European Banking Authority
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April 2 2012

Dear sirs,

This paper provides the response of the LCH.Clearnet Group (“LCH.Clearnet”) to the EBA’s Discussion Paper on Draft Regulatory Technical Standards on the capital requirements for CCPs under the draft Regulation on OTC Derivatives, CCPs and Trade Repositories (EBA/DP/2012/1).

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, established in 1888, has unrivalled experience in clearing and particularly in the clearing of OTC derivatives, making it uniquely qualified to contribute to the regulatory process for CCPs being undertaken by the ESAs. Below we introduce LCH.Clearnet’s OTC derivatives services before replying to the EBA’s questions.

LCH.Clearnet’s SwapClear service

LCH.Clearnet‘s SwapClear is the only truly global clearing service for interest rate swaps and currently clears more than 50% of the IR swap market, measured by notional principal. The over one million trades in SwapClear have an aggregate notional principal amount of over USD 283 trillion, with a further USD 110 trillion of cleared transactions removed through multilateral trade compression.

Launched in 1999, SwapClear initially cleared plain vanilla IR swaps in four major currencies. Today, it clears swaps in 17 currencies: USD, EUR, and GBP out to 50 years, AUD, CAD, CHF, SEK and JPY out to 30 years and the remaining nine currencies out to 10 years. The SwapClear service also clears overnight index swaps out to two years in USD, EUR, GBP, and CHF. Over the last 10 years, we have worked closely with market participants to build SwapClear into the leading OTC clearing service providing a range of benefits to the market. LCH.Clearnet successfully closed out the Lehman Brothers International Europe IR swap portfolio that comprised USD 9 trillion of notional in 5 currencies out to 30 years maturity; this is testament to LCH.Clearnet‘s deep expertise, provenance and risk management practices in clearing OTC derivatives markets in both normal and default environments. More recently, SwapClear has implemented end-user client clearing in both Europe and the U.S..

LCH.Clearnet’s CDSClear service

LCH.Clearnet’s Eurozone CDS clearing offering was launched in response to regulator and market demand in order to offer greater choice to the market. LCH.Clearnet defined its model keeping in line with market practices, which have been standardised through the successive ISDA Small and Big Bang protocols.

Existing key providers which have been incorporated into the process are: the DTCC Matching Platform, DTCC’s Trade Information Warehouse, Markit as the product and price provider, and ISDA for the contract characteristics and procedures. The business model provides added value to future participants through full STP multilateral clearing, guarantee and anonymity (including novation at T+1).

The offering encompasses the core requirements as determined by key industry and policy groups, including ISDA, CESR, the ECB and the European Commission. LCH.Clearnet provides participants with a backloading facility in order to upload portfolios of existing CDS contracts into clearing at the business start.

LCH.Clearnet’s Enclear service

The Enclear service provides an independent clearing service for the registration of OTC Forward Freight Agreements (FFAs) as well as OTC commodity swaps in Coal, Iron Ore and Fertiliser. All of these swaps are cash settled on a monthly basis. Globally-based chartering companies, ship owners, producers, and trading companies are increasingly managing their risk through cleared products. Approved Brokers have open and equal access to the service and can register their OTC brokered trades with LCH.Clearnet through a clearing member.

LCH.Clearnet’s ForexClear Service

ForexClear provides clearing for FX Non-Deliverable Forwards (NDFs) and was designed in close collaboration with our members. The service has launched with clearing between direct clearing members, whilst actively consulting with clients to deliver a full clearing service to other current and prospective clearing members, and their global clients in due course.

NDFs are cash settled products, actively traded in a range of high growth economy currencies. From launch the service clears NDFs in the following currencies – Brazilian Real, Chilean Peso, Chinese Yuan, Indian Rupee, Korean Won and Russian Ruble, all against the United States Dollar. Further currencies are being added to the service with the aim to provide 95% market coverage.

Our response to EBA’s Discussion Paper

LCH.Clearnet has been a major contributor to the regulatory dialogue relating to clearing and OTC derivatives over many years and is pleased to offer its comments. LCH.Clearnet’s

CCPs LCH.Clearnet Ltd and LCH.Clearnet SA are also members of EACH, the European Association of CCP clearing houses, and have contributed to its response.

We strongly support the EBA's goals in establishing European capital standards for CCPs clearing all asset classes. We believe it is vital that CCPs across Europe and globally observe standards that are high and that support the continuing development of financial markets. We also support the work of the European Commission and the EBA in other fora such as CPSS-IOSCO in seeking global regulatory agreements in this and other areas.

The LCH.Clearnet Group Ltd is the parent company of two separate CCPs: LCH.Clearnet Ltd, located in the UK, and LCH.Clearnet SA, located in France. LCH.Clearnet Ltd is a Recognised Clearing House regulated and supervised by the UK FSA. LCH.Clearnet SA is an établissement de credit regulated and supervised by the French Autorité de Contrôle Prudentiel. Under European banking regulation therefore both the LCH.Clearnet Group and LCH.Clearnet SA are already subject to the Capital Adequacy Directive (derived from the Basel II capital adequacy framework).

1 Introduction

Q1. Do you support this approach to capital requirements?

We fully support this 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.

In our view, CCPs should (as required by EMIR) also have some dedicated own resources ahead of the general default funds. These should be calculated to encourage the right behaviours and ensure that adequate initial margin is maintained to underpin the stability of the CCP.

We also believe that it would be beneficial to require greater transparency over the financial performance and, in particular, capital positions of CCPs, even where these are part of larger groups. This information should be published on a timely basis, perhaps within around three months of the year-end.

It will be important to ensure that in cases where CCPs are banks or credit institutions it does not lead to different or conflicting requirements. We do however have a concern arising from the statement in paragraph 10 that "The Regulation goes beyond the CPSS-IOSCO Principles". Many European CCPs compete with CCPs in third countries that are not (yet) subject to a similar regime. We urge the EBA to work with global CCP regulators to ensure equivalent treatment in all major jurisdictions.

Q2. Do you consider there to be any alternative approach which is more appropriate that would be consistent with Article 12 of the Regulation?

We do not consider that there is a superior alternative approach, but would be very happy to discuss any other proposals that are made to, or by, the EBA.

2 Operational expenses for winding-down or restructuring

Q3. 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 criteria include (i) the time to close out and/or transfer customer/member trading positions and collateral, (ii) the time to clear down employment and service contracts, and (iii) the time to close out third-party supplier contracts.

Q4. What is your estimation for the number of months necessary to ensure an orderly winding-down or restructuring of the CCP's activities?

Some products that could be easy to transfer to another CCP (e.g. cash equities, repos, listed derivatives) but others would be more difficult (especially OTC derivatives). Also the closing of IT contracts can take time and cost money. Within these parameters we believe six months should be an adequate period.

Q5. Do you think that a minimum list of items to be included in the operational expenses could be useful, such as the IAS 7?

We believe the benefits of a prescribed list may be outweighed by the risk of being too prescriptive if it does not take specific circumstances of the CCP into account. For example, in IAS 7 there is no distinction between operating and project expenses, the latter of which by nature would be more easily brought to a relatively immediate halt should a wind-down of activity be required. This would be consistent with current FRR practice. We believe in-year cost reductions should be allowed to be included, and we believe that (as is allowed by the US CFTC) eligible income for next year should be allowed to be offset against future wind-down costs in the case where revenues could be reasonably be expected to continue for some or all business lines. There may be a case for deducting accrued bonuses as these are unlikely to be payable under such circumstances.

In addition the Group has specific arrangements with certain groups of banks for clearing of OTC asset classes whereby the banks advance funds for project development and can only recover these advances out of surpluses made by the services. In a wind-down situation these liabilities would no longer be due and therefore the Group would request these liabilities to be netted out from the calculations.

3 Capital requirements for operational risk

Q6. 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.

Q7. 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.

Q8. What would be the 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.

Q9. 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).

Q10. In your view, which alternative indicator should the EBA consider for the Basic Indicator Approach? (Please elaborate why such indicator would be more appropriate for CCPs).

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

Q11. In your view, with regard to the Standardised Approach, which different lines of business or type of products can be relevant for CCPs' operational risk?

The 2 business lines are payment and settlement (18%) and trading and sales (18%). Where large amounts are paid and invested by the CCP, operational risk in these areas could give rise to significant losses. It may be appropriate to change the current standardised approach to be product oriented (i.e. cash equities, fixed income, listed derivatives, commodities, swaps, forex, CDS).

Q12. 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 CCP's. 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.

A first step could be the definition of a standardised approach for CCPs (based on product, volumes, and amounts) but also allow the alternative approaches for CCPs who want to do more.

Q13. Which other approaches should the EBA consider for operational risk measurement?

None suggested.

4 Capital requirements for credit and market risks stemming from "non-clearing activities"

Q14. How do you currently measure and capitalise for credit, counterparty credit and market risk stemming from "non-clearing activities"?

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

Q15. 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-clearing activities"? If not, which method would be more suitable for a CCP?

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.

Q16. What would be the cost of employing Standardised Approach methods for the calculation of your capital requirements for credit, counterparty credit and market risk stemming from "non-clearing activities"?

There would be no significant incremental cost as we already apply this approach.

Q17. In your view, are the Standardised Approach methods appropriate for the calculation of credit, counterparty credit and market risk a CCP faces stemming from "non-clearing activities"?

Yes, as the risks are similar to those borne by the banking sector.

Q18. Do you think that CCPs, which concentrate risks stemming from derivatives, should be allowed to calculate their capital requirements for credit, counterparty credit and market risk using internal models?

We do not see the use of such models as appropriate for the risks addressed in this Discussion Paper. However we do believe that internal models should be permissible for the calculation of a CCP's "hypothetical capital" as part of the calculation of capital requirements for exposures to CCPs' default funds as envisaged by the proposed Capital Requirements Regulation.

Q19. In your view, which assets held by a CCP should be better capitalised with a market risk treatment?

We do not believe any other assets would be better capitalised under a market risk treatment.

Q20. In your view, which other approaches should the EBA consider for credit, counterparty credit and market risk measurement?

As those risks are similar to those run in the banking sector, the same approaches should be followed.

5 Other risks, monitoring and reporting

6 Notification threshold

Q21. What is your view on the notification threshold? At which level should it be set?

We believe that given the systemic importance of CCPs the notification threshold should be set at a higher level – perhaps 120%. We support the proposal that CCPs should maintain general capital plans, which should be approved by the Board at least annually.

Q22. In your view, in which case should restriction measures be taken by the competent authority once the notification threshold is breached?

Measures should always be taken once the notification threshold is breached. This should include at least supervision and discussion of 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 100% threshold is breached.

7 Cost-benefit Analysis

See spreadsheet sent with this document.