

LCH.Clearnet:
a general introduction to risk mitigation

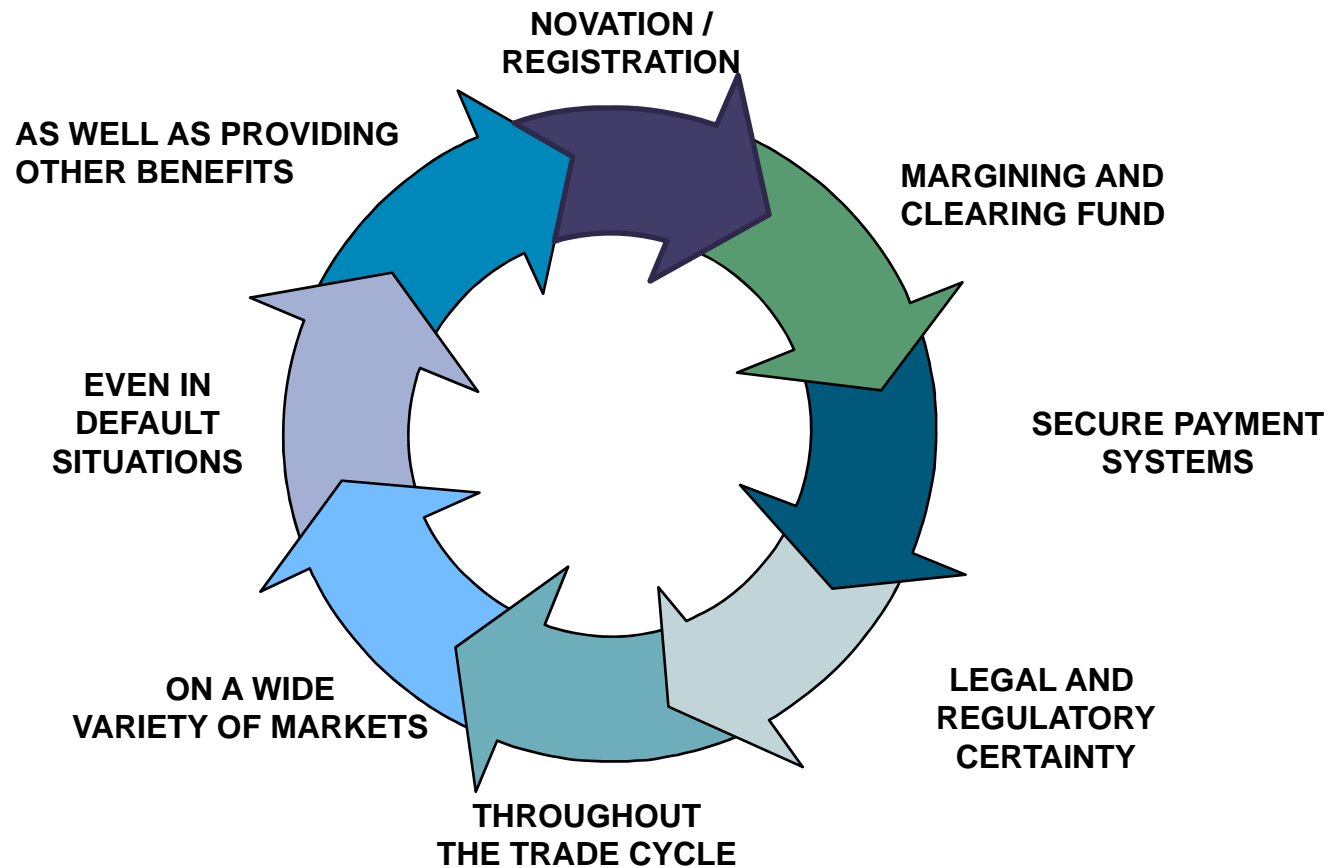
How we mitigate risk

LCH.Clearnet aims to:

- provide efficient and cost-effective services to its users,
- supported by risk management policies and actions which protect the integrity of the cleared markets and the interests of participants.

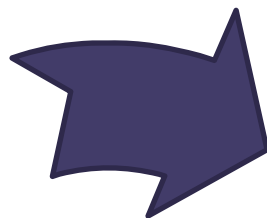
This means that the mitigation and management of risk is central to what we do.

How we mitigate risk – the virtuous circle



How we mitigate risk

NOVATION /
REGISTRATION



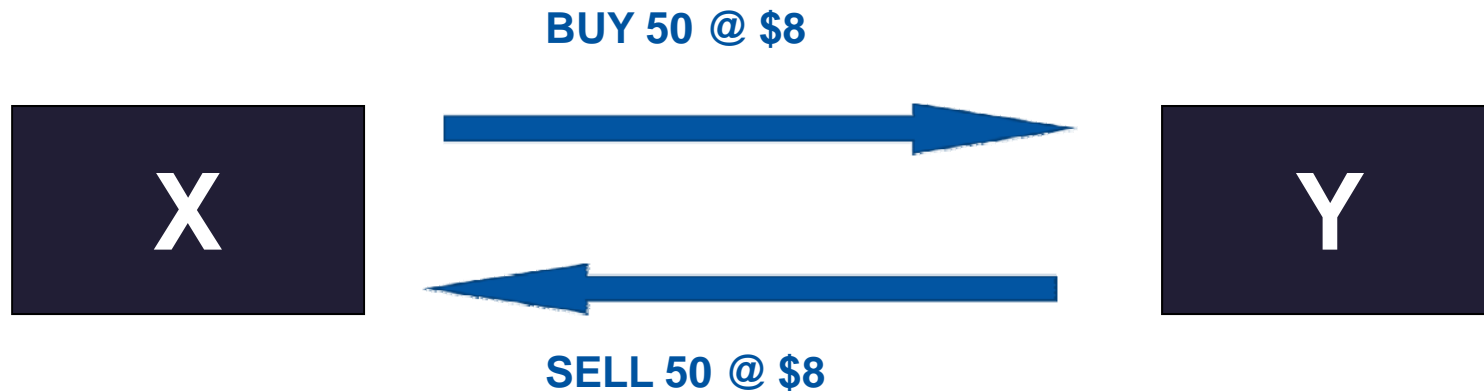
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Novation/Registration (1)

LCH.Clearnet “novates” (legally registers) trades so that it is on risk and so that a bilateral trade with bilateral credit risk ...



- ... becomes ...

Novation/Registration (2)

A cleared trade with LCH.Clearnet as central counterparty, **assuming the credit risk,**



- meaning that X no longer faces Y's credit risk and vice versa; if Y had been Lehman Brothers, X would only have been exposed to LCH.Clearnet not Lehman Brothers.

Novation/Registration (3)

With the exception of futures and options cleared by LCH.Clearnet Ltd, LCH.Clearnet novates trades as soon as they have been conducted and been received by its systems.

LCH.Clearnet Ltd currently novates futures and options at the end of each business day.

Novation/Registration (4)

LCH.Clearnet novates trades between its members in a “principal-to-principal” relationship.

Members therefore act as intermediaries for client transactions, while LCH.Clearnet manages the credit risk of its members.

LCH.Clearnet ensures its members meet various criteria (in terms of net capital and operational capability; and on some markets rating and regulatory status).

This ensures that LCH.Clearnet’s members are high quality counterparties.

How we mitigate risk

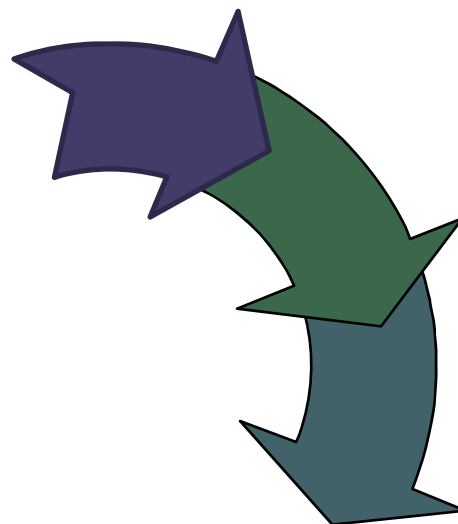


Margining and clearing fund

LCH.Clearnet covers the latent market risk on members' positions should they default by:

- Marking the positions to market and collecting losses/paying profits through variation margin;
- Taking initial margin to cover an estimate of potential future losses in managing a default in normal market conditions;
- Topping-up this initial margin intra-day if necessary;
- Maintaining clearing funds to cover potential losses beyond that (i.e. in abnormal market conditions).

How we mitigate risk



**SECURE PAYMENT
SYSTEMS**

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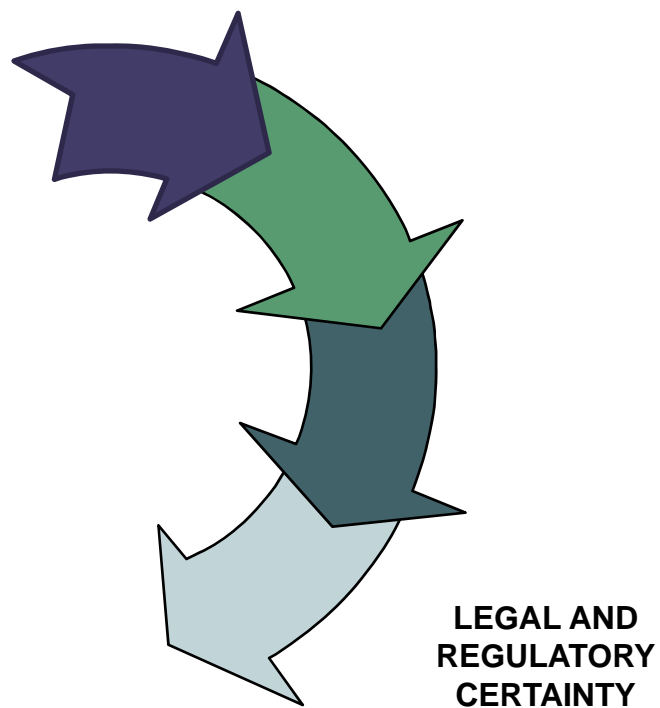
Secure payment systems

LCH.Clearnet requires its members to maintain accounts at payment banks, ensuring that risk is transferred from members to those banks, and that those banks then make payments on a timely basis.

All payments in major currencies are then concentrated into central banks (except USD in LCH.Clearnet Ltd).

All payments are processed through these systems, including fees and coupons as well as margin monies.

How we mitigate risk

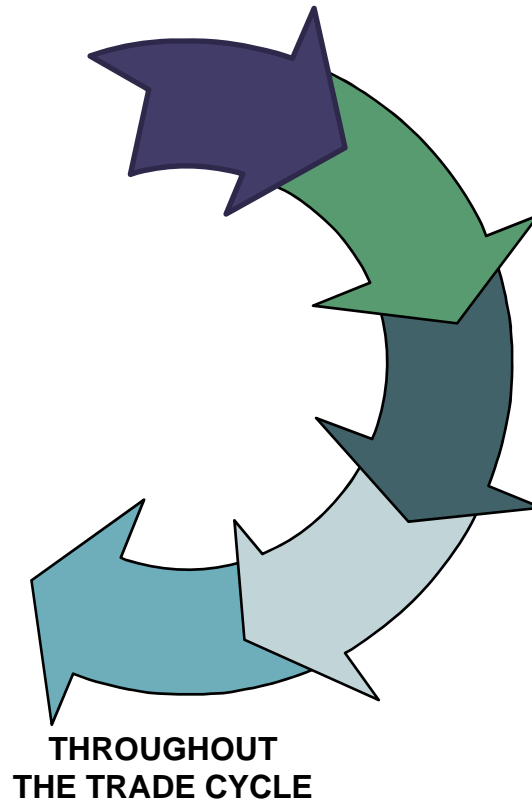


Legal and regulatory certainty

LCH.Clearnet's rule book acts as a standard set of conditions of business – with a comprehensive coverage of our processes and using standard market practices – adding legal certainty.

LCH.Clearnet is regulated by both Commission bancaire in France (Group and SA) and the FSA (Ltd) in the UK, as well as by several local regulators in other jurisdictions both in Europe and in the US.

How we mitigate risk



Throughout the trade cycle

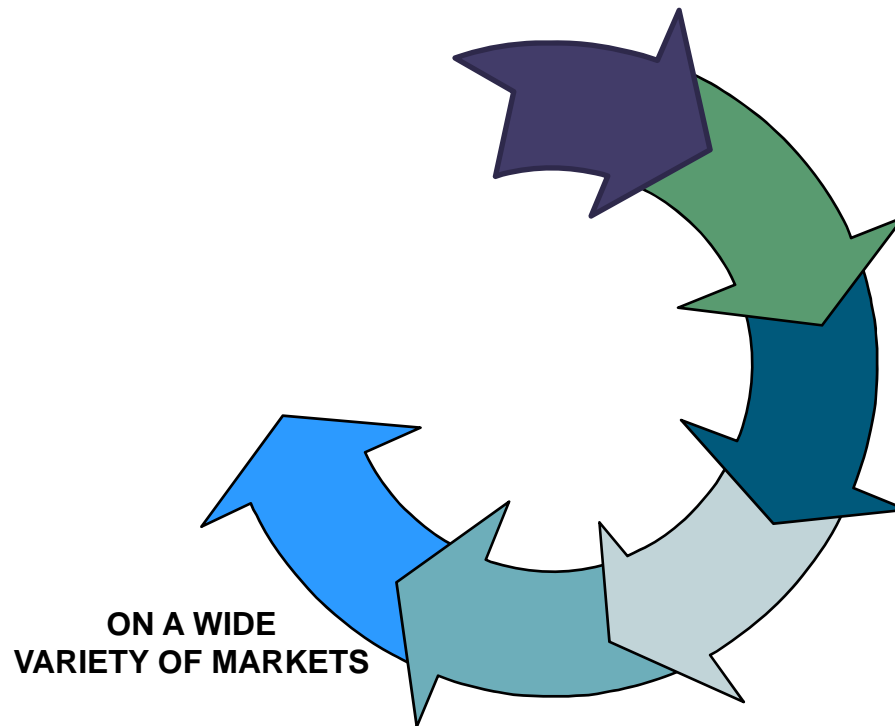
LCH.Clearnet remains counterparty to trades from the time of their registration right through until expiry/delivery.

It does so by administering delivery – using normal market practice – and the payments associated with delivery.

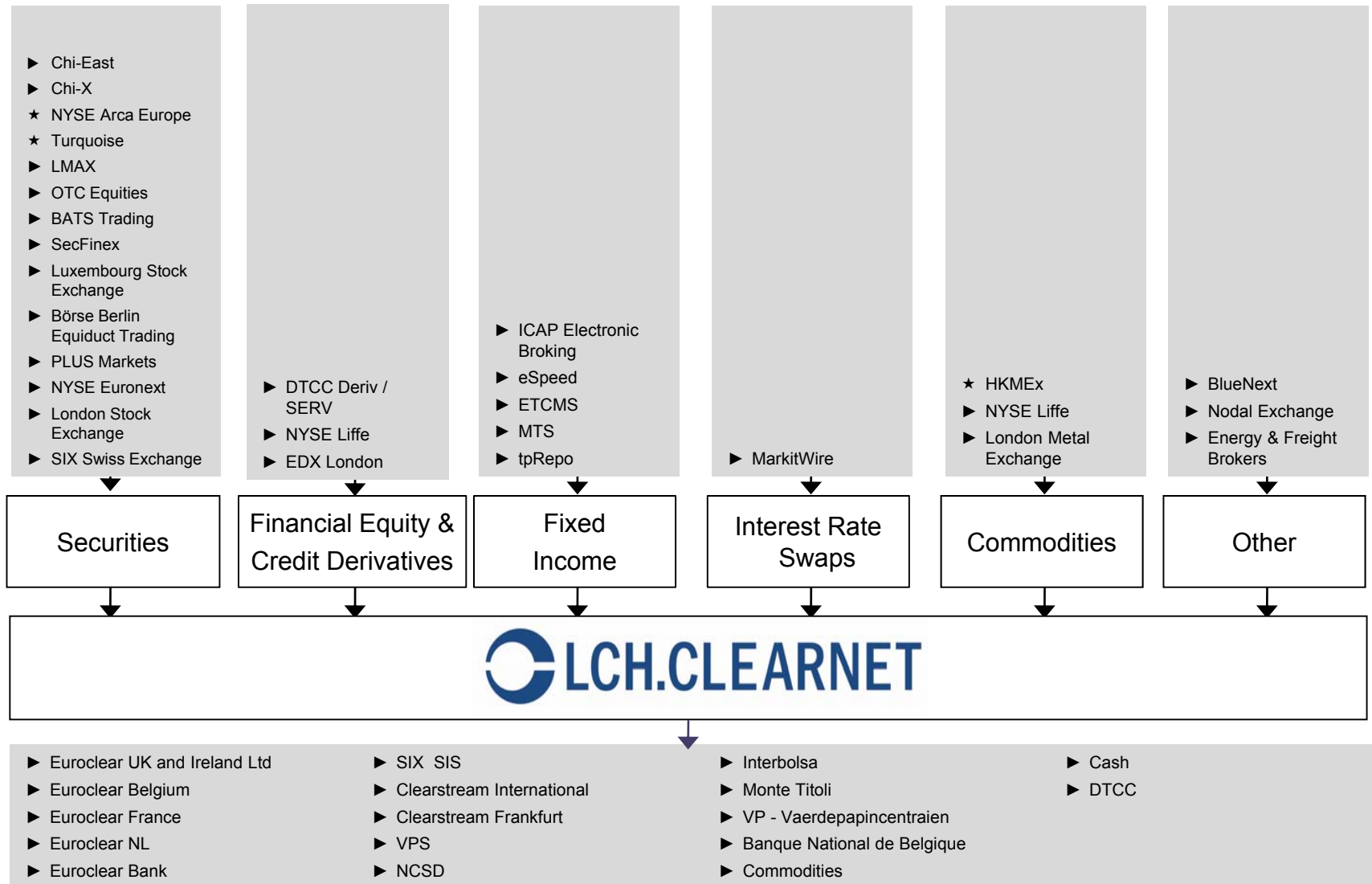
It also deals with issues like coupon flows and corporate events over the life of the trade.

And, where agreed by the market, it is able to net settlements, decreasing the risk/impact of fails.

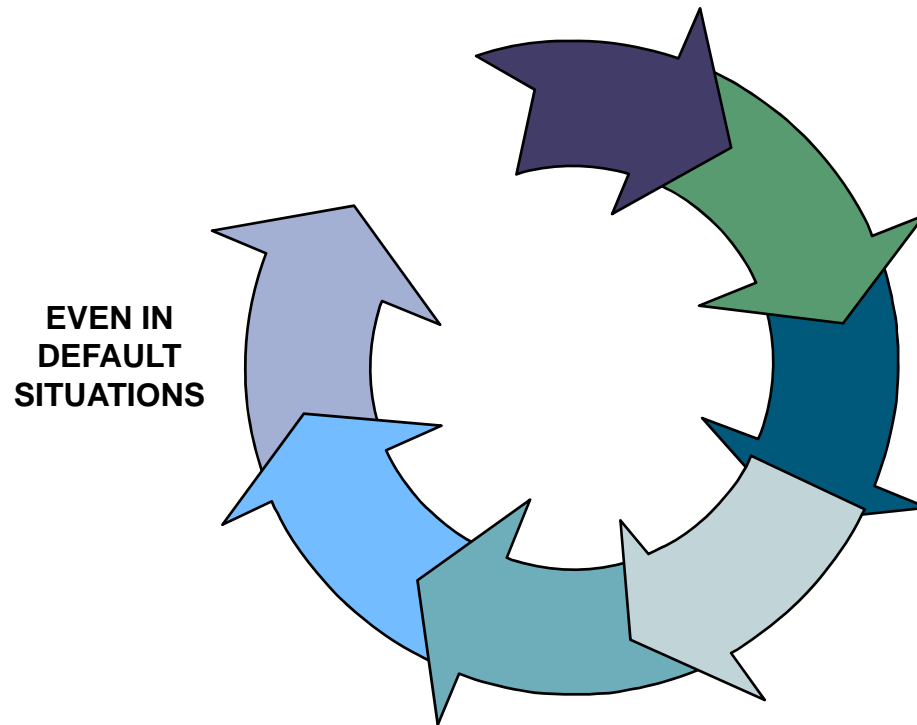
How we mitigate risk



Markets served by LCH.Clearnet



How we mitigate risk





Even in default situations

In the event of a default:

- Non-defaulters' positions are unaffected
- LCH.Clearnet closes out the defaulter's positions

There have been five defaults in our history:

Drexel Burnham Lambert (1990); Woodhouse, Drake and Carey (1991); Barings (1995); Griffin (1998) and Lehman Brothers (2008)

... plus some near misses:

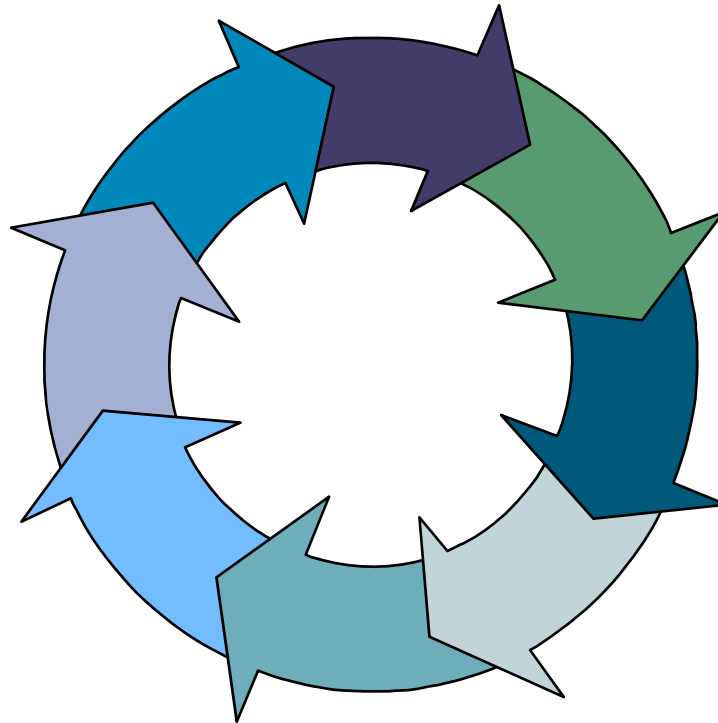
Yamaichi Securities (1997); Enron Metals (2001); and Refco Securities and Refco Overseas (2005)

In all cases these have had no knock-on impact on any of our other members.

[Click here for more detail](#)

How we mitigate risk

**AS WELL AS PROVIDING
OTHER BENEFITS**



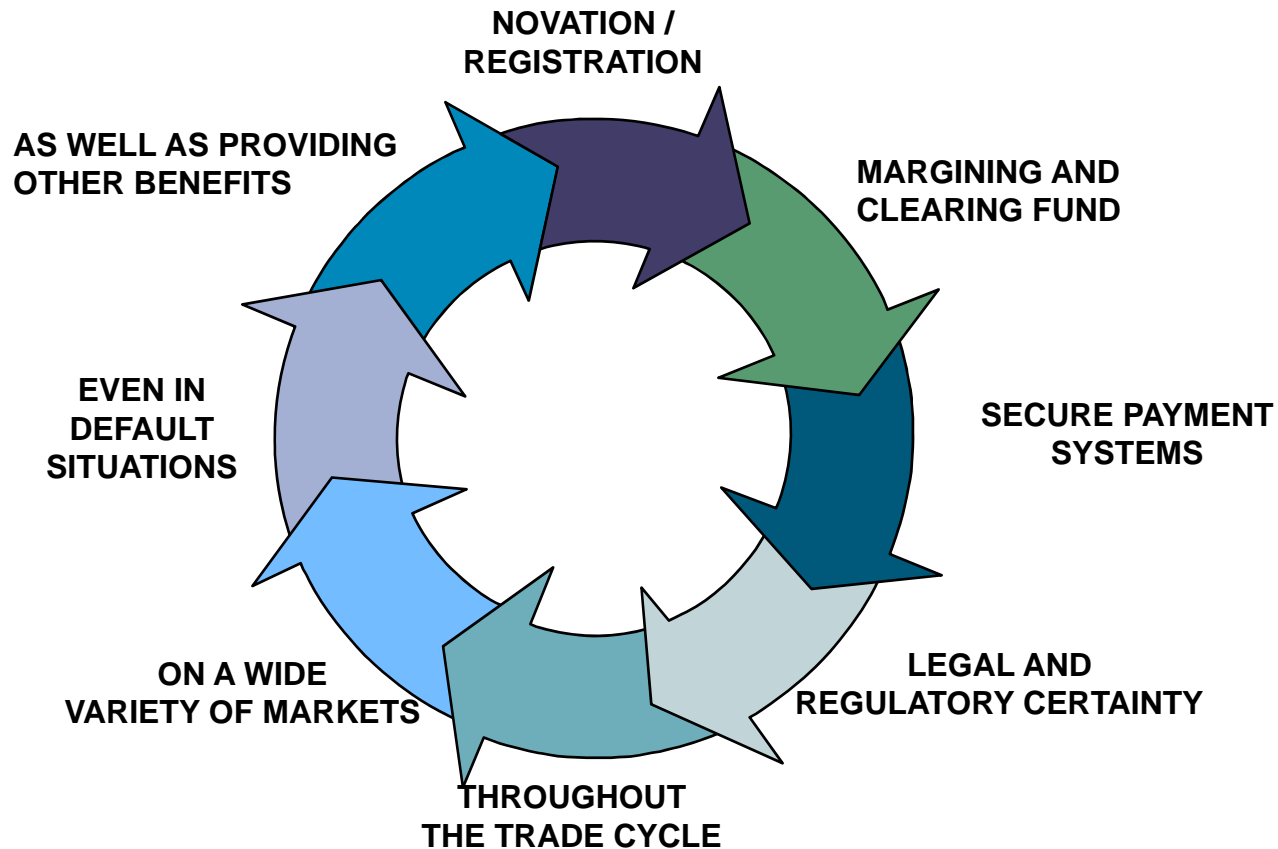
As well as providing other benefits

Worth remembering that risk mitigation is only one benefit provided by LCH.Clearnet:

- Risk mitigation (through effective risk management)
- Anonymity
- Multilateral netting
- Improved capital allocation and balance sheet usage
- Increased trading opportunity
- Reduced average cost
- Increased liquidity
- Netting of payments and settlements
- User involvement in product design and governance.

How we mitigate risk – the virtuous circle

Summary: LCH.Clearnet manages and mitigates risk in a variety of ways



How we mitigate risk – more information

Further information, including overviews of margining, default protections and membership criteria is currently available on LCH.Clearnet's risk management pages.

Contact Points at LCH.Clearnet

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

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