BNP PARIBAS
CORPORATE & INVESTMENT BANKING

LCH.CLEARNET
CDSClear

Connecting the dots in Europe's client clearing framework and segregation models

Mandatory clearing of over-the-counter derivatives is no longer a new topic. Set in motion by politicians in 2009, it has been extensively discussed in recent years and is now a reality in the US. But, for many European market participants, the practice itself is virgin territory. In a forum sponsored by BNP Paribas and LCH.Clearnet and convened by *Risk*, a panel of experts sheds some light on the remaining issues for European clearing clients

Risk: Over-the-counter (OTC) clearing is a transformative change for the market. The US has gone first, and now the clock is ticking for Europe. When do you expect the first mandates?
Gavin Dixon, BNP Paribas: The clock has been ticking for a long time, but we're getting some movement now, and the re-authorisation of a couple of central counterparties (CCPs) recently has set the ball rolling. The regulators still have to produce the Regulatory Technical Standard (RTS), carry out some consultation, define the products, and so on. At its earliest, the mandate will not be until December, and it is more likely to run into the beginning of next year. After that, we'll have some level of phasing.

Malavika Solanki, CDSClear, LCH.Clearnet: If phasing occurs, the market expectation is that there will be something in the first half of next year for most of the large counterparties. What happens after that is still an open question.

Pankaj Shah, Legal & General Investment Management: The US had a defined timeline; we don't have that in Europe. We have a convoluted approval process that determines the mandatory timeline, and I think we're going to have a staged implementation in Europe, depending on products that are included by the various clearing houses. The earliest is December 2014 but it could be delayed for a while.

Risk: There were three phases in the US process, with roughly 90 days between each of them. Might we see something similar in Europe?
Gavin Dixon: The regulators might try to compress the process, just because they know they are so far behind. The US will continue to add products to its requirements, and Europe could try to catch up by adding products and shortening the time horizon. There could be three to four phases – it might look a lot like the US, but time will tell.

Malavika Solanki: There was a hint there might be a move towards phasing in the clearing obligation consultation last September. Now it seems a little more certain, but it is not until we see timings and more information about what categories of products are included that this starts to become more real. The first tranche of obligations is likely to be more compressed, to ensure Europe doesn't fall too far behind from a product suite perspective.

THE PANEL (left to right)
Gavin Dixon, European Head of Derivatives Clearing Services, BNP Paribas
Malavika Solanki, Head of Business Development, Sales & Marketing, CDSClear, LCH.Clearnet
Pankaj Shah, Head of Emir & Central Clearing,Legal & General Investment Management

Pankaj Shah: As a firm, we have been encouraging our clients to prepare for clearing, but there are some who are not ready at this stage. There has been talk about phasing by financial counterparties then non-financial counterparties, as they're defined under the European Market Infrastructure Regulation (Emir). But pension schemes, for example, are financial counterparties, so they would be labelled along with banks and insurance companies. Regulators would have to think carefully about staging this, perhaps with banks first, then other financial counterparties, followed by the non-financial entities – corporates and treasurers.

Risk: Front-loading – in which existing trades might later need to be cleared – has been a running problem. The European Securities and Markets Authority (Esma) now plans to truncate the period over which front-loading would take effect, so it would only kick in after the RTS comes into force. Would this resolve the issue?

Gavin Dixon: It doesn't completely solve the issue. It gives some clarity as to which products will need to be cleared and when, but it still doesn't solve the execution pricing issue – that is, how it is priced upfront. Do you price it as if it is going to clear? Or do you price it as a non-cleared trade, and it then changes to a cleared trade at some time in the future? Both present a problem. If you price it as a cleared trade and it doesn't clear, then you have to unwind it as a non-cleared trade, and it has a completely different value. You might not have collected enough collateral, and you might have inherited risk you shouldn't have.

Conversely, if you priced it as an uncleared trade, and then it goes into clearing, it will have a valuation swing at that point in time. If the executing bank has it as an uncleared trade, and [it] changes value, do you take a loss on your books for that? Normally, with back-loading, you would agree with the counterparty any compensation for a change in the value. But, if it is set in law and the law says nothing about who compensates whom, I don't know how you solve that.

Pankaj Shah: Before Esma's recent proposal to the European Commission, there was no clarity about which products submitted by the clearing house would gain approval and the timing of that approval. That has created a huge amount of market concern around pricing, because you weren't sure whether it would be cleared in nine months' or 24 months' time. Esma's recent proposal is a big improvement as front-loading comes into play when the RTS come into force and we will know what products have been approved. Also, by then, we expect more clearing houses to have been approved and we will know the start date because it is based on that approval date.

Risk: Clients are concerned about how the assets they post to a CCP will be protected. What is segregation, and how many different types are there?
Gavin Dixon: Emir says a CCP and a clearing broker must offer clients two forms of segregation: an omnibus form and individual segregation. That lays it out at a high level.

From a client perspective, segregation is really about what happens to the assets given to the clearing broker to pay for initial margin – where they go, who can use them, whether the client gets them back, and what happens if there's a default. Does the client get their assets back or somebody else's, or something else of equal value? The various models have different segregation capabilities if there is a default scenario.

Within the omnibus model, you have the old futures style of a net omnibus, where everybody is in the same bucket and the risk is net within there. And then you have the gross omnibus approach, which is akin to the individual segregation by value that operates today, but won't count as an individual segregation under Emir because there are certain additional requirements.

For an account to be an individual segregated account, Emir requires that the CCP knows which asset belongs to each client. But it doesn't require the client's asset to be handed over. So the client could give their clearing broker asset one, and the broker could give to the CCP asset two – meaning this so-called asset tagging doesn't give the client anything further. Is there another way of doing that? There's a lot of development going on around individual physically segregated accounts – physically, at the custodian/central securities depository, so the assets stay within that structure with a pledge arrangement over the account. That would mean a client would not have to move their assets, and they would stay in an account they have some interest over.

Gavin Dixon

Risk: Segregation creates an area in which CCPs can differentiate themselves. How much competition is occurring in this space?
Malavika Solanki: It is interesting to see how client conversations have evolved; about 12 to 18 months ago, the focus for European clients was full physical or custodial segregation. Now, we still see clients requiring custodial segregation, but a large number seem to be saying that asset segregation will be enough, given the trade-offs, and given the way their funds are mandated. Asset segregation is available today, the rules are firm,and so is value protection or omnibus account structures. Other segregation models are works in progress, but very much subject to market demand.

Gavin Dixon: Some clients are going to be happy with value segregation under what is deemed an omnibus segregated account, the commingled account. Others are going to want individual segregation, but aren't going to want custodial segregation, because it may be too expensive, for example. The problem with competition is that clearing houses can take the flexibility Emir gives them and build one of any number of things. The clearing brokers will then be required to be able to support that – they will need to build channel one and channel two for one client; channels three and four for somebody else; and channels five and six for somebody else again. The infrastructure build and cost from the broker point of view is quite expensive when there is such a broad array of choice.

Pankaj Shah: There may be a menu of choices, but the models are still evolving and we don't know what each of the clearing houses will settle on, whether it will be full physical segregation or other models. Perhaps the individual segregated accounts are there, in theory, but can clearing brokers support them in practice from the outset?

We also need to ensure we can support our end-user clients in terms of the margin flows and new processing that might need to take place. We may have clients who say they definitely want individual segregation because that is what their trustees or governance structures require. In other cases clients are going to have to make an initial choice because of timelines while we obtain more clarity in terms of costs and operational complexity of supporting other models.

Gavin Dixon: The model is not fully defined, and certain types of clients are going to target certain types of accounts. The asset management community and the pension money, they want to have their assets segregated, and they might lean towards the physical segregation and custodial segregation approaches.

Malavika Solanki

Others that post cash all the time might be quite happy with value segregation, because they get back the same value they put in. A lot will depend on who the client is and what type of collateral they are using.

Risk: How competitive are the different clearing houses when it comes to segregation models? Will there be genuine points of difference from one house to the next?
Malavika Solanki: Over time, CCPs will be competing on service levels more than anything else, just because that is what the market is going to want us to do. There may be differences in the way we offer things, or in the way legal jurisdictions operate, or in the needs of clients, and that combination is quite an interesting one. That is what is going to determine prices. That's definitely the starting point. Over time we'll have to see how the market evolves, but I suspect competition will come down to service levels on an aggregate basis, not just on any one point.

Risk: Many, if not most, clients will be new to the clearing space. How well do they understand the pros and cons of different offerings?
Pankaj Shah: Until clearing houses come closer to authorisation, we do not have full details of the available models. If you look at it at a high level – at individual or omnibus – the differences are clear in terms of protection, risks, what the cost components may be and impact on operational processing. But when clearing houses are offering different flavours on these individual segregated or omnibus accounts, then the devil lies in the detail.

Some of the challenges are also around choosing the type of assets to post as margin and how insolvency considerations affect this – the impact of client money rules, regimes and domicile of the clearing house. There are a number of complexities here that will need to be clarified and communicated to clients so they can make an informed choice.

Risk: The big question, arguably, is will the market be ready? Will CCPs be ready? Will clearing brokers be ready? And, importantly, will the buy side be ready?
Gavin Dixon: Clearing will be able to happen, but there'll be some deep breaths taken in a few places, and people will still be learning and industrialising some of the processes, to make certain it runs smoothly.

There are a lot of firms that still haven't decided which clearing house to go with, or which clearing broker to select, and so are only just thinking about the due diligence they have to go through. Given a deadline that is probably only nine months away, and looking at the number of clients on the list, there is a lot of work to be done. The phasing, should it come out, is going to be critical. Once the rules are known, it is going to be a squeeze in terms of time frames to get everything done, and the risk is that it is going to start a stampede.

Malavika Solanki: Speaking from what we saw in the US, there definitely was a stampede. A number of institutions were prepared and managed the process accordingly but, for example, I received calls on the final day of the mandate from a couple of institutions asking if I knew clearing brokers I could introduce them to, so they could get moving. People need to recognise there's work to be done, not just in identifying operational readiness requirements but all the legal due diligence that goes with it, and that takes time. Not allowing enough time creates significant risk – people will be making uninformed choices in many instances because they do not have the time to go through things adequately.

Risk: How are you getting around this lack of preparation? How much advice and guidance are you providing to get clients through this process?
Pankaj Shah: We started clearing about 18 months back, for the reasons mentioned previously. It took us around 12 months to carry out not only the legal work, but also build pipes and technology to ensure we could automate the process around margins, statements and trade flows to build a scalable process that we could use for our clients. We've implemented that effectively for the funds we manage, and we're now seeing strong interest from some of our larger strategic clients who are interested in leveraging the infrastructure we've put in place before mandatory clearing comes in.

Risk: Competition in these early stages of client onboarding is tough, keeping tariffs low. Will the fees for clearing go up once the new regime is bedded in?
Pankaj Shah: Early movers have received some competitive pricing and brokers have pitched clearing at levels to win business. But that market is going to change as providers recognise what the breakeven levels are, and what they need to do to ensure they remain competitive. From a buy-side perspective, a number of brokers are offering these services and we want to make sure there is a healthy market place and the prices reflect that. As we see more demand we will definitely see changes in pricing. And, as we introduce new segregation models and build new processes, this is going to be much more costly for clients.

Gavin Dixon: A lot of the pricing so far has been done on the basis of, 'the rules are going to be like this, so therefore I'm going to price like this'. When the rules do evolve, whether it be Basel III capital rules, leverage ratios or segregation models, there will be changes in terms of how pricing is set.

Risk: One of the mechanisms required by Emir is indirect clearing, whereby a client of a clearing member can take on clients of its own. How is this progressing?
Gavin Dixon: There are issues around the requirements under indirect clearing and the requirement on the clearing broker to offer the ultimate end-client the same segregation access, pricing access and portability as the direct client, without really knowing who that end-client is. How is a clearing provider meant to think about what service to give that unknown client, at what price? There has been a bit of back and forth with the regulators questioning and suggesting, but it has not really had traction.

What we're seeing now is the development of models that are slightly different from how indirect clearing is defined, but will still give access to the end-client. At BNP Paribas we define this as an agency clearing model. Because it is not indirect clearing as the rules might define, it takes some of that burden away from the clearing broker, but will still enable the smaller clients to get access to clearing.

Malavika Solanki: In the OTC space, the conversations we have are mostly with regional bank participants who are trying to decide whether they come on as clients themselves and therefore offer indirect clearing, or whether they come on as direct members. There is not a huge conversation happening, but some people are looking at whether they are able to fulfil direct participation requirements, and therefore take membership. Or, if they're unable to do so, whether they can then find a way to use indirect clearing.

Risk: Emir has set out an exemption from the clearing mandate for pension funds. What firms will actually be exempt?
Pankaj Shah: Emir sets out the pension scheme arrangements that can qualify for exemption. The first category under Section 2(10)a comprises individual pension schemes – the typical segregated client. The other categories cover more complex pooled arrangements and category definitions have to be agreed by Esma and local regulators. This process has been going for months and needs to come to a conclusion.

For some categories it is not clear whether the pooled schemes qualify, and this is a concern for firms that want to rely on the exemption before front-loading comes in. Individual segregated schemes qualify as an entity under the rules but there is also a trade-level test to be considered, which determines the derivatives trades that qualify. There may be some trades being carried out for a pension scheme that may not satisfy that test, but the rules are not clear and add complexity to the process.

Risk: Are banks struggling to identify whether or not clients are exempt? What are some of the issues they need to consider when dealing with possibly exempt clients?
Pankaj Shah: The banks are struggling in terms of reaching out to their various counterparts. We're talking about hundreds of pension schemes here, potentially, but also corporates and other counterparts that they need to try to categorise. They need to have mechanisms in place to identify what capital they must put aside and allocate that capital into the pricing of the trade depending on whether the counterparty is exempt or not.

Gavin Dixon: Banks will just treat them like a normal counterparty, so they won't have the risk-weighted assets of a cleared trade, but they'll have a risk-weighted asset of a normal financial counterparty, so that hasn't changed a lot from today. Banks will not have to charge such clients the credit valuation adjustment, which is a good thing. Things will start to change as you then go into the uncleared margin rules, when they start kicking in at the end of 2015.

Malavika Solanki: The pace of due diligence on that has stepped up as well. The number of consultancies and agencies that have been tasked by pension funds to look at this in closer detail – that conversation has really stepped up for us.

Risk: What if the worst happens, and losses suffered by a CCP overwhelm its traditional financial resources? How do those losses get allocated?
Pankaj Shah: We need to ensure that clients and counterparties understand, in this cleared world, that counterparty risk hasn't gone away; it is just different. And a lot of that risk now centres on clearing members as well as the CCP.

We need to ensure each layer of the default waterfall is as robust as possible and that CCPs are well capitalised. All contributions to the default waterfall, whether from CCPs or clearing members providing default or guarantee funds, must be risk-based. There must be an agreed, robust clearing-house process to manage a timely and orderly resolution in the event of CCP default to minimise impact on client margins.

Pankaj Shah

Malavika Solanki: The one thing that is a given is that there will be change in the next 12 to 18 months. The scale of that change will depend on two things: where the final regulations end up; and where the various CCP waterfalls are today. Some have variation margin haircutting, others do not, so what is the scale of change the CCP has to undertake? It's about every piece of the default waterfall being adequately sized and being strong enough, so we are not relying on that very last piece to be the thing that saves everyone.

Risk: Is this something clients need to educate themselves about, or is it such an increasingly remote possibility that they can forget about it?
Gavin Dixon: It is remote. But clients need to understand the clearing brokers do not guarantee the performance of the clearing house, so if the clearing house goes down, the clients are at risk. They do need to understand the process that may happen, what happens to their trades and to their margins.

A major clearing house default is really an Armageddon scenario, but the key is to ensure that the risk process is robust, that the regulatory framework it sits within ensures there is not a race to the bottom. We've talked about competition between CCPs – you do not want competition in terms of lowering standards of risk management. You want to keep them as high as possible. The levels of stress tests must ensure there is enough margin, and that you're not going to be dipping into default funds. The levels of capital that CCPs hold have increased tremendously under the new regulations.

There's still some learning to do – by the regulators, by the clearing houses, by the banks and the clients, around the right level of risk – and who may take each piece of that risk. But I think that'll come in over time. We're in a much better place than we were.

>> View the full proceedings of the BNP Paribas/LCH.Clearnet-sponsored *Risk* forum, *Connecting the dots in Europe's client clearing framework and segregation models*, at *www.risk.net/2346535*