

Via CFTC Portal

25 February 2020

Mr Christopher J. Kirkpatrick
Office of the Secretariat
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street NW
Washington, DC 20581

Re: Proposed amendments to LCH SA Liquidity risk modelling framework

Dear Mr. Kirkpatrick,

Pursuant to CFTC regulation §40.6(a), LCH SA, a derivatives clearing organization (“**DCO**”) registered with the Commodity Futures Trading Commission (the “**CFTC**”), is submitting for self-certification the proposed amendments to its Liquidity Risk Modelling Framework.

The intended date of implementation is 10 March 2020, subject to any relevant regulatory review or approval process duly completed and in no event, the changes will be implemented earlier than ten (10) business days after the formal filing with the CFTC.

Part I: Explanation and Analysis

LCH SA is proposing to amend its Liquidity Risk Modelling Framework (the “**Framework**”), which describes the Liquidity Stress Testing framework by which the Collateral and Liquidity Risk Management department (“**CaLRM**”) of LCH Group Holdings Limited (“**LCH Group**”) assures that LCH SA has enough cash available to meet any financial obligations, both expected and unexpected, that may arise over the liquidation period for each of the clearing services that LCH SA offers.¹ The Framework is part of LCH SA’s Risk Management Procedures (the “**Procedures**”).

The amended Framework is intended to address more accurately LCH SA’s liquidity requirements in the event of the assignment and exercise of physically settled options involving a defaulting clearing member during the liquidation period of such clearing member.

Specifically, the amended Framework will anticipate, prior to their expiration dates, the amount of liquidity funding that may arise from options that may be exercised, in the event of the default of LCH SA’s two largest members.

¹ LCH SA, a subsidiary of LCH Group, manages its liquidity risk pursuant to, among other policies and procedures, the Group Liquidity Risk Policy and the Group Liquidity Plan applicable to each entity within LCH Group.

In addition to its CDSClear service, LCH SA provides clearing services in connection with cash equities and derivatives listed for trading on Euronext (EquityClear), commodity derivatives listed for trading on Euronext (CommodityClear), and tri-party Repo transactions (RepoClear).

In addition, the Framework has also been revised to take into account the expansion of sovereign debt for which LCH SA Repoclear provides clearing services

Part II: Description of Rule changes

The Framework is one of several well-developed policies and procedures that LCH SA maintains to manage its liquidity risk, *i.e.*, the risk that LCH SA will not have enough cash available, in extreme but plausible circumstances, to settle margin payments or delivery obligations when they become due, in particular upon the default of a clearing member. Such policies and procedures include, among others: (i) the Group Liquidity Risk Policy; (ii) the Group Liquidity Plan; (iii) the Group Financial Resource Adequacy Plan; (iv) the Group Collateral Risk Policy; (v) the Group Investment Risk Policy; and (vi) the LCH SA Collateral Control Framework. The Framework complements these policies and procedures and develops further the Group Liquidity Risk Policy.

In brief, the Framework: (i) identifies LCH SA's sources of liquidity and corresponding liquidity risks; (ii) identifies LCH SA's liquidity requirements with respect to its members and its interoperable central counterparty ("CCP");² (iii) describes the metrics and limits that LCH SA monitors; and (iv) describes the scenarios under which these metrics are computed.

A. Physically-settled options.

LCH SA is proposing to amend the Framework in order to address more accurately its liquidity requirements in the event of the assignment and exercise of physically-settled options involving a defaulting clearing member during the liquidation period of such clearing member. Specifically, the amended Framework will address LCH SA's liquidity requirements in the event options that are in the money are exercised either on the day ("T"), or on the business day immediately following the day ("T+1"), on which the clearing member that is a seller of the options defaults.

If such defaulting clearing member is a seller of a Call option that is in the money, LCH SA would have to purchase the underlying securities in the market at a stressed price and await payment at the strike price from the non-defaulting purchaser of the Call option at settlement. If such defaulting clearing member is a seller of a Put option that is in the money, LCH SA would have to purchase the underlying securities at the strike price from the non-defaulting purchaser of the Put option. Although margins should cover any potential loss, liquidity outflows as a result of the sales' proceeds are included as liquidity requirements, in each case.

In the current Framework, there is no liquidity provision related to the risk of assignment and exercise of options at expiration. In order to address this concern, the amended Framework will anticipate, prior to the expiration dates, the amount of liquidity funding that may arise from options that may be exercised, in the event of the default of LCH SA's two largest members ("Cover 2"). On a daily basis, LCH SA's liquidity coverage ratio ("LCR") calculation will identify all of the potential positions that are in the

² LCH SA has an interoperability agreement with Cassa di Compensazione e Garanzia ("CC&G"), an Italian CCP, pursuant to which LCH SA's clearing members and CC&G's clearing members are able to benefit from common clearing services without having to join the other CCP. Each CCP is a clearing member of the other one with a particular status when accessing the clearing system of the other counterparty.

money or at the money on that day and the next business day. Given the potential option exercise, the LCR will generate a liquidity need. The additional liquidity amount that LCH SA could potentially need will be equal to the sum of the equities to source following the option assignments at expiration and/or the difference between the underlying securities and the strike price or the strike price minus the asset in the event of a cash settlement.

In practice, the process will work as follows on a daily basis:

- The liquidity needs arising from the options that are in the money or at the money, having their expiries on T or T+1, will be computed by applying no market stress to the equities.
- The liquidity needs arising from the options that are in the money or at the money, having their expiries on T or T+1, will be computed by applying a stress scenario to the equities.
- LCH SA will select the positions consistent with the Cover 2 for both modes described above and will retain the most punitive one.

This amount will be added to the current cash equity amount in the LCR calculation, which LCH SA would then retain through qualified liquid resources.

B. Stress tests.

Further, LCH SA is proposing clarifications with respect to certain aspects of its stress tests. With respect to the operational liquidity target,³ which is a metric allowing LCH SA to confirm that the business as usual liquidity sources are sufficient for a five day period in stressed situations, consistent with the LCR time horizon, the Framework would note that LCH SA uses a three-day window, in particular with regard to margin reduction. The Framework would further clarify that, in calculating liquidity resources, LCH SA deducts funds required to facilitate settlements, cover end of day fails at Euroclear Bank and Clearstream Luxembourg, and avoid Target 2 Securities fails.⁴ In addition, the Framework assumes that members allowed to post Central Bank Guarantees (CBGs) will switch from cash or European Central Bank-eligible non-cash collateral to CBGs (although the Framework does not currently take such switches into account, since all eligible members, *i.e.*, Dutch and Belgian members, have already done so). Moreover, the amended Framework would confirm that, in calculating required variation margin payments to CC&G, LCH SA assumes a theoretical 5-day holding period.

The amended Framework would also clarify how stressed liquidity requirements and impact are calculated for each clearing member, in particular with respect to the cash equity settlement requirement for options. These calculations are used to determine the two clearing members that would potentially cause the largest aggregate liquidity exposure for the CCP in extreme but plausible market conditions.

Finally, the Framework would clarify how LCH SA conducts reverse stress tests in order to determine if there is a combination of changes in LCH SA's liquidity that could lead to a liquidity shortfall. In particular, the amended Framework would consider whether there is a combination of changes in LCH SA's liquidity resources that could lead to a liquidity shortfall, even in the absence of stress in the market.

³ Operational liquidity is defined to mean the amount of liquidity related to the operational management of LCH SA that is required to be held in a stressed environment that does not lead to a clearing member's default.

⁴ Target 2 Securities is a Eurosystem technical platform to which CSDs assign the management of securities settlement in central bank money.

Part III: Core Principle Compliance

LCH SA will continue to comply with all Core Principles following the introduction of this change and has concluded that its compliance with the Core Principles would not be adversely affected by this change.

Part IV: Public Information

LCH SA has posted a notice of pending certifications with the CFTC and a copy of the submission on LCH's website at: <https://www.lch.com/resources/rules-and-regulations/proposed-rule-changes-0>

Part V: Opposing Views

There were no opposing views expressed to LCH SA by governing board or committee members, members of LCH SA that were not incorporated into the rules.

Certification

LCH SA hereby certifies to the CFTC, pursuant to the procedures set forth in the Commission regulation §40.6, that this change submission complies with the Commodity Exchange Act, as amended, and the regulations promulgated there under.

Should you have any questions please contact me at: françois.faure@lch.com



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APPENDIX

Liquidity risk modelling framework **(to be filed separately with the CFTC under Confidential Treatment request)**