

Secretariat of the Financial Stability Board
c/o Bank for International Settlements
CH-4002
Basel
Switzerland

2 September 2011

Dear Sirs,

Effective Resolution of Systemically Important Financial Institutions

LCH.Clearnet Group Limited (“LCH.Clearnet”) is pleased to respond to the Consultative Document on Effective Resolution of Systemically Important Financial Institutions issued by the Financial Stability Board (“the Board”) on 19th July 2011.

We applaud the progress that is being made in many jurisdictions towards implementation of the G20 commitments. LCH.Clearnet, as the world's leading independent clearing house group, is particularly well-qualified to comment on the legislative and regulatory processes under way globally, of which the question of resolution of Systemically Important Financial Institutions (“SIFIs”) is a key element.

The comments we submit in relation to this consultation focus on specific areas of particular concern to central counterparties (“CCPs”).

Improving resolvability

LCH.Clearnet fully supports the proposals listed in Annex 6 of the document concerning measures to improve resolvability and, in particular, the points raised at 4.3 in relation to second-tier FMI members and clients. Arrangements to enable clients to switch both positions and assets from one clearing member to another must be robust and reliable. Furthermore, they must fully respect the regulatory provisions to be enacted in different jurisdictions, for example in the European Market Infrastructure Regulation (“EMIR”)¹ and must enable clients that are subject to capital adequacy rules to obtain the preferential treatment proposed in the Basel Committee on Banking Supervision's (“BCBS”) proposals for revisions to the “Capitalisation of bank exposures to central counterparties” issued in December 2010.²

¹ <http://projectserver/Legislation/EU%20Legislation/EMIR/EMIR%20EC%20proposal%2015.09.10.pdf>

² <http://www.bis.org/publ/cpss94.pdf>, proposed paragraph 112

Conditions for a temporary stay on early termination rights

LCH.Clearnet does not believe that resolution authorities should have the power to impose a temporary suspension of any close-out rights of a CCP.

When taking emergency action, it is vitally important that a CCP can take whatever actions it chooses in order to protect surviving clearing members, clients of the defaulting member (depending on what, if any, provisions the CCP has in place to enable protection and portability of positions and assets relating to clients' cleared business), and the CCP itself. In these situations the CCP's primary defence is the collateral held as margin for the cleared positions; this margin, under all but the most extreme circumstances, should suffice to enable close-out or transfer of a member's positions. In order to determine how much margin (and default fund) is necessary, and also what liquidity facilities it needs, the CCP will make judgements about how long it could take to execute offsetting positions (whether on organised markets or over-the-counter) and to realise collateral. Any provision that has the effect of preventing the CCP from taking these actions immediately upon its declaration of default will both introduce greater uncertainty in, and disruption to, the affected markets and will significantly increase the margin and therefore collateral requirements that the CCP is likely to require from its members (and which its members will require from their clients).

When managing a default, the CCP may have to: a) close out the defaulting member's positions – typically by executing offsetting contracts in the market to offset the member's proprietary positions, and transferring positions and, if possible, collateral held in a member's client account(s) to another member, and; b) liquidate collateral provided by the defaulting member and held as margin. This may be in the form of cash, securities or other instruments, or documentary credits. While it may be possible to execute sell transactions for accelerated settlement of collateral, the CCP is likely to remain subject to the standard settlement cycle for the instrument in question (or be subject to terms agreed in a documentary credit). The CCP may also have to execute foreign exchange transactions in order to realise cash in the currency of its obligations. However the CCP will have sufficient liquidity facilities in place to ensure that it can continue to meet these obligations – settlement of variation margins or net purchases of securities from the surviving market members – without having to wait for the proceeds of the sale of collateral. The effect of a stay may not therefore have a significant effect on the process of realisation of collateral, but rather on the use of cash proceeds.

Any stay or moratorium on close-out netting would prevent the CCP from taking action to close out positions and apply collateral (in whatever form) to offset realised liabilities. During this time the markets will continue to trade – or even if they do not, prices will change – and the values both of the positions and of the collateral will remain volatile. A stay on the actions of the CCP to take these steps will increase the likelihood that, once the moratorium is lifted and collateral can be applied, it will prove insufficient, and so the CCP will require additional collateral to cover the extra market risk. Such a stay will also make it less likely that the CCP will wish to run the risk of transferring positions and margins held for a member's client account to another member because (where for example clients' positions are recorded in omnibus accounts) uncertainty over potential depreciation in the adequacy of the remaining collateral – that cannot be applied until the moratorium is lifted – might cause the CCP to

wish to hold on to that collateral and then close out, rather than transfer, positions in clients' accounts.

LCH.Clearnet also has concerns over exactly when the stay might take effect, and how entities are made aware of its existence. In order to protect the markets they serve, CCPs have a degree of discretion over if and when they choose to invoke their default rules, and it is perfectly possible that a CCP could have declared a default and started to take the actions described above before a resolution authority has taken its decision. To introduce a stay on close-out netting in the midst of a CCP's management of a failed member would add even greater confusion and uncertainty to what is likely to be an already volatile situation.

CCPs as SIFIs

LCH.Clearnet would like to take this opportunity to raise the question of the designation of CCPs as systemically important. As a matter of principle, we concur with the view expressed in the recent consultative report³ issued by the Committee on Payment and Settlement Systems and the Technical Committee of the International Organization of Securities Commissions, which states that: *"The presumption is that all CSDs, SSSs, CCPs, and TRs are systemically important because of their critical roles in the markets they serve. Authorities should disclose which CSDs, SSSs, CCPs, and TRs they do not regard as systemically important and to which they do not intend to apply the principles and provide a comprehensive and clear rationale."* Furthermore, the BCBS's proposals on capitalisation of bank exposures to central counterparties require that the specific treatment of exposures to CCPs should only be permitted *"where the supervisor substantially enforces the CPSS/IOSCO Principles for Financial Market Infrastructures on an ongoing basis"*⁴. Some regulatory authorities are expected to impose heightened prudential standards on CCPs that are deemed systemically important⁵ and enable them to have access to central bank facilities that would be denied to other entities⁶. Given the G20 commitment to require far greater use of CCPs to clear OTC derivatives and concerns raised by commentators that more CCPs will become "too big to fail" we believe it is right that most if not all CCPs should be seen as systemically important.

In this connection it is vital that the systemic importance of such CCPs should not be compromised by increasing the degree of their interconnectedness and exposure to other, less highly regulated, infrastructures.

In particular we believe that no CCP that is designated as systemically important should be permitted to enter into interoperability or cross-margining arrangements with another CCP, unless that other CCP is subject to the same degree of regulation and supervision as it will itself become *de facto* systemically important by virtue of its connection to the one designated as systemically important.

³ <http://www.bis.org/publ/cpss94.pdf>, para. 1.20

⁴ <http://www.bis.org/publ/bcbs190.pdf>, p. 9

⁵ See for example the CFTC's Notice of proposed rulemaking on Financial Resources Requirements for Derivatives Clearing Organizations at <http://www.gpo.gov/fdsys/pkg/FR-2010-10-14/pdf/2010-25322.pdf>

⁶ e.g. pursuant to Title VIII of the Dodd-Frank Act

Conclusion

We hope that the Board finds these comments helpful and constructive. LCH.Clearnet, as the world's pioneering OTC derivatives CCP group, fully shares the G20's and the Board's goals in ensuring a stable, safe and efficient global financial system and looks forward to continuing its participation in the policymaking debate. Please do not hesitate to contact us should you wish to discuss these or other matters in further detail.

Yours faithfully,



Ian Axe
Chief Executive Officer

About LCH

LCH.Clearnet is the world's leading clearinghouse group. It was formed out of the merger of the London Clearing House Limited and Clearnet SA and operates two central counterparty clearing houses or CCPs, LCH.Clearnet Limited in London and LCH.Clearnet SA in Paris. It serves 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, metals, energy, freight, interest rate swaps and euro- and sterling-denominated bonds and repos. LCH.Clearnet Limited currently clears more than 50% of the OTC interest rate swap market representing trades with a total notional principal of over \$300 trillion in 17 currencies. LCH.Clearnet SA cleared more than €42 billion notional value in OTC credit default swaps over the last year. LCH.Clearnet works closely with market participants and exchanges to identify and develop services for new asset classes, particularly in support of OTC derivatives market reforms.

LCH.Clearnet Limited is both a registered Derivatives Clearing Organization regulated by the Commodity Futures Trading Commission in the US and a Recognised Clearing House regulated by the Financial Services Authority in the UK. LCH.Clearnet SA is regulated as a Credit Institution and Clearing House by a regulatory college consisting of, amongst others, the market regulators and central banks from the jurisdictions of: France, The Netherlands, Belgium and Portugal. It is also regulated as a Recognised Overseas Clearing House by the UK Financial Services Authority.