Julia: **Hello and welcome to a DerivSource podcast. I'm Julia Schieffer, the Founder and Editor of DerivSource.com.**

We recently hosted an on-demand webinar on how to select an asset segregation model for cleared OTC derivatives with buy side consultant Jaki Walsh of Derivati Consulting.

In this webinar, Jaki Walsh reviewed the various asset segregation structures available, including Omnibus, LSOC, and individual. She also offered some considerations asset managers should take on board when selecting the best structure to support CCP clearing of cleared derivatives.

We had many questions come through this on-demand webinar, so in this podcast today we are addressing some of those questions.

Jaki, welcome to the podcast.

Jaki: Thank you Julia, pleasure to be here.

Julia: **What additional documentation is required for each type of segregation?**

Jaki: So, unfortunately the answer is not too simple. Starting with the easiest: for Omnibus, OSA Accounts and for ISA individual accounts, across the CCP for the most part there is no additional documentation required. However, once you start to move to the more advanced and enhanced structures such as full segregation or custody segregation there will be additional documentation like deeds etc for each CCP. There is no market standard, and there is no consistency across CCP. Some of this documentation is still in the design mode, but I think the important takeaway point is that for Omnibus and ISA there is no additional documentation. It's only when you get into custody segregation, full segregation and tri-party arrangements that there will be bespoke documentation for each CCP.

Julia: **If I have listed derivatives in Omnibus and OTC in ISA, can I cross margin?**

Jaki: This is a very interesting question. The current state of play in the market is an expectation that listed business will remain in Omnibus for the near future, whereas there is more of a focus on OTC moving to an ISA account for obligation date. The key thing is, no, you cannot cross margin across different account structures. In fact, when you cross margin, your listed move to your OTC and therefore would need to move not only as the position but as the collateral, and therefore you have to have the same, either Omnibus or ISA account for both your listed and OTC positions when cross margining or portfolio margining is used.

Julia: **Third question here Jaki, is interest earned on cash or income passed back from securities based on client tax rules?**

Jaki: Again, very interesting question. Interest or income on securities, is generally passed back to the clearing members by the clearing house. So the first point: does the clearing house pass back to the clearing member? Usually, yes. Does the clearing member pass back to the client? That will need to be specified in the documentation with the client. But, again, usually, yes. However, the key thing here is that assets are held by the clearing house, usually on a title transfer basis. Therefore, the clearing house's tax rules will apply, and only the income received as per the clearing house's tax rules will be passed up the food chain.

Julia: **Do clients face pass through of any CCP investment losses incurred on client cash margin?**

Jaki: Now, here in Europe there is actually a requirement for the clearing house to invest 95% of cash that they receive. This needs to be invested in liquid deposits or repos for the most part. Now, most CCPs will absorb a certain amount of investment losses; each CCP has their own different cap. Once that cap is exceeded, investment losses will be passed to the clearing members, which in turn means that the clearing members could pass those losses back to the client.

Julia: **There appears to be different segregation models between European CCPs which is causing significant confusion in the market. Jaki, why didn't ESMA adopt a similar model to the US in terms of segregation?**

Jaki: The key concerns that ESMA have (and this has been through a lot of lobbying by end clients in Europe as well), is that the Omnibus structure allows fellow customer risk. And ESMA do not want clients to face losses based on other clients. So Omnibus is an option but there is needed to be a higher form of segregation; that leads us to LSOC. As much as LSOC is a higher form of segregation, it again only protects the value of assets, and there was significant lobbying from European end user clients with their worries and concerns with regard to the liquidation, the replacement cost, the ability for a mandate to hold cash instead of the actual asset that was purchased. So the reason why ISA is in place is for the difference between value protection and actual asset protection, and this was driven mostly by the actual end users, and not just the regulators.

Julia: **Jaki, in your view, which model is the most superior for the safety of assets?**

Jaki: I think the most superior type of protection would always be the full segregation where assets do not have to move in the market and they can be held with your own custodian. However, realistically in current day where these models are still evolving, and certainly the costs being understood, I would say that the Individual Segregated Account (ISA) is the superior safety of assets account that is likely to be used in the near term.

Julia: **In a survey conducted during a different DerivSource webinar last year, just under 40% of attendees were clear with what asset segregation model its firm would be selecting. So, Jaki, what is the biggest stumbling block for firms in selecting a model?**

Jaki: I think the understanding of the costs versus the benefits. I think, generally, most firms will all agree that they would rather take the most amount of protection that there is available. This becomes complicated, a) because the variants between the clearing houses as to what protection and type of account they offer, and b) which clearing members are supporting those segregation options? But most importantly, having a full suite of options, ie. the same type or level of protection at each CCP with all clearing members that a firm wants to use has been a struggle, but the complete lack of transparency or clarity in what the total costs are have been a hurdle that has put most decisions on hold for a period of time. Fortunately, certainly for Omnibus and ISA, we are now getting to a place where there is more clarity. ESMA have asked for disclosures from clearing houses and clearing members, and these entities are understanding their models and able to provide a greater level of granular detail. However, that process is still ongoing with regard to full segregation, for example.

Julia: **Final question for you Jaki. Is there any advice that you would give our listeners or the webinar attendees as to how they could best select an asset segregation model going forward?**

Jaki: I think the most important way to be able to identify which segregation model is appropriate is a) to go through the steps that we went through in the webinar as to what type of protection each fund needs, but really if you take your portfolios and you run your margin with your clearing members or your clearing houses, you will identify whether you need cross margining, for example. You will identify the level of margin that you have and then, you know, whether… what type of excess you would need, and what form that excess would need to take shape in, given the underlying assets. And once you can actually see a tangible portfolio that you would have to have the segregation, it then becomes a lot easier to benchmark the protection and the risks that you are taking and then willing to accept. That's my big recommendation: to run simulations for each of your portfolios and look at what it would actually be like in the cleared world.

Julia: **Thank you, Jaki, for answering the questions from our audience today. Now, those of you who listening, if you have a question that we didn't address today on either**

asset segregation or CCP clearing in general, please feel free to email us at editor@derivsource.com. If you haven't viewed this free on-demand webinar, we encourage you to do so. You can find the link via our Podcast Notes page as well as more information on the presenter, Jaki Walsh of Derivati Consulting.

Thank you for listening to today's DerivSource podcast. Join us next time.