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ESMA
103 rue de Grenelle
75007 Paris

22 October 2014

LCH.Clearnet Group Limited response to the ESMA discussion paper on calculation of counterparty risk by UCITS for OTC financial derivative transactions subject to the clearing obligation

Dear Sir, Madam

This letter provides the response of LCH.Clearnet Group Limited[1] ("LCH.Clearnet") to the ESMA discussion paper on calculation of counterparty risk by UCITS for OTC financial derivative transactions subject to the clearing obligation issued in July 2014.

LCH.Clearnet is the 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$ denominated bonds and repos. LCH.Clearnet works closely with market participants and trading venues to continually identify and develop innovative clearing services for new asset classes. LCH.Clearnet Group Ltd 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.

In this response we advocate that there should be no counterparty risk limits for UCITS in centrally-cleared derivatives. A limit would unnecessarily constrain the benefit available to the UCITS from the reduction of counterparty risk associated with central clearing. We note the following in support of this position:

1) CCPs authorised/recognised under EMIR are subject to strong prudential requirements; also the recently issued international reports and the upcoming EU framework for recovery and resolution of FMIs will further strengthen the CCP's ability to withstand stressed market conditions;

[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. For further information in relation to the Legal and Regulatory Structure of the Group please see: http://www.lchclearnet.com/about_us/corporate_governance/legal_and_regulatory_structure.asp.

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2) The exposure limits currently in force under article 52 of the UCITS Directive[2] ("Directive"), as read with the CESR guidelines[3], intend to avoid a build-up of credit risk of a UCITS with a single financial institution in OTC derivative transactions. CCPs are unlike the bilateral counterparties originally contemplated by the Directive;

3) The Directive does not apply any counterparty risk limits to UCITS entering into exchange traded derivatives ("ETDs"). We believe that the absence of such limits relies on the assumption that ETDs are always cleared via a CCP. The absence of a limit for cleared OTC derivatives would harmonise the position between the two;

4) Imposing counterparty risk limits on OTC derivative transactions subject to the clearing obligation will most likely require UCITS to use multiple CCPs, which will lead to increased operational costs and decreased netting efficiency for UCITS.

Responses to specific questions in the consultation paper

1. Do you agree with the working assumptions above?

We agree with the working assumption made in the consultation. However, we note that some of the questions in this section of the consultation paper refer only to non-EU CCPs recognised by ESMA. We would like to clarify that the comments provided in our response apply to both EU CCPs authorised by their national regulator and non-EU CCPs recognised by ESMA under EMIR.

2. In particular, do you agree that UCITS should regard the counterparty risk of all ESMA-recognised CCPs as being relatively low? Are there some ESMA-recognised CCPs for which counterparty risk may not be low? If so, please explain.

We agree that UCITS, as clients of a clearing member, should regard the counterparty risk of both EU CCPs authorised and non-EU CCPs recognised under EMIR as being relatively low, if not equal to zero. Central clearing has been introduced as a means of reducing counterparty credit risk. Accordingly, the credit risk exposure of a UCITS to the CCP is lower than it would be if the UCITS traded bilaterally with the original counterparty.

In addition to the above, we would like to highlight that CCPs compliant with EMIR are subject to strong prudential requirements, e.g. minimum capital requirements; minimum membership requirements to ensure members are of high credit quality; minimum size of the default fund/s to withstand the losses of the largest two members; rigorous order in which resources have to be used in the default waterfall. We believe these are important factors to be taken into account to justify that there should be no counterparty risk limits for UCITS in derivatives cleared via a CCP. In addition, the recently issued international reports and the upcoming EU framework for recovery and resolution of FMIs will further strengthen the CCPs' ability to withstand stressed market conditions.

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[2] Directive 2009/65/EC

[3] CESR/10-788

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3. Do you think that UCITS should apply any counterparty risk limits to ESMA-recognised CCPs? What should be the limits?

We believe that imposing limits to the counterparty risk exposure of a UCITS to a CCP is contrary to the policy objective of incentivising central clearing, which reduces counterparty credit risk. There are several arguments in favour of imposing no counterparty risk limits for cleared derivatives transactions.

Firstly, the exposure limits currently in force under the Directive intend to avoid a build-up of credit risk of a UCITS with a single bilateral counterparty in OTC derivative transactions. However, a CCP is unlike the financial institutions originally contemplated by the Directive. A CCP runs a matched book, and does run a risk opposite to the UCITS, as might a bilateral counterparty. Further, a CCP mutualises risk across its membership; this mutualisation of losses across non-defaulting members affords specific regulatory treatment of banks and investment firms to CCPs, for example reduced risk weightings. The concentration of risk of a UCITS towards a CCP is therefore not comparable with that against a single bilateral counterparty.

Secondly, the Directive does not apply any limits to ETDs and we believe that the absence of such limits relies on the assumption that these are always cleared via a CCP. We do not see an argument for discriminating between cleared OTC derivatives (by imposing a concentration limit) and ETDs (where no such limits apply).

Lastly, imposing counterparty risk limits on derivative transactions subject to the clearing obligation will most likely require UCITS to use multiple CCPs, which will lead to increased operational costs and decreased netting efficiency for UCITS.

On the basis of the arguments above, we argue that all cleared derivatives, irrespective of how they are traded, should not be subject to any counterparty risk limits.

If ESMA and the EU Commission believe it is appropriate to recognise some counterpart risk of a UCITS to a CCP, we strongly recommend that the same limits apply to ETDs and OTC derivatives. It is not clear how the limits will be calculated for OTC derivatives transactions, but we would like to point out that they should not be based on the notional outstanding amount as this is not an appropriate measure to quantify the real exposure associated with a portfolio of OTC derivatives trades. This has been demonstrated in the development of the Basel III capital requirements for banks against their exposure to CCPs for their default fund contributions. In this context regulators have recognised the shortcomings of the interim methodology based on notional exposure. The final standards are based on a more robust and risk-sensitive methodology which recognises the reduced risk in a cleared environment and so maintains members' incentives to use CCPs for OTC derivatives.

4. Do you agree that the assessment of counterparty risk vis-à-vis the CM and the client should distinguish between the different types of segregation arrangement? If not, please justify your position.

Historically clients clearing ETDs, which are not subject to any counterparty risk limit, have opted for the lower level of segregation account provided in Article 39.2 of EMIR (i.e. omnibus account). On this basis we believe that there should be no limits for centrally-cleared derivatives irrespective of the choice of the segregation model.

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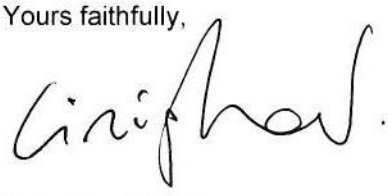
16. Do you agree that UCITS should treat OTC derivatives transactions cleared by non-EU CCPs outside the scope of EMIR as bilateral OTC derivatives transactions and apply the counterparty risk limits of Article 52 of the UCITS Directive to CMs? If not, please justify your position.

We believe that OTC derivatives transactions cleared by UCITS via CCPs which are considered qualifying CCPs (QCCPs) in their jurisdiction and therefore comply with the CPMI-IOSCO Principles for Market Infrastructures should not be subject to any counterparty risk limit. The QCCP status of a CCP should ensure that the clearing arrangements that they offer provide the necessary protection to clients, such as UCITS, in case of default of a clearing member.

We hope that the above response will assist ESMA in developing a possible recommendation to the European Commission on a modification of article 52 of the Directive to ensure UCITS can fully benefit from the reduction of counterparty risk associated with central clearing. If you would like to discuss any aspect of the response please do not hesitate to contact me at Valentina.Cirigliano@lchclearnet.com.

Yours faithfully,



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