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London Stock Exchange Group response to the CPMI-IOSCO, FSB and BCBS consultation on incentives to centrally clear OTC Derivatives

Introduction

The London Stock Exchange Group (LSEG or the Group) is a financial market infrastructure provider, headquartered in London, with significant operations in Europe, North America and Asia. Its diversified global business focuses on capital formation, intellectual property and risk and balance sheet management. LSEG operates an open access model, offering choice and partnership to customers across all its businesses.

LSEG operates multiple clearing houses. It has majority ownership of the multi-asset global CCP operator, LCH Group (LCH). LCH has legal subsidiaries in the UK (LCH Ltd), France (LCH S.A.), and the US (LCH LLC). It is a leading multi-asset class and international 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, foreign exchange derivatives, interest rate swaps, credit default swaps and euro, sterling and US dollar denominated bonds and repos.

In addition, LSEG operates Cassa di Compensazione e Garanzia S.p.A. (CC&G), the Italian clearing house, providing clearing services for a range of European securities as well as exchange traded equity and commodities derivatives.

LSEG welcomes the opportunity to comment on CPMI-IOSCO, FSB and BCBS consultation on incentives to centrally clear OTC Derivatives.

General remarks

1. LSEG considers that the combination of clearing mandates, capital implications, increased liquidity and highly efficient margin netting have all influenced the amount of clearing for OTC derivatives undertaken by dealers and larger clients.
2. However, we observe that access to clearing services can be inhibited because of shortcomings in the definition of certain requirements such as the Leverage Ratio requirements under Basel III. We believe that this should be solved by removing barriers to access to clearing (client IM offsetting in the leverage ratio and GSIB) accompanied by reasonable phase-in periods to allow small financial firms to arrange client clearing structures rather than extensions of exemptions for smaller participants.
3. The product coverage of the clearing mandates has been carefully extended to consider product liquidity and the capabilities of CCPs to manage the relevant risks within their BAU and default management processes. It is important that clearing mandates are broadly consistent as we have noticed that for some credit derivatives, the clearing mandate is broader in the US than it is in EU or other jurisdictions.
4. In addition to the points raised in the report, we believe that the availability of cross-border or jurisdictional deference mechanisms and direct registration models have had a crucial role in the successful implementation of G20 commitments and access to clearing. In line with G20 Leaders Declarations, the global nature of OTC derivatives markets should be protected to avoid excessive costs and risks stemming from the isolation of the local customers from global markets.

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Specific responses

Section 1: Incentives

1. **Do you agree or disagree with the finding that, in general, there are strong incentives for dealers and larger (in terms of level of derivatives activity) clients to centrally clear OTC derivatives? Do you agree or disagree with the finding that some categories of clients have less strong incentives to use central clearing?**

   LSEG considers that the combination of clearing mandates, capital implications, increased liquidity and highly efficient margin netting have resulted to the increased amount of clearing activity for OTC derivatives undertaken by dealers and larger clients.

   A key component we have found in practice, and as the study notes, is that both dealers and clients would like to access the counterparty credit risk management benefits of clearing. However, access to clearing services can be inhibited, in particular because of shortcomings in the definition of the Leverage Ratio requirements under Basel III (for e.g. the need to recognise client IM offsetting in the leverage ratio). This can affect incentives to clear, especially when contemplating arrangements designed to increase protection for clients, such as individually segregated accounts – the costs of which can be very high and their uptake by clients considerably limited.

   LSEG believes that the current scope of clearing is broadly adequate. We also believe that although not all participants should be required to centrally clear, they should all be able to access central clearing facilities and benefit from counterparty credit risk management.

   However, the scope of participants subject to clearing mandates should be adequately defined by considering the specificities of the relevant market. For instance, small financials entities play a significant role in the CDS market, due to its size. Key considerations when calibrating participant scope or granting exemptions from clearing mandates should include assessment of the impact on the relevant market liquidity, the potential emergence of price basis between cleared and uncleared, etc. Besides, one could argue that such exemptions could further disincentivise clearing brokers to offer CCP access to smaller clients willing to clear, which would be contrary to the initial objective.

   When it comes to products, clearing mandates should be broadly consistent and exemptions should be limited. Finally, we believe that more consistency is needed in some credit derivatives where the clearing mandate is broader in the US than it is in EU or other jurisdictions.

2. **Do you agree or disagree with the finding that relevant post-crisis reforms have, overall, contributed to the incentives to centrally clear? Is the consultative report's characterisation of distinctions in how the reforms have affected incentives for different types of clients consistent or inconsistent with your experience?**

   LSEG agrees that post-crisis reforms have, overall, contributed to the incentives to centrally clear. It is worth noting, however, that the level of OTC uncleared margin requirements highlights the need to introduce sufficient incentives to ensure that market participants increase their use of centrally clearing services. LSEG considers that this aspect must be addressed adequately to ensure parties have sufficient incentives to clear transactions.

3. **Do the margin requirements for uncleared derivatives give a sufficient incentive to clear? How do these requirements interact with mandatory clearing obligations to incentivise clearing? Are there particular instruments, and specific types of entities where the incentive to clear is not adequate? In such cases, are there specific aspects of the requirements that diminish incentives to clear?**

   The level of margin required for uncleared transactions versus centrally cleared transactions enhance the resiliency of the bilateral derivatives market and influence whether clients choose to maintain bilateral OTC transactions or clear them at a CCP. The full adoption of uncleared margin requirements (UMR) has a profound impact on the incentives to clear. As shown in Figure D13, without IM in the UMR space, incentives to clear are materially less pronounced.

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LSEG is therefore of the opinion, that the level of margin (MPOR and SIMM) should be set at appropriate levels to maintain incentives to clear. It is not so much the CCP's MPOR which is an issue to incentivise clearing but rather the margin period of risk (MPOR) attached to a clearing member's exposure to the CCP for its own capital purposes. This will impact both clearing member and client behaviour.

LSEG believes given the exclusion of FX delta deriving from FX forwards, FX swaps and cross-currency swaps in the calculation of UMR, there is an uneven playing field between the cleared and uncleared risk management frameworks for these products which disincentives clearing.

As the risks from these products often dominate the market risk of large bilateral portfolios, and other bilateral market risk factors are being increasingly cleared, compressed and optimised to lower levels, the proportion of bilateral market risk in scope for UMR is materially reduced by these exclusions. This proportion is likely to decrease further in the absence of some degree of incentive for these bilateral risks to be reduced through clearing, compression, optimisation or some combination thereof.

Whilst we identify this as a space where the incentives to clear are likely not adequate, we recognise that these exclusions were intentional, that the numbers involved in this space can be very large, and that opinions vary as to the merits of these markets clearing. Any change to margin or capital regimes to incentivise this market towards clearing would need to be very carefully calibrated given the crucial importance of maintaining healthy FX markets to the global economy.

Finally, in respect of the CSA study we believe that the models should address the potential counterparty and systemic risk implications of the different scenarios, particularly in the case where entities do not exchange IM.

4. **The consultative report seeks to identify the most important regulatory and non-regulatory factors which affect incentives to centrally clear OTC derivatives for dealers, other financial intermediaries, large clients and small clients. Please identify any significant missing factors and comment on the relative strength of regulatory and non-regulatory factors discussed in the consultative report.**

Further to the points raised in the report, we believe that the availability of cross-border or jurisdictional deference mechanisms and direct registrations models have had a crucial role in the implementation of G20 commitments. In line with G20 Leaders Declarations, the global nature of OTC Derivatives markets should be protected and interconnected to avoid excessive costs and risks stemming from the isolation of the local customers from global markets.

It is worth noting that LCH. Ltd is subject to extensive supervisory input as it is directly regulated by several authorities in addition to its home supervisor the Bank of England. These authorities include ASIC, the Bank of England, the Japanese FSA, the Federal Reserve Bank of Australia, the CFTC, FINMA, OSC, the Quebec AMF, Finanstilsynet, the Monetary Authority of Singapore and the Hong Kong Securities and Futures Commission. Particularly, LCH Ltd's SwapClear internationally-integrated service is directly licensed in many jurisdictions (including the EU, US, UK, Australia, Canada, Japan, Singapore, Hong Kong and Switzerland), clearing 21 currencies and serving clients across the globe in 60 countries.

The approach of G20, when conceiving the clearing mandates, included the recognition that the OTC derivatives market was essentially a global market and there was a need to adapt supervisory activities to reflect this global nature. We believe that this played a crucial role in ensuring the success of the implementation of the G20 commitments and corresponding reforms to facilitate access to clearing on a global scale. In translating these aims into standards and regulatory practices, it is important for regulators and lawmakers to take under consideration the need to use deference mechanisms to avoid regulatory gaps, duplication, conflicts and inconsistencies which can lead to regulatory arbitrage and market fragmentation.

Finally, the costs of clearing could be affected by CCP recovery regimes that would impose additional resources or costs to the CCPs. These costs could make central clearing less attractive and raise further barriers for smaller market participants.

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Section 2: Markets

5. **Is the consultative report's characterisation of the shift of activity and trading liquidity towards centrally cleared products, and the consequent impact on uncleared products, consistent or inconsistent with your experience?**

Market participants tend to operate where liquidity pools are formed, utilising markets in the most efficiency way in terms of costs (for e.g. bid/ask spread, margin/funding costs). The consultative report largely confirms this, where for many OTC products today the liquidity is at CCP's while for others it remains in the bilateral market.

As mentioned above, uncleared margin requirements can play a significant role in promoting incentives to clear. However, as is indicated in Figure D.3, this is not yet seen as a major incentive. The phase-in of the UMR is still underway so it is likely that margin requirements will have a clearer impact once fully implemented.

6. **There are various industry efforts underway to reduce the cost of clearing, including portfolio compression and direct clearing membership models. Based on your experience are these proposals, or other forthcoming changes to clearing infrastructure and models, likely to affect incentives to provide or use clearing services?**

LSEG has added client clearing capabilities to its services in accordance with demand and is constantly monitoring market developments to respond to clients' needs in a safe way. It is however important to have clarity and stability into the prudential rules before CCPs invest resources into developing new solutions. In the context of new products eligible for clearing, LSEG has been developing tools and services that provide additional benefits to clearing participants, promote central clearing and enhance the service offering for clearing participants.

This includes tools such as margin efficiencies, compression services, and specific account structures as requested by customers. As noted in the report, these techniques have enabled the reduction of operational risks and funding needs, streamlining the clearing service offering. The widespread adoption of compression techniques has allowed to materially reduce the typical portfolio sizes in terms of trades and has brought material benefits to systemic risk reduction in the context of default management and porting of portfolios.

However, we believe that the on-going debate and uncertainty surrounding changes to the Basel III Leverage Ratio (client IM offsetting) continues to inhibit incentives to centrally clear derivatives for all participants and in many cases impede clients' access to centrally cleared markets. This report should lead FSB / CPMI / IOSCO / BCBS to consider addressing the deficiencies in the Basel III Leverage Ratio calibration as a priority but also consider other regulatory reforms and unintended consequences that may only now be more apparent.

Section 4: Reforms

7. **Do you agree or disagree with the report's characterisation of the effects of the following reforms on incentives to centrally clear?**

   a. **Central clearing mandates (both in terms of product scope and entity scope);**

We agree with the report's characterisation. It would also be beneficial for more international convergence in the description of products for clearing mandates. For e.g. we believe that there is a case for more alignment in the mandatory clearing of credit derivatives where the clearing mandate is broader in the US than it is in EU or elsewhere. Figure D.21 of the report seems to show that quite a few market participants (across CCPs, Dealers, Clearing Brokers and Clients) think that the clearing mandate scope is "*too narrow for products*".

   b. **minimum standards for margin requirements for uncleared derivatives;**

We agree. However, the survey responses highlight the need to continue the rollout of UMR to ensure that it acts as a proper regulatory incentive to centrally clear.

   c. **capital requirements for credit valuation adjustment (CVA) risk;**

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We agree with the report.

d. capital requirements for jump-to-default risk (including where applicable the Standardised approach for counterparty credit risk (SA-CCR) and the Current exposure method (CEM));

We broadly agree with the description made by the report and support the transition from the CEM to SA-CCR. We would however support the need for a further evaluation of the SA-CCR.

e. G-SIB requirements; and

We note the use of relative measures of activity amongst a peer group to determine the outputs of certain GSIB calculations. While recognising the challenge associated with setting thresholds in absolute terms, we observe that relative measures can dilute incentives for industry participants to work collectively (within the constrains of anti-competitive behaviour) towards solutions that benefit the financial system. Put another way, if a network of firms is considering whether to invest in an initiative to reduce a given metric equally for all participants, GSIB rules provide no incentive to go ahead despite the positive systemic outcome.

With regards to GSIB rules, LSEG would like to point out that the cleared exposures which are included in the leverage ratio exposures, also feed into the GSIB calculation under the size indicator. As a result, for OTC client cleared transactions, notional is included on both CCP facing and client facing legs of the cleared transaction under the "principal" clearing model. Consequentially, in the context of porting, the doubling of the amount of notional associated with client portfolios creates further disincentives to facilitate the porting of client portfolios which in turn could have an impact on the overall GSIB score and buffer to be applied. In addition, we believe that the difference in risk characteristics between cleared and uncleared OTC derivatives should be reflected in the GSIB complexity indicator and that these products should not be treated in an identical way.

f. The leverage ratio.

As noted above, the Leverage Ratio needs to be reformed to recognise the offset of a client's IM. Furthermore, we believe that all jurisdictions should adopt SA-CCR for the calculation of derivatives' exposures to promote regulatory convergence.

8. Do you agree or disagree with the consultative report's characterisation of the impact of these reforms on the incentives to provide client clearing services?

The report illustrates the various considerations and perspectives for incentives to clear and highlights the more commonly discussed negative incentives. However, it does not provide any path forward on how the international standard settlers would address mutually agreed shortcomings in the regulatory reforms. We would encourage using the outcomes of this report to suggest the necessary changes to international frameworks that would allow broader access to clearing services.

9. Are there any areas where potential policy adjustments should be considered which would enhance the incentives for or access to central clearing of OTC derivatives, or the incentives to provide client clearing services?

Mechanisms ensuring that access to global OTC markets based on deference between jurisdictions have ensured the success and effectiveness of G20 reforms so far and should not been undermined.

Disincentives to clearing need to be removed from the prudential frameworks (e.g. client IM offsetting in the leverage ratio, GSIB surcharge, SA-CCR vs. CEM, SA-CCR improvements) before any decisions on scaling back or removing clearing mandates should be made. Until then, the scope of clearing mandates should remain intact or come into force as scheduled, to incentivise firms to enter the central clearing eco-system. Finally, individual jurisdictions should maintain mechanisms ensuring that the global nature of OTC derivatives is acknowledged.

In addressing disincentives to clear (while there are many areas consistent with those identified in the report) LSEG suggests that adjustments to the Basel III Leverage Ratio - such as client IM offsetting - should be treated as a priority.

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Section 5: Access

10. Do you agree or disagree with the report's characterisation of the difficulties some clients, especially clients with smaller or more directional derivatives activity, face in:

a. accessing clearing arrangements; and

The conclusions cited in the report are consistent with client feedback and industry perspectives received over the past several years.

b. conducting trading and/or hedging activity given the restrictions imposed by their client clearing service providers?

The conclusions cited in the report are consistent with client feedback and industry perspectives received over the past years.

11. Do you agree or disagree with the finding that the provision of client clearing services is concentrated in a relatively small number of banks? Does the current level of concentration raise any concerns about incentives to centrally clear, or risks to the continuity of provision of critical economic functions, including during periods of stress?

LSEG believes that concentration of client clearing services is not uniform as clearly illustrated by the DAT. The example used in the DAT report (page 21) shows that for one large EU interest rate derivatives CCP, the number of client clearing service providers has increased from 48 in 2015 to 54 in 2017, and client positions attributable to the five largest clearing members have fallen from 83% to 78%. However, for markets where concentration has increased, this trend stands to introduce systemic risks and potential financial market risk instability during times of market distress (for e.g. impact of Basel III Leverage Ratio with respect to porting in the event of a large CCP clearing member) although we observe different trends depending on asset classes.

Client clearing is a business with high relative fixed costs which profitability would appear to depend in part on achieving economies of scale. While this drives clearing members to compete to attract new business, LSEG believes that OTC derivatives that are not appropriate for clearing should remain bilaterally cleared subject to appropriate UMR. Any change to margin or capital regimes to incentivise towards clearing would need to be very carefully calibrated given the crucial importance of maintaining healthy derivatives markets to the global economy.

12. Do you agree or disagree with the report's characterisation of the incentive effects created by up-front and ongoing fixed costs of:

a. using clearing services?

We agree with the report's characterisation of cost impacts.

b. providing client clearing services?

We agree with the report's characterisation of its impacts. However, clearing provides benefits to the derivatives markets through counterparty risk management and greater position netting and efficiency. There is an inherent value in this and corresponding costs that should be emphasised.

13. In light of the finding in this report that economic factors generally incentivise central clearing for certain market participants but perhaps not for others, please describe your views regarding the costs and benefits of the scope of the clearing mandates, both in terms of the products and entities covered.

The product coverage of the clearing mandates has been carefully extended to consider product liquidity and the capabilities of CCPs to manage the relevant risks within their BAU and default management processes. As discussed above, clearing mandates should be broadly consistent and exemptions should be limited. For e.g. we believe that more consistency is needed in some credit derivatives where the clearing mandate is broader in the US than it is in EU or other jurisdictions. Furthermore, LSEG believes that OTC derivatives that are not appropriate for clearing should remain bilaterally cleared subject to appropriate UMR.

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Regarding the entity scope of the clearing obligation, we believe it is important to grant exemptions only when risks are immaterial from a financial stability standpoint as these exemptions maintain or increase bilateral transactions with reduced transparency and increased counterparty risk. Commercial and other reasons should be carefully considered in the light of increases to the associated systemic risks. We believe that regulatory reforms should be fully implemented before any decisions are made regarding the scope and application of clearing mandates. Finally, any change to margin or capital regimes to incentivise towards clearing would need to be very carefully calibrated given the crucial importance of maintaining healthy derivatives markets to the global economy.

14. Should regulation seek to create incentives to centrally clear OTC derivatives for all financial firms, including the smallest and least active? If so, what would that imply for the costs of uncleared trades? If not, for which types of firm and product is it most important to have incentives for central clearing? Conversely for which types of firm and product would it be acceptable not to have incentives for central clearing? Please elaborate.

The report confirms that the market demand for central clearing services is based around the substantial risk management benefits afforded by the CCP. However, access and incentives remain an issue for some clients and market participants. While smaller participants may not pose systemic risk to the financial system they would still benefit from efficiencies and market liquidity while further reduce bilateral risk in the financial markets.

We acknowledge that certain participants or transactions should not be subject to the clearing mandate but believe that exemptions should be granted when risks are immaterial from a financial stability standpoint. Commercial and other reasons should be carefully considered in the light of increases to the associated systemic risks.

With regards to financial firms, we acknowledge that small financial firms struggle to access clearing services, either directly as clearing members or indirectly as clients of clearing members, to cover risks related to their portfolios and as shown by the consultative report: permanent exemptions maintain bilateral transactions with reduced transparency and increased counterparty risk.

Granting exemptions to small financial firms from the clearing obligations is not always the right approach. Regulations should be reviewed to remove any barriers to clearing which were created unintentionally (client IM offsetting in the leverage ratio and GSIB) and allow reasonable phase-in periods to small financial firms to arrange client clearing structures rather than extensions of exemptions for smaller participants.

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