Is There a Future for Indirect Clearing?

By Simon Puleston Jones

Of all the areas of impending European regulation, the provisions relating to the indirect clearing of swaps and futures are proving to be among the most challenging for the centrally cleared derivatives industry. As the timetable for the mandatory clearing of derivatives begins to take effect next year, the need to find a legally enforceable and economically viable way of meeting regulatory obligations in this area is becoming acute.

The requirements for indirect clearing – in essence, referring to the chain of back-to-back contracts that exist between an indirect client, a client, a clearing member and clearinghouse – were written into the European Markets Infrastructure Regulation (EMIR) to provide indirect clients with a way of meeting their obligation under EMIR to clear certain OTC contracts through a clearinghouse. The indirect client is seen to be a smaller financial institution, such as a mid-sized regional bank or a commodity producer.

Through the creation of a series of back-to-back OTC contracts on essentially identical terms – between indirect client and direct client; direct client and the clearing member; and the clearing member and clearinghouse – the indirect client is considered to have met its obligation (if any) to "clear" that OTC contract under EMIR.

Porting, Segregation and Leapfrogging

In addition to helping clients meet their clearing obligations, indirect clearing addresses other objectives. EMIR and Markets in Financial Instruments Regulation (MiFIR) dictate that derivatives transactions (OTC in the case of the former and exchange-traded derivatives in the case of MiFIR) should not necessarily have to terminate upon the default of the direct client and that the risk to the indirect client is mitigated if the transaction is terminated in circumstances in which the direct client is insolvent.

If the direct client defaults, the indirect client is given the opportunity to "port" (novate) its rights and obligations under the derivatives contract to a third party within a specified time period (the "porting window"). If the contract is not ported before the end of the porting window, it is terminated, along with all the corresponding back-to-back contracts relating to that contract.

Finally, prior to termination of the chain of back-to-back contracts, the clearinghouse is required to segregate in its books and records the positions and collateral relating to the derivative contract entered into by the indirect client from the positions and collateral of the direct client and the clearing member. Furthermore, following any such termination, any excess collateral held by the clearinghouse and/or clearing member must be returned directly to the indirect client, thereby 'leapfrogging' the direct client and, in theory, avoiding the insolvency estate of the direct client.

While the cleared derivatives industry has spent the past two years trying to resolve the difficulties placed on it by the indirect clearing requirements for OTC derivatives – and has yet to come up with a definitive solution – the problem has been further compounded by the introduction of indirect clearing requirements for exchange-traded derivatives with respect to the MiFIR, which is currently in its consultation and drafting phase.

Two Models

There are two possible models through which indirect clearing may work in practice.

The principal-to-principal model, whereby:

- the indirect client enters into a derivative contract with the direct client; and
- the direct client (in its own name, rather than as agent of the indirect client) enters into an equivalent back to back contract with the clearing member; or

The guaranteed agency model, whereby:

- the direct client (as agent of the indirect client) enters into a derivative contract with the clearing member; and
- the direct client guarantees the performance of the indirect client to the clearing member

One important difference between the two models is that the direct client enters into two contracts in the principal-to-principal model—one facing the clearing member and one facing the indirect client—and only one under the guaranteed agency model.

Legal Challenges

The overarching challenge for regulators and the industry is to find a model that meets the requirements of EMIR and MiFIR, while also being economically viable. As of the time of writing, no such model has been definitively identified due to the legal, economic, risk and practical challenges.

From a legal perspective, these challenges fall in three areas:

- Insolvency law: at the time of writing, while English insolvency laws have been updated to facilitate porting and the "leapfrog" return of excess if all parties are English, neither the U.K. nor any of the 28 Member States of the European Union had updated their insolvency laws in a way that fully supports portability and the leapfrog payment on a cross-border basis (e.g. if the clearinghouse, clearing member, direct client and/or indirect client are located in different countries). In the absence of a pan-EU amendment to insolvency law, this may render the principal-to-principal model unsupportable and any leapfrog

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return of collateral at risk of challenge from the bankruptcy official of the direct client.

- Scope: it is unclear whether the regime is only intended to apply where both the direct and indirect clients are established in the European Union.
- Segregation: it is unclear whether the CCPs will be required to facilitate the opening of individually segregated accounts (ISAs) for indirect clients.

As highlighted in responses to the European Securities and Markets Authority (ESMA) consultation papers on MiFIR, more than 50% of existing global ETD activity involves clearing where the ultimate client is not in a direct relationship with the ultimate clearing member, and in many cases will not be in the same jurisdiction.

If ETD indirect clearing is not permitted under its current form, the client would potentially need to put in place multiple separate legal relationships, comply with multiple separate operational processes and meet multiple margin calls. This will be significantly more expensive for the client, in addition to being more complex both legally and operationally.

Practical Challenges

Meanwhile, there are four main challenges from an economic perspective:

- Notwithstanding that clearing members already receive collateral from their direct and indirect clients, the Capital Requirements Directive (CRD IV) also requires clearing members to hold a significant amount of capital on their balance sheet to protect them against the risk of default by direct clients, indirect clients and clearinghouses. This is one of the primary cost drivers for clearing members when providing a clearing service. Some banks have already ceased providing clearing services as the regulatory costs of doing so to direct clients rendered their business models unviable, to the extent of being loss making. For clearing members, there is a material risk that additional regulatory capital costs of providing clearing services to indirect clients is the difference between them being able to stay in the business of providing clearing services or not.
- CRD IV also has a feature known as the "leverage ratio." Essentially, this ratio limits the amount of balance sheet that clearing members are able to use in their business. Given their finite balance sheet resources, clearing members are accordingly incentivised through necessity to obtain as much profit as possible out of each euro of balance sheet that they commit to a transaction. Given the limited balance sheet available, there is little incentive for clearing members to facilitate such a limited-profit service as indirect clearing, especially if their senior management are able to identify other business lines within the clearing member to which the balance sheet could be applied to receive higher returns.
- The guaranteed agency model will not be acceptable to the credit departments of the clearing members, as it will expose them to the credit of the indirect clients if the direct client is unable to pay out under the guarantee by reason of its insolvency.
- The resource and operational costs of providing indirect clearing are very significant, with little economic return.

Of equal concern to the industry are the practical challenges of the indirect clearing proposals. Repapering of direct and indirect clients will be required; should a supportable indirect clearing model be found, new documentation would need to be put in place with direct clients and indirect clients to evidence its terms. The clearing member will also have to carry out know-your-customers (KYC) checks on the indirect client. The clearing member is unlikely to be willing/permitted to rely on KYC checks carried out on the indirect client by the direct client, save in limited circumstances. Equally, if required, indirect client individual segregated accounts (ISA) will be an operational challenge to manage.

There are concerns about the application of rules to the ETD industry that were principally designed for the OTC derivatives industry. Many consider that ESMA, which oversees both EMIR and MiFIR/MiFID II, should adopt different approaches for indirect clearing arrangements for OTC and exchange-traded derivatives, especially in light of the problems with finding a workable solution for the former.

Search for a Solution

While some banks have already made it known that they will not offer indirect clearing for OTC derivatives, market participants are in pursuit of a solution that would not only comply with regulatory requirements, but also be legally, commercially and operationally viable. However, in the absence of a single pan-EU insolvency regime and client asset protection framework, there are significant reservations as to whether, as a matter of law, indirect clearing under EMIR or MiFID II/R is supportable. In any event, indirect clearing should not apply to ETD under MiFIR. The current market practice provides good access to global markets and works extremely well.

If a solution suitable to all parties is not found, the risk is that a large swathe of current users of OTC derivatives will no longer have access to the market as they will not find clearing firms willing to enter into clearing arrangements with them as an indirect client. For ETD markets, a large number of users may have to rethink how they access global markets in future.

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