EUROPEAN COMMISSION
Directorate General Financial Stability, Financial Services and Capital Markets Union
B-1049 Brussels BELGIUM

13th August 2015

Dear Sirs

This letter provides an overview of the priorities of LCH.Clearnet Group Limited ("LCH.Clearnet") in respect to the ongoing EMIR review. The comments and recommendations highlighted in this paper should be read in conjunction with the responses to the specific questions included in the online form on the EU Commission's website.

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 and sterling 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 appreciates the opportunity to provide input into the review of EMIR and believes that the following issues should be prioritised by the EU Commission.

1. **CCPs' investment policy**
2. **CCPs' access to central bank facilities**
3. **Portfolio margining requirements**
4. **Functioning of the EMIR colleges**

LCH.Clearnet's position in respect to the above issues is explained in detail in the answers to the specific questions in the consultation. Below we provide an overview of our comments and recommendations.

[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

1. **CCPs' investment policy**

Investment in Money Market Funds (MMFs): We believe that investment in MMFs under EMIR should be allowed, provided it is subject to certain conditions. The current restriction under EMIR is particularly problematic for those CCPs which offer clearing services both in the EU and in the US, where such investment is allowed. LCH.Clearnet includes active cross border CCPs which collect cash collateral from clients and members intraday throughout the Asian, European and North American time-zone, and therefore needs safe, liquid and reliable outlets to invest securely the late cash-inflows. We would like to encourage the EU Commission to revise the current restriction in respect to MMFs or provide guidance as to whether there is a possibility of creating an EMIR-compliant MMF. The LCH.Clearnet response suggests amendments to Annex II of the ESMA RTS No 153/2013 in order to permit this activity. We hope the EU Commission and ESMA will consider the amendments.

Highly creditworthy buy-side firms as investment counterparties of CCPs: We encourage EMIR to allow CCPs to treat regulated and highly creditworthy buy-side firms (e.g. pension funds and insurance undertakings) as potential investment counterparties for the purpose of repo'ing cash balances with high quality liquid assets. Regulatory and capital requirements are leading banks to reduce their repo market activities. CCPs are challenged daily as they have to use the repo market to secure the increasing amount of cash balances resulting from cash collateral posted by a growing number of market participants meeting their initial margin obligations. Amongst these are buy-side firms that are simultaneously finding it harder to utilise the repo market to gain reliable access to cash fund cleared margin requirements at CCPs. Allowing CCPs to enter into repo transactions with highly creditworthy buy-side firms would allow CCPs to diversify their investment counterparty risk profile, while simultaneously provide additional liquidity in the repo market for the buy-side.

Use of derivatives by CCPs for the purpose of hedging interest rate risk: The current provisions in Annex II para. 2 of the ESMA RTS No 153/2013 limit the CCPs' use of derivatives to hedge the risk arsing from default management and the currency risk arising from liquidity management. We also believe that CCPs should be allowed to use derivatives to micro-hedge the interest rate exposure for their investment activity. As required under EMIR, CCPs invest the cash collateral received by clearing members into highly liquid financial instruments; a significant percentage of the cash is invested at fixed rate. As global markets are currently preparing for raising interest rates, EMIR-authorised CCPs have no options available to hedge the interest rate risk, which arises naturally from their business model, leaving CCPs exposed to P&L implications. The current rules could be amended to ensure that the CCP invests in specific derivatives, such as Overnight Index Swaps (OISs), and that the average time to maturity of the CCPs' portfolio is below two years, as required under Annex II 1(c); such amendment would enable the CCPs to use certain derivatives to micro-hedge interest rate exposure, thereby preserving their financial resources. We believe that prudent use of specific interest rate derivatives for hedging of investment risks should be compliant with Article 47(1) of EMIR subject to the conditions of reliable price data and Board and Risk Committee approval, as required under Annex II, para. 2 of the ESMA RTS No 153/2013.

2. CCPs' access to central bank facilities

LCH.Clearnet supports the adoption of measures to facilitate access of CCPs authorised under EMIR to central bank liquidity facilities. On a daily basis CCPs manage large cash balances resulting from margin requirements and default fund contributions. Over the coming years, CCPs anticipate further growth in collateral balances driven by buy-side firms entering clearing. In this context, the investment of cash is and will continue to be a key part of a CCP's business as usual activities. Having the possibility to deposit cash at central banks' accounts on a business as usual basis would significantly support CCPs' liquidity management and limit their exposure to commercial banks. Limiting CCPs' exposure to commercial banks would provide further confidence in the merits of clearing for buy-side firms. As the regulatory environment increasingly drives the use of central clearing and the implementation of clearing mandates globally brings more market participants and products into clearing, it would indicate strong positive regulatory co-ordination to enable CCPs to access deposit facilities at central banks in Europe to cover the major currencies relevant to the products cleared by the CCP.
We believe that the legislative text of EMIR does not need to be changed to facilitate CCPs' access to central banks' liquidity facilities; neither CCPs should be required to hold a banking license to be granted such access. Instead, we would support any efforts to change central banks' policies in order to enhance the reforms developed as a result of the implementation of EMIR and in support of the principle in the Regulation whereby there should not be impediments for a CCP in one jurisdiction to clear a product denominated in the currency of another Member State or in the currency of a third country.

3. Portfolio margining requirements:

Article 27 of RTS provides a solid foundation for consistent portfolio margining practices across CCPs. LCH.Clearnet believes that this presents an opportunity to address and clarify a few remaining areas of ambiguity in the industry, as well as to consider five underlying principles that could lead to a more robust and transparent risk management framework.

In general, LCH.Clearnet considers it is important to more tightly define and quantify some of the terms used in the context of correlations, and to address the importance of appropriate portfolio margining in a default management scenario.

Significant and reliable correlations

It is too simplistic to assess the significance and reliability of individual correlations separately; rather, the level and reliability of portfolio margining techniques depend on the entire correlation structure embedded in the portfolio, and require a portfolio-level assessment standard.

The risk mitigation impact of low correlation

Both positive correlation and the absence of correlation have an impact on the joint price risk of a portfolio, and therefore on portfolio risk management. When two contracts are positively correlated, one expects a price increase in one contract to be accompanied by a price increase in the other contract. Conversely, if two contracts are not correlated, one expects prices to move independently. A price increase in one contract is then neither more nor less likely to be accompanied by a price increase in the other contract. This intuitive concept can be made more precise through statistical definitions of dependence, covariance and correlation.

In seeking to introduce standards around correlation measurement, LCH.Clearnet believes that it is important to recognize the absence of correlations as a risk diversification tool.

If an investment or trading position is split between two uncorrelated contracts, risk goes down. This is because a loss on one contract is now not certain, and in the case of low correlations not more likely, than a gain on the second contract. In other words, a joint position is somewhat less risky than either of the two contracts separately. This form of risk reduction – the diversification of idiosyncratic risk – is a staple of risk management.

A Proposed Standard

Type II model errors. LCH.Clearnet proposes that correlations be allowed within the portfolio margining framework if they can be modelled with a Type II error below 5%.

LCH.Clearnet recommends a framework that is consistent with existing regulatory requirements, in that it allows portfolio margining within broad asset classes, but recognises margin benefits only to the extent that they are reliably present at times of stress. In fact, the framework goes beyond current regulatory standards, by setting well-defined and quantitative criteria for the significance and reliability of correlations in the context of margin modelling.

Model Risk Framework: 5 Requirements

1. Reliable and representative price data on all contracts in the portfolio

A robust source of actual prices needs to be available for all contracts in the portfolio. In some instances, this may require techniques for interpolating or inferring implied prices for less liquid contracts. If so, these techniques need to be consistently applied across the entire portfolio.

2. Ability to price entire portfolio across a wide range of historical and hypothetical scenarios

If some contract prices are interpolated or inferred, the techniques used need to enable portfolio pricing during hypothetical scenarios. All segments of the portfolio need to remain liquid at all times.

3. Portfolio margining aligned with default management procedures

In particular, only those positions are margined jointly that can be exited jointly in the event of a member default. In practice, this limits portfolio margining to portfolios within, but not across the major asset markets (rates, equities, credit).

4. Ability to quantify model risk/ type II errors

Model testing procedures based on historical back testing, bootstrapping or hypothetical scenarios in order to estimate the probability of a type-II error (underestimation of margins due to statistical noise in the model inputs)

5. Margin add-ons as required to keep model risk below 5%

If the risk of a Type II error is above 5%, a suitable margin add-on is required.

4. **Functioning of the EMIR colleges:**

The implementation of the G20 commitment in Europe is bringing more products into clearing and CCPs continue to develop new products to address systemic risks associated with specific asset classes. It is therefore important that regulators and ESMA maintain an efficient college approval process for new products and services (Art 15). Likewise, a smooth and reasonably fast process for the approval of risk methodologies would promote effective risk management by CCPs (Art 49). Below is an overview of our comments and recommendations:

<u>Article 15</u> – We believe it would be beneficial for national regulators and ESMA to have a common understanding of what is deemed as new product/service/activity that would require the process under Article 15. We appreciate, for example, that the clearing of new classes of financial instruments is likely to introduce additional and novel risk within a CCP and so it requires an appropriate level of consideration by national competent authorities and ESMA. On the other hand, we would not expect regulators to require an approval process for less significant changes under the existing risk framework; this is the case of a change affecting an asset class already cleared by the CCP, for example in the case of extension to new currencies, range of tenors or indices or single names in the case of CDS. Where the risk entailed by a change in a product or service is outside of a CCP's risk framework and the CCP's risk methodology also needs to be reviewed, it may then be a case of considering the process required under Article 49.

<u>Article 49</u> – this article requires the opinion of the college in respect to significant changes to risk models and parameters. We would like to receive clarification on:

i. The circumstances in which the article applies, as the interpretation of what is deemed 'significant' may differ across competent authorities.
ii. The relationship between the various steps required in 49(1) and their sequence, i.e. the independent validation, the validation by ESMA and the competent authority, the opinion of the college.

We would support the development of guidelines by ESMA and national competent authorities to ensure a common basic understanding among regulators and CCPs of the scope of the articles 15 and 49 and therefore the circumstance where they would be applied.

Responses to specific questions in the consultation

<u>Question 1.1: CCP Liquidity</u>

i. Is there a need for measures to facilitate the access of CCPs to central bank liquidity facilities?

LCH.Clearnet supports the adoption of measures to facilitate access of CCPs authorised under EMIR to central bank liquidity facilities.

ii. If your answer to i. is yes, what are the measures that should be considered and why?

On a daily basis CCPs manage large cash balances resulting from margin requirements and default fund contributions. Over the coming years, CCPs anticipate further growth in collateral balances driven by buy-side firms entering clearing. In this context, the investment of cash is and will continue to be a key part of a CCP's business as usual activities. Having the possibility to deposit cash at central banks' accounts on a business as usual basis would significantly support CCPs' liquidity management and limit their exposure to commercial banks. Limiting CCPs' exposure to commercial banks would provide further confidence in the merits of clearing for buy-side firms.
In this context it is also important to note that, under EMIR, CCPs have to comply with the rule under which no more than 5 % of cash balances, calculated over an average period of one calendar month, can be deposited on an unsecured basis[2]. Another point for consideration is that allowing CCPs to deposit cash at central banks would increase transparency for central banks on how their respective cash currency is managed by the CCP at the time of a large clearing member(s) default or market stress.

As the regulatory environment increasingly drives the use of central clearing and the implementation of clearing mandates globally brings more market participants and products into clearing, it would indicate strong positive regulatory co-ordination to enable CCPs to access deposit facilities at central banks in Europe to cover the major currencies relevant to the products cleared by the CCP.

In addition, given the fundamental role played by CCPs and their increasing systemic importance in providing critical financial services to the real economy, central banks' policies may consider changes to allow CCPs access to liquidity in relevant currencies on a secured basis, such as via the discount window similar to banks.

We believe that the above points do not require a change in the legislative text of EMIR in order to be addressed and are in line the CPSS-IOSCO Principles for Financial Market Infrastructures. We also do not believe that CCPs need to hold a banking license to be granted access to central bank liquidity facilities. Instead, we would support any efforts to change central banks' policies in order to enhance the reforms developed as a result of the implementation of EMIR and in support of the principle in the Regulation whereby there should not be impediments for a CCP in one jurisdiction to clear a product denominated in the currency of another Member State or in the currency of a third country[3].

Question 1.3: CCP Colleges

a) What are your views on the functioning of supervisory colleges for CCPs?

LCH.Clearnet appreciates that supervisory colleges for EU CCPs are new structures that national competent authorities and policy makers have had to adapt to since the application of EMIR. Involving multiple regulators in the decision making process on supervisory matters for each CCP requires a high level of coordination. Based on our experience with such colleges we would like to make suggestions on how to improve their functioning.

b) What issues have you identified with respect to the college system during the authorisation process for EU CCPs, if any? How could these be addressed?

[2] RTS No 153/2013 - Art 45.2 'Highly secured arrangements maintaining cash'.
[3] EMIR Recital 47

LCH.Clearnet believes that both the process to approve new products and services required under Article 15 and that to approve changes to CCPs' risk methodologies under Article 49 could be streamlined.

The implementation of the G20 commitment in Europe is bringing more products into clearing and CCPs continue to develop new products to address systemic risks associated with specific asset classes. It is therefore important that regulators and ESMA make the college approval process efficient. Likewise, a smooth and reasonably fast process for the approval of risk methodologies would promote effective risk management by CCPs.

<u>Article 15</u> – National regulators and ESMA should have a common understanding of what is deemed as new product/service/activity that would require the process under Article 15. We appreciate, for example, that the clearing of new classes of financial instruments is likely to introduce additional and novel risk within a CCP and so it requires an appropriate level of consideration by national competent authorities and ESMA. On the other hand, we would not expect regulators to require an approval process for less significant changes to a product belonging to an asset class already cleared by the CCP; for example, in the case of extension to new currencies, indices or single names in the case of CDS, or range of tenors under the existing risk framework. Where the risk entailed by a change in a product or service is outside of a CCP's risk framework and the CCP's risk methodology also needs to be reviewed, the process required under Article 49 may be more appropriate.

LCH.Clearnet Limited recently received college approval for clearing of inflation swaps, which was a new product not covered by the original authorisation. We believe that the process has been applied in line with our expectations and such process should be common practice for all colleges.

<u>Article 49</u> – this article requires the opinion of the college in respect to significant changes to risk models and parameters. We would like to receive clarification on:

iii. The circumstances in which the article applies, as the interpretation of what is deemed 'significant' may differ across competent authorities.
iv. The relationship between the various steps required in 49(1) and their sequence, i.e. the independent validation, the validation by ESMA and the competent authority, the opinion of the college.

An example where the approach of regulators has not been in line with our expectations on the application of article 49 includes the requirement to receive the approval of the college where changes to our risk methodologies are subject to the approval of the CCPs' Risk Committee. We believe that depending on the nature, type and materiality of the change, approval from the CCPs' competent authority, followed, if necessary, by a notification to the EMIR college, would provide sufficient rigor and oversight to the process. We do not believe that the escalation of all changes sets the right incentive for effective risk management by CCPs, and seems therefore against the policy objective of EMIR; CCPs should be able to take timely action to respond to changing circumstances under their own governance frameworks to best minimise risk. For example, LCH.Clearnet considers over one hundred stress scenarios for stress tests to determine the financial resources they need to manage both credit and liquidity risk. Our risk department reviews the stress scenarios regularly and may therefore decide to add or remove a scenario from the current list. We would not expect our regulators to require the need for college approval every time the list of stress scenarios is reviewed. The need to take into account new scenarios or discontinue others swiftly is critical to our risk management. It would not be appropriate for such review to be implemented over a number of months.

We believe that the issues noted above will not require a change in the legislative text nor prescriptive rules. Instead, the development of publicly-disclosed guidelines by ESMA and national competent authorities would be useful. While in some circumstances national regulators may find it appropriate or necessary to go beyond the guidelines, these should form the basis for a common understanding among regulators and CCPs of the scope of the articles 15 and 49 and therefore, the circumstance where they would apply. In the case of Article 49 such guidelines could be based, for example, on a self assessment by CCPs on the estimated impact of proposed changes to risk models and parameters; on this basis competent authorities could assess whether the process under Article 49 is necessary or not. The CCP should be able to provide any relevant supplementary information in the responses to the questions in the self assessment to allow an adequate explanation of the changes and enable the competent authority to make an informed decision. This approach would ensure coordination between the CCP and their competent authority, prior to a potential involvement of the college.

Question 1.4: Procyclicality

(a)

i. **Are the requirements under Article 41 EMIR and Article 28 *Regulation (EU) No 153/2013* adequate to limit procyclical effects on CCPs' financial resources?**

We believe that the current requirements on procyclicality are adequate.

(b)

i. **Is there a need to define additional capacity for authorities to intervene in this area?**

We do not believe there is a need to intervene in this area at this stage.

Definitions and Scope

Question 2.1

i. **Are there any provisions or definitions contained within Article 1 and 2 of EMIR that have created unintended consequences in terms of the scope of contracts or entities that are covered by the requirements?**

We would like to suggest adding specific definitions in Article 2 of EMIR.

ii. **ii If your answer to i. is yes, please provide evidence or specific examples. How could these be addressed?**

We would like to suggest adding the term 'authorised' in respect to both financial institutions and financial counterparties. EMIR should include a reference to the definition of the term 'authorisation' currently in place in the Capital Requirements Regulation. We suggest the following change to Article 2:

New: 'authorisation' means an instrument as defined in point 42 of Article 4(1) of Regulation No 575/2013/EC and the term 'authorised' shall be interpreted accordingly.

As explained in more details in our answer to question 2.8(a)(ii), we encourage EMIR to allow CCPs to treat regulated and highly creditworthy buy-side firms (e.g. pension funds and insurance undertakings) as potential investment counterparties for the purpose of repo'ing cash balances with high quality liquid assets. This could be clarified by replacing 'authorised financial institutions' with 'authorised financial counterparties' in Article 47 of EMIR; we would therefore encourage EMIR to enable CCPs to invest with counterparties listed in Article 2(8) of EMIR as well as 'authorised third country counterparties subject to equivalent regimes'.

We also think EMIR should provide a definition of 'affiliate' of a clearing member. The definition is relevant in the context of account segregation. We note that the CRR contains a reference to the term 'close links[4]'. The Commission may consider the CRR one possible source of definition for affiliates to be added to in Article 2 of EMIR. In our answer to question 2.6 (a) (i), we also note that EMIR should clarify that the positions and collateral of affiliates should not be included in a client's accounts; instead they should either be included in the clearing member's proprietary account (House account) or in a separate dedicated account. This approach would avoid clients' exposure to entities belonging to the clearing member's group.

Lastly, we note that Article 39(6) on segregation and portability refers to 'excess margin', which is not a defined term. We would like to suggest that the below definition, which builds on the clarification in the ESMA Q&A (answer 8 (a) of Part II on CCPs), is added to article 2 of EMIR. This will ensure that CCPs, clearing members and clients have clarity on the definition and treatment of excess margin.

New: 'margin in excess' means, in respect of a client which has opted for individual client segregation, an amount of margin provided by such client to its clearing member that is over and above the amount called by the CCP, in respect of the relevant individually segregated account.

<u>**Clearing Obligations**</u>

Question 2.2

(b)

i. Are there any other significant ongoing impediments or unintended consequences with respect to preparing to meet clearing obligations generally in accordance with Article 4 of EMIR?

We do not believe that there are any significant ongoing impediments in meeting the clearing obligation. In fact, we encourage the EU policy makers to expedite the process for the adoption of ESMA's proposed mandates for IRS denominated in G4 currencies and CDS, for which both market participants and CCPs are ready.

As explained in the answer below, we would welcome clarification on the process to be followed in the following two cases:

- Review of a decision not to impose a clearing obligation on a class or sub-class of OTC derivatives
- Removal/suspension of the clearing obligation on a class or sub-class of OTC derivatives

ii. ii If your answer to i. is yes, please provide evidence or specific examples. How could these be addressed?

[4] Regulation (EU) No 575/2013, Article 4(1)(38)

As noted in the LCH.Clearnet's responses to the ESMA consultations on the OTC clearing mandates issued so far, we believe that ESMA RTS or guidelines should clarify the triggers and procedures for reviewing a decision not to impose a clearing obligation on a class or sub-class of OTC derivatives. We also support ESMA's intention, stated in the final report for the clearing obligation of G4 currencies IRS, to ensure that an efficient process is built for removing the clearing obligation on OTC derivatives, so that such removal can be completed with the appropriate level of urgency.

A clarification on the above aspects of the clearing obligation would increase certainty for both market participants and CCPs.

<u>Cross-Border Activity in the OTC derivatives markets</u>

Question 2.6
(a)

i. With respect to activities involving counterparties established in third country jurisdictions; are there any provisions or definitions within EMIR that pose challenges for EU entities when transacting on a cross-border basis?

Yes, we would like to provide comment on the following:

1. The definition and treatment of affiliates under EMIR
2. The investment in money market funds (MMFs)

ii. If your answer to (i) is yes, please provide evidence or specific examples. How could these be addressed?

1. <u>The definition and treatment of affiliates under EMIR</u>
   As noted in our answer to question 2.1 (ii), the Commission should provide a definition of 'affiliate' in the legislative text of EMIR and may consider the current definition in the CRR one possible source of definition. We would also encourage the EU Commission or ESMA to clarify, either in the legislative text or in a Q&A document, that the positions and collateral of affiliates should not be included in clients' accounts and allow them to be either included in the clearing member's proprietary account or in a separate dedicated account(s). This approach would provide increased protection to clients, which are otherwise exposed to the potential failure of entities belonging to the clearing member's group. In addition, LCH.Clearnet includes entities which are dual registered under both the US and the EU regimes, it would, therefore, be beneficial to have the definition and treatment of affiliates aligned between the two regimes.

2. <u>The investment in money market funds (MMFs)</u>
   We believe that investment in MMFs under EMIR should be allowed, provided it is subject to certain conditions. The current restriction, noted in the ESMA final report on the draft RTS on CCPs' requirements issued in 2012[5], is particularly problematic for those CCPs which offer clearing services both in the EU and in the US. As in the US, investment in MMFs is allowed subject to certain conditions, a revision to the current restriction in Europe would ensure a level playing field between EMIR-authorised CCPs and US CCPs regulated by the CFTC.

[5] ESMA/2012/600, Final Report on draft technical standards under the Regulation (EU) No 648/2012 http://www.esma.europa.eu/system/files/2012-600_0.pdf

LCH.Clearnet includes active cross border CCPs which collect cash collateral from clients and members intraday throughout the Asian, European and North American time-zone, and therefore needs safe, liquid and reliable outlets to invest securely the late cash-inflows. The prohibition under EMIR imposes material constraints on cross-border CCPs and can result in an increased risk profile if such CCPs are unable to locate high quality secured investment capacity for clients' and members' money. We would like to encourage the EU Commission to revise the current restriction in respect to MMFs or provide guidance as to whether there is a possibility of creating an EMIR-compliant MMF.

As a suggestion, in order to permit this activity, we propose that Annex II of the ESMA RTS No 153/2013 be amended to add a new paragraph as set out below.

New 3. For the purpose of Article 47(1) of Regulation (EU) No 648/2012, interests in money market mutual funds can be considered highly liquid financial instruments bearing minimal credit and interest risk if they meet the following conditions:

(a) the fund must be appropriately registered by its competent authority and must hold itself out to investors as a money market mutual fund;

(b) the fund must be sponsored /managed by (i) an authorised credit institution as defined under Regulation (EU) No 575/2013, (ii) a third country financial institution that is subject to and complies with prudential rules considered by the relevant competent authorities at least as equivalent as those laid down in Directive 2013/36/EU and Regulation (EU) No 575/2013 and which has robust accounting practices, safekeeping procedures and internal controls, (iii) an investment firm authorised under Directive 2014/65/EU, (iv) an alternative investment fund managed by AIFMs authorised or registered in accordance with Directive 2011/61/EU, (v) an undertaking for collective investment in transferable securities authorised or registered in accordance with Directive 2009/65/EC or (vi) third country investment firm and investment fund subject to equivalent rules as those under points iii, iv and v.

(c) the CCP must limit the investment size to at least 5% of the overall fund net asset value, as well as that of the CCP's portfolio in accordance with the CCP's investment policy;

(d) a fund shall be required to redeem an interest and to make payment in satisfaction thereof by the business day following a redemption request (subject to suitable exemptions);

(e) the assets held by the money market mutual fund should be of the type that CCP is permitted to invest in pursuant to paragraph 1 and its approved investment policies; and

(f) the agreement pursuant to which the CCP has acquired and is holding its interest in a fund must not contain a provision which would prevent the pledging or transferring of shares.

(b)

i. Are there any provisions within EMIR that create a disadvantage for EU counterparties over non-EU entities?

Yes, we believe that the prohibition in EMIR and ESMA RTS for CCPs to invest in MMFs puts EU CCPs, particularly those with cross-border activities, at a disadvantage with their peers in jurisdictions, such as the US, where such investment is allowed. As noted in our answer to question 2.6 (ii), the prohibition under EMIR imposes material constraints on cross-border CCPs and can result in an increased risk profile if such CCPs are unable to locate high quality secured investment capacity for clients' and members' money.

ii. If your answer to i. is yes, please provide evidence or specific examples. How could these be addressed?

As noted in the above answer, in the US, investment in MMFs is allowed subject to certain conditions; therefore a revision to the current restriction in Europe would ensure a level playing field between EMIR-authorised CCPs and US CCPs regulated by the CFTC.

<u>Requirements for CCPs</u>

Question 2.8

(a)

i. Are there any significant ongoing impediments or unintended consequences with respect to CCPs' ability to meet requirements in accordance with Titles IV and V of EMIR?

Yes, in our answer below we provide specific comments on the following issues, listed in order of priority:

1. CCPs' investment policy
2. Portfolio margining
3. CCPs' skin in the game
4. Transparency requirements

ii. If your answer to (i) is yes, please provide evidence or specific examples. How could these be addressed?

1. <u>CCPs' investment policy:</u>

- **Investment in MMFs:** Please see our answer to question 2.6 (a)(ii) in respect to our comments on the investment in MMFs.

- **Highly creditworthy buy-side firms as investment counterparties of CCPs:** We encourage EMIR to allow CCPs to treat regulated and highly creditworthy buy-side firms (e.g. pension funds and insurance undertakings) as potential investment counterparties for the purpose of repo'ing cash balances with high quality liquid assets.

  Regulatory and capital requirements are leading banks to reduce their repo market activities. CCPs are challenged daily as they have to use the repo market to secure the increasing amount of cash balances resulting from cash collateral posted by a growing number of market participants meeting their initial margin obligations. Amongst these are buy-side firms that are simultaneously finding it harder to utilise the repo market to gain reliable access to cash fund cleared margin requirements at CCPs. Allowing CCPs to enter into repo transactions with highly creditworthy buy-side firms would allow CCPs to diversify their investment counterparty risk profile, while simultaneously provide additional liquidity in the repo market for the buy-side.

A way to address the issues above would be to replace 'authorised financial institutions' with 'authorised financial counterparties' in Article 47 of EMIR; we would therefore encourage EMIR to enable CCPs to invest with counterparties listed in Article 2(8) of EMIR as well as third country equivalent counterparties.

- **Use of derivatives by CCPs for the purpose of hedging interest rate risk:** The current provisions in Annex II para. 2 of ESMA RTS No 153/2013 limit a CCP's use of derivatives to hedge the risk arsing from default management and the currency risk arising from liquidity management. We appreciate that the reference to the use of derivatives to hedge currency risk was added in the final RTS following LCH.Clearnet's and other market participants' comments to the ESMA consultation at the time. We welcome that our comments were taken in consideration at the time. In addition, our response noted that CCPs should be allowed to use derivatives to micro-hedge the interest rate exposure for their investment activity. However, this aspect was not taken into account.

  As required under EMIR, CCPs invest the cash collateral received by clearing members into highly liquid financial instruments; a significant percentage of the cash is invested at fixed rate. As global markets are currently preparing for raising interest rates, EMIR-authorised CCPs have no options available to hedge the interest rate risk, that arises naturally from their business model, leaving CCPs exposed to P&L implications. The current rules could be amended to ensure that CCPs can invest in specific derivatives, such as Overnight Index Swaps (OISs), and that the average time to maturity of a CCP's portfolio is below two years, as required under Annex II 1(c). Such amendment would enable CCPs to use certain derivatives to micro-hedge interest rate exposure, thereby preserving their financial resources. We believe that prudent use of specific interest rate derivatives for hedging of investment risks should be compliant with Article 47(1) of EMIR subject to the conditions required under Annex II, para. 2 of ESMA RTS No 153/2013.

  In order to address the issue above, we encourage the EU Commission and ESMA to amend paragraph 2 (b) of Annex II to include "hedging currency and ***interest rate risks*** arising from its ***collateral and*** liquidity management framework established in accordance with Chapter VIII". The last sub-paragraph of paragraph 2 may be amended as follows:

  > 'Where derivative contracts are used in such circumstances, their use shall be limited to derivative contracts in respect of which reliable price data is published on a regular basis and to the period of time necessary to reduce the credit and market risk to which the CCP is exposed; ***where derivatives contracts are used to hedge interest rate risk, the average time-to-maturity of the CCP's portfolio shall not exceed two years***'.

2. Portfolio margining

Article 27 of RTS provides a solid foundation for consistent portfolio margining practices across CCPs. LCH.Clearnet believes that this presents an opportunity to address and clarify a few remaining areas of ambiguity in the industry, as well as to consider five underlying principles that could lead to a more robust and transparent risk management framework.

In general, LCH.Clearnet considers it is important to more tightly define and quantify some of the terms used in the context of correlations, and to address the importance of appropriate portfolio margining in a default management scenario.

Significant and reliable correlations

It is too simplistic to assess the significance and reliability of individual correlations separately; rather, the level and reliability of portfolio margining techniques depend on the entire correlation structure embedded in the portfolio, and require a portfolio-level assessment standard.

The risk mitigation impact of low correlation

Both positive correlation and the absence of correlation have an impact on the joint price risk of a portfolio, and therefore on portfolio risk management. When two contracts are positively correlated, one expects a price increase in one contract to be accompanied by a price increase in the other contract. Conversely, if two contracts are not correlated, one expects prices to move independently. A price increase in one contract is then neither more nor less likely to be accompanied by a price increase in the other contract. This intuitive concept can be made more precise through statistical definitions of dependence, covariance and correlation.

In seeking to introduce standards around correlation measurement, LCH.Clearnet believes that it is important to recognise the absence of correlations as a risk diversification tool.

If an investment or trading position is split between two uncorrelated contracts, risk goes down. This is because a loss on one contract is now not certain, and in the case of low correlations not more likely, than a gain on the second contract. In other words, a joint position is somewhat less risky than either of the two contracts separately. This form of risk reduction – the diversification of idiosyncratic risk – is a staple of risk management.

A Proposed Standard

Type II model errors. LCH.Clearnet proposes that correlations be allowed within the portfolio margining framework if they can be modelled with a Type II error below 5%.

LCH.Clearnet recommends a framework that is consistent with existing regulatory requirements, in that it allows portfolio margining within broad asset classes, but recognises margin benefits only to the extent that they are reliably present at times of stress. In fact, the framework goes beyond current regulatory standards, by setting well-defined and quantitative criteria for the significance and reliability of correlations in the context of margin modelling.

Model Risk Framework: 5 Requirements

1. Reliable and representative price data on all contracts in the portfolio

A robust source of actual prices needs to be available for all contracts in the portfolio. In some instances, this may require techniques for interpolating or inferring implied prices for less liquid contracts. If so, these techniques need to be consistently applied across the entire portfolio.

2. Ability to price entire portfolio across a wide range of historical and hypothetical scenarios

If some contract prices are interpolated or inferred, the techniques used need to enable portfolio pricing during hypothetical scenarios. All segments of the portfolio need to remain liquid at all times.

3. Portfolio margining aligned with default management procedures

In particular, only those positions are margined jointly that can be exited jointly in the event of a member default. In practice, this limits portfolio margining to portfolios within, but not across the major asset markets (rates, equities, credit).

4. Ability to quantify model risk/ type II errors

Model testing procedures based on historical back testing, bootstrapping or hypothetical scenarios in order to estimate the probability of a type-II error (underestimation of margins due to statistical noise in the model inputs)

5. Margin add-ons as required to keep model risk below 5%

If the risk of a Type II error is above 5%, a suitable margin add-on is required.

3. CCPs skin in the game

Recent debate in the industry on CCPs' risk management, recovery and resolution has focused on CCPs' total loss-absorbing capacity and the size of a CCP's own resources. In our view, this debate has not been clear as to the distinction between clearing members' risks and resources, and those of the CCP operator. For the members, a CCP is essentially a risk management system through which they can mitigate and pool their counterparty risk and benefit from other services, such as daily mark-to-market and settlement of payment on a netted basis. The CCP operator is responsible for the design and functioning of this system, and primarily has operational and business risks. It is not the place of a CCP to take on the trading risk from its members and be seen as a means of risk transfer, as opposed to risk mutualisation.

Under EMIR and related EBA RTS on CCPs' capital requirements, CCPs must hold regulatory capital towards a number of risks such as business, operational and legal risk as well as capital necessary to wind down its operations; in addition 25% of this regulatory capital is dedicated to the default waterfall. As noted in the LCH.Clearnet's white paper 'CCP Risk Management Recovery & Resolution'[6], skin in the game is designed to create appropriate incentives for risk management and is not a material component of loss absorption. We believe that 25% is a material percentage of the CCP operator's regulatory capital and achieves the appropriate alignment. Any requirement for the CCP operator to contribute significant additional resources to the default waterfall and link them to the overall member exposure or the size of the default fund would fundamentally change the operator's risk profile, creating increased risk exposure to

[6] 'CCP Risk Management Recovery & Resolution, An LCH.Clearnet White Paper'

http://www.lchclearnet.com/documents/731485/762448/final+white+paper+version+three.pdf/1d1700aa-a1ae-4a6c-8f6f-541eec9b7420 member default at the very time that the operator should be resilient in order to ensure continuity of the clearing service and stability of the market.

4. Transparency requirements

In respect of Article 38(5), both the CCP and the clearing member are required to disclose prices and fees associated with their services. Paragraph 5 requires CCPs to disclose when one or more clearing members breach this requirement. We would argue that this requirement for CCPs is unenforceable and should be removed. We do believe that CCPs and members should be only responsible for their own observance of the rule.

(b)

i. Are the requirements of Titles IV and V sufficiently robust to ensure appropriate levels of risk management and client asset protection with respect to EU CCPs and their participants?

As noted in our answer to question 2.6 (ii), we would encourage the Commission or ESMA to clarify, either in the legislative text or in a Q&A document, that the positions and collateral of affiliates should not be included in clients' accounts and allow them to be either included in the clearing member's proprietary account or in a separate dedicated account(s). This approach would provide increased protection to clients' assets, which are otherwise exposed to the potential failure of entities belonging to the clearing member's group.

(c)

i. Are there any requirements for CCPs which would benefit from further precision in order to achieve a more consistent application by authorities across the Union?

Please refer to our specific comments on the functioning of the supervisory college.

ii. If your answer to i. is yes, which requirements and how could they be better defined?

We believe that the functioning of the EMIR supervisory college is a key area which requires a more consistent application by authorities across the Union. As suggested in our previous answers on this topic, we believe that ESMA and national authorities should develop guidelines to ensure that there is a common level of understanding and tolerance as to what specific changes in the operations of the CCPs require the approval of the college. We would also welcome cooperation between each leading national authorities and their respective CCPs to address any discrepancies on the interpretation of the rules.