

Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th and Constitution Avenue, NW
Washington, DC 20551

19 June 2012

Dear Ms. Johnson:

Re: Docket No. 1438 and RIN 7100-AD-86, Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies

LCH.Clearnet Group Limited (“LCH.Clearnet” or “The Group”) is pleased to respond to the request for comment on the Board of Governors of the Federal Reserve System’s (“the FRB” or “Board”) proposal on Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies (“proposed rules”).¹

The Group strongly supports the policy goals underpinned by the proposed rules and the statutory provisions contained in Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”).

The FRB proposes to adopt rules implementing the enhanced prudential standards required by Section 165 of Dodd-Frank and the early remediation requirements established under section 166 of Dodd-Frank. The Group’s comments address the impact of the proposed rules on a covered company’s exposure to a central counterparty (“CCP”). The proposed rules consider margin posted and contributions to a CCP guaranty fund to be “credit exposures” of the covered company. This characterization results in the application of proposed single counterparty credit limits (“SCCL”) for the exposure of a covered company to a CCP.

The FRB proposes to measure credit exposures to CCPs using the Current Exposure Method (“CEM”). Calculations by our members indicate that, under the CEM proposal, clearing swaps through a qualified CCP (“QCCP”) may require them to set aside more capital than clearing bilaterally. This result is at odds with the G-20 commitment to encourage CCP clearing of OTC derivatives. LCH.Clearnet respectfully suggests that the Board should exempt the exposure of covered companies to CCPs from the definition of “credit exposure” and the SCCL provisions of the proposed rules to avoid this result. If these exposures are not exempted, then the use of CEM, as currently proposed, is likely to lead to significant disincentives to clearing. If these exposures are not exempted, then the proposed use of CEM is likely to lead to significant disincentives to clearing, particularly for products such as interest rate swaps, where the notional is never settled. If the SCCL provisions continue to include CCPs, then we would propose using a measure which is risk-sensitive – CEM is not – and appropriately reflects the benefits of netting.

¹ 77 FR 594 (January 5, 2012).

LCH.Clearnet's SwapClear Service

LCH.Clearnet's SwapClear is the only truly global clearing service for OTC interest rate swaps and currently clears more than 50% of the IR swap market, measured by notional principal.² The over one million trades in SwapClear have an aggregate notional principal amount equivalent to over USD 297 trillion, with a further USD equivalent of 126.5 trillion of cleared transactions removed through multilateral trade compression.³

Launched in 1999, SwapClear initially cleared plain vanilla interest rate swaps in four major currencies. Today, it clears interest rate swaps in 17 currencies: USD, EUR, and GBP out to 50 years, AUD, CAD, CHF, SEK and vanilla JPY out to 30 years and the remaining nine currencies out to 10 years. The SwapClear service also clears overnight index swaps out to two years in USD, EUR, GBP, and CHF. Over the last 10 years, we have worked closely with market participants to build SwapClear into a leading and successful inter-dealer OTC clearing service providing a range of benefits to the inter-bank market. SwapClear successfully closed out the Lehman Bros International Europe OTC interest rate swap portfolio that comprised USD 9 trillion of notional in 5 currencies out to 30 years maturity; this is testament to SwapClear's deep expertise, provenance and risk management practices in clearing OTC derivatives markets. More recently, SwapClear has implemented end-user client clearing in both Europe and the U.S.

SCCLs for Exposure to CCPs and Shortcomings of CEM

LCH.Clearnet is concerned that applying SCCL to the exposures of covered companies to CCPs could discourage the use of CCPs by covered companies. This result would be contrary to the commitments made by the members of the G-20 in Pittsburgh in 2009 and to the provisions of Title VII of Dodd-Frank both of which seek to mandate clearing of derivatives in order to reduce systemic risk and promote transparency. LCH.Clearnet understands that bank exposure to a CCP is not risk free. That is why we support high, globally consistent regulatory standards for CCPs, and appropriate capital charges for bank exposure to CCPs. In the proposed rules, the Board notes "that there are competing policy concerns in considering whether to limit a covered company's exposure to central counterparties."⁴ LCH.Clearnet suggests that the Board resolve these tensions in favour of unambiguous encouragement of clearing through CCPs by exempting covered company exposures to CCPs from the definition of "credit exposure" in the proposed rule and from SCCL.

LCH.Clearnet is also concerned that the application of SCCL to the exposure of covered companies to CCPs could prevent a level playing field between US and non-US banks. Non-US banks are explicitly excluded from the proposed rules. In addition, the large exposure limit regime in pending European legislation does not include exposures to CCPs.⁵ LCH.Clearnet urges the Board to harmonize its requirements under the proposed rules with those applicable to banks in other jurisdictions to the extent possible.

² Market share percentage based upon BIS statistics and SwapClear volumes as of January 31, 2012.

³ As of May 31, 2012.

⁴ 77 FR at 618.

⁵ See, Article 379(6) of CRD4.

If the Board decides to maintain SCCLs for covered company exposure to CCPs, we request that the exposures to CCPs be measured using a risk sensitive measure, rather than CEM which employs gross notionals. CEM is a risk insensitive method for measuring credit exposure particularly for products such as interest rate swaps where there is no exchange of the notional amount. Use of CEM to calculate credit exposures on interest rate swaps in a cleared environment results in potentially significant credit exposures even when two trades are exactly offsetting in terms of risk exposure. In addition, CEM does not capture risk diversification in portfolios because CEM is calculated for each individual position. One way to mitigate the substantial shortcomings of CEM is to use effective notional, rather than gross notional, in calculating covered company exposures to CCPs.

Conclusion

LCH.Clearnet appreciates the opportunity to share our views on the provisions of the proposed rules that address the exposure of covered companies to CCPs. We look forward to working with the FRB as it continues to implement the Dodd-Frank Act. Please do not hesitate to contact Lisa Rosen at +44 (0)207 426 7541 regarding any questions raised by this letter or to discuss these comments in greater detail.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Ian Axe', written in a cursive style.

Ian Axe
Chief Executive Officer