The to do list for German Investment companies (Kapitalanlagegesellschaften: KAGs) until year end is extensive and complex. It includes the selection of clearing brokers, choice of clearing houses, internal analysis and adaptations. All this follows the EMIR regulation that came into force on the 16th August 2012 for over-the-counter (OTC) derivatives. Core elements of this new regulation focus on the obligation to centrally clear OTC derivative trades through a clearing house.

In response to the financial crisis of 2008, the aim of the new regulation is to reduce systemic risk and protect investors. A central counterparty clearing house (CCP) becomes the buyer to every seller and the seller to every buyer, thus reducing counterparty risk and delivering netting efficiencies; with a view to increase transparency, introduce anonymity and risk mitigation. In this context, KAGs are facing complex operational and legal challenges deriving from the need to balance daily business and legal requirements imposed by EMIR and the German investment fund law restrictions. How KAGs can cope with these challenges depends to a significant extent on the choice of CCP. The clearing models offered by European CCPs vary significantly.

The operational challenges that KAGs face are largely due to the structural characteristics of their current business model. At the core of this lies the impact of including two new players – CCP and clearing member – into their existing and complexly balanced relationship with the so-called “Depotbank” (custodian) and, in some cases, also collateral manager and asset manager.

Traditional clearing models do not cater to KAG-specific needs. One of the key legal considerations for KAGs is the required segregation of assets. A German KAG is obliged to segregate assets belonging to its various funds and sub-funds as well as from the assets of other third parties, such as the clearing member. In the context of implementing the clearing obligation under EMIR, it is therefore vital for KAGs to evaluate the different account structures and segregation models offered by CCPs.

EMIR outlines the framework of segregation models CCPs should offer – omnibus and individually segregated accounts – but details of how these accounts operate are defined by the respective CCPs. Bankruptcy remoteness plays a key role for KAGs in this context, since KAGs will look to collateralise their cleared exposures with non-cash collateral where possible. In the context of traditional clearing models, KAGs would port cash rather than the deposited non-cash collateral, in the case of a clearing member default.

Those CCPs that offer fully individually segregated accounts (including client individual custodial accounts) create alternative structures enabling KAGs to port their non-cash collateral. But if the CCP model is structured so that the client-individual collateral account does not reside at the KAG’s custodian, additional complexities can result for the KAG.

An innovation in this space is the CCP working with and integrating the KAG’s custodians directly into its full individual segregation model. This then enables the porting of non-cash collateral in the case of a clearing member default and offers KAGs additional benefits in the form of transparency, efficiency, control, and cost advantages.

As published in German on 25th September in daily newspaper “Handelsblatt”, p. 43
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