



**Via Electronic mail**

January 22, 2013

Ms. Melissa Jurgens  
Secretary of the Commission  
Commodity Futures Trading Commission  
Three Lafayette Centre  
1155 21<sup>st</sup> Street, N.W.  
Washington, DC 20581

**RE: Changes to LCH.Clearnet Limited Initial Margin Model for SwapClear**

Dear Ms. Jurgens:

Pursuant to §40.6(a) of the Commission Regulations, LCH.Clearnet Limited ("LCH.Clearnet"), a derivatives clearing organization registered with the Commodity Futures Trading Commission (the "CFTC"), hereby submits for self-certification information relating to changes to the Initial Margin Methodology utilized by its SwapClear service. LCH.Clearnet notes that, while these changes will result in no changes to the LCH.Clearnet Rules and Regulations, since the changes to its methodology affect a stated policy of LCH.Clearnet, these changes are within the definition of a "rule" as contained in §40.1(i) and are therefore being submitted for the Commission's review.

**Part I: Explanation and Rationale for the Amendments**

LCH.Clearnet is making these changes as part of its ongoing review of its margin methodologies to ensure optimal performance under a variety of market conditions, and to further enhance the SwapClear risk models. The changes will also serve to maintain the balance between the 'defaulter pays' approach and the mutualization of losses in the SwapClear default waterfall. In order to best achieve the benefits of these changes, LCH.Clearnet is planning to implement changes to the VaR model for SwapClear as soon as the changes can be effectuated in the LCH.Clearnet systems<sup>1</sup> and in accordance with §40.6(a).

**Description of Changes**

LCH.Clearnet currently uses the PAIRS VaR methodology as the primary model for SwapClear Initial Margin. SwapClear will continue to utilize PAIRS as its primary model, but will make the following key changes to its current PAIRS algorithm<sup>2</sup>:

- (a) altering the risk factor returns from relative to absolute returns;
- (b) moving from a value at risk (VaR) measure to an expected shortfall (ES) measure;

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<sup>1</sup> Subject to final regulatory approval by the UK Financial Services Authority

<sup>2</sup> PAIRS stands for Portfolio Approach to Interest Rate Scenarios (PAIRS) and is LCH.Clearnet's acronym for the underlying quantitative methodology



(c) adjustments to the chosen decay factor ( $\lambda$ ) in the exponentially weighted moving average (EWMA) volatility estimate.

The most significant of the changes detailed above is the application of absolute returns instead of relative returns. The new model will ensure a better balance between defaulter pays approach and the mutualization of losses in the default waterfall in a range of interest rate environments. LCH.Clearnet has conducted extensive testing of the new methodology to validate its confidence that the change to absolute returns will continue to perform in both low and high interest rate environments, which demonstrated that the model continued to perform to expectation under various scenarios<sup>3</sup>. For this reason, LCH.Clearnet seeks to implement these changes as soon as possible.

Although there are a number of amendments to the model, many aspects remain unchanged. Holding period assumptions remain constant for SwapClear at 5 days for house accounts and 7 days for clients. The methodology also retains the existing standard deviation scaling parameters applied at a risk factor level, applies the same correlation assumptions and utilizes one-tailed scenario generation. In addition, no changes are being made to the current liquidity risk multipliers, which will continue to be based on IM.

## **Part II: Amendments to the Rules & Regulations of LCH.Clearnet**

No changes to either the LCH.Clearnet Rules and Regulations or the Clearing House Procedures are required to effectuate these changes. SwapClear intends to issue a SwapClear Circular to ensure that all affected parties are aware of the changes. The draft Circular is attached as Exhibit A.

## **Part III: Certification by LCH.Clearnet**

LCH.Clearnet certifies to the CFTC, in accordance with CFTC Regulation §40.6, that the planned changes comply with the Commodity Exchange Act and the CFTC Regulations promulgated there under. LCH.Clearnet further certifies that, upon the submission of this material, LCH.Clearnet will post a notice of pending certification with the CFTC and a copy of the submission on LCH.Clearnet's website at

[http://www.lchclearnet.com/rules\\_and\\_regulations/ltd/proposed\\_rules.asp](http://www.lchclearnet.com/rules_and_regulations/ltd/proposed_rules.asp)

## **Part IV: Compliance with Core Principles**

LCH.Clearnet will continue to comply with all Core Principles following the introduction of these proposed changes in methodology. LCH.Clearnet has concluded that its compliance with Core Principles would not be adversely affected by these changes. Finally, the changes will ensure continued compliance with the Core Principles and in particular with Core Principle D.

## **Part V: Opposing Views**

There were no opposing views expressed to LCH.Clearnet by its governing board or committee members, members of LCH.Clearnet or market participants that were not incorporated into the planned changes.

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<sup>3</sup> LCH.Clearnet notes that the model it intends to utilize has been validated by its external advisers, and that evidence of that review was submitted to CFTC Staff under separate cover pursuant to a Request for Confidential Treatment on 1/16/13.



## Certification

LCH.Clearnet Limited hereby certifies to the Commodity Futures Trading Commission, pursuant to the procedures set forth in Commission regulation §40.6, that the attached rule submission complies with the Commodity Exchange Act, as amended, and the regulations promulgated thereunder.

Should you have any questions regarding this submission please contact me at 1-212-513-5636 or [suzanne.calcagno@lchclearnet.com](mailto:suzanne.calcagno@lchclearnet.com) or Jay Iyer at +44-207-426-7285 or [jay.iyer@lchclearnet.com](mailto:jay.iyer@lchclearnet.com)

Sincerely yours,

A handwritten signature in cursive script that reads "Suzanne Calcagno".

**Suzanne Calcagno, Executive Director**  
**North American Head, Compliance & Public Affairs**  
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cc: Jay Iyer, LCH.Clearnet  
Dennis McLaughlin, LCH.Clearnet  
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Kenji Takaki, CFTC