

EBA

One Canada Square (Floor 46)
Canary Wharf
London E14 5AA| UK

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LCH.CLEARNET GROUP RESPONSE TO THE EBA CONSULTATION ON THE VALUATION OF DERIVATIVES PURSUANT TO ARTICLE 49(4) OF THE BANK RECOVERY AND RESOLUTION DIRECTIVE (BRRD)

Dear Sirs,

This letter provides the submission of LCH.Clearnet Group Limited ("LCH.Clearnet") to the EBA consultation on Draft Regulatory Technical Standards on the valuation of derivatives pursuant to Article 49(4) of the Bank Recovery and Resolution Directive (BRRD).

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 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.

Please note that our response provides comments only on the proposed provisions in the BRRD that apply to the valuation of derivatives contracts cleared by a CCP.

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

KEY POINTS OF LCH.CLEARNET RESPONSE:

- We welcome the clarification in the executive summary of the consultation document that liabilities of a bank in resolution owed to a CCP are likely to fall under the exemptions from bail-in provided under the BRRD, particularly the exemption for secured liabilities under Article 44(2)(b).
- We welcome the EBA proposal that allows CCPs to perform the valuation of the *bail-inable* amount in accordance with its default procedures, subject to specific circumstances where the resolution authority would perform such valuation for the purpose of the bail-in tool only.
- We would like to emphasise that the completion of a CCP's default procedures is crucial in order to ensure the integrity of financial markets. The books of the CCP must always be balanced to fulfil its obligations towards the non-defaulting clearing members². While we appreciate the purpose of these RTS, it is important they avoid any adverse impact on the default management process of a CCP; particularly the procedure related to the bail-in tool should be kept separate from the procedure to complete the default management process.
- We encourage the final rules to define the 'close-out date' in the case of cleared derivatives contracts as the date on which the CCP triggers its default procedures against a clearing member in resolution.
- We suggest that the deadline for the CCP to provide the *bail-inable* amount should be realistic and extendable in case of need, to cater for the specific circumstances of a default.
- Given the significance of the CCPs' default management processes in the context of crisis management, we would support any initiative by national competent authorities and the EBA to discuss the practicality of the final RTS with CCPs.

RESPONSES TO SPECIFIC QUESTIONS IN THE CONSULTATION:

Question 1: Do you agree with the definitions above? Do you consider it necessary to specify some of them further, and in particular the definitions of "commercially reasonable replacement trades" and "unpaid amounts"?

We believe that Article 1(9) should include a definition of 'close-out date' that is specific to the valuation of cleared derivatives contracts. We propose the following amendment to this article:

(9) 'Close-out date' means the day and time of the close-out as specified by the resolution authority in the notification of a close-out; ***in the case of cleared derivatives contracts such date coincides with the day and time the CCP triggers its default procedures against a clearing member in resolution.***

In addition, our understanding is that the terms 'close-out amount' and 'early termination amount' refer to the same amount, therefore we would suggest the final rules to use either one or the other and add a definition of such amount in Article 1 that distinguishes what this amount is in the context of derivative contracts cleared by a CCP from those that are not cleared by a CCP. In respect to the valuation of derivatives contracts cleared by a CCP, the 'close-out amount' or the 'early termination amount' is the amount of loss that still remains unpaid after the CCP has taken action, as part of its default procedures, to

² As opposed to the close out of bilateral contracts, where a contract is closed against its bilateral counterparty, in the close out of cleared contracts the CCP needs to find a replacement contract to re-establish a matched book and, therefore, continue to operate.

neutralise the risk associated with the defaulting clearing member's portfolio and has used all the available resources of such clearing member to cover any resulting losses. In other words, the netting set for the purposes of the CCP's close out action would be the cleared transactions between the CCP and the defaulting clearing member and the collateral provided by the defaulting clearing member, which are netted against each other on default under the CCP's rules. Any loss amount resulting from this process that is still due from the defaulting clearing member, although exceeds the defaulting members' own resources, would have to be covered by the remaining resources in the default waterfall (i.e, CCPs' skin in the game and surviving clearing members contributions); this amount would be subject to the bail-in tool. This means that the bail in tool would be the mechanism under which non-defaulting members and the CCP would recover losses they respectively suffered as a result of the defaulting clearing member's default. To address these comments, we suggest that the following definition is added to Article 1:

New: 'In the case of valuation of derivatives contracts cleared by a CCP the close-out amount is the amount of loss which remains unpaid following the completion of the CCP's default procedures in respect of derivative contracts between it and an institution under resolution acting as a clearing member and any offset against any collateral provided to the CCP by the institution under resolution'.

Question 7: Do you agree with the treatment of CCPs as laid down in this Article? Are the conditions laid down in this article compatible with a swift and efficient valuation of cleared derivatives within the context of a resolution process? Do you see any material risk that the treatment of CCPs as laid down in this Article could conflict with the requirements for a sound risk-management framework to deal with the default of a clearing member?

We welcome the clarification in the executive summary of the consultation document that **liabilities of a bank in resolution owed to a CCP are likely to fall under the exemptions from bail-in** provided under the BRRD, particularly the exemption for secured liabilities under Article 44(2)(b). However, in the case an exemption would not apply, we agree with the proposed approach that the valuation of liabilities arising from cleared derivatives will be established according to the CCPs' default procedures established under EMIR.

In this context we would like to emphasise that notwithstanding the ability of a CCP to perform the valuation of liabilities arising from cleared derivatives or where such valuation is performed, in limited circumstances, by the resolution authority, the CCP must reserve the right to conclude the default management process set out in its' rules when a clearing member defaults. Particularly in the case where the calculation is performed by the resolution authority, we would like to ensure that such valuation will not be intended to be used to value the actual net loss amount on the basis of which the CCP will apply resources available to it under its' default procedures. In order to address this concern we suggest that the EBA adds the following wording to recital 19:

(19) The provisions in this Regulation should not affect the CCP's procedures for the transfer of the assets and positions held by a defaulting clearing member ("porting"), adopted in accordance with Article 48(5) and (6) of Regulation (EU) No 648/2012, and any other relevant provisions which, in principle, have the effect of precluding liabilities from arising from the relevant derivative contract. *To this effect, the valuation of cleared derivatives contracts described under Article 6, whether performed by the CCP or, in limited circumstances, by the resolution authority, is applied for the sole purpose of providing the amount subject to bail-in and shall not interfere with the application and completion of the CCP's default procedures as envisaged in their rulebooks.*

In addition, we would like to clarify that Article 6(2) refers to a scenario where the resolution authority would instruct the CCP to trigger its default procedures to the extent that the CCP has not yet done so. This approach is consistent with the safeguards currently in place in the BRRD whereby a CCP retains the rights

to put a member into default if it does not meet its obligation to the CCP. To this effect we suggest the amendment below:

(2) Where the CCP has not already decided to trigger its default procedures against an institution under resolution acting as a clearing member, the resolution authority shall notify the CCP and the CCP's competent authority of its decision to close-out the derivative contracts pursuant to Article 6(23)(1), letter (k), of Directive 2014/59/EU...'

Lastly, Article 6(5) requires the CCP to provide the close-out amount for the purpose of bail-in within a timeline agreed between the CCP, the CCP's competent authority and the resolution authority of the failing clearing member. We support the approach whereby both the CCP and its competent authority are involved in the decision of the timeline, because the default procedures to achieve the close-out amount can take weeks rather than days. It is fundamental that the CCP is not prevented from completing its default procedures or has to act under an unrealistic and tight timeline to complete such procedures for the purpose of the valuation required under Article 6. We would therefore like to emphasise the point that the deadline in paragraph 5 should be realistic and extendable in case of need. Indeed, we believe that to cater for the specific circumstances of each default, the agreement between the resolution authority, the competent authority and its CCP on a given deadline should be based on the possibility to extend such deadline. To address this issue we suggest the amendment below to recital 16):

(16) Conducting CCP default procedures may take several days or weeks following the trigger event. However, for the particular case of resolution, the application of default procedures over a long period of time could undermine the resolution timeline and objectives and could result in unnecessary disruption in the financial markets. It is therefore necessary for the resolution authority to ensure the cooperation of the CCP and the CCP competent authority in order to determine, by common agreement, a deadline for determining the close-out amount, taking into account both the *realistic timeline for the CCP to complete its* default procedures and the resolution timeline envisaged by the resolution authority. *Depending on the specific circumstances of a default event, the agreed deadline could be extended, provided the resolution authority, the competent authority and its CCP agree on such extension.*

In the case the close-out amount of cleared derivative contracts is not provided by the CCP within the agreed timeline or it is not provided in line with its default procedures, the resolution authority may determine the close-out amount in accordance with its own methodology, as described in Article 5 of the draft RTS. In this context we would like to emphasise that any amount that the resolution authority derives from its own methodology must not, under any circumstances, interfere with the continuation of the default management process of the CCP and any close-out amount that the CCP will calculate for the purpose of its default management.

We welcome the proposed approach whereby if a resolution authority determines a close-out amount based on its own estimate, such estimate will have to be updated upon completion of the CCP default procedure. This will ensure that any loss that has not been accounted for in the early estimate will be compensated once an actual valuation is provided by the CCP.

Question 11: The possibility to produce an early determination is available also in relation to claims of a CCP. In this case the final valuation will reflect the CCP claim as determined pursuant to Article 6, on the basis of the CCP default procedures if provided under the conditions of that Article. Do you consider it appropriate to also allow an early determination in relation to CCP claims?

The requirements in Article 7 seem to reflect the requirements under Article 6, whereby CCPs should establish a value of cleared derivative contracts in accordance with its default procedure, but, in limited circumstances, the resolution authority may intervene early to perform its own valuation estimate. Therefore we do not see any differences in principle between the objective of Article 6 and 7. However, we support

the approach in Article 7(3) which specifies that the resolution authorities should always be obliged to adjust the bail-in treatment of the CCP if and once the CCP provides its determination pursuant to Article 6.

Question 12: If so, do you consider that, with regard to CCP claims, resolution authorities should always be obliged to adjust the bail-in treatment of the CCP if and once the CCP provides its determination pursuant to Article 6? In that case, how do you assess the risk that the CCP determination process could hold back the finalisation of the bail-in process also for other claims? Alternatively, does the assessment of difference in treatment pursuant to Article 74 of the BRRD provide a sufficient safety net for CCPs?

We note that Article 74 of the BRRD provides for an independent person to conduct a valuation of the difference in treatment a party would have received if the institution under resolution had entered into normal insolvency proceedings. This mechanism would not therefore allow for the CCP's determination to be automatically substituted for the value imposed by the resolution authority. However, Article 74 does envisage that final valuations can be assessed following the resolution action and therefore we do not consider that completion of the CCP's default processes should delay the finalisation of the remainder of the bail-in process if adjustments can be subsequently made to reflect the CCP's actual losses.

ADDITIONAL COMMENTS:

We would like to suggest amendments to the following recitals in the draft RTS:

- **Recital 14:** Regulation (EU) No 648/2012 on OTC derivatives, central counterparties and trade repositories ("EMIR") requires CCPs authorised (*in the case of CCPs established in the EU*) *in a Member State* or recognised (*in the case of CCPs established in third countries*) *to offer services in the EU...*.
- **Recital 16:** Conducting CCP default procedures may take several days *or weeks* following the trigger event...'. 'It is therefore necessary for the resolution authority to ensure the cooperation of the CCP and the CCP competent authority in order to determine, by common agreement, a deadline for determining the close-out amount, taking into account both the *finalisation of the* CCP default procedures and the resolution timeline envisaged by the resolution authority.
- **Recital 17:** 'The resolution authority should nevertheless have the possibility to rely on its own estimates or on an alternative objective methodology to determine the close-out amount where the CCP fails to deliver the valuation of a close-out amount within the agreed deadline or does not apply its default procedures *according to its rulebook*'.
- **Recital 20:** The point in time for the valuation of derivative contracts should reflect the valuation principle retained by this Regulation which takes into account the actual or the hypothetical replacement costs incurred by counterparties. Therefore the valuation should be as at the close-out date or, if that would not be commercially reasonable, as at the first day and time at which a market price is available for the underlying asset. *In the case of cleared derivatives contracts, the valuation should be the amount provided within an agreed deadline by the CCP as required in Article 6(5) or by the resolution authority as required in Article 6(6).*

We hope that the above comments assist the EBA in the development of the final RTS on this topic. Should you have any questions on this response or wish to discuss it in detail, please do not hesitate to contact myself at Corentine.Poilvet-Clediere@lchclearnet.com or Valentina Cirigliano at Valentina.Cirigliano@lchclearnet.com.

Yours sincerely



Corentine Poilvet-Clediere
Head of Post Trade Regulatory Strategy