

LCH.Clearnet Ltd's Default Fund

Purpose

LCH.Clearnet Ltd only faces market risk in the event of the default of one of its clearing members.

In normal conditions, the market risk it then faces should be covered by the initial margin (IM) it has taken from the defaulter.

However, in stressed market conditions, this initial margin could conceivably be insufficient.

The Default Fund is therefore designed to cover potential market risk, over and above IM, in stressed conditions following a clearing member default. It is made up of members' cash contributions, held by LCH.Clearnet Ltd.

Adequacy (1)

The adequacy of the Default Fund is measured using a model that simulates such stressed conditions (a “stress testing model”)

This stress testing model uses around sixty scenarios which represent stressed conditions in the key contracts cleared by LCH.Clearnet Ltd

These scenarios are mostly historical, and of two types:

- Events (e.g. 1987 stock market crash, 1994 bond market crisis, Gulf War, Hurricane Katrina, LTCM etc.);
- Largest moves (up and down in specific contracts).

Adequacy (2)

However, the model also includes a number of theoretical scenarios which stress the correlations assumed in the historical scenarios

We believe that the combination of such historical and theoretical scenarios makes this stress testing model best practice; this view has been externally validated

All members' positions across all cleared markets are valued under all scenarios every day

Losses under all scenarios are then compared to each member's initial margin; losses beyond initial margin are then compared to the size of the Default Fund

Adequacy (3)

The worst case loss of the member with the largest exposure, or the combined losses of the two members with the second and third largest exposures – irrespective of their credit quality– is used to test the adequacy of the Default Fund.

This worst case loss includes two additional components:

- The losses of any affiliates of the member
- An assumed knock-on impact where the five lowest credit scored members of LCH.Clearnet Ltd also default as a consequence.

If this worst case loss is above or equal to 90% of the Default Fund, the Risk Committee of LCH.Clearnet Ltd must determine whether member-specific action or an increase in the size of the Default Fund is required.

Size

The stress testing model therefore determines the size of the Default Fund, currently £584.5 million (as at February 2011)

This Default Fund is fully mutualised across all of the markets cleared by LCH.Clearnet Ltd

This means that risk exposures are efficiently managed and costs of clearing are reduced

This is because the stress testing model and Default Fund structure allows for genuine offsets within a cross-product portfolio and therefore a smaller collateralised pool of risk protection

Structure

The relative contribution made by the different markets is determined by their relative level of initial margin and is currently as follows (maximum and actual amounts):

Market	Maximum	Actual
Exchange traded derivatives	£310mn	£310mn
RepoClear	£105mn	£105mn
SwapClear	£125mn	£125mn
EquityClear ¹	£100mn	£45mn
Total	£640mn	£585mn

- ¹ The actual contribution to the Fund relating to the EquityClear market is below its maximum because of the number of members and level of initial margin (see next slide)

Member contributions

Members make contributions according to the markets that they clear, based on their usage of those markets and subject to minimum levels:

Market	Formula ¹	Minimum
SwapClear	Average initial margin relative to other members	£2mn
RepoClear	Average initial margin relative to other members	£1mn
EquityClear	10% of initial margin, while fund size is below the maximum; when maximum is reached pro rata as above	£1mn
Exchange traded derivatives	50% based on volume relative to other members; 50% based on initial margin relative to other members	£100,000

¹ The contributions of members are pro rata to arrive at the market level contributions to the Fund (see previous slide)

More information, and contact points at LCH.Clearnet Ltd

For further information on LCH.Clearnet Ltd's Default Fund,
please use the following link ... 

... or contact one of the following:

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