

European Banking Authority  
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25 Old Broad Street  
London EC2N 1HQ

July 31 2012

Your ref: EBA/CP/2012/08

Dear sirs,

This letter provides the response of the LCH.Clearnet Group (“LCH.Clearnet”) to the EBA’s Consultation Paper EBA/CP/2012/8) on “Draft Regulatory Technical Standards on Capital Requirements for CCPs” under the draft Regulation on OTC Derivatives, CCPs and Trade Repositories (“EMIR”).

LCH.Clearnet is the world’s leading clearing house group, serving major international exchanges and platforms, as well as a range of OTC markets. It clears a broad range of asset classes including: securities, exchange traded derivatives, commodities, energy, freight, interest rate swaps, credit default swaps and bonds and repos; and works closely with market participants and exchanges to identify and develop clearing services for new asset classes. LCH.Clearnet and its OTC derivatives clearing services were briefly described in our response<sup>1</sup> to the EBA’s Discussion Paper.

### **Key concern**

We strongly support the ESAs’ goals in establishing heightened European prudential standards for CCPs and that support the continuing development of robust financial markets. As part of this, we support the implementation of regulations that would increase the amount of capital held by CCPs. However, before replying to the EBA’s specific questions, we take this opportunity to express our deep concern over the revised proposal that require capital “that is at all times at least equal to the higher of the following two amounts: (i) its operational expenses during an appropriate time span for winding-down or restructuring its activities, **and** (ii) the sum of the capital requirements for the overall

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<sup>1</sup> Published at

[http://www.eba.europa.eu/cebs/media/Publications/Discussion%20Papers/Comment\\_Letter\\_EBA-DP-2012-1\\_LCH-C.pdf](http://www.eba.europa.eu/cebs/media/Publications/Discussion%20Papers/Comment_Letter_EBA-DP-2012-1_LCH-C.pdf)

operational risk and for credit, counterparty and market risks stemming from “non-clearing activities” it carries out.

We do not believe that these elements should be additive for the following reasons:

- Should a CCP get into trouble, it would suffer an accounting loss. The first question is therefore whether the situation is one of resolution or recovery. Recovery planning involves keeping the business going – recapitalising it if necessary. In order to keep a business going it needs to have sufficient capital to enable it to continue trading. In a recovery situation a *liquidity pool* (which is what the EBA requirement amounts to) is not what is necessary, because the whole point of the exercise is to keep the business going and therefore revenue coming in. If at any time revenues are substantially less than costs, the firm is no longer in a recovery situation. The point of *capital* is that the firm has sufficient equity to enable it to absorb the loss concerned and to continue operating;
- If a CCP cannot recover it is then in resolution. In resolution it would by definition have suffered a loss sufficiently large that it can no longer carry on as is. This loss may wipe out most of its capital, or all of it, or more than all of it, but the point is that it is sufficiently large that the CCP cannot continue operating. At this point the CCP has to close the business and start running it off. The objective here is to ensure an orderly rather than a disorderly wind-down. A CCP is not going to be able to raise third party funding, so in order to accomplish an orderly wind-down it needs a liquidity pool which is sufficiently large to meet its expected costs. However, once it goes into wind-down its capital position no longer matters – the sole purpose of wind-down is to minimise losses to creditors by ensuring that realisations remain orderly;
- Thus, capital is necessary to meet the *first* of these cases – in order to ensure that a loss suffered by the CCP can be absorbed, leaving it solvent and able to continue trading. If the loss is sufficiently large to have overwhelmed the capital available, then it needs a liquidity pool to manage the wind-down, and the capital position becomes irrelevant. It therefore need what is required for investment firms; i.e. capital equal to the higher of a risk requirement and a wind-down requirement. Adding the two together is not meaningful, because it will never be in a situation where it is both in recovery and in wind-down;

In addition, we believe the proposals raise the following concerns:

- Ultimately, a CCP's own capital is not the primary indicator of a CCP's resilience: it is effective risk management and levels of margin monies and default funds that make markets safer and it is on this element that we believe regulators and CCPs should focus;

- It could increase risk in the event of the management of a default. In fact the capital requirement has a direct impact on the amount of “dedicated own resources” (skin in the game) that a CCP will have to include in its default waterfall – currently proposed by ESMA as 50% of the capital requirements. Such a high amount of dedicated own resources would run the risk of diluting a key incentive on members to participate in the default management of an OTC position;
- It is inconsistent with CPSS/IOSCO Principles for Financial Market Infrastructures and with rules proposed in the US pursuant to the Dodd-Frank Act which do not require separate capital for credit and market risks, and could lead to European CCPs becoming uncompetitive when offering services in third countries;
- By significantly increasing the capital requirements on CCPs, the proposal could make bilateral transactions cheaper than centrally cleared ones and therefore make those types of transactions more attractive to market participants. This would run against the objectives of the G20 commitments;
- Asking CCPs to raise large amounts of additional capital would create stress on the markets at an already difficult time and such stress could outweigh the additional safety cushion that such extra capital would provide;
- Non-publicly traded CCPs who cannot go to market to raise capital will need to go to their owners, in majority banks, which are already under capital pressures. Capital will become even scarcer and banks will reduce lending to small businesses and retail lending, further hampering the economic recovery.

Finally, from a legal perspective, we do not believe that the Level 1 EMIR text must be interpreted as making these separate elements additive.

### **Questions for consultation**

#### **Q 1. Do you support this approach to capital requirements?**

We fully support the requirement for CCPs to maintain general capital plans on how they would raise new capital if it fell below the capital requirements and fully support the notion that CCPs should have a robust level of capital to ensure against unanticipated shocks and the possibility of insolvency/bankruptcy of the CCP itself. However, as noted above, we do not support the proposed “additive” approach to capital requirements.

We note that in its March Discussion Paper the EBA contemplated that “a CCP should hold capital, including retained earnings and reserves, that is at all times at least equal to the higher of the following two amounts: (i) its operational expenses during an appropriate time span for winding-down or restructuring its activities, and (ii) the sum of the capital requirements for the overall operational risk and for credit, counterparty and market risks stemming from “non-clearing activities” it carries out.” As stated in our response to that

paper, “we fully support [that] approach which we believe to be entirely appropriate for the determination of CCPs’ capital requirements. We believe that the focus of the capital requirements should in the first instance ensure that adequate capital is maintained in the CCP to absorb shocks, whilst ensuring that sufficient liquid resources are also available to support an orderly wind-down in the ultimate event of a catastrophic failure.”

We see no convincing rationale for the EBA’s having subsequently decided to propose that the separate requirements, for winding-down/restructuring and to cover the risks inherent in non-clearing activities, should be additive. Our reading of the Level 1 text is (as the EBA’s must have originally been) that a CCP must have enough capital for either eventuality but that the same capital resources would only be necessary for one or the other. We outline our rationale for this above.

The revised approach seems to have lost sight of the fact that the size of a CCP’s capital base is not relevant to its ability to perform as a “bulletproof” counterparty – what is necessary is that its margins/default funds are adequate to withstand major members’ failures. As can be seen in Annex 1, in the case of LCH Clearnet Group, Initial Margins of the largest member is 7 times higher than the proposed capital that the combined Group entities would have to hold under the EBA proposal. These resources, supported by robust rules and procedures for uncovered losses (required under CPSS-IOSCO Principles for Financial Market Infrastructure) that would come into effect should even these prove insufficient, are where the regulatory focus should be. Adjusting the CCP’s capital in the way proposed will provide little overall benefit when the overall risk resources available to a CCP will be significantly greater.

The proposed approach is inconsistent with both CPSS/IOSCO principles for Financial Market Infrastructure and rules proposed in the US pursuant to the Dodd-Frank Act which do not require separate capital for credit and market risks. This could place European CCPs at a disadvantage when providing services in the US and other third countries.

In addition, by increasing the capital requirements, the proposal could make bilateral transactions cheaper than centrally cleared ones and therefore make those types of transactions more attractive to market participants. This would run against the objectives of the G20 and regulatory community to incentivise the use of central clearing.

The EBA should take into account the fact that asking CCPs to raise large amounts of additional capital would create stress on the markets at an already difficult time. Such stress could outweigh the additional safety cushion that such extra capital would provide. Furthermore, non-publicly traded CCPs who cannot go to market to raise capital will need to go to their owners, in majority banks, which are already under capital pressures. Capital will become even scarcer and banks will reduce lending to small businesses and retail lending, further hampering the economic recovery.

The overall requirement has a direct impact on the amount of “dedicated own resources” that a CCP will have to include in its default waterfall – currently proposed by ESMA as

50% of the capital. We understand that the intention is that the 50% would be based on the CCP's capital requirement and would not include any additional capital that the CCP chose to hold (e.g. supervisory or internal buffers). Otherwise it would have the perverse effect of penalising CCPs that are more strongly capitalised. As we will state in our response to the ESMA Consultation Paper we view 50% as too high as it would run the risk of diluting a key incentive on members to participate in default management of an OTC position. By increasing the size of the "backstop" amount within a CCP, members are more likely to rely on the existence of this "backstop" and therefore less likely to try to contain the impact of a default before utilising the CCP's capital, thereby increasing systemic risk.

**Q 2. Do you have any other option to suggest that is not covered in this draft RTS?**

For the reasons outlined above, we believe that the best option is to revert to the original EBA proposal that the capital requirement should be the greater of the amount required for winding-down or restructuring and the amount required for operational, credit, counterparty and market risks stemming from "non-clearing activities".

The emphasis should be on ensuring that a CCP has sufficient capital to cover operational, credit and other risks whilst alternatively ensuring sufficient liquidity for an orderly wind down. The "higher of" approach can be justified by the fact that a CCP is always in either one of two states: going concern (i.e. running operational, credit, and other risks) or winding-down. As such, it only needs capital for one or the other. The focus of the regulation should be to ensure that CCPs have adequate financial resources to enable them to absorb significant shocks to avoid it being necessary to wind them down, particularly as winding down a more substantial CCP would be difficult to achieve without market dislocation.

If the additive capital requirements are nevertheless maintained in the final legislation, we would urge the EBA to make the adjustments proposed below to avoid damaging competitiveness by overstating capital requirements.

Treatment of multi-asset CCPs

The Consultation Paper suggests that in a wind-down scenario, a multi asset class CCP would have all asset classes impacted simultaneously. However, the requirement to have "living wills" should help to avoid, in the case of CCPs covering multiple asset classes, contagion between them.. This should enable some asset class services to close before the CCP's capital is affected. If we assume a CCP has four asset classes (e.g. Fixed Income, Swaps, CDS and Forex), each with a segregated default fund and service closure provisions, an extreme but plausible scenario would be that before wind-down two services (e.g. Fixed Income and CDS) would be closed and the CCP would only have two remaining services (Swaps and Forex) for which capital should be held. It does not seem plausible that all four services would close simultaneously and lead to the winding up of the CCP.

The RTS should therefore recognise that a multi-asset class CCP that has a level of operational independence across its asset classes sufficient to prevent contagion ('living wills') should only have to hold capital against the closure a proportion of its services. We would suggest that a CCP needs to hold enough capital against the two services giving rise to the largest closure costs. Therefore, a multi-asset class CCP should only calculate ongoing annual expenses for these two services for the wind down scenario.

#### Discretionary and non-cash costs

The Consultation Paper suggests that a CCP's wind-down expenses are equivalent to its operational expenses for an appropriate time span for winding-down. This is inappropriate as, in the wind-down state, there are numerous business-as-usual and development activities that a CCP would not be carrying out (for example marketing, strategic systems investment) whilst other material discretionary expenditure, for example bonuses, would be significantly reduced. Please also see our response to Question 10 below. In addition, the standards should clarify that the applicable accounting framework should ensure exclusion of non-cash costs from winding down expenses (e.g. depreciation and amortisation).

#### Timeframe for wind-down

The EBA Consultation Paper proposed a minimum of 12 months of operating costs for winding down. Given the systemic importance of CCPs, a wind down and transfer of positions of the clearing members to another CCP would need to be executed sooner than 6 months. We suggest that the wind down period should be linked to detailed plans that need to be constructed by CCPs to assess the length of times in which to achieve an orderly wind down with a minimum time period of 6 months as prescribed by CPSS/IOSCO to maintain a level international playing field.

#### Drafting suggestions on Article 6:

1. In order to calculate operational expenses referred to in Article 3, a CCP shall firstly calculate its ongoing annual expenses referred to paragraph 2, secondly, divide the resulting number by twelve in order to determine its monthly operational expenses; and finally multiply the resulting number by its estimated winding-down or restructuring period. The estimation of the winding-down or restructuring period is subject to a floor of ~~twelve~~ **six** months.

**A CCP that can demonstrate to its competent authority that the level of operational independence across its asset classes is sufficient to prevent contagion from one asset class to another may calculate its ongoing annual expenses for wind down scenario on the two services that give rise to the largest such expenses.**

2. Ongoing annual gross expenses of a CCP are:

Staff costs, which are:

- (i) Wages, salaries and other employees' remunerations (including variable remuneration)
- (ii) Salaries charges and social insurance,
- (iii) Other employees' expenses/staff costs **less any amounts accrued for discretionary bonus,**
- (b) Non-discretionary external costs, which are expenses related to:
  - (i) Offices and building rents,
  - (ii) Software and equipment,
  - (iii) Communications,
  - ~~(iv) Travelling, marketing and promotion,~~
  - (v) Professional services and outsourcing,
  - (vi) Information services,
  - (vii) Energy and heating,
  - (viii) Security, cleaning and maintenance,
  - ~~(ix) Publications,~~
  - ~~(x) Consulting services~~
  - (xi) Legal services,
- (c) Taxes,
- (d) Losses related to operational failures,
- (e) Other expenses as defined in the applicable accounting framework.

**A CCP that can demonstrate to its competent authority that an activity listed in the sub - paragraph above would not be conducted in a wind down situation may deduct the costs associated with this activity from its operational expenses.**

The CCP shall also include additional costs that may occur in case of winding-down or restructuring its activities.

**Q 3. Do you consider there to be any alternative approach which is more appropriate that would be consistent with Article 16 of the Regulation?**

See response to Q 2

**Q 4. What is the incremental cost to your CCP for the implementation of this proposal?**

LCH Clearnet regulated entities are already currently required to hold capital to cover operational risks, credit risks (treasury activities) and market/counterparty credit risk (prospective risk to earnings and capital arising from a decline in the value of a member's portfolio of assets due to changes in market factors).

For reasons of commercial confidentiality we are providing separate data separately to the EBA indicating the potential impact on LCH.Clearnet under various scenarios.

**Q 5. What is the incremental benefit to your CCP for the implementation of this proposal?**

We see no benefit to us from the implementation of this proposal in comparison with the original proposal.

**Q 6. What is the incremental cost for the supervisors for the implementation of this proposal?**

This question is for the supervisors to answer.

**Q 7. What is the incremental benefit for the supervisors for the implementation of this proposal?**

This question is for the supervisors to answer.

**Q 8. What is your view on the notification threshold? At which level should it be set?**

As stated in our response to the March Discussion Paper, we believe that given the systemic importance of CCPs the notification threshold should be set at perhaps 120%. As a result we are content with the proposal of 125%. We believe the CCP's capital should be compared with its regulatory requirement daily and all breaches reported to supervisors the same day.

However we believe that this should be calculated with reference only to the risk requirement and not the operational expense requirement, should both be retained. Likely decreases of capital that may or may not happen on a regular basis are based on a going-concern principle and consequently should not relate to an event of wind-down or restructuring. This capital requirement is likely to be fixed annually as it is less variable.

**Q 9. In your view, in which case should restriction measures be taken by the competent authority once the notification threshold is breached?**

As stated in our response to the March Discussion Paper, measures should always be taken once the notification threshold is breached. This should include at least heightened supervision and discussion with the CCP on the timeline and process to return above the threshold. We do not however believe the CCP's activities should be restricted during this period except in exceptional circumstances or where the capital requirement is breached.

**Q 10. Which criteria do you take into account for estimating the appropriate time span for orderly winding down or restructuring of the CCP's activities?**

The following criteria are taken into account:

- the ease to transfer products to another CCP (e.g. cash equities, repos, listed derivatives are easier to transfer than OTC derivatives).
- time and costs associated with the closing of IT contracts.

We do not agree with the proposal for the calculation of gross expenses in Article 6.2. In the case of LCH.Clearnet, current operational expenses are those of a business in a "build" phase, not a wind-down process. Specifically, the following should be excluded:

- exceptional items which would not be incurred
- roll-off of operating costs, staff etc. in line with 'living wills' plans
- wind-down / elimination of strategic project costs, hiring plans etc.
- intercompany costs which would not be charged
- non-cash items (depreciation & impairments)
- variable remuneration such as bonuses and long-term incentive plans
- travelling, marketing and promotion
- most professional, consulting, and legal services (i.e. apart from those necessary for the wind-down/restructuring), and
- publications.

See also our comments under Question 3 above.

**Q 11. What is your estimation for the number of months necessary to ensure an orderly winding-down or restructuring of the CCP's activities?**

As stated in our response to the earlier Discussion Paper, we believe that a maximum of six months would be sufficient for an orderly wind-down or restructuring. Given the systemic importance of CCPs, a wind-down and transfer the positions of the clearing members to another CCP would need to be done more quickly than over 12 months.

If CCPs are going to construct detailed plans which assess the length of time in which to achieve an orderly wind down the plan period should be allowed to be used, provided it is above the 6 months. This would also ensure harmonisation with the period identified in the CPSS-IOSCO Principles for Financial Markets Infrastructures.

**Q 12. What is the incremental cost or benefit to your CCP of this proposal assuming that the time span for winding down or restructuring a CCP's activities is 12 months?**

We understand the question to ask what would be the incremental cost of using a wind down period of 12 months instead of 6 months.

The costs would be half of the wind-down cost plus half of that amount as dedicated own resources in the default waterfall. Further information is provided separately.

**Q 13. How do you currently measure and capitalise for operational risk?**

Our capital requirement on operational risk is currently calculated following the Basic Indicator Approach, i.e. 15% of 3 years' average unadjusted net revenues.

**Q 14. Do you think that the banking framework is the most appropriate method for calculating a CCP's capital requirements for operational risk? If not, which approach would be more suitable for a CCP?**

The banking framework is the most appropriate as it proposes various approaches to measure the capital requirement (from simple to complex approaches) and provides, as well as the capital requirement itself, clear guidance on the qualitative aspects of the necessary operational risk framework. This second element is an important part of the overall operational risk mitigation framework.

**Q 15. Do you think that the Basic Indicator Approach set out for banks is appropriate for CCPs?**

As a starting point, the BIA is appropriate as it is a simple calculation methodology on the basis of revenues of CCPs or banks. However, CCPs' revenues are not commensurate with the inherent operational risk arising from risk scenarios such as the default management process, system failure over a long period or internal fraud via its payment systems.

Therefore BIA could be appropriate but in the case of a CCP with low revenues (whether from low levels of business or because of its business model), the capital requirement for operational risk may be low but could understate the real risks which could be much larger. In this case the EBA should consider a floor of minimum capital, possibly related to the type of asset cleared (higher for more complex instruments).

We assume (and support) that the EBA is proposing that the Basic Indicator Approach would be 15% of 3 years' average unadjusted net revenues.

**Q 16. In your view, which alternative indicator should the EBA consider for the Basic Indicator Approach?**

We do not have a view on an alternative indicator for the BIA.

**Q 17. What would be the incremental cost of employing the basic indicator approach set out for banks for the calculation of your capital requirements for operational risk?**

For us there would be no additional cost as this is already observed by both Group entities.

**Q 18. Do you think CCPs should be allowed to calculate the capital requirements for operational risk with an internal model, as in the advanced measurement approach?**

As the Advanced Measurement Approach is a more elaborate model intended to better tailor the level of operational risk for banks, it should also be considered for CCPs. However, the AMA needs to take into account internal and external losses which are difficult to obtain today for CCPs' activities. The AMA may therefore have to be adapted to cater for that lack of information and allow a specific AMA treatment for CCPs that could be mainly based on scenario analyses. Regulators should then ensure consistency between those scenarios across CCPs. The scenarios could be, for example, default management process failures, major system interruptions, model error or internal fraud.

This would be appropriate provided the scenarios take into account the nature of the products cleared (operational risk is different for cash equities, listed derivatives or OTC derivatives), the volumes and gross/net positions, and the capacity for early detection of operational risk via internal control.

**Q 19. Which other approaches should the EBA consider for operational risk measurement?**

We do not suggest alternative approaches.

**Q 20. What are the incremental costs and benefits to your CCP for the implementation of the advanced measurement approach for operational risk?**

Because of the 80% floor and high implementation costs, the benefits are likely to be minimal and CCPs will have little incentives to use the more risk sensitive AMA approach.

**Q 21. Do you think CCPs should be allowed to calculate the capital requirements for market, credit and counterparty credit risks with internal models?**

Yes, we believe that CCPs should be able to use internal models if such models are appropriate to the risks that CCPs actually face in their "non-clearing" activities. Their use

would provide a CCP's management and potentially users with a significantly more sensitive and valuable measure of the risks they are running. A CCP that is clearing a range of products especially OTC derivatives should not be prevented from using such models, subject to supervisory approval.

**Q 22. How do CCPs currently measure and capitalise for credit, counterparty credit and market risk stemming from non-covered activities?**

We apply the Standardised Approach of 8% weighting on the positions.

**Q 23. Do you think that the banking framework is the most appropriate method of calculating a CCP's capital requirements for credit, counterparty credit and market risk stemming from non-covered activities?**

Yes, as non clearing activities are mainly related to the investment of members' funds in the market, which is similar to a banking activity and triggers the same types of risk. Use of a harmonised framework will help to create level playing field for all CCPs. For smaller CCPs with (theoretically) lower risks, they will end up with lower risk assessments so it is not unbalanced nor unfair. We do not believe that it would be a major overhead for smaller CCPs as there are standard calculations permissible which do not require significant modification. In general, just as there are smaller banks which run less risks than larger banks, there are smaller CCPs which run less risks: use of the same approach by all should derive appropriate requirements.

**Q 24. What are the incremental costs or benefits to your CCP of this proposal assuming that for credit risk stemming from non-covered activities is computed with the approach required in Article 8?**

For us there would be no additional cost as this is already observed by both Group entities.

**Q 25. What are the incremental costs or benefits to your CCP of this proposal assuming that for counterparty credit risk stemming from non-covered activities is computed with the approach required in Article 8?**

For us there would be no additional cost as this is already observed by both Group entities.

**Q 26. What are the incremental costs or benefits to your CCP of this proposal assuming that for market risk stemming from non-covered activities is computed with the approach required in Article 8?**

For us there would be no additional cost as this is already observed by both Group entities.

**Q 27. Do you think that CCPs, should be allowed to calculate their capital requirements for credit, counterparty credit and market risk using internal models?**

See answer to Q 21.

**Q 28. In your view, which other approaches should the EBA consider for credit, counterparty credit and market risk measurement?**

We do not propose any other approaches.

**Q 29. What other risks should be considered in Article 9?**

We do not propose coverage of other risks.

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We urge the EBA to consider these arguments carefully. No CCP is more concerned about the safety of the world's financial markets than LCH.Clearnet and our history fully bears this out. The prospect of developing an efficient European financial system that remains properly competitive with third countries must not be destroyed through the introduction of disproportionate requirements, the cost of which would ultimately be borne by European enterprises and individuals.

Yours faithfully,

A handwritten signature in black ink, appearing to read 'Ian Axe', written in a cursive style.

Ian Axe  
Chief Executive Officer