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Capital Requirements Directive IV Framework *Clearing*

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CRD IV Framework: *Clearing*

This briefing paper is part of a series of briefings on the implementation of Basel III in Europe via the Capital Requirements Directive IV¹ (**CRD IV**) and the Capital Requirements Regulation² (**CRR**), replacing the Banking Consolidation Directive³ and the Capital Adequacy Directive.⁴ The legislation is highly complex:

¹ 2013/36/EU.

² Regulation 575/2013.

³ 2006/48/EU.

⁴ 2006/49/EU.

these briefings are intended to provide a high-level overview of the architecture of the regulatory capital and liquidity framework and to draw attention to the legal issues likely to be relevant to the in-house lawyer. This briefing is for general guidance only and does not constitute definitive advice.

NOTE: This briefing paper is based on information available as of 17 January 2014.

Background and Scope

The global financial crisis has prompted legislators to address perceived weaknesses in derivatives and associated markets. As part of the European response to this, Basel III contains, and CRD IV implements, a framework for calculating the counterparty credit risk associated with exposures to central counterparties (**CCPs**). This is designed to incentivise clearing through CCPs.

The regulation of exposures to CCPs takes into account the exposures that a clearing member of a CCP has to the CCP – both in relation to own account positions, and in relation to those positions taken in the course of providing clearing services for clients. It also seeks to capture the exposures that a clearing member has to its client (and vice versa). Historically, the European markets have offered clearing on a principal to principal basis, with clients effectively taking double default risk (the risk of loss in the event that either the CCP or the clearing member defaults). As the regulatory environment increasingly drives segregation of assets in the hands of the clearing member, the new regime seeks to recognise the effect of segregation in the hands of the clearing member by recognising the loss of double default risk.

Sources

CRR (*Regulation 575/2013*): Recitals (81) to (86); Articles 107, 300 -311 and 497; Annex II.

[UK Financial Conduct Authority \(FCA\) Policy Statement \(PS13/10\) CRD IV for Investment Firms \(December 2013\).](#)

[UK Prudential Regulation Authority \(PRA\) Policy Statement \(PS7/13\) Strengthening capital standards: implementing CRD IV, feedback and final rules \(December 2013\).](#)

[PRA Supervisory Statement \(SS12/13\) Counterparty Credit Risk \(December 2013\).](#)

Pre-CRR position

Pre-CRR, clearing member exposures to CCPs attracted a 0% risk weight and client exposures to a

clearing member would be treated under the bilateral framework for credit risk.

Key changes

Under the CRD IV framework, exposures to CCPs will attract own funds requirements for the first time. The own funds requirements for exposures to CCPs that have been authorised or recognised in

accordance with EMIR⁵ (**Qualifying CCPs**) will be lower than the own funds requirements imposed on exposures to other CCPs (**Non-Qualifying CCPs**) and bilateral transactions.

⁵ The European Market Infrastructure Regulation: *Regulation 648/2012*.

Post-CRR position

There are specific detailed rules governing derivative transactions (as set out in Annex II of the CRR), repurchase transactions, securities or commodities lending or borrowing transactions, long settlement transactions, and margin lending transactions.

Other exposures (including exposures arising from securities clearing) are to be risk weighted as exposures to institutions (for Qualifying CCPs) or corporates (for Non-Qualifying CCPs).

The regime for credit risk in the context of clearing makes various key distinctions. As those distinctions frame the issues covered in this briefing, they are highlighted here in general terms for convenience.

Exposures covered: clearing member to CCP; clearing member to client; client to clearing member

Firstly, the regime distinguishes between the exposures of a CCP clearing member and the exposures of a clearing member's client. With respect to a clearing member, the regime deals both with the clearing member's exposures to a CCP and its exposures to a client.

Trade exposures and default fund exposures

Secondly, the regime generally distinguishes between “trade exposures” and “default fund exposures”. A “trade exposure” consists of current exposure and potential future exposure arising in connection with a transaction, including both initial margin and variation margin. A “default fund exposure” represents a clearing member’s exposure to loss on its contributions to a CCP’s default fund – the pool of assets held by a CCP to cover losses from the default of one or more clearing members that exceed the margin held by the CCP. The own funds requirements are considerably higher in respect of default fund exposures than trade exposures, reflecting its equity-like characteristics.

Risk: effect of limited recourse and segregation

Where a clearing member clears client trades, it is customary for it to pass CCP default risk to the client. This is recognised in the risk weighting of the clearing member’s exposure to the CCP with respect to client clearing. With respect to a clearing member’s client, the regime distinguishes between the client’s exposures to its clearing member depending on the availability of segregation and portability in respect of the client’s transactions and assets – effectively ‘looking through’ to the CCP for risk weighting where there is segregation.

We summarise below the risk weighting of:

- clearing member exposures to a Qualifying CCP;
- clearing member exposures to a Non-Qualifying CCP;
- clearing member exposures to a client; and
- client exposures to a clearing member.

Clearing member exposures to a Qualifying CCP

Trade exposures

Clearing members are given a choice of approaches with respect to trade exposures to Qualifying CCPs.

The first option requires the clearing member to calculate its exposure value as it would for bilateral exposures and then to apply a risk weighting of 2% to that exposure value. The calculation of the clearing member’s exposure value is subject to an exception where the clearing member’s trade exposure to the Qualifying CCP is a back-to-back transaction that corresponds to a transaction between the clearing member and its client. Where the terms of that clearing member/client transaction state that the clearing member is not obliged to reimburse the client for any losses suffered by the client on that clearing member/client transaction as a result of the Qualifying CCP defaulting, the exposure value of the clearing member’s transaction with the Qualifying CCP is zero.

The second option is an alternative calculation that, if followed, is applied both to the clearing member’s trade exposures to a Qualifying CCP and its contributions to the Qualifying CCP’s default fund. This calculation (the **Alternative Calculation**) is described below at “Clearing member exposures to a Qualifying CCP – Alternative calculation”.

Default fund exposures

Clearing members are also given a choice of approaches with respect to their default fund exposures to Qualifying CCPs.

The first option comprises a series of calculations that set the clearing member’s own funds requirements according to the risk it faces on its contributions to a Qualifying CCP’s default fund and it therefore varies from Qualifying CCP to Qualifying CCP. In summary, this calculation takes account of three elements:

- (a) the hypothetical capital of the Qualifying CCP, calculated as the capital that the Qualifying CCP

would have to hold if it treated all of its exposures to clearing members under the bilateral framework;

- (b) the aggregate capital requirements of all the Qualifying CCP's clearing members, calculated by comparing the hypothetical capital of the Qualifying CCP with all the contributions (ie the Qualifying CCP's contributions as well as its clearing members' contributions) to the default fund (from which contributions the contributions of two clearing members that are assumed to have defaulted are deducted); and
- (c) the allocation of those aggregate capital requirements among the Qualifying CCP's clearing members.

The second option is, as for trade exposures, the Alternative Calculation described below at "Clearing member exposures to a Qualifying CCP – Alternative calculation".

Alternative calculation

As an alternative to treating trade exposures and default fund exposures to a Qualifying CCP in the manner described above, a clearing member may opt to apply the following formula to calculate its own funds requirements:

$$\text{Own funds requirement} = 8\% \times \min((2\% \times \text{TE} + 1,250\% \times \text{DF})(20\% \times \text{TE}))$$

Where:

TE is the clearing member's trade exposure to the CCP (including its exposure in respect of transactions it is clearing on behalf of a client), calculated in accordance with the bilateral framework.

DF is the clearing member's contribution to the CCP's default fund.

This approach effectively applies a risk weight of 1,250% to the clearing member's default fund exposure but caps the clearing member's risk weighted assets in respect of the Qualifying CCP at 20% of its trade exposures to the Qualifying CCP.

Clearing member exposures to a Qualifying CCP that ceases to meet certain conditions

The CRR provides for clearing members to use other treatments for their exposures to Qualifying CCPs in two circumstances.

One circumstance is where it has become known to the clearing member (by way of notification from the CCP in question or from that CCP's competent authority) that a CCP will no longer comply with the requirements for authorisation or recognition under EMIR, ie that it will no longer be a Qualifying CCP. In such circumstances, the clearing member must (within three months of the notification (or earlier, if and as required by its competent authority)):

- (a) cease to apply to its trade exposures to that CCP its chosen treatment (ie one of the two treatments described in relation to trade exposures under "Clearing member exposures to a Qualifying CCP" above);
- (b) calculate the exposure value for its trade exposures to the CCP as it would for bilateral exposures and risk-weight those exposure according to the Standardised approach;⁶
- (c) apply to its contributions, and unfunded commitments to make future contributions, to the CCP's default fund the treatment described for such exposures in "Clearing member exposures to a Non-Qualifying CCP" below; and
- (d) treat all other exposures to the CCP as exposures to corporates in accordance with the Standardised Approach.

The other circumstance is where the clearing member has received a notification from the CCP that it has stopped calculating its hypothetical capital. Where the clearing member's competent authority decides that the CCP's reasons for doing

⁶ As defined in the CRD IV framework.

so are valid, the competent authority may permit the institution to apply the Alternative calculation to its exposures (both trade exposures and default fund exposures) to that CCP. Where the clearing member's competent authority does not consider the CCP's reasons for ceasing to calculate its hypothetical capital to be valid, the clearing member must apply the treatment described in (a) to (d) immediately above, irrespective of the treatment that the clearing member had previously chosen.

Clearing member exposures to a Non-Qualifying CCP

Trade exposures

A clearing member must capitalise its trade exposures to a Non-Qualifying CCP by:

- (a) calculating its exposure value as it would for bilateral exposures; and
- (b) risk-weighting that exposure according to the Standardised Approach.

As with a clearing member's exposure to a Qualifying CCP, the calculation of the clearing member's exposure value according to the framework for bilateral exposures is subject to an exception where the clearing member's trade exposure to the Non-Qualifying CCP is a back-to-back transaction that corresponds to a transaction between the clearing member and its client. Where the terms of that clearing-member/client transaction state that the clearing member is not obliged to reimburse the client for any losses suffered by the client on that clearing member/client transaction as a result of the Non-Qualifying CCP defaulting, the exposure value of the clearing member's transaction with the Non-Qualifying CCP is zero.

Default fund exposures

Basel III prescribes that clearing member contributions to the default fund of a Non-Qualifying CCP attract a risk weight of 1,250% and that "contributions" in this context include unfunded commitments to make future

contributions to the Non-Qualifying CCP's default fund.

The CRR drafting is not entirely clear on this issue, and on its face is potentially circular, but it appears to require that a clearing member's own funds requirement in respect of its contributions to a Non-Qualifying CCP's default fund are calculated as 1.2 times the sum of the clearing member's contributions, and unfunded commitments to make future contributions, to that default fund.

Clearing member exposures to a client

General position

Generally, a clearing member must calculate its own funds requirements with respect to CCP-related transactions with a client⁷ in accordance with the bilateral framework except that two elements are introduced to recognise the fact that the close-out period for cleared transactions is shorter:

- (a) if the clearing member is using the Internal Model Method⁸ to calculate its exposure value, it may apply a shorter margin period of risk provided that such margin period of risk is not less than five days; and
- (b) the clearing member may multiply any exposure at default value by a scalar corresponding to a given margin period of risk – the effect is to reduce the exposure at default depending on the margin period of risk (with shorter margin periods of risk attracting greater reductions).

Guaranteed portability

Where a clearing member agrees to act as a back-up clearing member for a client of another clearing member to ensure portability – ie it agrees to accept transactions and collateral of that client being ported to it from the other clearing member – it may apply an exposure value of zero to the contingent obligation created by that agreement.

⁷ "CCP-related transactions" being those transactions between the clearing member and its client that are back-to-back with transactions between the clearing member and a CCP.

⁸ As defined in the CRD IV framework.

If that client's transactions and/or collateral are ported to it, however, then it will need to calculate its own funds requirements for the resulting exposures as described in "General position" immediately above.

Client exposures to a clearing member

General position

Generally, a client is required to calculate its own funds requirements with respect to trade exposures under CCP-related transactions⁹ with a clearing member in accordance with the bilateral framework, except in the two instances described below where the CCP in question is a Qualifying CCP.

Segregation, portability and legal opinion available

Where, in respect of a client's trade exposures to a clearing member under a CCP-related transaction,¹⁰ the CCP is a Qualifying CCP and the conditions described below are met, a client may calculate its exposure value as it would for bilateral exposures and then apply a risk weighting of 2% to that exposure value.

The conditions are that:

- (a) the client's positions and assets are segregated at both clearing member and CCP level from the positions and assets of the clearing member and its other clients so that they are bankruptcy remote¹¹ on the default or insolvency of the clearing member or any of its other clients;
- (b) laws, regulations, rules and contractual arrangements ensure the portability, within the relevant margin period of risk, of the client's positions and corresponding collateral in the

⁹ As defined in footnote 7.

¹⁰ As defined in footnote 7.

¹¹ For the purposes of the clearing regime, "bankruptcy remote" means in relation to client assets, that effective arrangements are in place to ensure that the assets are not available to the CCP's creditors in the case of the CCP's insolvency, or a clearing member's creditors in the case of the clearing member's insolvency, or to the clearing member in the case of a default of another of the clearing member's clients.

event of the default or insolvency of the clearing member; and

- (c) the client has a legal opinion confirming that, on the insolvency of the clearing member or any of the clearing member's other clients, the client would suffer no loss under: (i) the laws of the jurisdiction of the client, the clearing member and the CCP; (ii) the law governing the transactions the client clears through the CCP; (iii) the law governing the collateral; and (iv) the law governing any contract required for the portability arrangements in (b).

Where the client is an indirect client of the clearing member (ie it is a client of a client of the clearing member), each condition must be met with respect to each chain of intermediaries if it is to benefit from this treatment.

No segregation but portability and legal opinion available

Where the segregation condition described in (a) above is not met, but the conditions in (b) and (c) are met¹² (and the CCP in question is a Qualifying CCP), then the client may calculate its exposure value as it would for bilateral exposures and then apply a risk weighting of 4% (rather than 2%) to that exposure value.

Collateral

Where assets posted as collateral to a CCP are bankruptcy remote¹³ in the event of the insolvency of the CCP, the clearing member or another client of the clearing member, the clearing member or client, as the case may be, may attribute an exposure value of zero to those assets.

Transitional provisions regarding QCCPs

The process for CCPs becoming authorised or recognised under EMIR (and therefore consisting of QCCPs for capital purposes) is ongoing.

¹² To the extent that the required segregation is not available, it would presumably be carved out of that segregation.

¹³ As defined in footnote 11.

Accordingly, the CRR allows for a transitional period during which institutions may treat a CCP as a QCCP provided that the CCP is authorised or recognised in a particular EU member state. This transitional period ends on the sooner of:

- (a) a decision being made under EMIR as to whether a CCP is to be authorised or recognised; or
- (b) 15 months after the last EMIR regulatory technical standard relating to CCPs comes into force.

The PRA has noted in its policy statement that it anticipates the transitional period expiring on 15 June 2014 (subject to the possible extension by the

European Commission). It states that during the transitional period, QCCPs will comprise:

- (a) all CCPs listed on the Bank of England's register of Recognised Clearing Houses (**RCH**)¹⁴; and
- (b) those third country CCPs that currently provide clearing services to UK credit institutions, or their subsidiaries.

¹⁴ The Bank of England's register of RCHs is available on the following link:

http://www.bankofengland.co.uk/financialstability/Pages/fmis/supervised_sys/rch.aspx

European Banking Authority (EBA) technical standards

The CRR mandates that various technical standards shall be produced. In connection with clearing, the following standards shall be produced:

CRR SOURCE	TECHNICAL STANDARDS/GUIDELINES REQUIRED	DEADLINE FOR SUBMISSION TO THE EUROPEAN COMMISSION	EBA PUBLICATIONS
Article 304(4) (<i>Treatment of clearing members' exposures to clients</i>)	Draft regulatory technical standards to specify the margin periods of risk that institutions may use for the purposes of calculating own funds requirements to clients.	30 June 2014.	None to date.

Further reading

Client Briefing 1 (*Introduction to Regulatory Capital and Liquidity*)

Client Briefing 3 (*Standardised Approach to Credit Risk in the Banking Book*)

Client Briefing 4 (*Internal Ratings Based Approach to Credit Risk in the Banking Book*)

Client Briefing 5 (*Collateral: Funded Credit Risk Mitigation in the Banking Book*)

Client Briefing 6 (*Unfunded Credit Risk Mitigation in the Banking Book: Guarantees and Credit Derivatives*)

Client Briefing 8 (*Counterparty Credit Risk*)

Client Briefing 10 (*Credit Valuation Adjustment (CVA)*)

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