

Via CFTC Portal

3 December 2019

Mr Christopher J. Kirkpatrick
Office of the Secretariat
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street NW
Washington, DC 20581

Re: Proposed LCH SA CDSClear Index Basis Packages initiative

Dear Mr. Kirkpatrick,

Pursuant to CFTC regulation §40.6(a), LCH SA, a derivatives clearing organization (“**DCO**”) registered with the Commodity Futures Trading Commission (the “**CFTC**”), is submitting for self-certification the amendments to the Reference Guide : CDSClear Margin Framework (the “**Rules**”) in order to allow index basis packages (“**IBP**”) margining as a single instrument.

The intended date of implementation is December 30, 2019, subject to any relevant regulatory review or approval process duly completed and in no event, the changes will be implemented earlier than ten (10) business days after the formal filing with the CFTC.

The submission changes made to the Rules are attached hereto as Appendix¹.

Part I: Explanation and Analysis

LCH SA is proposing to amend its CDSClear Risk Methodology in order to consider any relevant and identified Index Basis Packages identified as a single instrument.

LCH SA currently clears CDS on a number of indices such as iTraxx Main, iTraxx Cross-over, iTraxx Senior Financials as well as all the Single Name constituents of these indices. The iTraxx Subordinated Financials indices will soon be made eligible for clearing as well². Indices and their constituents are currently managed and margined as independent instruments.

¹ All capitalized terms not defined herein have the same definition as the Rule Book, Supplement or Procedures, as applicable.

² Subject to regulatory review/approval process duly completed

However, market participants may execute Index Basis Packages consisting of an Index CDS trade and individual Single Name CDS trades on each of the reference entities constituents of such Index perfectly offsetting the index.

The following criteria would need to be required to constitute an Index Basis Package:

- The package is constituted of an Index CDS and Single Names CDS on all the entities constituting the index,
- The position (Long /Short) on the Index offsets the positions on the Single Names (Short / Long),
- The notional of the Index and across all the Singles Names match exactly,
- All the Single Names CDS trades to have the same currency, coupon and maturity as the Index CDS,
- All the Single Name CDS trades to have the same Seniority, ISDA Definition and Restructuring Clause than as constituents of the Index.

Clearing Members and/or Clients will be required to identify all trades being part of an Index Basis Package and to notify LCH SA CDSClear. CDSClear would then perform controls to ensure all principles and requirements stated above for qualifying the trades as an Index Basis Package are satisfied and would flag them with a common ID number. These trades will continue to be margined as different trades until these tasks and controls have been fully completed and the qualification as an Index Basis Package confirmed.

Once an Index Basis Package is validated as complete, the margin enhancement proposed in the current rule change would then be applied as part of the overnight margin calculation.

In order to ensure that the trades continue to meet the criteria of an Index Basis Package, controls will be performed every day at the start of the overnight batch process.

Index Basis Packages identified and flagged as such will be excluded from compression runs with the rest of the portfolio in order to avoid breaking any packages.

Index Basis Packages can be un-flagged as such at the Clearing Member and/or Client's request. The Index CDS and the Single Name CDS would then be treated and margined separately as per the current framework.

In case of a Clearing Member's default, CDSClear will have the ability to liquidate Index Basis Packages in a dedicated auction should it be advised to do so by the Default Management Group in order to minimize the liquidation costs.

Part II: Description of Rule changes

1) CDSClear Risk Methodology

In order to take into account the specific risk created by Index Basis Packages positions, LCH SA proposes to amend the calculation of the Spread Margin and the calculation of the Liquidity Charge Margin as described in its Reference Guide, CDSClear Margin Framework.

LCH SA CDSClear currently considers an Index Basis Package as multiple instruments in the calculation of its Spread Margin. In accordance with the portfolio margining requirements under Article 27 of Commission Delegated Regulation (EU) No 153/2013³ (the “RTS”), LCH SA CDSClear applies a cap of 80% to the possible margin offsets reduction.

Therefore the Spread Margin of an Index Basis Package is calculated as the maximum between the expected shortfall of the package and 20% of the sum of the expected shortfalls calculated for each components of the package.

Considering that this does not appropriately reflect the actual risk of an Index Basis Package meeting the criteria stated above, CDSClear is proposing to amend its CDSClear Risk Methodology in order to consider Index Basis Packages identified as such as a single instrument when calculating the amount of margins required. In particular, the 80% cap on offsets between the components of the Index Basis Package would not be applied in the calculation of the Spread Margin, but would be maintained between an Index Basis Package and all the other positions in the portfolio.

In the opinion published in April 2017⁴ and clarifying the application of Article 27 of the RTS, the European Securities and Market Authority (“ESMA”), acknowledges the low level of risk presented by a package consisting in a future on an index and futures on each of the constituents of the index and allows a CCP to acknowledge margin reduction in excess of 80% in this specific case.

Considering that an Index Basis Package would likely be sold off in a dedicated auction in case of default of a Clearing Member, LCH SA also proposes to amend the calculation of the Liquidity Charge Margin described in the CDSClear Risk Methodology in order to better reflect the actual cost it would incur when liquidating an Index Basis Package. CDSClear proposes to charge a specific bid/ask spread for each Index family underlying an Index Basis Package identified as such rather than use the current Liquidity Charge Margin algorithm based on charging bid/ask spreads for each individual component in the package taken independently. The current Liquidity Charge Margin methodology will nevertheless remain in the calculation specific to Index Basis Packages identified as such by acting as a cap to the new calculation method.

Finally, Index Basis Packages flagged as such would be excluded from the Recovery Risk, Interest Risk, or Wrong Way Risk Margin calculations as by construction Index Basis Packages are immune to the risks these margins aim at capturing.

³ <https://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:052:0041:0074:EN:PDF>

⁴ https://www.esma.europa.eu/sites/default/files/library/esma70-708036281-18_opinion_on_portfolio_margining.pdf

No other changes are made to the CDSClear Risk Methodology.

2) CDS Clearing Rules:

The CDS Clearing Rulebook, Supplement and Procedures will not need to be amended for the IBP initiative purposes. Only one new Clearing Notice is expected to be published, this notice defines what an IBP is and the procedure to be followed to request a set of Cleared Trades to be identified as an IBP.

Part III: Core Principle Compliance

LCH SA will continue to comply with all Core Principles following the introduction of this change and has concluded that its compliance with the Core Principles would not be adversely affected by this change.

Part IV: Public Information

LCH SA has posted a notice of pending certifications with the CFTC and a copy of the submission on LCH's website at: <https://www.lch.com/resources/rules-and-regulations/proposed-rule-changes>

Part V: Opposing Views

There were no opposing views expressed to LCH SA by governing board or committee members, members of LCH SA that were not incorporated into the rules.

Certification

LCH SA hereby certifies to the CFTC, pursuant to the procedures set forth in the Commission regulation §40.6, that this change submission complies with the Commodity Exchange Act, as amended, and the regulations promulgated there under.

Should you have any questions please contact me at: françois.faure@lch.com

A handwritten signature in blue ink, appearing to read 'Faure', written over a horizontal line.

Francois Faure
Chief Compliance Officer
+33 1 70 37 65 96

APPENDIX

Reference Guide: CDSClear Margin Framework **(to be filed separately with the CFTC under Confidential Treatment request)**