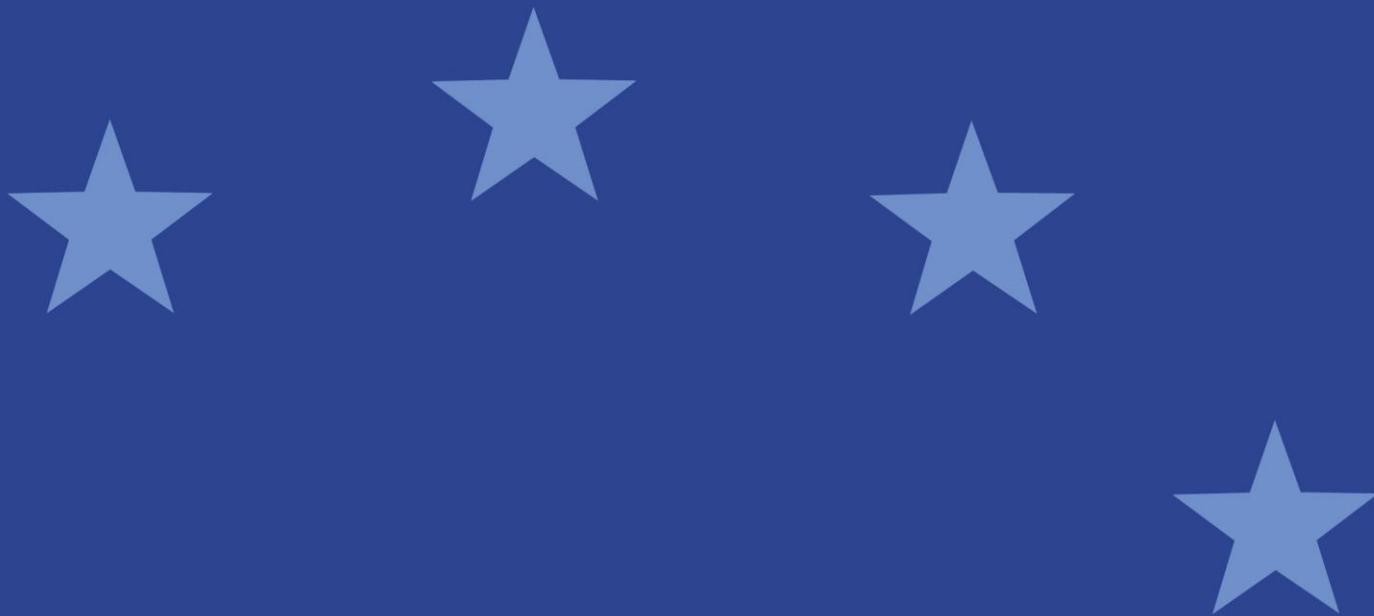


Discussion paper

Calculation of counterparty risk by UCITS for OTC financial derivative transactions
subject to clearing obligations



Responding to this paper

ESMA invites comments on all matters in this paper and in particular on the specific questions summarised in Annex 1. Comments are most helpful if they:

- respond to the question stated;
- indicate the specific question to which the comment relates;
- contain a clear rationale; and
- describe any alternatives

ESMA will consider all comments received by 22 October 2014.

All contributions should be submitted online at www.esma.europa.eu under the heading 'Consultations'. Contributors should identify themselves and indicate the industry sector in which they operate or in which they are interested and the extent to which that sector is already subject to regulation at a national level. Contributors are also asked to consider the costs or benefits attached to the various options and quantify these costs to the extent possible.

Publication of responses

All contributions received will be published following the close of the consultation, unless you request otherwise. Please clearly and prominently indicate in your submission any part you do not wish to be publically disclosed. A standard confidentiality statement in an email message will not be treated as a request for non-disclosure. A confidential response may be requested from us in accordance with ESMA's rules on access to documents. We may consult you if we receive such a request. Any decision we make not to disclose the response, is reviewable by ESMA's Board of Appeal and the European Ombudsman.

Data protection

Information on data protection can be found at www.esma.europa.eu under the heading 'Disclaimer'.

Who should read this paper?

This paper should be read by managers of UCITS, clearing members, depositaries of UCITS, clients of clearing members and central counterparties.



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Annex I – List of questions



Acronyms used

CCP	Central Counterparty
CM	Clearing Member
EMIR	European Market Infrastructure Regulation
ICA	Indirect Clearing Arrangement
ESMA	European Securities and Markets Authority
ETD	Exchange-traded derivative
OTC	Over-the-counter
UCITS	Undertakings for Collective Investment in Transferable Securities



I. Executive Summary

Reason for publication

Directive 2009/65/EC (the UCITS Directive) allows UCITS to invest in both exchange-traded derivatives (ETDs) and in OTC derivative transactions. Only investments in OTC derivative transactions are subject to counterparty risk exposure limits in the UCITS Directive. The guidelines on Risk Measurement and Calculation of Global Exposure and Counterparty Risk for UCITS (CESR/10-788)¹ recommend that initial margin posted to and variation margin receivable from a broker relating to exchange-traded derivatives which are not protected by client money rules or other similar arrangements should also be taken into account for the calculation of counterparty risk of Article 52 of the UCITS Directive.

Under EMIR, certain OTC derivative transactions will become subject to clearing obligations. ESMA is seeking stakeholders' views on how the limits on counterparty risk in OTC derivative transactions that are centrally cleared should be calculated by UCITS and whether the same rules for both OTC transactions that are centrally cleared and ETDs should be applied by UCITS.

Contents

This discussion paper distinguishes between different clearing arrangements. For each of those clearing arrangements, ESMA analyses the impact of a default of the clearing member (CM) and the client for the calculation of the counterparty risk by UCITS.

Next steps

ESMA will use the feedback received from the public consultation to determine its final views on the appropriate way forward, including a possible recommendation to the European Commission on a modification of the UCITS Directive.

¹ http://www.esma.europa.eu/system/files/10_788.pdf

II. Background

1. Directive 2009/65/EC (the UCITS Directive) allows UCITS to invest in both exchange-traded derivatives (ETDs) and in OTC derivative transactions. Only investments in OTC derivative transactions are subject to counterparty risk exposure limits in the UCITS Directive. More specifically, according to Article 52 of the UCITS Directive, the risk exposure to a counterparty in an OTC derivative transaction shall not exceed 5% of the assets of a UCITS, or 10% when the counterparty is a credit institution.
2. However, paragraph 1 of Box 27 of the guidelines on Risk Measurement and Calculation of Global Exposure and Counterparty Risk for UCITS (CESR/10-788) recommends 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 of Article 52 of the UCITS Directive.
3. Under Regulation 648/2012 (EMIR), certain OTC derivative transactions will become subject to clearing obligations. Therefore, the question arises as to how the limits on counterparty risk in OTC derivative transactions that are centrally cleared should be calculated by UCITS and whether the same rules for both OTC transactions that are centrally cleared ETDs should be applied by UCITS. Indeed, it could be argued that ETDs and OTC derivative transactions that have similar counterparty risk profiles (taking into account elements such as the type of segregation arrangement, or the portability of the assets and the positions of the UCITS in the case of a default of a CM) should be treated in the same manner and that UCITS should apply the same counterparty risk limits to both types of transaction.
4. In December 2013 ESMA published a revised version of the Q&A on Risk Measurement and Calculation of Global Exposure and Counterparty Risk for UCITS (ESMA/2013/950)². The Q&A clarified the main elements that UCITS management companies should take into account when they calculate their counterparty risk for OTC transactions subject to clearing obligations, without being prescriptive on how counterparty risk should be calculated. The Q&A also indicated that further work would take place with a view to providing more detailed guidance in early 2014.
5. Section III of this discussion paper sets out several working assumptions. Stakeholders should take note that those working assumptions are only relevant in the context of a possible recommendation to the European Commission to initiate a modification of the UCITS Directive for the calculation of counterparty risk for centrally-cleared OTC derivative transactions and ETDs.

III. Definitions and working assumptions

6. The following definitions are used in this discussion paper:
 - a. Central Counterparty: a legal person as defined in Article 2(1) of EMIR.
 - b. Clearing Member: an undertaking as defined in Article 2(14) of EMIR.
 - c. Excess margin: any margin in excess of the client's requirements as referred to in Article 39(6) of EMIR.

² http://www.esma.europa.eu/system/files/2013-1950_qa_risk_for_ucits.pdf

- d. Individual client segregation: segregation arrangement as defined in Article 39(3) of EMIR.
 - e. Omnibus client segregation: segregation arrangement as defined in Article 39(2) of EMIR.
 - f. Client: an undertaking as defined in Article 2(15) of EMIR.
 - g. Indirect client: an undertaking as defined in Article 1(a) of Regulation (EU) No 149/2013 (the EMIR Level 2 Regulation).
 - h. Indirect clearing arrangements: an arrangement as referred to in Chapter II of the EMIR Level 2 Regulation.
7. This discussion paper does not address the way in which UCITS should take into account exposure to any EU CCPs or to those non-EU CCPs that are recognised by ESMA when assessing their counterparty risk for centrally-cleared OTC transactions. EU CCPs and non-EU CCPs recognised by ESMA³ are entities subject to stringent requirements which are assessed on an on-going basis by the relevant authorities. Therefore, they should generally be considered as market infrastructures with relatively low counterparty risk. This is consistent with other pieces of legislation such as the Capital Requirements Regulation (Regulation 575/2013)⁴, where trade exposures with CCPs benefit from a lower capital treatment without being considered as risk-free. Furthermore, the EU regulatory framework and the clearing obligations under EMIR recognise that CCPs should contribute to lowering systemic risk by reducing the number of bilateral derivative exposures. Therefore, this discussion paper is focused on the impact of a default of a CM or of other clients of the CM on UCITS that enter into centrally-cleared OTC derivative transactions.
8. This discussion paper does not take into account default fund contributions referred to in Article 42 of EMIR because those funds are not subject to segregation and portability obligations.

Questions to stakeholders:

- 1. Do you agree with the working assumptions above?**
- 2. In particular, do you agree that UCITS should regard the counterparty risk of all ESMA-recognised CCPs as being relatively low? Are there some ESMA-recognised CCPs for which counterparty risk may not be low? If so, please explain.**
- 3. Do you think that UCITS should apply any counterparty risk limits to ESMA-recognised CCPs? What should be the limits?**
- 4. Do you agree that the assessment of counterparty risk vis-à-vis the CM and the client should distinguish between the different types of segregation arrangement? If not, please justify your position.**
- 5. When assessing the counterparty risk for centrally-cleared OTC derivative transactions, do you think that UCITS should look at other factors than the segregation ar-**

³ The requirements for recognition of non-EU CCPs, and the process to be followed, are set out in Article 25 of EMIR.

⁴ See in particular Articles 305 and 306 CRR

rangements? If yes, what are those factors?

IV. Direct clearing arrangements

9. In the paragraphs below, it is assumed that UCITS are clients of the CM (i.e. the arrangement is not one of indirect clearing between the CCP, the CM, the client of the CM and UCITS).

IV.I. Individual client segregation with EU CCP or non-EU CCP recognised by ESMA

10. In the case of a default of a CM, the CCP has an obligation to attempt the transfer (to port) of the assets and positions of the UCITS (OTC contract + initial and variation margins + excess margin if applicable) to another CM or to close the positions of the UCITS. If the CCP liquidates the positions, the UCITS will get directly from the CCP (if the UCITS is known to the CCP) the liquidated value of its positions and any residual collateral to cover such positions. In other words, the UCITS' assets will be returned directly to the UCITS (if known to the CCP) without the risk of being impacted by the default of the CM.
11. Furthermore, under individual client segregation, the assets and positions of the UCITS are legally and operationally separated from the assets and positions of other clients of the CM.
12. Therefore, it seems reasonable to believe that under individual client segregation UCITS have no counterparty risk vis-à-vis the CM or other clients of the CM, but they may have some exposure to market risk if the positions are liquidated by the CCP and new positions need to be re-established. However, the risk that under an individual client segregation arrangement, the CM defaults before it posts the assets to the CCP, is not considered as significant.

Questions to stakeholders:

- 6. Do you agree that under an individual client segregation UCITS have a low counterparty risk vis-à-vis the CM for all the assets posted (initial margins, variation margin and excess margin if applicable)? If not, please justify your position.**
- 7. Do you think that UCITS should apply any counterparty risk limits to the CM under individual client segregation? What should be the limits?**
- 8. To what extent do you think that the liquidation of derivative positions by a CCP in respect of a defaulting CM (and the associated market risk) is a significantly likely scenario that should be taken into account by the UCITS?**
- 9. Do you agree that UCITS should apply the same counterparty risk limits to CMs under individual client segregation for both OTCs and ETDs? If not, please justify your position.**
- 10. Notwithstanding the choice of segregation model, do you believe that the effective level of protections and degree to which the UCITS will be exposed to counterparty credit risk should be assessed on a case-by-case basis?**

IV.II. Omnibus client segregation with EU CCP or non-EU CCP recognised by ESMA

13. In an omnibus client segregation, the obligation for the CM and the CCP is only to distinguish the assets and positions of the CM from the assets and positions held for the account of the clients of the CM. This means that the CM is allowed to post to the CCP only the net amount of collateral necessary to clear the OTC transactions of its clients. There is no individual segregation of the collateral at the CCP level and no requirement to collect the margins from clients on a gross basis.
14. In the case of a default of a CM under an omnibus client segregation model, in the majority of cases the CCP will deliver back to the CM/the liquidator of the CM the residual collateral (if any) following the liquidation of the CM's clients positions. This means that (a) UCITS may not get their assets back (initial and variation margins + excess margin if applicable) or (b) there may be a substantial delay in the return of the assets because this depends on the outcome of the liquidation procedure of the CM. It also means that the UCITS will be unhedged and will therefore be exposed to market risk until such time as it re-establishes a new position since the original derivatives position was liquidated/terminated.
15. Therefore, it is fair to conclude that omnibus client segregation provides UCITS with less protection than individual client segregation when the CM defaults. In particular, under omnibus client segregation, UCITS will be exposed to both the default of the CM and of other clients of the CM. It would seem logical for UCITS to apply counterparty risk limits to CMs in the case of omnibus client segregation.
16. Given that under an omnibus client segregation structure UCITS will be subject to the default of the CM (and of other clients) irrespective of whether the contracts cleared by the CCP are ETDs or OTC derivatives, it does not seem appropriate to apply limits only to OTC derivatives.

Questions to stakeholders:

- 11. Do you agree that, under an omnibus client segregation, UCITS have a higher counterparty risk vis-à-vis the CM than under an individual client segregation? If not, please justify your position.**
- 12. Do you agree that UCITS should be subject to counterparty risk limits to the CM under omnibus client segregation? If yes, do you agree that UCITS should apply those limits to the amount of collateral posted to the CM (i.e. initial margin, variation margins and excess collateral if applicable)? What should be the limits?**
- 13. Do you agree that UCITS should be subject to the same counterparty risk limits to CMs under omnibus client segregation for both OTC derivatives and ETDs? If not, please justify your position.**

IV.III. Other types of segregation arrangement with EU CCP or non-EU CCP recognised by ESMA

17. According to Article 39(2) and (3) of EMIR, CCPs shall offer two types of segregation: the individual client segregation and the omnibus client segregation. However, CCPs may offer different types of cli-

ent segregation arrangement and those arrangements may differ from one CCP to another (such as with respect to the consequences of the default of a CM).

18. One of these possible structures, which is offered by some CCPs, is an omnibus account where the margins from clients are collected on a gross basis and posted to the CCP on the gross basis (while the margins are held in an omnibus account, it may be the case that they are individually identified in the books and records of the CM). Under this type of segregation arrangement, the CCP could ensure the portability of the clients' positions (either individually or collectively) to another CM, although it may be more complex than under individual segregation.
19. Even if there is no portability, the CCP may have a similar level of resources to deal with the liquidation of clients' positions as under an individual client segregation model. However, participation in a gross omnibus account is combined with a risk of loss mutualisation with other clients of that account.
20. In this structure the value of the liquidated positions and the residual collateral are returned to the CM (or the liquidator of the CM) for the account of its clients. However, the excess margin that the CM might collect from clients might not be passed on to the CCP, as prescribed under individual client segregation. Also, in the case of a default of the CM, the CCP might not be in a position to allocate the excess collateral between the clients of the CM. Finally, the UCITS might be unhedged (and therefore exposed to market risk) until such time as it re-establishes a new position since the original derivatives position was liquidated/terminated.
21. Therefore, it seems to be justified to apply some counterparty risk limits to these other types of segregation arrangement. This approach would also be consistent with the approach currently envisaged for capital treatment of banks' exposures to CCPs.
22. For the same reasons already mentioned above (under omnibus client segregation), it does not seem justified to treat ETDs and OTC derivatives differently in terms of their CM counterparty risk limits.

Questions to stakeholders:

- 14. Do you agree that UCITS should apply counterparty risk limits to the CM under those other types of segregation arrangement? What should be the limits and the criteria for setting them?**
- 15. Do you agree that UCITS should be subject to the same counterparty risk limits applying to the CM under these other types of segregation arrangement for both OTC financial derivatives and ETDs? If not, please justify your position.**

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

23. UCITS may enter into OTC derivative transactions (not subject to the clearing obligation⁵) cleared through a non-EU CM⁶ by non-recognised third country CCPs. Since those third country CCPs are

⁵ For the purpose of complying with the clearing obligation only authorised or recognised CCPs under EMIR can be used.

⁶ Under EMIR, third country CCPs which are not recognised by ESMA under EMIR are prohibited from offering services to EU clearing members (unless transitional provisions apply).

subject to standards which may not be equivalent to those applicable to EU CCPs, it seems logical to consider that those transactions do not provide a level of protection equivalent to OTC derivative transactions centrally cleared under EMIR.

24. Therefore, UCITS should treat those transactions as bilateral OTC derivative transactions and apply the 5%/10% counterparty risk limits of Article 52 of the UCITS Directive to CMs.

Questions to stakeholders:

16. Do you agree that UCITS should treat OTC derivative transactions cleared by non-EU CCPs outside the scope of EMIR as bilateral OTC derivative transactions and apply the counterparty risk limits of Article 52 of the UCITS Directive to CMs? If not, please justify your position.

V. Indirect clearing arrangements

25. Pursuant to Article 4 of EMIR, a counterparty shall become a CM, a client, or shall establish indirect clearing arrangements with a CM, provided that those arrangements do not increase counterparty risk and ensure that the assets and positions of the counterparty benefit from protection with equivalent effect to that referred to in Articles 39 and 48 of EMIR.
26. If a UCITS enters into an indirect clearing arrangement (ICA) with individual client segregation in line with the one envisaged in Article 4(2)(b) of Commission Delegated Regulation (EU) No 149/2013 (the EMIR Level 2 Regulation), it could be argued that the UCITS has a very low counterparty risk vis-à-vis the client providing the ICA.
27. However, if UCITS do not benefit from individual client segregation as described above, UCITS are exposed to higher counterparty risk than in an ICA with individual client segregation. Therefore, it would seem logical for UCITS to apply counterparty risk limits to clients providing ICAs in those circumstances.
28. It should be noted that Recital 6 of the EMIR Level 2 Regulation provides that ICAs should be established so as to ensure an equivalent level of protection as under direct clearing arrangements. This recital suggests that an ICA should be treated in an equivalent manner as a direct clearing arrangement. Therefore, it would make sense to apply to ICAs the same limits applicable to the different segregation models envisaged for direct clearing arrangements.

Questions to stakeholders:

17. Do you agree that ICAs should be considered equivalent to direct clearing arrangements and that the same limits envisaged for the different segregation models in a direct clearing arrangement should apply to an ICA? If not, please justify your position.

18. Do you believe there might be circumstances under ICAs where UCITS have an exposure to the client of the CMs? If yes, what are those circumstances and do you think that UCITS should be subject to counterparty risk limits applying to the clients of the

CMs? What should be the limits?

Annex I - List of questions

- 1. Do you agree with the working assumptions above?**
- 2. In particular, do you agree that UCITS should regard the counterparty risk of all ESMA-recognised CCPs as being relatively low? Are there some ESMA-recognised CCPs for which counterparty risk may not be low? If so, please explain.**
- 3. Do you think that UCITS should apply any counterparty risk limits to ESMA-recognised CCPs? What should be the limits?**
- 4. Do you agree that the assessment of counterparty risk vis-à-vis the CM and the client should distinguish between the different types of segregation arrangement? If not, please justify your position.**
- 5. When assessing the counterparty risk for centrally-cleared OTC derivative transactions, do you think that UCITS should look at other factors than the segregation arrangements? If yes, what are those factors?**
- 6. Do you agree that under an individual client segregation UCITS have a low counterparty risk vis-à-vis the CM for all the assets posted (initial margins, variation margin and excess margin if applicable)? If not, please justify your position.**
- 7. Do you think that UCITS should apply any counterparty risk limits to the CM under individual client segregation? What should be the limits?**
- 8. To what extent do you think that the liquidation of derivative positions by a CCP in respect of a defaulting CM (and the associated market risk) is a significantly likely scenario that should be taken into account by the UCITS?**
- 9. Do you agree that UCITS should apply the same counterparty risk limits to CMs under individual client segregation for both OTCs and ETDs? If not, please justify your position.**
- 10. Notwithstanding the choice of segregation model, do you believe that the effective level of protections and degree to which the UCITS will be exposed to counterparty credit risk should be assessed on a case-by-case basis?**
- 11. Do you agree that, under an omnibus client segregation, UCITS have a higher counterparty risk vis-à-vis the CM than under an individual client segregation? If not, please justify your position.**
- 12. Do you agree that UCITS should be subject to counterparty risk limits to the CM under omnibus client segregation? If yes, do you agree that UCITS should apply those limits to the amount of collateral posted to the CM (i.e. initial margin, variation margins and excess collateral if applicable)? What should be the limits?**
- 13. Do you agree that UCITS should be subject to the same counterparty risk limits to CMs under omnibus client segregation for both OTC derivatives and ETDs? If not, please justify your position.**

- 14. Do you agree that UCITS should apply counterparty risk limits to the CM under those other types of segregation arrangement? What should be the limits and the criteria for setting them?**
- 15. Do you agree that UCITS should be subject to the same counterparty risk limits applying to the CM under these other types of segregation arrangement for both OTC financial derivatives and ETDs? If not, please justify your position.**
- 16. Do you agree that UCITS should treat OTC derivative transactions cleared by non-EU CCPs outside the scope of EMIR as bilateral OTC derivative transactions and apply the counterparty risk limits of Article 52 of the UCITS Directive to CMs? If not, please justify your position.**
- 17. Do you agree that ICAs should be considered equivalent to direct clearing arrangements and that the same limits envisaged for the different segregation models in a direct clearing arrangement should apply to an ICA? If not, please justify your position.**
- 18. Do you believe there might be circumstances under ICAs where UCITS have an exposure to the client of the CMs? If yes, what are those circumstances and do you think that UCITS should be subject to counterparty risk limits applying to the clients of the CMs? What should be the limits?**