ESMA_QA_850

Submission Date
27/04/2023

Status: Answer Published

Additional Information

Level 1 Regulation
Regulation 648/2012 - OTC derivatives, central counterparties and trade repositories (EMIR) - CCPs

Topic
EU-CCPs

Additional Legal Reference
Article 48 of EMIR - old CCP question 3 dated 4/02/2016

Subject Matter
Default management (old CCP question 3 dated 4/02/2016)

Question

(a) What is the requirement on a CCP for portability of client assets in a member default scenario –for both individual and omnibus accounts?

1. Port the “required collateral” only, less outstanding variation margin payments i.e. the value of assets used to cover liabilities; or
2. Port the assigned value of the assets, less outstanding variation margin payments (post-haircut); or
3. Port the proceeds from liquidation of assets, less outstanding variation margin payments; or
4. Port the assets themselves, less outstanding variation margin payments?

(b) Articles 48(5) and 48(6) of EMIR provide that, if a clearing member defaults, “the CCP shall, at least, contractually commit itself to trigger the procedures for the transfer of the assets and positions… to another clearing member designated by [the client or clients]…”. They further provide that if porting of client positions “has not taken place for any reason within a predefined transfer period specified in its operating rules, the CCP may take all steps permitted by its rules to actively manage its risk in relation to those positions, including liquidating the assets and positions held by the defaulting clearing member for the account of its clients”.

How long should the predefined transfer period be, and can a CCP liquidate the client(s’) position(s) and assets before the end of the predefined transfer period if it deems that necessary for risk management purposes?

(c) Can a CCP require the client(s) to designate a back-up clearing member prior to the default of its primary clearing member as a precondition for triggering the procedure for porting in the event of the default of the primary clearing member?

(d) Article 48 of EMIR permits a CCP to liquidate the house positions of a defaulting clearing member and any client positions of that defaulting clearing member that the CCP has not been able to transfer to another clearing member.

i) Is it permissible for the CCP to actively manage its risk in relation to the positions held in more than one account by one or more transactions, rather than being required to execute transactions to manage the risks of the positions held in each account separately?

ii) If it is acceptable for the CCP to execute one or more transactions to manage its risks across more than one account, how should the costs of the transactions be allocated between the affected accounts?

ESMA Answer

04-02-2016

Original language

(a) Article 48 of EMIR establishes the circumstances and parameters under which a CCP must transfer the assets and positions of the clients of defaulted clearing members or may liquidate such assets and positions.

Following a member default, a CCP is required to transfer the assets and positions recorded as being held for the account of the clients of the defaulted clearing member if the conditions defined in Article 48 are met. Otherwise, the CCP may try to transfer the assets and positions, on a best effort basis, but ultimately has the right to liquidate the assets and positions. If the assets of a client of the defaulted clearing members are only partially liquidated then the non-liquidated portion of the assets will be returned to the clients when they are known to the CCP or, if they are not, to the clearing member for the account of its clients.

Article 39(10) of EMIR provides that assets (in respect of segregation and portability) refers to collateral held to cover positions and includes the right to transfer assets equivalent to that collateral or the proceeds of the realisation of any collateral.

(b) Although EMIR does not specify a minimum (or maximum) for the predefined transfer period, it should be of sufficient length to enable the client(s) to make a request for porting, and for the CCP to trigger the porting as contemplated in Articles 48(5) & (6) of EMIR, within that period. Under Article 48(2) of EMIR a CCP “shall take prompt action to contain losses and liquidity pressures resulting from defaults and shall ensure that the closing out of any clearing member’s positions does not disrupt its operations or expose the non-defaulting clearing members to losses they cannot anticipate or control”. Furthermore, EMIR Recitals 49, 65 and 67 emphasise the importance of a CCP having robust risk management arrangements. Accordingly, a CCP can opt for a short pre-defined period if it judges that such would be necessary to liquidate client(s’) position(s) and assets shortly after a clearing

member default has occurred in order to contain losses or liquidity pressures. A CCP may extend the transfer period, however the legislator has indicated that liquidation should only take place following the end of a CCP's predefined transfer period and a CCP cannot liquidate client(s') position(s) and assets prior to the end of the predefined transfer period.

(c) Articles 48(5) and 48(6) of EMIR require that clients be able to designate another back-up clearing member upon request. It is not compatible with EMIR for a CCP to require that such designation has been made prior to the default of the client's primary clearing member as a precondition for the CCP triggering the procedure for porting. However if a client has not designated a back-up clearing member prior to the default of the client's primary clearing member and has not agreed that the CCP may choose a back-up clearing member for the client, then that may mean that porting is less likely to occur. Such a risk should be clearly disclosed by CCPs and clearing members; for example, as required by Article 39(7) of EMIR.

(d) In the event of the default of a clearing member, a CCP may liquidate (i) any house positions of the defaulting clearing members and (ii) any client positions of the defaulting clearing member that the CCP has been unable to transfer to a new clearing member within the predefined transfer period specified in the CCP's operating rules . To minimise its market risk, the CCP may hedge or replace such positions. Article 39(9) of EMIR requires that positions recorded in different accounts are not netted against each other and that assets covering the positions in one account are not exposed to losses connected to positions held in a different account.

i) In the event the CCP elects to hedge or liquidate positions that are recorded in more than one account (which may include client accounts), the CCP may assess that executing one or more transactions across accounts would be likely to result in a quicker or more efficient reduction in market and operational risk compared to hedging or liquidating the positions held in each account separately.

For example, it may be more operationally effective for the CCP to include all positions to be hedged or liquidated in an auction for which participating clearing members are requested to provide a single auction price covering all instruments and positions being auctioned. This reduction in risk will benefit both the CCP and the affected clients.

Accordingly, a CCP's operating rules may permit it to manage the risks present in more than one account through one or more transactions.

For the avoidance of doubt, this does not preclude the CCP from hedging or liquidating the positions held in each account separately, where this is provided for in its operating rules. In some circumstances, the CCP may assess this is likely to be a more effective way of managing the default.

ii) Where the CCP elects to hedge or liquidate positions across accounts through one or more transactions, it should allocate the costs of hedging or liquidation of the positions on the basis of the market value of the positions held in each account at the point the transaction or transactions were executed.

Any extra cost or gain which remains unallocated following this initial allocation process based on market value may be allocated pro rata on the basis of the risks presented to the CCP by each account that was subject to hedging or liquidation.

The methodology a CCP implements to allocate costs to each account in the event of the default of a clearing member should be publicly disclosed in accordance with Article 39(7) of EMIR.