CLEARING DERIVATIVES UNDER EMIR – CCP ACCOUNT STRUCTURES

FINANCIAL SERVICES

To assist derivatives market participants in choosing an account type, this note considers the difference between the account options available and certain potential benefits or risks associated with them. We do not consider the impact of national insolvency laws.

WHY DO I NEED TO CONSIDER CCP ACCOUNT STRUCTURES?

A number of central counterparties (CCPs) have now received re-authorisation from their national regulator under the European Market Infrastructure Regulation (EMIR). EMIR requires CCPs and their clearing members (CMs) to offer a choice of accounts that provide varying degrees of segregation of positions and margin. While the implementation of mandatory clearing for OTC derivatives in Europe is still a number of months away, users of exchange-traded derivatives (ETDs) need to choose between the different account types now.

WHAT ARE THE OPTIONS AVAILABLE?

CCPs must offer CMs a choice of accounts providing, as a minimum, individual client segregation (ICS) and omnibus client segregation (OCS). In turn, CMs must offer their clients at least these two structures and inform them of the costs and level of protection for each option. While EMIR mandates that CCPs (and CMs) must offer OCS and ICS, CCPs are generally offering a range of options of OCS accounts. Therefore, even where the decision is made to elect an OCS account structure, clients of CMs will need to choose between different OCS accounts. We have included a summary of the primary account types at the end of this note.

WHAT IS OMNIBUS CLIENT SEGREGATION?

OCS is the minimum level of client protection permitted under EMIR. The positions and margin of the CM are separated from those of its clients, thereby protecting the contents of the client account from the CM's creditors on the CM's insolvency. The positions and margin of the CM's clients are commingled, and each client bears the risk of any shortfall in the commingled client account (and potentially margin posted with the CCP) should one of the clients default or become insolvent at the same time as the CM defaults. Note that under the rules of the two largest CCPs in Europe, LCH.Clearnet and Eurex Clearing, if, at the same time as the CM defaults, some clients in the OCS account default while having insufficient margin the CCP ***will not*** make a claim on the CM's default fund to make up for any loss inflicted on other clients in the OCS account. This may also be the case for other CCPs.

CCPs are developing variations of the OCS account and examples that may be encountered include:

- **Net OCS account** – the positions of all clients in the account are *netted[1] against each other* and net margin is posted to the CCP. This is normally a lesser figure than the CM would be required to post under a gross OCS account. Any excess margin is held by the CM. Net OCS accounts are what most clients in Europe have been operating under in the past few years for their ETDs.

- **Gross OCS account** – the margin for each client in the account is *calculated independently under the CCP methodology and the CM posts at least the sum of these calculations to the CCP.* Any excess margin is usually held by the CM.

- **Legally separated, operationally commingled (LSOC) omnibus account** – similar to a gross OCS account but *excess margin demanded by the CM required by the CCP* methodology is also held by the CCP instead of the CM. This broadly replicates the statutory account structure available in the US.

A client choosing a gross or net OCS account takes the credit risk of the CM for excess margin that is not posted to the CCP. Excess margin is better protected under an LSOC omnibus account as it is held by the CCP. In addition, if a CM defaults while a net OCS account is under-collaterised (for example, due to a time lag in a margin call being met, on the default or insolvency of one client or due to the error (or fraud) of the CM), the CCP may use the net posted margin to cover a shortfall in the client omnibus account leaving less margin to cover the positions of the other non-defaulting clients.

WHAT IS INDIVIDUAL CLIENT SEGREGATION?

As the name suggests, ICS is an individual account at the CCP for one client of a particular CM. This means that positions of different clients cannot be netted to achieve a better margin position. However, ICS offers greater protection on the insolvency of the CM since there is no commingling of margin with other clients. Excess margin is posted to the CCP and segregated from the margin of other clients. The cost of ICS will be higher than that of OCS (perhaps significantly).

WHY IS THERE A COST INCREASE?

The problem of electing an account structure other than a net OCS account from a cost perspective (beyond the operational cost of maintaining separate accounts per client) is that the CM loses a substantial funding benefit if it must post all margin received from clients to the CCP. If clients choose net OCS

[1] Netting in this context means the reduction in initial margins that need to be posted to the CCP due to offsetting trades, as more fully described in the section "Why is there a cost increase?"

then, from the perspective of the CM, bigger is better when it comes to number of positions held. The reason is that size increases the number of instances where different clients will have opposite positions – say, one client is short the March 2015 contract and another is long the same contract. The CM would take initial margin from both clients (since it has a credit risk on both clients), but would not need to post initial margin to the CCP on the two offsetting contracts since from the perspective of the CCP when considering the market risk of the omnibus account as a whole, there is no net risk when both clients are in the same OCS account. If a client wanted to take this funding gain away from a CM by opting for all initial margin to be held by the CCP, the CM would need to charge the client for the loss of this benefit in order to maintain profitability.

WHAT ABOUT PORTING ON THE CM'S DEFAULT?

It is critical to distinguish between porting of positions and porting of margin. Porting of positions has a relatively successful history: when Lehman Brothers defaulted, the large majority of client positions at CCPs in Europe successfully ported (although outside of Europe and North America porting was less successful, with significant numbers of terminations). However, porting of margin has been both less immediate and less certain, as it is difficult for CCPs to determine which margin belongs to which client, meaning that clients have had to wait for CCPs to determine whether margin should be retained to cover as yet unported positions on which the CCP was still exposed. EMIR attempts to address these problems.

If a CM defaults, EMIR requires CCPs to attempt to transfer the positions and margin of clients to another CM designated by the client(s). In relation to ICS accounts, client margin posted with the CCP should be used exclusively to cover the positions held for their account[2] and any balance owed by the CCP after the completion of its default management process should be returned to the clients if known to the CCP, or to the CM (or the insolvency practitioner) for the account of the clients. Note that if an OCS account is in shortfall then the CCP will use the commingled margin and, if that client does not make good the shortfall, all other clients in that account may share in the loss.

Porting conditions will be set by the CCP and the substitute CM. Porting of margin will be difficult with respect to OCS accounts as all clients in the account need to agree to a substitute CM to take the ported positions. In particular, while porting may be workable for gross OCS accounts (as it is more likely that sufficient margin are held by the CCP for each client), for net OCS accounts industry bodies have raised concerns that porting the entire portfolio of margin and positions as a unit would be difficult and would rarely work in practice. In particular, there would typically be a shortfall in margin and, since excess margin in these accounts is held by the CM, the excess margin would not be ported to the substitute CM. Should an alternative CM agree to take on the account, the CM may impose conditions to do so, one of which is likely to require margin to immediately replace that retained by the CM.

For both OCS and ICS accounts, the substitute CM is obliged to accept positions only where it has previously contracted with the client(s) to do so. While this may be relatively straightforward for an ICS account, it may prove difficult to obtain the commitment of a substitute CM to take on all clients in an OCS account, given that it will occur in the inevitably disruptive circumstances of another CM defaulting. Should that transfer not take place within a time period specified in the CCP's rules, the CCP may actively manage its risks in relation to those positions, including closing out the positions. The terms under which a CCP may close out the client's positions will differ between CCPs. In general, however, if a CCP terminates positions, that CCP is more likely to pay any amount owed directly to the client that has an ICS account as the client identity in this case should be known to the CCP. However, even if margin is not paid directly to the client, it is held as a segregated amount for the account of the client to be distributed to that client by the insolvency official, and does not get paid into the insolvency estate of the defaulting CM.

WHAT ABOUT BUSINESS AS USUAL PORTING?

If a CM is not in default, there is no obligation under EMIR for a CM to transfer a client's positions and margin to another CM. The client agreement with the CM and the rules of the CCP will determine whether and how such a transfer may be facilitated. This is likely to be a simpler process for ICS accounts than OCS accounts as between OCS accounts, sufficient assets and margin to facilitate a transfer are more likely to be available (though not guaranteed) where a gross, rather than net, OCS account is held. This is because only net margin is posted when using the latter type of account structure. Along the same lines, whether a client may transfer from an OCS account into an ICS account with the same CM, and the terms under which it may do so, will depend on the terms of its agreement with the CM.

WHAT SHOULD A FUND MANAGER DO AT THIS JUNCTURE?

Clients of CMs should review the accounts offered by their CMs and undertake a cost/benefit analysis of whether the additional protections beyond that of net OCS accounts justify the extra costs of those accounts. Having done so, clients should make their elections of the relevant account type to their CM.

[2] In relation to OCS, the ability of the CCP to return margin to individual clients depends upon the ability of the CCP to distinguish between individual claims pooled in the account.

SUMMARY OF THE OMNIBUS AND INDIVIDUAL CLIENT SEGREGATION ACCOUNT STRUCTURES

STRUCTURE	ADVANTAGES	DISADVANTAGES
Net Omnibus Client Segregation	◆ The lowest cost election, as CM benefits from netting of initial margin requirements for offsetting transactions, meaning the CM has to post the least amount of margin to the CM. ◆ Operationally simplest and uses existing infrastructure, so lowest operating cost.	◆ Commingling of margin exposes client to the risks of the positions and default of other clients in the same pooled account. ◆ Porting of margin difficult as ***all*** clients in the account need to agree to a new CM and to port. ◆ Porting may not result in return of client's original margin due to commingling. ◆ Excess margin held with CM and not ported thereby exposing client to credit risk of CM. ◆ CM loses funding benefit on all non-netted initial margin. ◆ As the least amount of client margin is posted by the CM to the CCP, this option gives the client the greatest credit risk on the CM.
Gross Omnibus Client Segregation	◆ More client margin is held with the CCP, reducing client's credit risk on the CM. ◆ Easy for CM and CCPs to administer – as no new accounts required there is little cost difference to net OCS.	◆ Commingling of margin exposes client to the risks of the positions and default of other clients in the same pooled account. ◆ Porting of margin difficult as ***all*** clients in the account need to agree to a new CM and to port. ◆ Porting may not result in return of client's original margin due to commingling. ◆ Excess margin held with CM and not ported thereby exposing client to credit risk of CM. ◆ Compared to net OCS, higher posting of initial margins to the CCP increases the funding cost for the CM, which is likely to be passed on to clients.

Legally Separate, Operationally Commingled	◆ All client margin protected from default of CM as posted to CCP. ◆ Easy for CM and CCPs to administer – as no new accounts required there is little cost difference to net OCS.	◆ Commingling of margin exposes client to the risks of the positions and default of other clients in the same pooled account. ◆ Porting of margin difficult as ***all*** clients in the account need to agree to a new CM and to port. ◆ Porting may not result in return of client's original margin due to commingling. ◆ CM suffers full loss of funding, so CMs will likely pass on all of this cost to clients.
Individual Client Segregation	◆ Account ring-fenced, giving highest level of credit protection. ◆ Facilitates porting of margin, and return of margin should be certain. ◆ No exposure to other clients' positions/ default. ◆ All client margin protected from default of CM as posted to CCP.	◆ Highest operational cost due to the creation of individual accounts at CCP. ◆ CM suffers full loss of funding, so CMs will likely pass on all of this cost to clients.

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