

ESMA  
103 rue de Grenelle  
75007 Paris  
France

5 September 2016

Dear Sirs,

This letter provides the submission of LCH Group ("LCH") to ESMA's Consultation Paper on the clearing obligation for financial counterparties with a limited volume of activity.

LCH is a leading multi-asset class and international clearing house, which services 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, commodities, energy, freight, interest rate swaps, credit default swaps, bonds, repos, and foreign exchange derivatives. LCH is majority owned by the London Stock Exchange Group ("LSEG"), a diversified international exchange group that sits at the heart of the world's financial community.

### **General comments**

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. 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 regulation should look to build upon the CCP model.

Therefore, we are pleased to see the entry into force of the clearing obligations of certain interest rate swaps and credit default swaps under Regulation (EU) No 648/2012 of the European Parliament and Council on OTC derivatives, central counterparties and trade repositories ("EMIR"), and their progressive application for the different categories of counterparties.

We are aware that smaller financial counterparties are facing issues to establish clearing arrangements and obtain access to CCP clearing. In this context, we understand the rationale for ESMA's proposal to adjust the application dates for this category of counterparties. This extension will provide them with additional time to comply with the clearing obligations. However, we feel that it is important to appropriately determine the duration of this extension, in light of the broader G20 goals and concerns around systemic risk, and also the characteristics of the IRS and CDS markets, such as liquidity, size of the market and number of counterparties.

In addition, we believe that it is also crucial to address some of the impediments to clearing access for small financial counterparties. This could notably be done through adjustments to the leverage ratio framework. We also fully support the recent regulatory initiatives to further develop indirect clearing arrangements in the OTC derivatives market. Given the importance of the G20 objectives for the promotion of financial stability, we think it is crucial that regulatory and capital rules do not, whether directly or indirectly, disincentivise the use of central clearing. We discuss these points further in our answers below.

### Specific comments

**Question 1: To which category of counterparties does your organisation belong: (1) in the context of the 1st Commission Delegated Regulation on the clearing obligation, and (2) in the context of the 2nd Commission Delegated Regulation on the clearing obligation?**

**Please indicate the likely category of counterparties if the determination has not been done yet. For respondents that are in none of the four categories, please indicate the nature of the activity performed in relation to the clearing obligation (e.g. CCP). For associations, please indicate the category of counterparties that you mainly represent.**

LCH operates two CCPs authorised under EMIR, LCH Limited in the United Kingdom and LCH SA in France.

The SwapClear service of LCH Limited offers clearing of a wide range of OTC interest rate derivatives, including the classes subject to the clearing obligation for Interest Rate Swaps ("IRS") denominated in the G4 currencies pursuant to Commission Delegated Regulation (EU) 2015/2205 of 6 August 2015, and for IRS denominated in some EEA currencies pursuant to Commission Delegated Regulation (EU) 2016/1178 of 10 June 2016.

The CDSClear service of LCH SA offers clearing of a wide range of OTC Credit Default Swaps ("CDS"), including the classes subject to the clearing obligation for Index CDS pursuant to Commission Delegated Regulation (EU) 2016/592 of 1 March 2016.

**Question 2: If you offer clearing services, please provide evidence on the constraints that would prevent you from offering clearing services to a wider range of clients.**

We consider that some principles in the design of the leverage ratio framework under Basel III and the Capital Requirements Regulation (CRR) currently have a negative impact on access to central clearing. We believe that the failure to recognise the risk-reducing effect of segregated initial margin ("IM") in calculating the exposure measure in the leverage ratio results in significantly increased capital requirements for clearing members. It makes central clearing more expensive and greatly contributes to the reduction of clearing members' appetite to provide client clearing services to a wider range of clients. We, therefore, strongly support the recognition of IM in the exposure calculation for both the international and the European leverage ratio frameworks. This recognition is justified on risk grounds (margin reduces exposure) and would materially promote increased clearing capacity amongst clearing members. Consequently, it would help mitigate issues around access to clearing.

With regard to indirect client clearing arrangements, both the SwapClear service of LCH Limited and the CDSClear service of LCH SA comply with the requirements set out in Commission Delegated Regulation (EU) 149/2013, and therefore are able to facilitate indirect clearing services at the request of a clearing member. However, no clearing member has requested these services to date, although we are aware that several of them have investigated doing so. This seems to confirm the view that indirect clearing arrangements are currently limited or even non-existent in the OTC derivatives market. We welcomed ESMA's proposed amending RTS aiming to align the requirements on indirect clearing under EMIR for OTC derivatives and under MiFIR for ETDs, and we look forward to engaging further with regulators and market participants to contribute to the development of indirect clearing arrangements.

**Question 3: Have you already established clearing arrangements (1) for interest rate swaps? (2) for credit default swaps? If not, please explain why (including the difficulties that you may be facing in establishing such arrangements) and provide an estimation of the time needed to finalise the arrangements.**

LCH has established clearing arrangements as per our answer to Q1. For interest rate swap clearing, we have more than 30 firms offering client clearing, and have cleared an aggregate notional amount of swaps on behalf of these clients of more than \$300 trillion since inception. The arrangements are finalised, but are of course subject to continuous development in light of commercial and regulatory changes.

It is difficult to fully assess the time required for the finalisation of client clearing arrangements. As an indication, the estimated time needed to onboard a clearing member for client clearing on the CDSClear service would be a maximum of 2 months for the application process, and 2 weeks for the testing phase. However, we understand that some operational and legal arrangements are also required between the clearing member and its clients, which will affect the overall timeframe.

**Question 4: Please provide information and data you may have that could complement this analysis on the level of experience and preparedness of financial counterparties with CCP clearing.**

We do not provide comment to this question.

**Question 5: Do you agree with the proposal to keep the definitions of the categories of counterparties as they currently are and to postpone the date of application of the clearing obligation for Category 3? If not, which alternative would achieve a better outcome?**

We agree with the proposal to keep the definitions of the categories of counterparties as they currently are, as we believe that doing so is the simplest and most consistent approach. However, in this respect, it is worth noting that there are structural differences between the IRS and CDS markets. Indeed, as highlighted in ESMA's analysis, the ratio between Category 2 and Category 3 in the IRS and CDS markets are approximately 4:1 and 2:1 respectively. This demonstrates that the impact on the CDS market of a delay on Category 3 risks being more material than on the IRS market. This being said, we understand the rationale for ESMA's proposal to postpone the application date for Category 3, but would advise caution with respect to the impact on the liquidity of these markets. For this reason, we recommend a differentiated approach as per our response to Q6 below.

**Question 6: Do you agree with the proposal to modify the phase-in period applicable to Category 3, by adding two years to the current compliance deadlines?**

While we understand the proposed extension of the phase-in period applicable to Category 3, we believe that a two year extension would be problematic for both the IRS and CDS markets.

Firstly, with respect to the phase-in, a two year delay would cause the compliance dates for Category 3 to occur after those for Category 4. Category 4, which comprises non-financial counterparties, is expected to cover institutions that are less accustomed to clearing than Category 3. We believe that the proposed approach would be counter-intuitive and could create confusion in the market. It would also seem inconsistent with ESMA's original goal to introduce clearing obligations gradually based on the counterparties' level of sophistication, activity and systemic relevance.

Secondly, we would suggest a differentiated approach for IRS and CDS:

- For the IRS market, we suggest a shorter extension for Category 3. We would recommend that the phase-in period for Category 3 is modified by adding a maximum of one year to the current compliance dates, i.e. 21 June 2018 for G4 IRS and 9 February 2019 for EEA IRS at the latest.
- For the CDS market, we are particularly concerned about the proposed delay. Due to the size of the CDS market, Category 3 counterparties play a more significant role compared to the IRS market. For this reason, we fear that the proposed delay could present a threat of drying up the liquidity in Europe. Indeed, liquidity may shift to other jurisdictions that have already implemented clearing mandates, and are even facing client demands to extend the mandates to other product types. Delaying the start of the CDS clearing obligation for Category 3 could also lead to the development of a price basis between cleared and uncleared CDS transactions which in turn could result in smaller market participants having to quit trading this market. Finally, a delay could disincentivise clearing brokers to offer CCP access to clients willing to clear, which would refrain market actors that only trade cleared transactions from entering the CDS market. It is crucial for the European Regulatory framework to support increased liquidity in the CDS market, and we believe the clearing obligations will greatly contribute to achieving this goal. Therefore, we do not recommend a delay for Category 3 under the CDS Clearing Obligation. In the case where ESMA would decide to implement a delay, we would not recommend such delay to exceed 6 months, i.e. a compliance date of 9 August 2018 at the latest.

We believe such approach would strike a balance between addressing the issues of clearing access and maintaining the appropriate liquidity in the market.

**Question 7: Do you agree with the proposal to modify the three Commission Delegated Regulations on the clearing obligation at the same time?**

In the case where ESMA would decide to implement a delay for Category 3 under the CDS Clearing Obligation, then we would support the proposed approach.

\* \* \*

We hope that ESMA finds this submission useful and we look forward to engaging further as policies are developed. Should you have any questions on the response or wish to discuss it in detail, please do not hesitate to contact us at [Corentine.Poilvet-Clediere@lch.com](mailto:Corentine.Poilvet-Clediere@lch.com) or [Jean-Philippe.Collin@lch.com](mailto:Jean-Philippe.Collin@lch.com).

Yours sincerely,



Corentine Polivet-Clediere

Head of Regulatory Strategy and Post Trade Policy, Europe