LCH The Markets' Partner

Mr Pat Brennan
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Policy and Advance Division
Australian Prudential Regulation Authority

By email: policydevelopment@apra.gov.au

20 May 2016

Dear Sir,

Discussion Paper – Margining and risk mitigation for non-centrally cleared derivatives

LCH.Clearnet Group Limited ("LCH" or "The Group") is pleased to respond to the Australian Prudential Regulation Authority ("APRA") on the discussion paper on margining and risk mitigation requirements for non-centrally cleared derivatives.

The Group strongly supports APRA's goal of strengthening resiliency in the non-centrally cleared derivatives market by establishing margin requirements.

The comment letter provides a view on the overall approach of APRA on this extremely important topic which will help shape the future of the OTC derivatives market.

LCH Overview

LCH[1] is a leading multi-asset class and international clearing house, 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, foreign exchange derivatives, interest rate swaps, credit default swaps and euro, sterling and US dollar denominated bonds and repos. LCH works closely with market participants and exchanges to continually identify and develop innovative clearing services for new asset classes. LCH is majority owned by the London Stock Exchange Group, a diversified international exchange group that sits at the heart of the world's financial community. As an Australian clearing and settlement facility licensee, LCH provides clearing services for interest rate and inflation rate derivatives in Australia.

[1] LCH.Clearnet Group Limited consists of three operating entities: LCH.Clearnet Limited, the UK entity, LCH.Clearnet SA, the Continental European entity, and LCH.Clearnet LLC, the US entity. Link to Legal and Regulatory Structure of the Group:
http://www.lchclearnet.com/about_us/corporate_governance/legal_and_regulatory_structure.asp

LCH position

As a multi-asset class and international clearing house we have been responsible for deploying prudent risk management techniques across both OTC and exchange traded derivatives for many years. This experience gives us a unique point of view on this subject. We have invaluable experience in model design, collateral management and the operational processes of calling, collecting and settling initial and variation margins ("IM" and "VM", respectively).

LCH continues to be fully supportive of the G20 commitment to promote financial stability and reduce systemic risk in the OTC derivatives markets through the increased use of central counterparties. We recognise that clearing is not suitable for all products; however, where possible, standardised OTC derivatives should be cleared by a central counterparty. The benefits of CCP clearing have been recognised over many years in the OTC markets and any regulation should look to build upon the CCP model. Given the importance of the G20 objectives, we believe it is imperative that international regulatory and capital rules do not, whether directly or indirectly, disincentivise the use of central clearing for the promotion of financial stability.

LCH believes that due consideration should be given to the following areas in the context of margin requirements for non-centrally cleared derivatives:

- Commensurate margin
- International consistency
- Regulatory certainty
- Timing for the exchange of margin

The above aspects are discussed further below.

Commensurate margin

CCP margin models are subject to rigorous quantitative and qualitative regulatory requirements, and are maintained in compliance with such regulations. Further, CCPs employ extensive stress testing and, as a result, collect additional resources such as a default fund. These resources strengthen the protection afforded by clearing but are not without cost to participants. Critically, these extra resources are not present in a non-centrally cleared environment. LCH recognises that the margin requirements for non-centrally cleared contracts necessarily differ from those within a CCP framework; however we believe these differences should not disincentivise the use of CCPs. Should a CCP be authorised to offer a clearing service for a specified asset class, this should be seen as recognition by the CCP's regulators and policy makers that centrally clearing this asset class will further promote financial stability and reduce systemic risk. In such cases and in order to promote and incentivise the reduction of systemic risk, the overall capital and funding costs associated with centrally clearing these products should never be more than that required to hold the equivalent contracts in a non-centrally cleared environment.

International consistency

Significant divergence between major jurisdictions, resulting from the transposition of the BCBS-IOSCO framework, can have unintended consequences for the OTC derivatives market. Disparities in IM and VM calculations, eligible collateral and collection requirements for margin will all have an impact on a participant's funding costs and the pricing of derivatives contracts. Without international consistency, the true value of a derivatives contract may differ between regulatory regimes. This may give rise to regulatory arbitrage and bifurcation of the global liquidity pool. Consequently, a harmonised approach between regulators is essential to ensuring the OTC derivatives markets continue to operate efficiently.

Regulatory Certainty

The need for regulatory certainty should be a primary consideration for regulators. With the first participants set to exchange IM in September 2016, according to the BCBS-IOSCO final standards[2], the market must be given sufficient certainty of the rules to allow for implementation. Where changes to the rules are envisaged, they should be well communicated to the market to promote certainty, maintain international consistency and minimise implementation costs for participants. We support the early communication of final rules to allow participants adequate time for implementation in advance of September 2016. Any delay to the implementation dates, must be internationally coordinated to ensure the effective functioning of the OTC derivatives market.

Timing for the exchange of margin

We strongly support the principle of daily exchange of margins as a core component of the margin framework for non-cleared swaps. Timely exchange of both IM and VM is vital in achieving the genuine systemic risk reduction to which these measures are directed. LCH operates clearing services that support a number of large global marketplaces, and we calculate, call and collect margin with a frequency no less than daily (and often, more frequently).

Specific comments

<u>Variation Margin requirements</u>

- Introduction of a minimum qualifying level and extended implementation period for variation margin requirements

  LCH does not agree with the proposed introduction of a minimum qualifying level of AUD 3 Billion for VM requirements at the end of the phase-in period, and with the extension of the implementation timetable for margining groups with lower levels of activity. Indeed, these proposals are inconsistent with the BCBS-IOSCO framework and we believe that international consistency should be a key consideration. In our view, this partial alignment with the BSBC-IOSCO framework will create unnecessary complexity for clearing members in their compliance with margin requirements for non-centrally cleared transactions in Australia and globally.

Conclusion

CCP margin models have been developed over time under rigorous regulatory oversight. LCH recognises that the margin requirements for non-centrally cleared contracts may differ; however we believe these differences should only reinforce the G20 aim that "Non-centrally cleared

[2] BCBS-IOSCO (March, 2015) http://www.bis.org/bcbs/publ/d317.pdf

derivatives contracts should be subject to higher capital requirements" and the BIS aim that these margin rules should promote central clearing.

We hope that our comments will assist APRA in the development of the new margin rules for non-centrally cleared OTC derivatives in Australia. Should you have any questions on the response or wish to discuss it in detail, please do not hesitate to contact me at or my colleagues Juliet Lee ( ), Natalie Caldwell ( ) or Jean-Philippe Collin ( ).

Yours sincerely,

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Head of Regulatory Strategy and Post Trade Policy, Europe