CPSS secretariat
c/o Bank for International Settlements
Centralbahnplatz 2
Basel
Switzerland

IOSCO secretariat
C/ Oquendo 12
28006 Madrid
Spain

11 October 2012

Dear sirs,

CPSS/IOSCO Consultative Report on the recovery of financial market infrastructures

This paper provides the response of the LCH.Clearnet Group ("LCH.Clearnet") to CPSS and IOSCO's consultation on "Recovery of financial market infrastructures" of August 2013. Our response focuses on the recovery of Central Counterparties (CCPs).

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: cash equities, exchange traded derivatives, commodities, energy, freight, interest rate swaps, credit default swaps, bonds and repos and foreign exchange derivatives.

Overarching comments

We support the objective of recovery plans which is that CCPs can continue to provide critical services under stress scenarios and welcome CPSS/IOSCO's guidelines in this respect. We would however like to emphasize the following points:

- We would urge CPSS/IOSCO to use all its power and influence to encourage individual jurisdictions to take a common approach to implementing any final proposals. We recognise that separate jurisdictions will necessarily be starting from different positions and may not be able to move together at the same speed. Nevertheless in this issue of fundamental importance to systemic stability a harmonised global approach is vital. Some jurisdictions, such as the UK, have already enacted law that require CCPs to have recovery plans in place in early 2014, while others jurisdictions are waiting for international guidelines in this area. We are concerned that this could lead to inconsistent requirements on CCPs that may ultimately result in an unlevel playing field.

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- We welcome the recognition in the report that CCPs should have flexibility in the *design and implementation* of recovery tools.
- We believe that recovery of a CCP may be more efficiently and safely achieved if, where the CCP has established a separate default waterfall in respect of specified product lines, its product lines are capable of being 'recovered' separately.
- Provisions should be made to protect directors of a CCP from legal risk where they take actions pursuant to directions given to them by an authority during recovery.

Recovery and resolution phases

The boundaries between 'business as usual', recovery and resolution phases must be clearly established.

In the case of losses occurring from a participant default, we believe the recovery phase should start when the pre-funded financial resources are exhausted. In the case of losses occurring from other sources than participant default, recovery should start when the CCP's capital is below the minimum regulatory capital.

It is essential that CCPs are allowed to implement their recovery tools before authorities intervene. We therefore support the conditions for entry into resolution defined in the FSB report on the 'Application of the Key attributes of Effective Resolution Regimes to non-Bank Financial Institutions'. The resolution authorities should only step in where the recovery measures taken by the CCP have failed to return the CCP to viability or have not been implemented in a timely manner so that it is clear that they will fail; or where the resolution authorities determine at the time of the event that recovery measures will not be sufficient to return the CCP to viability or would otherwise compromise financial stability.

Judgement in the use of tools

We agree that recovery tools should be established ex-ante and transparent so that those bearing the losses understand how these will be allocated. However, CCPs may still need to exercise judgement on the use or timing of a tool. We therefore welcome the recognition in the report of the need for an appropriate balance between the automatic application in a given situation and discretion by the CCP to use its judgement. We believe that the discretion is particularly important for losses that do not occur from a participant's default, as the size of the losses could be difficult to quantify ex-ante.

Stress scenarios

We believe that the report accurately identifies the stress scenarios that a recovery plan should address credit loss or liquidity shortfalls created by a participant default, general business losses, investment losses and losses from failure of a third party.

Tools to allocate uncovered losses caused by participant default

We believe that recovery of a CCP may be more efficiently and safely achieved if, where the CCP has established a separate default waterfall in respect of specified product lines, its product lines are capable of being 'recovered' separately. This will ensure that participants are only exposed to defaults in product classes in which they participate. We believe that the extent to which direct participants would pass on these losses to their clients should be subject to contractual arrangements between them. Concentrating losses with direct participants may have broader consequences on financial stability.

The report identifies cash calls on participants, Variation Margin (VM) haircutting and Initial Margin (IM) haircutting as tools to address uncovered losses from a participant's default. We agree that such tools should only be used when the default fund has been exhausted.

Cash calls on participants is an efficient tool that already forms part of LCH.Clearnet's default waterfalls. We agree with the report that these calls should be controllable and that CCPs should retain the ability to calibrate the amount. The cash calls can be used to replenish the CCP's financial resources or to enable CCPs to continue providing clearing services.

VM haircutting is a powerful tool that has the advantage of being controllable and aligning the interests of a CCP with those of its participants. In addition, unless VM haircutting is capped at less than 100% of the amount owed, the cumulative sum of clearing participants' VM gains since a participant's default would always be sufficient to cover the defaulter's mark-to-market losses in the same period. However, VM haircutting is not appropriate for all products cleared by a CCP. Where VM does not reflect realised losses/profits but rather collateral against fluctuations in the value of the cleared instrument and the members do not retain it on maturity, VM haircutting is not appropriate (e.g. for physically settled products such as repos, equities, commodities).

The report notes that IM haircutting may be used as a tool in recovery in jurisdictions where some or all of the initial margin may be exposed to claims of creditors other than the participant who posted it. We agree that IM has the advantages of being capped and controllable by clearing members, constituting a large pool of assets and not posing any performance risk. These advantages however need to be balanced with the drawback of having to replenish IM in stressed conditions and the capital implications that it would have for participants. IM haircutting is also inferior to VM haircutting in that it does not provide participants with an incentive to help the CCP to re-establish a matched book.

Tools to address uncovered liquidity shortfalls

We consider that the tools to address uncovered liquidity shortfalls should generally be separate to those which address credit losses.

CCPs have several sources of liquidity. The primary sources of liquidity for a CCP are the cash posted by its members to meet margin requirements and the cash contributions to Default Funds, as well as the CCP's own capital. Another primary source of liquidity for a CCP that has access to a central bank facility is non-cash collateral posted by its members that the CCP can pledge through the central bank window to generate liquidity on the same

day. If a CCP can access the non-cash collateral pledged by the defaulting clearing member, this margin collateral can also be used to meet liquidity needs. Finally, as highlighted in the report, CCPs can also rely on obtaining liquidity from participants who are owed funds by the CCP or by having arrangements with third party institutions

We believe that obtaining liquidity only from those participants who are owed funds by the CCP has several advantages compared with obtaining it from participants more broadly, which is the other option highlighted in the report. First it mitigates operational risk about having to call liquidity from third party providers. Second, it reduces the high cost of obtaining syndicated third party credit lines.

We also think that it is in the interest of financial stability that CCPs are able to obtain short-term liquidity from central banks against very high quality collateral in times of stress. This would ensure that a CCP that has sufficient financial resources to cover the losses from one or several participants' default is able to manage short-term liquidity. As noted in the report, a CCP may have insufficient funds to meet its financial obligations when due, even though it may be able to do so in the future. Some CCPs already have access to short-term liquidity from central banks and we would welcome this access being extended to all CCPs that meet the PFMIs. This would also ensure a level playing field among CCPs. In the same vein, we would like to stress that maintaining direct accounts at central banks or non-account services such as the US Fed's National Settlement Service facilitate a CCP's management of liquidity risk. We would encourage central banks to review their eligibility criteria in this respect.

Tools to allocate losses not related to participant default

The report indicates that CCPs will need to cover losses relating to general business, custody and investment or operational risk. We would like to stress that CCPs have robust frameworks in place to avoid these types of losses and in addition, in the EU, will need to hold capital to address these to comply with the European Market Infrastructure Regulation (EMIR). EMIR[1] requires CCPs to hold capital that is sufficient to ensure an orderly winding-down or restructuring of the activities over an appropriate time span and protect the CCP against credit, counterparty, market, operational, legal and business risks. In addition EMIR requires CCPs to notify their regulators if they hold less than 110% of the minimum required[2]. This means that EU CCPs will in practice operate with a 10% buffer that can be used to cover some of the losses envisaged in the report without breaching the minimum regulatory capital.

We believe that the appropriateness of a tool will depend on the magnitude of the losses and how the losses arise, including the timeframe over which they accumulate. The loss may be greater than the capital retained to cover them; contained within this level; or not quantifiable ex-ante. Each of these scenarios will necessitate different tools.

We support the statement in the report that an ex ante recapitalisation agreement is not an option for CCPs that are organised as limited liability entities.

1 Article 16 of EC Regulation 648/2012
2 Article 1(3) of EC Regulation 152/2013

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Tools for CCPs to re-establish a matched book

CCPs must have in place tools to re-establish a matched book following a participant's default. CCPs' rules should incentivise participants to bid in auctions undertaken as part of default management, but we believe that this should remain voluntary. Since there may however be circumstances where these incentives are not sufficient and the auction is unsuccessful, CCPs may for certain products benefit from rules that enable forced allocation to non-defaulting participants at a price determined by the CCP. We are in favour of voluntary partial tear-ups but not forced ones as this would also challenge net accounting criteria.

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We hope that CPSS and IOSCO find this contribution useful and we look forward to engaging further as policy options are developed. Please do not hesitate to contact Perrine Herrenschmidt at +44 (0)20 7426 7246 regarding any questions raised by this letter or to discuss these comments in greater detail.

Yours faithfully

Jacques Aigrain
Executive Chairman