

RESPONSE TO CONSULTATION PAPER

Consultation topic:	Policy Consultation on Margin Requirements for Non-Centrally Cleared OTC Derivatives
Organisation:	LCH.Clearnet Group Ltd
Contact number for any clarifications:	+61 2 8259 4111
Email address for any clarifications:	rory.cunningham@lchclearnet.com
Confidentiality	
I wish to keep the following confidential:	n/a

LCH.Clearnet Group Limited (“LCH.Clearnet” or “The Group”) is pleased to respond to the MAS’s Policy Consultation on Margin Requirements for Non-Centrally Cleared OTC Derivatives (“proposed rules” or “proposals”).

LCH.Clearnet¹ 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.

The Group strongly supports the policy goals underpinned by the proposed rules and the statutory provisions contained in the Securities and Futures Act (“the Act”) and related regulations.

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

The Group strongly supports the Authority's proposal to adopt margin requirements for uncleared derivatives for entities conducting regulated activities under the Act as well as the proposal for the treatment of cross-border transactions. Our comments provide a view on the overall approach of the MAS on this extremely important topic which will help shape the future of the OTC derivatives market.

General comments:

As a multi-asset class and international clearing house LCH.Clearnet has been responsible for deploying prudent risk management techniques across both OTC and exchange traded derivatives for many years. This experience provides a unique viewpoint on this subject. LCH.Clearnet has 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, disincentive 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

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.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 not 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 Margin in September 2016, in accordance with the BCBS-IOSCO final standards², 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.

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

Responses to certain questions follow below.

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

Question 5. MAS seeks comments on the proposed margin obligations (including operational requirements) on MAS Covered Entities, specifically on the options of (i) a post-and-collect requirement; and (ii) a collect-only requirement, and the pros and cons for the suggested option.

We fully support the requirement of 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). We, therefore, recommend that IM obligations should be calculated, and exchanged, at least daily.

Question 7. MAS seeks comments on the proposed IM calculations and requirements, particularly, but not limited to, the recalculation frequency and requirements of IM, data history for IM calculation and the recalibration and back-testing requirements of the IM model.

We note that the use when calculating bilateral margin of a 99% confidence level over a liquidation period of 10 days differs from current CCP margin requirements. Without accounting for factors such as key periods of historical volatility, this is likely to lead to cases where bilateral margins may be lower than those in clearing and we question whether this outcome is consistent with G20 policy goals. Should additional factors be introduced which lead to more robust standards, we ask for consistent implementation across jurisdictions.

CCPs' margin models are subject to rigorous tests; we suggest that the provisions applied to CCPs should be considered minimum standards required for the mitigation of systemic risks. In accordance with the main theme of our comments, we urge that bilateral margin requirements are not lower than the margin requirements that would be applied by CCPs.

Question 9. MAS seeks comments on the proposed range of eligible collateral and corresponding schedule-based haircuts.

As noted in relation to comments on other specific aspects of risk management, bilateral standards for collateral should be higher than the CCPs' most conservative standards to maintain the right incentives in line with the G20 commitments. While we recognise that equities are included in the list of eligible collateral assets in the BCBS IOSCO framework, we would like to note that equities are not permissible as collateral by CCPs in Europe. Therefore MAS may wish to consider whether they should be permitted for bilateral collateralisation.

Question 10. MAS seeks comments on the proposed application of the 8% schedule-based standardised FX mismatch haircut when cash is used to meet the VM requirements in the case of an FX mismatch (i.e. where the collateral is denominated in

a different currency from the settlement currency of the underlying derivative transaction).

Specifically, MAS seeks comments on whether cash collateral denominated in certain liquid currencies (please specify currencies) should be subject to a lower FX mismatch haircut (please specify). If so, what criteria should be used in assessing the liquidity of these currencies?

MAS also seeks comments on whether there are cases where a higher than 8% FX mismatch haircut may be warranted.

The recognition of FX risk is a critical factor in assessing the adequacy of margin requirements; the exclusion of FX haircuts for VM or IM may allow for a significant build-up of 'hidden' risk within the market and should therefore not be allowed.

Question 11. MAS seeks comments on the proposed safe-keeping of IM collateral.

We support the proposals.

Question 12. MAS seeks comments on examples of the types of legally-enforceable safe-keeping arrangements that may be put in place under paragraph 7.2 (b).

We support the proposals.

Question 13. MAS seeks comments on the proposal that all collateral arrangements need to be reviewed periodically with updated legal opinions to ensure that the arrangements continue to be legally enforceable.

We support the proposals.

Question 14. MAS seeks comments on the proposal to permit a one-time re-hypothecation of non-cash IM collateral and the liquidity implications of such a proposal.

We support the proposals.

Question 16. MAS seeks views on the proposed treatment of cross-border transactions, and whether there are other arrangements that may better address concerns of level playing field and regulatory arbitrage. Please elaborate on the rationale for the suggested option.

We are pleased to see MAS's continuing recognition of the global nature of OTC markets and fully support its efforts to create local regulation which limits the risk of regulatory arbitrage by firms operating internationally. An important component of this is not to

create artificial incentives e.g. relating to the booking of derivatives activities in a specific location for purely regulatory reasons, and therefore support the intention to avoid duplicative and/or conflicting regulation on margin requirements.

Question 17. MAS seeks views on the proposed approach for the application of deemed compliance, particularly for cross-border transactions.

We support MAS's intention to focus on outcomes when considering deemed compliance, allowing maximal recognition of equivalent foreign regimes.

Question 18. MAS seeks comments on the proposed phase-in schedule for margin requirements to apply to MAS Covered Entities.

Where possible, we urge that the timings of the introduction of mandates should be aligned across jurisdictions. We therefore suggest that, in order to avoid regulatory arbitrage, the implementation schedule is as coherent as possible with the implementation of the European and US rules in September 2016, in line with the target date recognised in the BCBS IOSCO framework.