

Feedback statement

Discussion paper on the impact of EMIR on the calculation of counterparty risk for OTC financial derivative transactions by UCITS

1 Background

1. On 22 July 2014 ESMA published a [discussion paper](#) on the impact of EMIR on the calculation of counterparty risk of financial derivative transactions by UCITS. ESMA received 20 responses. Respondents included asset managers, national associations of asset managers and central counterparties (CCPs).

2 Summary of responses to the discussion paper

Q1) Do you agree with the working assumptions above?

2. The vast majority of respondents agreed with the working assumptions. Some respondents felt that ESMA should also include models such as the agency model whereby UCITS have a direct relationship with the CCP. In the view of those respondents, client protection is comparable in the two models (agency and principal model) even if it is achieved via different means.

Q2) 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. The vast majority of respondents believed that ESMA-recognised CCPs should be considered as free of counterparty risk because these entities are subject to strong prudential requirements.
4. Two respondents that considered that EU CCPs and non-EU CCPs recognised by ESMA presented a very low counterparty risk profile also stressed that some CCPs were safer than others. In particular, CCPs that are registered as credit institutions or banks and that have direct access to central bank liquidity should be considered as the safest CCPs. In contrast, non-EU CCPs recognised by ESMA should be considered as less safe because there is less certainty about their supervision.

Q3) Do you think that UCITS should apply any counterparty risk limits to ESMA-recognised CCPs? What should be the limits?

5. All respondents to the consultation were of the view that UCITS should not apply any counterparty risk limits to some EU CCPs and some non-EU CCPs recognised by ESMA.

ESMA's response: Although EU CCPs and non-EU CCPs recognised by ESMA should be regarded as entities with very low counterparty risk, ESMA is of the view that UCITS might need to apply some counterparty risk limits to these entities. However, these limits should be high because of the relatively low counterparty risk of EU CCPs and non-EU CCPs recognised by ESMA.

Q4) 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.

6. The majority of respondents agreed that the assessment of the counterparty risk vis-à-vis the CM should distinguish between the types of segregation arrangement.
7. According to some respondents, UCITS are currently assessing other types of arrangement such as omnibus gross arrangements, where the initial margin is transferred in property to the CCP and the variation margins are segregated at the level of the CM in an account under client money rules.
8. Some respondents were of the view that there should not be any counterparty risk limits at all for financial derivative transactions that are centrally cleared, irrespective of the type of segregation model.

ESMA's response: ESMA agrees with the majority of respondents that the assessment of the counterparty risk vis-à-vis the CM should distinguish between the types of segregation arrangement. This was reflected in the opinion submitted to the European Commission, European Council and European Parliament.

Q5) 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?

9. According to several respondents, UCITS management companies may also want to consider other factors such as whether the model allows segregation at the sub-fund level, the specifics of the clearing arrangements regarding the treatment of over-collateralisations or the existence of client money rules at the level of the CM.

Q6) 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.

10. The vast majority of respondents agreed that UCITS have a low counterparty risk vis-à-vis the CM under individual client segregation. Some respondents felt that the counterparty risk was non-existent.

Q7) Do you think that UCITS should apply any counterparty risk limits to the CM under individual client segregation? What should be the limits?

11. None of the respondents to the consultation believed that UCITS should apply any counterparty risk limits to the CM under individual client segregation.

ESMA's response: ESMA agrees that UCITS should not apply any counterparty risk limits to CMs under individual client segregation.

Q8) 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?

12. In the view of several respondents, if there is individual client segregation, this scenario should not be taken into account by UCITS. However, under an omnibus segregation, CCPs might be forced to liquidate the positions.

13. Some other respondents took the view that there would have to be a significant market dislocation for this situation to arise. If this situation were to happen, it would very much depend on the availability of alternative CMs to offer the same type of clearing arrangement, thereby ensuring the portability of the assets and positions of the UCITS.

Q9) 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.

14. The vast majority of respondents felt that the distinction should no longer be between OTC financial derivative transactions and ETDs but rather between cleared and non-cleared financial derivative transactions.

ESMA's response: ESMA is of the view that UCITS should take into account both OTC financial derivative transactions that are centrally cleared and ETDs in the calculation of counterparty risk. ESMA believes that the assessment of the exact impact of this approach would warrant further consultation with stakeholders.

Q10) 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?

15. For many respondents the assessment should be done on a case-by-case basis because of the variety of segregation arrangements that exist.

Q11) 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.

16. Respondents to the consultation agreed that the counterparty risk vis-à-vis the CM under an omnibus client segregation was higher than under an individual client segregation.
17. However, several respondents explained that the level of protection offered by the different omnibus accounts could vary. In some circumstances, in an omnibus account the CCP knows the clients and if the CM defaults, the CCP can deliver the assets directly back to the client, bypassing the insolvent estate of the CM. Where the CCP does not know the client, the collateral balance is returned to the CM for the account of its clients but security structures may be used to protect the assets of the clients. In the absence of security structures, assets that sit at the level of the CM are at risk in the case of default of the CM.

Q12) 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?

18. According to some respondents, UCITS should apply any counterparty risk limits to the CM under gross omnibus segregation only when UCITS are not known to the CCP, or when UCITS are not protected by client money rules or similar arrangements, or under a net omnibus segregation model, when the UCITS are not protected by client money rules or similar arrangements.
19. In the majority of cases, responses to the consultation did not include any suggestions for counterparty risk limits, except one respondent that suggested a counterparty risk limit of 50% of the assets.

ESMA's response: ESMA is of the view that UCITS might need to apply counterparty risk limits to CMs in the case of omnibus client segregation but that these limits should be applied to the proportion of the assets that are not passed on to the EU CCP or the non-EU CCP recognised by ESMA. In case UCITS are not in a position to quantify the amount of assets that stay at the level of the CM, ESMA believes that UCITS should apply the counterparty risk limits to all of the assets passed to the CM.

Q13) 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.

20. In line with question 9, the vast majority of respondents believed that the distinction should no longer be between OTC financial derivative transactions and ETDs but rather between cleared and non-cleared financial derivative transactions.

Q14) 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?

21. Responses to questions 14 were largely in line with responses to question 12. According to several respondents, there may be other types of segregation arrangement that deliver the same level of protection as individual segregation, and UCITS should not apply any counterparty risk limits to the CM in that case.

ESMA's response: ESMA is of the view that the counterparty risk limits should be proportionate to the degree of protection offered to the UCITS taking into account elements such as the portability of the positions and assets of the UCITS. For example, if the degree of protection is equivalent to individual client segregation, UCITS should not apply any counterparty risk limits to CMs. However, if the protection is lower than an individual client segregation, the UCITS should apply a counterparty risk limit to the CM and the level should not be lower than the one for omnibus client segregation because the latter should be considered as the clearing arrangement that provide the lowest level of protection.

Q15) 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.

22. In line with question 9, the vast majority of respondents believed that the distinction should no longer be between OTC financial derivative transactions and ETDs but rather between cleared and non-cleared financial derivative transactions.

Q16) 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.

23. Several respondents to the consultation disagreed with this approach. According to them, ESMA should look at the details of the clearing arrangements offered by these CCPs and not only at the status of the CCP.

ESMA's response: ESMA believes that UCITS should apply the counterparty risk limits of Article 52 of the UCITS Directive to OTC financial derivative transactions cleared by non-EU CCPs not recognised by ESMA.

Q17) 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.

24. The majority of respondents agreed that the same limits should apply to ICAs.

Q18) 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?

25. For some respondents, ICAs can create a further layer of counterparty risk and in particular with certain types of omnibus accounts when there are no security structures in place at the level of the clients of CMs.

ESMA's response: ESMA recognises that indirect clearing arrangements may introduce an additional layer of counterparty risk which would need to be further assessed in the context of a modification of Article 52 of the UCITS Directive.