

LCH.Clearnet Ltd: how its risk management compares to external standards

LCH.Clearnet Ltd and external standards

- LCH.Clearnet Ltd has a stated aim that its risk management should be best practice
- It reviews its risk management against the following external standards:
 - European Association of Central Counterparty Clearing Houses (EACH) standards of risk management control;
 - The CPSS-IOSCO Recommendations for Central Counterparties

EACH Risk Management Standards (1)

○ A – Counterparty Risk

○ 1 Clearing Membership Requirements

LCH.Clearnet Ltd establishes net capital and regulatory/legal criteria, has the facility to charge additional margin, and insists that members have appropriate banking arrangements, operational capability and experience, and management oversight.

○ 2 Membership evaluation and monitoring

LCH.Clearnet Ltd credit scores its members and monitors them on a daily basis; it also shares information with other CCPs and with regulators.

EACH Risk Management Standards (2)

○ B – Valuation and Margining

○ 3 Revaluation of positions

LCH.Clearnet Ltd revalues all positions daily; it checks, assesses and cleans prices intra-day and end-of-day; and it can override exchange prices if necessary.

○ 4 Risk-based initial margin requirements

LCH.Clearnet Ltd maintains appropriate margining models; regularly reviews parameters used in those models; uses an assumed close-out period of at least two days; calculates, collects and backtests initial margin daily; and maintains independence of decision-making on initial margins from the business.

EACH Risk Management Standards (3)

○ B – Valuation and Margining (continued)

○ 5 Initial margin cover

LCH.Clearnet Ltd's list of collateral eligible as margin cover is restricted to the types identified in the Standards; it also operates issuer-quality, illiquidity and holding restrictions, as well as daily re-valuations and prudent haircuts which are kept under review.

○ 6 Intra-day margining

LCH operates routine intra-day margin evaluation and margin calling procedures which limit excessive intra-day margin erosion. These are portfolio-based on all markets except futures and options, where intra-day margining is on a contract-by-contract basis.

EACH Risk Management Standards (4)

☉ C – Money settlement and custodial arrangements

☉ 7 Money Settlement

LCH.Clearnet Ltd uses central banks to concentrate sterling and euros and high quality commercial banks for other currencies. Its PPS network is available in UK and US timezones and uses irrevocable commitments and full account reconciliation.

☉ 8 Physical Delivery

All deliveries, whether at LCH.Clearnet Ltd or at a (I)CSD, are delivery-versus-payment (with the exception of, necessarily small, free of delivery netting outturns, which are in any case fully margined); and members must demonstrate the ability to deliver.

EACH Risk Management Standards (5)

☉ C – Money settlement and custodial arrangements (continued)

☉ 9 Custody and security of cash and non-cash collateral

LCH.Clearnet Ltd secures at least 85% of its cash holdings; it deposits the rest with banks with a rating of at least AA- and with any single deposit being within its capital base; securities are held with (I)CSDs or highly rated banks who are regularly assessed; bank guarantees are held by LCH.Clearnet Ltd itself.

EACH Risk Management Standards (6)

○ D – Financial resources ...

○ 10 (i) ... to cover default

LCH.Clearnet Ltd maintains a Default Fund of £590.7mn (as at February 2010) which is stress tested daily against both the largest member group exposure, and the second and third largest member group exposures combined (plus five small members), with headroom of at least 10%; the Fund is held by LCH.Clearnet Ltd in cash.

○ 10 (ii) ... to cover non-default risk

LCH.Clearnet Ltd has a capital base of €268.4mn (as at end 2008) which is held in cash, which is well in excess of regulatory requirements, and which is not “double-counted” in the analysis of default resources outlined above.

EACH Risk Management Standards (7)

○ E – Default Arrangements

○ 11 (i) Rules

LCH.Clearnet Ltd's Rules form part of its Rulebook which meets the requirements of this standard

○ 11 (ii) Management framework

LCH.Clearnet Ltd maintains a default management framework which draws on its practical experience handling defaults and near-default events and which is kept under constant review; key staff are aware of its requirements and involved in testing it.

○ 11 (iii) Legal protection in the event of insolvency

LCH.Clearnet Ltd has extensive protection under English (part VII of the Companies Act) and US law (as a DCO), and is designated under the Financial Markets and Insolvency (Settlement Finality) Regulations. This removes all but remote residual risk of legal challenge. It also has legal opinions on netting for all major jurisdictions and its rulebook is clear on its powers and obligations.

EACH Risk Management Standards (8)

○ F – Risk Management arrangements & resources

○ 12 Dedicated, specialist staff

LCH.Clearnet Ltd has a separate Risk Management Department of ~50 staff who report directly to the CEO

○ G – IT arrangements & resources

○ 13 Robust arrangements and continuity

LCH.Clearnet Ltd has established standards for the performance and recovery times of all major systems. It also has a remote data centre and two back-up sites and regularly tests its facilities by moving to back-up. It also did this “for real” on 7 July 2005.

EACH Risk Management Standards (9)

- H – Disclosure of risk management practices and of the nature of the clearing house ‘guarantee’
 - LCH.Clearnet Ltd believes that this set of communication packages meets these requirements.
- LCH.Clearnet Ltd therefore believes it meets the EACH standards of risk management controls in full.

CPSS-IOSCO recommendations for CCPs



- LCH.Clearnet Ltd was, in June 2006, assessed by the FSA and the Bank of England against the CPSS-IOSCO recommendations for CCPs.
- Of the 15 recommendations, LCH.Clearnet Ltd was found to have observed 14 and to have “broadly observed” the other.



Contact Points at LCH.Clearnet Ltd

🕒 For further information on LCH.Clearnet Ltd's risk management, please contact one of the following:

Damon Batten
Risk Analyst, Risk Policy
Risk Management
LCH.Clearnet Limited
33 Aldgate House
London EC3N 1EA

☎ : +44 (0)20 7426 6379
✉ : damon.batten@lchclearnet.com

Christopher Jones
Director and Head,
Risk Management
LCH.Clearnet Limited
33 Aldgate House
London EC3N 1EA

☎ : +44 (0)20 7426 7103
✉ : christopher.jones@lchclearnet.com