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The Hong Kong Monetary Authority,
55th Floor, Two International Finance Centre,
8 Finance Street
Central, Hong Kong

By email: kyeung@hkma.gov.hk; jehrentraud@hkma.gov.hk

15 January 2016

Dear Sirs,

Consultation on Non-centrally Cleared OTC Derivatives Transactions – Margin and Other Risk Mitigation Standards

LCH.Clearnet Group Limited ("LCH.Clearnet" or "The Group") is pleased to respond to Consultation Paper (CP15.02) on Non-centrally Cleared OTC Derivatives Transactions – Margin and Other Risk Mitigation Standards.

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

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

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LCH.Clearnet Overview

LCH.Clearnet[1] is a leading multi-asset class and multi-national 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.Clearnet works closely with market participants and exchanges to continually identify and develop innovative clearing services for new asset classes. LCH.Clearnet 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.

LCH.Clearnet 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 viewpoint 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.

LCH.Clearnet 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.Clearnet 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

[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

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.Clearnet 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 Initial Margin and Variation Margin 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 Initial Margin 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 Initial and Variation Margins is vital in achieving the genuine systemic risk reduction to which these measures are directed. LCH.Clearnet 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

1. Margin standards

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

(a) Comparability assessments and guaranteed transactions

- Introduction of partial compliance in addition to substituted compliance

  LCH.Clearnet does not agree with the proposed introduction of partial compliance on the basis that it is inconsistent with the BCBS/IOSCO framework, given that international consistency should be a key consideration. In our view, partial compliance will create unnecessary complexity for clearing members in their compliance with margin requirements for non-centrally cleared transactions in Hong Kong and globally.

(e) Eligible collateral

- Proposed set of eligible assets for margin purposes as outlined in Sub-section 3.8 of the draft SPM module.

  In order to ensure that bilateral margin rules do not disincentivise central clearing, LCH.Clearnet suggests that sub-section 3.8.1 of the draft SPM module is amended to reflect EU CCP collateral requirements[3]. For example, publically traded equities should be excluded from the list of eligible collateral for margin purposes.

  We would also like to note that, when calculating bilateral margins, the confidence level and liquidation period to be used should not differ from current CCP margin requirements in a way that would disincentivise central clearing. Without accounting for factors such as key periods of historical volatility, bilateral margins may be lower than those in clearing and we question whether this is consistent with G20 goals. Should additional factors be introduced which lead to more robust standards, we ask for consistent implementation across jurisdictions.

2. Risk mitigation standards

- Trading relationship documentation: minimum retention period of 5 years;

  LCH.Clearnet supports the 5 year minimum retention period for trading relationship documentation. However, in order to achieve consistency with corresponding EU rules[4] and to ensure that accurate records are retained, LCH.Clearnet proposes that sub-section 4.1.2 of the draft SPM module is amended to clarify that such retention requirement also applies to any modifications to such documentation.

Conclusion

CCP margin models have been developed over time under rigorous regulatory oversight. LCH.Clearnet 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 derivatives contracts should

[3] Article 46 of Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories ("**EMIR**") and Articles 38-39 and Annex II of Commission Delegated Regulation (EU) No 153/2013 of 19 December 2012.

[4] Article 9(2) EMIR.

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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 HKMA in the development of the new margin rules for non-centrally cleared OTC derivatives in Hong Kong. Should you have any questions on the response or wish to discuss it in detail, please do not hesitate to contact me at Corentine.Poilvet-Clediere@lchclearnet.com, Natalie Caldwell at Natalie.Caldwell@lchclearnet.com or Juliet Lee at Juliet.Lee@lchclearnet.com.

Yours sincerely,

Corentine Poilvet-Clediere
Head of Post-Trade Regulatory Strategy