Will you get caught in clearing?


WHAT DOES THE CENTRAL CLEARING OF OTC DERIVATIVES MEAN FOR YOUR BUSINESS? **GUY USHER** AND **EDWARD MILLER** EXAMINE THE ISSUES FOR CORPORATES.

As the new world of mandatory clearing of over-the-counter (OTC) derivatives gets ever closer, in both Europe and the US the details of who will be caught, and what it means in practice, are gradually becoming clearer. In this article, we look at the likely impact of OTC clearing outside the world of banks, brokers and investment funds. Instead we will look at how non-financial corporate users[1] of OTCs will be affected. The first half of this article examines when the obligation to clear will apply, either under the EU legislation (European Markets Infrastructure Regulation (EMIR)) or the US legislation[2] (Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act). The second half then looks at some of the practical issues that corporate users will need to consider if caught.

Under both EMIR and Dodd-Frank, for a non-financial corporate user the obligation to clear OTC derivatives will be a function of the type of OTC derivative and the purpose for which it is entered into and level of activity.

Potentially all OTC derivatives could be caught. However, forward FX transactions look like they will be exempted from the clearing obligation under Dodd-Frank, and EMIR can be expected to follow suit. The same applies to physically settled commodity derivatives. Other than that, all vanilla OTCs may be expected to be cleared eventually, although not until central counterparties (CCPs) develop the capacity to accept the different transaction types into clearing. Non-standard OTCs are unlikely ever to be cleared as there will be no-one willing to accept them for clearing.

Even if trading only vanilla OTCs, there are bases on which a corporate user might not have to clear its OTCs.

Intra-group transactions, which may include intra-group transactions between non-financial and/or financial entities, are generally exempted from clearing under EMIR. A similar exemption under Dodd-Frank does not yet exist but may come.

Hedging transactions are also treated differently to OTCs entered into for investment purposes. Hedging transactions are those entered into by non-financial corporate users to reduce the risks of the commercial activity or as part of the treasury financing activity of the corporate user or its group. These are all exempt from clearing under Dodd-Frank.

The position is slightly different under EMIR, where there is a threshold for mandatory clearing applicable to corporate users. Corporate users will be required to clear OTCs only if their non-intra-group and non-hedging transactions exceed thresholds (yet to be established by ESMA[3]). Once the threshold is exceeded for 30 days over a three-month period, the clearing obligation applies and will remain until the corporate user can demonstrate to ESMA that it does not exceed the clearing threshold for 30 days over a three-month period. Hedging transactions will also have to be cleared once the threshold is exceeded.

SELECTING A CLEARER When an OTC has to be cleared through a CCP, a corporate user will typically not be able to access the CCP directly. Only a "clearing member" of a CCP is able to clear an OTC directly with the CCP. One of the ways that each CCP ensures its systemic integrity is to restrict the entities able to become clearing members by applying criteria such as good financial standing, an initial contribution to the CCP's default fund (typically in excess of $10m or equivalent) and sufficient operational capability and expertise. Almost all corporate users will be unable to satisfy these criteria, nor will they want to.

Clearing members will typically be banks and swap dealers, so the corporate user will need to have an arrangement in place with a clearing member for their OTCs to be cleared.

When choosing a clearer, corporate users should consider which CCPs the clearer is a member of. For many types of OTC, there will be more than one CCP able to clear that OTC. It is possible that, on entering into an OTC, the corporate user will have a preference for one particular CCP. For example, a potential

SOME COLLATERAL UPGRADES TYPICALLY ATTRACT HAIRCUTS, WHICH MEAN THAT LESS THAN THE VALUE OF THE ASSET CAN BE CONVERTED INTO CASH.

counterparty might offer a more favourable price for an OTC to be cleared on CCP Alpha than for the same OTC being cleared on CCP Beta. Likewise, the corporate user might have a preference for CCP Alpha because it prefers certain features of that CCP. Or quite simply the cost and/or margin requirement for the corporate user of CCP Alpha may be more favourable than that for CCP Beta. On the other hand, separate documentation needs to be entered into for each CCP under the non-US clearing model; if this remains the case, the attraction of multiple CCPs may be limited.

MARGIN AND FUNDING The funding arrangements and other services that the clearer can offer around margin are also important. When an OTC derivative is cleared, the clearer has to post margin to the CCP and collect margin from its customer – here the corporate user. This margin requirement consists of two components: initial margin and variation margin. Many corporate users have never posted margin for their OTCs before and those that have will not typically have had to provide anything other than variation margin (and even that may be subject to substantial thresholds). This requirement will therefore mean that the corporate user has to find additional cash or other assets available for this purpose[4].

Even if the corporate user is used to posting margin for its OTC derivatives, for cleared OTCs the clearer will be required to meet several intra-day margin calls to the CCP. Collateral calls are made only once a day at most for uncleared OTCs and the settlement periods for margin calls on uncleared OTCs are typically days rather than the hours required by the CCP. This means that clearers will end up extending credit to their customers, which will require the establishment of credit lines, which may in turn require collateral (and will not be protected by the CCP).

In addition, the corporate user may not have assets of a type the CCP will accept and so may have to negotiate financing arrangements with its clearer whereby cash can be raised from ineligible assets to meet the CCP margin requirements. This might be by a secured financing or repo, for example. Collateral upgrades of this nature typically attract haircuts, which mean that less than the value of the asset can be converted into cash; if the financing is done by way of title transfer, as with a repo, this can also give rise to a significant credit exposure to the clearer, which, again, does not benefit from the CCP protections.

UNCLEARED OTCS: INITIAL MARGIN/INDEPENDENT AMOUNTS Both EMIR and Dodd-Frank will also impose new requirements for OTCs that are outside the scope of mandatory clearing. Dodd-Frank and the detailed US rules refer to "initial margin". In the context of an ISDA Credit Support Annex, the "independent amount" element of the credit support to be provided equates to the initial margin.

In particular, the provision of collateral or margin for uncleared OTCs will become mandatory for corporate users of OTCs if they are subject to the clearing obligation. When clearing applies, corporate users are obliged to post both initial margin and variation margin for the uncleared OTCs. Although the requirement for initial and variation margin corresponds to the margin requirements that CCPs will apply to cleared OTCs, the amount of initial margin to be provided will be much greater (perhaps double or quadruple the size) than for cleared OTCs.

The US rules on this are more developed than those in the EU. The US rules have three categories of end-user for this purpose: non-financial, low-risk financial and high-risk financial. Investment funds (including regulated funds and hedge funds), pension schemes and any other entity whose activities are "predominantly… financial in nature" would be financial end-users, with any other end-user being non-financial. To be low-risk, the financial end-user must not have a significant exposure to OTCs, must use OTCs predominantly to hedge or mitigate the risks of its business activities and must be subject to the capital requirements of a prudential regulator.

When dealing with a US bank, a non-financial end-user would be required to provide initial margin and variation margin for its uncleared OTCs (the latter on at least a weekly basis), although the bank can set thresholds below which the margin requirements would not kick in. There are no limits as to how high the thresholds can be. By contrast, when dealing with a non-bank US swap-dealer, a non-financial end-user would not be required under Dodd-Frank to provide initial margin or variation margin, although the parties could bilaterally agree to provide margin.

Financial end-users will be required to provide initial margin and (daily) variation margin for their uncleared OTCs to both US banks and other US swap-dealers. Banks and swap-dealers can adopt thresholds for the margin requirements, although there are limits as to how high these thresholds can be.

The requirements that will apply in the EU are less developed but, again, can be expected to broadly follow those in the US. At the moment EMIR simply requires both financial counterparties and non-financial counterparties that exceed the clearing threshold to have procedures for "the timely, accurate and appropriate exchange of collateral" for their uncleared OTCs. ESMA is to produce detailed rules to implement this, but the expectation is that they will be broadly similar to those which apply in the US.

The delivery of initial margin for OTC derivatives normally gives rise to counterparty credit risk for the person providing it (since the total margin provided will be greater than the exposure under the OTC). The US rules therefore require the margin-taker to offer segregation of the initial margin to each margin-provider, and to notify the margin-provider that segregation is available. Segregation involves the initial margin being held by an independent third-party custodian, with the rules concerning the release of the initial margin being prescribed in a tri-party custodial agreement. Again, it is very likely that the EU rules will require either mandatory segregation or the mandatory offer of segregation[5].

Corporate users that are likely to be required to provide initial margin should be aware that segregated margin arrangements can be time-consuming to put in place. Sufficient time for these to be finalised should be allowed but it is something that can be started now.

CORPORATE USERS SHOULD CONSIDER OPTIMISING THE MARGIN REQUIREMENT BY BACK-LOADING TRANSACTIONS WHICH ARE NOT REQUIRED TO BE CLEARED BUT WHICH CAN BE CLEARED.

LEGACY TRANSACTIONS When OTCs are cleared, they become a separate, ring-fenced, pool of transactions for exposure and margining purposes from uncleared OTCs. The requirement to clear, when it applies, will apply only to new or novated OTCs. This could mean that what would otherwise be a balanced pool of OTC transactions becomes imbalanced, resulting in a requirement to post variation margin, where for the balanced pool this requirement might not otherwise exist or not to the same extent. Corporate users, like others, should therefore consider optimising the margin requirement by back-loading transactions which are not required to be cleared but which can be cleared.

START PREPARING Although precisely when mandatory CCP clearing in both the US and Europe will start is not yet known, there is plenty that UK corporate users should be doing now to get ready if they are going to be, or might later be, caught by the obligation to clear OTCs.

They should be talking to potential clearing brokers about what they would need in order to sign up the corporate. To do that effectively, the corporate user should create a checklist of issues that could be relevant to them, including those highlighted in this article. They should consider the potential funding requirement and the cost and timing of putting arrangements in place to get that funding. They should undertake a risk analysis so that they understand what risks there will be in the new world compared to the old world. It is wrong to assume that those risks will be less than they are today; they will just be different. The uncleared OTC position should not be ignored; inevitably there will be a long period before many vanilla trades are accepted for clearing and some trades will never be cleared.

Guy Usher and Edward Miller are partners in the derivatives group at Field Fisher Waterhouse.
Edward.Miller@ffw.com
Guy.Usher@ffw.com
www.ffw.com

Footnotes

1. A non-financial corporate user is anyone other than a bank, swap dealer, fund, insurance company or pension scheme, although pension schemes will most likely not be subject to the clearing requirements for a number of years after implementation. Public sector entities will be exempt.
2. UK corporate users (and other entities) will still need to consider the scope of the US requirements if trading with a US bank or a US branch of a foreign bank.
3. The European Securities and Markets Authority (ESMA) is the newly established EU entity with the job of developing detailed rules for implementing EMIR.
4. CCPs currently accept only cash and, for initial margin only, government bonds as collateral. There are also proposals in the EU for bank guarantees to be an acceptable form of margin for CCPs.
5. For more on segregation of initial margin for OTC derivatives, see the ISDA White Paper on Independent Amounts, available from the ISDA website www.isda.org