

Responding to the discussion paper on

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

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1. Do you agree with the working assumptions above? Partly

We read the main working assumption as follows: “the working assumption is that the discussion paper should focus on the impact of a default of a CM or of other clients of the CM on UCITS, rather than taking into account the exposure to any EU CCPs or to those non-EU CCPs that are recognized by ESMA, due to relatively low counterparty risk”.

We agree with the mentioned focus points, but as CCPs are not risk-free we are of the opinion that UCITS should take into account their exposures to CCPs when they calculate their counterparty risk for centrally-cleared OTC derivative transactions. We are of the opinion that the exposures limits for exposures to CCPs should be adjusted (i.e. relaxed), reflecting the high level of creditworthiness of CCPs. This approach is in line with Basel III’s final standard on capital requirements for bank exposures to central counterparties.

(<https://www.bis.org/publ/bcbs282.pdf>)

CMs directly face the risk of CCP failure through their initial margins, while this is different for clients (UCITS) who clear indirectly through a CM as they face different risk and also have additional protection. In the event of the failure of the CCP, UCITS may be protected as long as their CM is solvent. Still, clients can be potentially exposed to CCPs, CMs and other clients of the CM.

Another working assumption is that the discussion paper does not take into account default fund contributions. We agree with this assumption as clients (UCITS) do not contribute to default funds. Therefore, they do not have this direct exposure to CCPs that exists for CMs.

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. Partly

Although CCPs are supposedly extremely safe, they do represent some default risk to their CMs and their clients. Furthermore, there should also be a distinction between different CCPs, which will have different levels of riskiness. We would be in favour of adhering to the same approach as put forward by Basel III’s final standard on capital requirements for bank exposures to central counterparties, making a distinction to qualifying and non-qualifying CCPs¹. Prior to Basel III, regulatory capital requirements allowed all CCP-related exposure to be given (explicitly or not) a zero capital charge. Clearly, this gives out the wrong message and

¹ “A qualifying central counterparty (QCCP) is an entity that is licensed to operate as a CCP (including a license granted by way of confirming an exemption), and is permitted by the appropriate regulator/overseer to operate as such with respect to the products offered. This is subject to the provision that the CCP is based and prudentially supervised in a jurisdiction where the relevant regulator/overseer has established, and publicly indicated that it applies to the CCP on an ongoing basis, domestic rules and regulations that are consistent with the CPSS-IOSCO Principles for Financial Market Infrastructures.”

potentially leads to moral hazard problems and the assumption that a CCP would therefore never be allowed to fail (or even impose losses on participants).

3. Do you think that UCITS should apply any counterparty risk limits to ESMA-recognised CCPs? What should be the limits? Yes, see below

Within Basel III's final standard on capital requirements for bank exposures to central counterparties, exposures to QCCPs will receive preferential capital treatment as opposed to non-qualifying CCPs, which will be treated more conservatively (e.g. as bilateral exposures). Therefore, our opinion is to theoretically align the counterparty risk limit structure with these Basel III standards². However, it is difficult to advice for the level of concentration limits, as it is very dependent on the number of recognized CCPs in the market to clear a specific product. The advice would be to start with a relatively high exposure limit and to be stricter in the future when more recognized CCPs are available, which would allow for further diversification (dependent on the relation with the CM).

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. Yes

Segregation corresponds to margin posted being legally protected in the event that the receiving counterparty becomes insolvent. Therefore, segregation of margin reduces the risk that a UCITS will lose some or their entire margin in the event of such a default. As the type of segregation arrangement influences the exposure to the counterparty, it is relevant that the different types of models should be distinguished. For instance, in a full physical segregation setup using a tri-party custodian (holding the margin), the UCITS will be exposed to another counterparty.

The UCITS should take reasonable efforts to ensure that the clearing member adheres to the segregation agreements as agreed with the UCITS (i.e. to ensure that the CM posts collateral received by the UCITS to the CCP in line with the segregation agreements).

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? Yes, see below

Factors that should be considered are (a) segregation arrangement; (b) (likelihood of) portability of trades in the event of CM defaulting; (c) exposure to CCP rules³; (d) whether the CCP is / is not a qualified CCP.

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 ex-cess margin if applicable)? If not, please justify your position. Yes

Typically the counterparty risk vis-à-vis the CM will be lower under an individual client segregation than under an omnibus client segregation, as – different from the omnibus client segregation – under individual client segregation any margin in excess of the client's requirement is also posted to the CCP. However, even in a fully segregated case the UCITS is still at risk to CCP loss allocation. This is because CMs generally make their obligations to clients conditional on the CCP performing on its obligations.

² This would (also) imply that concentration limits for non-qualifying CCPs would be lower than for qualifying CCPs.

³ If CMs contractually pass on the effects of loss allocation methods (such as variation margin gains haircutting) then clients face unfair and arbitrary reduction of gains.

7. Do you think that UCITS should apply any counterparty risk limits to the CM under individual client segregation? What should be the limits? Yes, see below

The UCITS should apply the limits (on excess margin) set out in Article 52(1) to CMs (in contrast to CCPs), independent of the type of segregation arrangement. As said earlier, the type of segregation arrangement may however influence the exposure to the CM.

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? No

In the event of a CM default, the UCITS fund has a number of potential options as to the treatment of their portfolio, of which the porting to a backup CM (with whom the fund already has a relationship) is the ideal solution. In the absence of a backup CM, the porting could be facilitated by the CCP directly who may auction the portfolio amongst other CMs. The third and least likely scenario is that the CCP may terminate the portfolio via the auction. This will happen in the event that some kind of portability is not possible. Therefore, Factor (b) as mentioned under Question 5 is a relevant factor; possibly more than the liquidation scenario.

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.

Yes, as the UCITS will be subject to the default of the CM irrespective of whether the cleared contracts are ETDs or OTC derivatives.

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?

Yes, especially given the dynamic market, legal and regulatory environment (possibly offering new ways to protect the UCITS).

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.

Yes, refer to the answer given to Question 6.

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?

Yes, refer to the answer given to Question 7 (regardless of segregation arrangement).

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.

Yes, as the UCITS will be subject to the default of the CM irrespective of whether the cleared contracts are ETDs or OTC derivatives.

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?

Yes, refer to the answer given to Question 7 (regardless of segregation arrangement).

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.

Yes, as the UCITS will be subject to the default of the CM irrespective of whether the cleared contracts are ETDs or OTC derivatives.

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.

Yes, refer to the answer given to Question 3, where a distinction is made between qualifying and non-qualifying CCPs. In this context, non-qualifying CCPs would be non-EU CCPs outside the scope of EMIR.

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.

Yes, as CMs are required to guarantee the indirect clients' trades (for a certain period of time) and facilitate indirect clearing.

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?

This is not entirely clear.