

CCP12 RESPONSE

TO

CPMI-IOSCO

DISCUSSION PAPER ON

CENTRAL

COUNTERPARTY

DEFAULT MANAGEMENT

AUCTIONS



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EXECUTIVE REMARKS

The Global Association of Central Counterparties (“CCP12”) welcomes the opportunity to provide its response on behalf of our membership to the Committee on Payments and Market Infrastructures and the International Organization of Securities Commissions (“CPMI-IOSCO”) discussion paper entitled “Central Counterparty Default Management Auctions”.

CCP12 is a global association of 37 members who operate more than 60 individual CCPs globally across Europe/Middle East/Africa (EMEA), the Americas, and the Asia-Pacific (APAC) regions. CCP12 aims to promote effective, practical and appropriate risk management and operational standards for CCPs to ensure the safety and efficiency of the financial markets it represents. CCP12 leads and assesses global regulatory and industry initiatives that concern CCPs to form consensus views of its members and seeks to actively engage with regulatory agencies and industry constituents through consultation responses, forum discussions and position papers.

CCP12 has previously contributed input to CPMI-IOSCO on default management auctions on a bilateral basis. Now we welcome the opportunity to respond to this discussion paper as we believe that the default management auction process is one of the most important processes within a CCPs business. We have therefore also highlighted this topic in our recently published paper “CCP Best Practices – a CCP12 Position Paper”¹.

Going forward, we would like to highlight, that a “one-size-fits all” approach to CCPs is inappropriate and it is critical to recognize that differences rightfully exist due to cleared product types, market structures and characteristics, regulatory and legal environments in different jurisdictions, operational requirements, and other factors. It is also imperative that CCP’s retain flexibility in their default management approach to react to the facts and circumstances at the time of the event. Furthermore, CCP12 believes, the recent regulatory guidance and interaction which was provided on this topic has been useful and effective and we therefore believe that any further prescriptive requirements are not necessary.

CCP12 would like to thank CPMI-IOSCO for the opportunity to comment on this discussion paper. CCP12 is highly interested to discuss these further and to elaborate on any of the comments described in our response.

For further information please email office@ccp12global.com or visit www.ccp12.org.

¹ https://ccp12.org/wp-content/uploads/2019/05/CCP-Best-Practices_CCP12_Position_Paper.pdf

ROLES AND RESPONSIBILITIES

Question 1:

What are the considerations for a CCP's board when determining whether and how to assign tasks related to the planning and conduct of default management auctions within the CCP's risk management framework? How does the CCP's board identify potential limits to the assigned responsibilities?

CCP12 Response:

The auction process should be well defined ex-ante and clearly documented. The default management process tools, governance arrangements and obligations of the clearing members should be defined in the CCP's rulebook.

The primary role of a CCP's board is to provide oversight of the risk management activities and the senior management of the CCP, including the effectiveness of the overall default management process. It should further seek advice from consultative bodies, such as CCP Risk Committees in establishing such oversight. However, in regards to the consultative bodies, CCPs need the appropriate level of flexibility to adjust for different markets. For highly liquid exchange traded markets, traders and risk working group members can help formulate a strategy in advance. For OTC markets and less liquid exchange traded markets, the process may be better supported with a Default Management Group (DMG), which could include traders/participants seconded from clearing members.

Acting in an oversight capacity, the board should delegate responsibility for the planning and execution of default management processes, including auctions, to the CCP's senior management, who should further delegate authority to a CCP's dedicated default management team. It is the default management team that is best positioned to provide expedient and timely expertise in planning and conducting auctions, together with CCP senior management, while incorporating ex-ante guidance received from clearing members and other market participants where appropriate.

The board should be informed of material developments related to default management auctions by the CCP's senior management, including design elements and results from default management drills.

Question 2:

What different considerations may apply when a CCP's board establishes procedures for consulting external experts, such as independent consultants or clearing members, when designing or conducting a default management auction? How does a CCP's board address such concerns?

CCP12 Response:

A CCP's board should provide discretion for the CCP's senior management to consult with a broad range of market participants ex-ante, when in the CCP's judgment it deems such consultation necessary, in designing a default management auction. Market participants with relevant expertise across each of the major asset classes cleared by the CCP may provide valuable guidance related to the design and execution of an orderly auction. In some cases, it might also be beneficial to decide on an asset class level, if convention of a DMG or invitation to other market experts is required.

Guidance from external stakeholders should be used to complement a CCP's own expertise to enhance the design of auctions. Subject to the discretion provided by the board regarding an external consultation, the CCP's default management team and/or senior management should provide periodic updates to the board on the results of these consultations. In the event that a DMG is convened, the convention of a DMG should not in any way change the ultimate decision-making capacity of the CCP's senior management, or the responsibility of the CCP. To the extent a CCP has a DMG, it should participate during regular default simulation exercises to confirm operational readiness and address potential limitations.

The rules of the CCP should clearly outline the obligations and responsibilities of the seconded DMG members. CCPs may also ask their DMG members to maintain confidentiality by signing dedicated "Default Management Committee Rules," although this may not be a requirement. Also, to avoid any conflict of interest the Ethical Wall Principle should be established, making it clear by an agreed commitment that a DMG participant's obligations are to the CCP and not to the DMG participant's clearing member.

CONSIDERATIONS FOR A SUCCESSFUL AUCTION

Question 3:

Do you agree with the description of a successful auction in the discussion paper? Do you agree with the scenarios identified that would constitute an unsuccessful auction, and are there additional such scenarios?

CCP12 Response:

CCP12 in general agrees with the description of a successful auction as described in the 1st paragraph of section 4:

'In an auction, a CCP generally seeks to liquidate the portfolio at a reasonable estimate of its market value (which may reflect a risk premium) while at the same time seeking to limit disruptions to the market to the extent possible.'

CCP12 would add that the description of a successful auction should align with the key objectives of the default rules and procedures described in Principle 13 of the PFMI. In particular, the restoration of a matched book in a prudent and orderly manner, minimizing losses to the CCP and its non-defaulting members, limiting disruptions to the market and the completion of timely settlements.

Restoring a matched book is the foremost objective, so until that objective has been achieved the default management process remains unsuccessful.

Other scenarios that may constitute an unsuccessful auction are for example, when the best bid received is so unreasonable or illegitimate based on the relevant market conditions that it is considered invalid.

Question 4:

What are the primary challenges to achieving a successful default auction? In addition to those included in the discussion paper, are there other elements in the design of an auction that a CCP could consider in order to increase the likelihood of a successful auction?

CCP12 Response:

First of all, CCPs should attempt to liquidate contracts where practicable. CCPs should also attempt to hedge the portfolio if needed. Hedging is one of the critical elements of the entire default management process that has to be executed as soon as reasonably practicable following the member default, as the transfer of significant portions of the market risk mostly happens during the hedging phase and not in auctions.

To increase the likelihood of a successful default management process, CCPs should have properly balanced incentives, perhaps having in place mandatory participation in auctions for certain asset classes, fines or juniorization of default fund contributions. CCP rules should provide transparency on the auction format, obligations of mandatory auction participants (where applicable) and consequences in case of non-compliance with bidding requirements. Where appropriate, in the selection of mandatory auction participants the activity in the asset class/product type, as well as operational and risk absorption capacities of the invitees, should be considered.

Generally, CCPs should facilitate appropriate participation in default auctions to improve their results. The number of members a CCP involves in the auction process may vary depending on the asset class and/or the size and the complexity of the defaulted clearing member's portfolio.

Regular default management drills help to establish clearing members and other participants commitment and proficiency in the auction process.

Question 5:

What process/set of factors, including applicable governance, is used/considered to determine whether an auction is successful or unsuccessful? What governance would apply to this determination, including the decision whether to run an additional auction (as opposed to using other tools) and why?

CCP12 Response:

CCPs should maintain robust governance arrangements over their entire default management processes, including the process for determining whether an auction was successful and the subsequent actions to take in response to a failed auction. This would generally include appropriate oversight bodies such as the CCP's board.

A CCP may determine that an auction was unsuccessful for many reasons, but the most likely are that it has failed to receive bids for the entire auctioned portfolio or the bids it has received are unreasonable or illegitimate based on relevant market conditions. In these scenarios, a CCP's governance arrangements should allow for reasonable flexibility to not award a portfolio and run an additional auction based on the unique circumstances. In doing so, a CCP may expand the pool of potential bidders to make the subsequent auction more competitive, change the design of the auction itself, and/or solicit feedback from auction participants or other consultative bodies where appropriate.

Question 6:

What are the considerations for CCPs in choosing to utilize auctions as a default management tool? What product categories are most suitable for auctions and what product categories are least suitable for auctions? How do you assess suitability?

CCP12 Response:

For assessing and deciding the appropriate liquidation strategy, CCPs would have to consider various aspects including market type (exchange traded versus OTC), product type (e.g. securities, repo or derivatives), liquidity, as well the size of the defaulter's portfolio. The CCP then assesses the appropriate liquidation strategy and executes the strategy in accordance with its procedures.

Multi-unit or single unit auctions (hedged where applicable) with appropriate participation to sell large portfolios comprising exchange traded derivatives and/or OTC instruments may be an efficient means for establishing the matched book.

In case of liquid, exchange-traded and small sized portfolios, the default management approach may call for establishing a matched book by entering close-out orders on behalf of the defaulter. This approach should be designed to ensure a matched book is established with minimal information leakage or price impact. Portfolios containing products cleared by a limited number of market participants, as well as products where the market is fragmented, for example the bond market, may be more suitable for liquidation via independent sale (e.g. bilaterally). Furthermore, for some asset classes like cash equities or bonds, where the CCP might be seeking to buy securities, members that do not hold the securities may not be mandated to participate in any auctions.

Question 7:

In addition to those outlined in the discussion paper, are there other considerations that may be useful for a CCP to take into account when designing its hedging strategy, including circumstances where a CCP may wish to delay hedging?

CCP12 Response:

Hedging is one of the most critical elements of the default management process which has to be executed as soon as reasonably practicable following a member default, as the transfer of significant portions of the market risk mostly happens during hedging and not in auctions.

In general, CCP may consider hedging the directional risk of the default portfolio such as hedging delta risk for ETD, or DVO1/PV01 risk for IRS first and then taking care of other risks factors and residual risk.

Under some circumstances, for example, if there is no liquidity or if markets are halted, hedging may be delayed or foregone in favor of straight liquidation.

Question 8:

How do you incorporate cross-margining arrangement considerations in the hedging strategy and in the broader auction design process?

CCP12 Response:

CCPs that have entered into cross-margining arrangements should have default management plans that are agreed ex-ante and perform joint default management drills.

For some CCPs, the default management process, as well as cross-margining, is conducted via a group level liquidation. As such, products with similar risk characteristics form one liquidation group.

Correlations of underlying risk factors are considered in any hedging strategy and auction portfolio composition. However, a CCP may reserve the right to split or combine liquidation groups if deemed risk-reducing or required due to the market structure of a particular asset class or if it makes it easier to find counterparties for the new portfolio composition.

Question 9:

The discussion paper notes that, with respect to hedging, execution methods vary and depend on a CCP's choice of hedging instruments. What methods are used for hedging, and what is the rationale for implementing (or not implementing) a particular method?

CCP12 Response:

For exchange traded markets, CCPs may execute hedging trades in the open market through brokers or, if the CCP has direct access, through an exchange.

For OTC markets, CCPs may execute hedging by an auction or by a direct offer approach.

Question 10:

What factors, other than those identified in the discussion paper, do you see as relevant when determining how to split a portfolio? Are there situations where certain factors would be more important than others? Please provide examples.

CCP12 Response:

In the determination of how to split a defaulted portfolio, all factors mentioned in the discussion paper are relevant and the importance depends on the specific circumstance of the auction and the portfolio.

Examples of other factors which may drive further splitting are:

- Inflation indices (specialist market within an asset class);
- Deliverable vs non-deliverable products (different settlement assumptions appeal to different participants even though in the same asset class);
- Number of line items (for operational reasons) may require splitting the auction file; and
- Specialist books (unique markets that appeal to specialists).

Question 11:

The discussion paper describes two common auction formats. Are there other auction formats not included that could be beneficial for a CCP to consider employing? What factors influence the decision to implement (or not implement) a particular auction format?

CCP12 Response:

Regardless of the auction format, it is critical that a CCP continues to maintain appropriate flexibility to structure the default management auction based on the existing facts and circumstances surrounding the default.

In addition to these two common formats, other auction formats may be used, such as a two-way, multi-unit pay-as-you-bid auction. Winning bids are filled at the price provided by each winning participant instead of applying the lowest winning price to all auction winners.

In order to implement a particular auction format, asset class specifics, liquidity of the auction portfolio, risk appetite, and time constraints should be designed to incentivize competitive bidding, prevent information leakage and take into account operational feasibility for CCPs and auction participants.

CCPs should test various auction formats during regular default management drills and request auction participants provide feedback.

Question 11a:

Besides promoting competitive bidding, are there other considerations for choosing two-way pricing? Are there circumstances where it would be beneficial or circumstances where it might not be appropriate? If so, please describe.

CCP12 Response:

One benefit of two-way pricing is that it can mitigate any potential front running, as it minimizes information leakage to the market on the direction and/or the total size of the auction portfolio.

Notwithstanding this, CCPs may take into consideration the product type and the complexity of the auction portfolio, in deciding whether two-way pricing is an appropriate format. For example, an auction portfolio, which has added complexity (e.g. OTC IRS) may result in potential pricing inaccuracies if participants are forced into two-way pricing. In comparison, an auction portfolio with all long positions and all short positions or calendar spreads may, be more straightforward to provide a two-way price.

Timing is an important consideration for a successful auction. In this regard, CCPs should take into account participants' abilities to respond with two-way prices in a timely manner per the prescribed timelines in conducting the auction. Where there are multiple auction portfolios, participants may face operational challenges in providing two-way prices.

Question 11b:

What are the considerations for choosing to use a reserve price in an auction? Are there circumstances where it would be beneficial or circumstances where it might not be appropriate? If so, please describe.

CCP12 Response:

CCPs should have the ability to compute an indicative portfolio value (i.e. fair value reflective of the market conditions), for the purpose of assessing what is a reasonably economic price to accept or reject, in accordance with the respective CCP's governance structure.

While many CCPs do not have reserve prices as part of their auction process, some CCPs, in order to maintain appropriate flexibility, may apply the practice of fixing a reserve price as a way to have a predetermined idea of the economic value they are willing to accept for the auction portfolio (this could also be done only internally and therefore not shared with the auction participants), which could be used as an effective tool for both hedging as well as auctioning the defaulter's portfolio.

In the event where a large concentrated OTC portfolio is being auctioned, the supply may exceed demand and therefore, the reserve price could ensure that bids are not executed. Market prices at the time of the

auction and the potential future movements from this point may form the basis for determining the reserve price.

Question 12:

The discussion paper highlights two factors that affect the amount of time auction participants may need to evaluate a portfolio and submit bids. Are there other factors that are important to consider? Is there a minimum time period that a CCP should consider providing to auction participants?

CCP12 Response:

It should be noted that CCPs likely have differing procedures/guidance on minimum time periods for auction participants to respond, due to the different types of products cleared, time zones for conducting auctions, and single vs multiple auction portfolios, among other factors. A CCP's default management team should take all of these into account when defining the timeframe required to evaluate a defaulted portfolio and submit bids.

Notwithstanding this, CCPs should establish clear communication protocols for disseminating auction requirements including specific timelines for participants' responses, ahead of the auction. As an example, a CCP can issue a directive to notify participants of an auction to be conducted, after which the auction portfolio will be circulated within a specified time from the issuance of the directive.

In addition to the two factors cited in the discussion paper, CCPs may consider other factors such as the complexity of the products included in the defaulted portfolio and whether these products are exchange-traded or OTC.

Regular default management drills are required to validate the timing of auction pricing with the CCP's operational capabilities.

Question 13:

If a clearing member contributes a "significant" part of the default fund, should that clearing member automatically be included in the auction process? What reasons are there for not including the clearing member?

CCP12 Response:

CCPs may allow their clearing members to participate in auctions, although not every clearing member will necessarily be asked to participate in every auction. Accordingly, clearing members who contribute significant parts of a CCP's default fund are not automatically included in every auction. In the context of mandatory auction participation, where it could involve clearing members who are active in the contract(s)

in the auction portfolio, a CCP may decide to restrict member participation in auction to mitigate the risk of information leakage that could be disruptive for the market.

Generally, a CCP should aim to maximize participation in the auction process, based on whether a participant has an exposure in the contract(s) that constitute the auction portfolio. A participant can be a clearing member or a client.

For a clearing member, this provides clarity of its obligations as to which products a CCP would expect the member to participate. In the event that an auction portfolio may be significant and/or large, a CCP should make a further assessment if clearing members who are active in the contract(s), albeit with small exposures, would have the capability from both risk and operational perspectives to process the auction portfolio. CCPs should measure this by outstanding initial margin requirements of the respective clearing member which is also reflected in the size of the default fund contribution.

A possible reason for not including a certain clearing member in an auction could be that the clearing member does not have exposures in the contract(s) that constitute the auction portfolio and therefore, may not want to be forced to bid for an auction portfolio for which it has no expertise. Furthermore, it is possible that the clearing member does not actively trade in their firm account the relevant asset class or product group in the auction portfolio or the CCP has concerns over the credit and/or liquidity risk of the clearing member, contagion risk, and/or regulatory restrictions, among other factors.

In striving for the fairest practical treatment of clearing members, CCPs should apply objective, risk-based criteria when utilizing their discretion to exempt a member from the auction invitation rosters of asset classes which that member clears.

Question 14:

The discussion paper discusses the trade-off between flexibility and predictability. How do you assess these trade-offs? Can you elaborate on the ways you provide for predictability while still maintaining flexibility (e.g. establishing rules and conditions to govern the determination of auction parameters)?

CCP12 Response:

Default management is a critical process for a CCP and the main objective is to get back to a matched book, and minimize losses to participants (other members and CCP).

CCPs should strive to achieve the right balance between the predictability of its process for managing a default and the required flexibility to exercise expert judgment based on the prevailing facts and circumstances. Maintaining a predictable and repeatable auction process, along with transparent rules that outline the use of discretion, will enable auction participants to be prepared to participate during a

default. For example, it is intended that participants will be able to quickly digest an auction portfolio, if they receive auction packs in the same format during default management drills.

As a general matter it is important to recognize that a CCP's rules are binding on its clearing members. They set out ex-ante the general obligations and rights for both the CCP and its clearing members in relation to an auction. Further guidance on the procedural details on conducting an auction, such as templates, auction format, information sheet, and NDA agreements should be covered as part of a CCP's default management handbook (or an equivalent document) that supplement the CCP's rulebook.

Due to unpredictable market conditions at the time of a clearing member default, predefined rules and robust governance arrangements have to allow certain flexibility for CCPs to act appropriately to ensure the best possible liquidation outcome while disrupting the market to the least extent possible. CCPs should have the appropriate level of flexibility to adapt auction parameters, subject to the approval of the relevant governance body within the CCP, such as the auction bidding window, auction participant invitation, auction portfolio decomposition, hedging and/or winning bidder determination.

The default management process, including governance and execution, should be tested by a CCP and its clearing members, which includes involving relevant internal and external stakeholders, during regularly organized default management drills.

Question 15:

If a CCP uses juniorization as an incentive to encourage competitive bidding, and in a scenario where the CCP has invited only a subset of participants to an auction, how will the CCP apply the juniorization to the clearing participants who were not invited?

CCP12 Response:

For mandatory auctions, CCPs should consider providing the appropriate bidding incentives such as juniorization of default fund contributions of participants required to bid, while minimizing negative consequences for non-defaulting participants who were not required to bid. Such mechanisms must be clearly set out ex-ante.

Uninvited clearing members to the default auction process are still subject to mutualization in the event that the losses go to the default fund, but those clearing members would not be subject to any juniorization, For non-mandatory auctions, where not all the clearing members have been invited to participate in the auction, juniorization may not be applicable.

CCPs should grant clearing members the possibility to provide bids before juniorizing their default fund contribution or applying penalties.

OPERATIONAL CONSIDERATIONS

Question 16:

CCPs may distribute information that would help auction participants estimate the potential impact of a successful auction bid on their margin requirements. Besides those that members and clients would have during BAU, what information (and at what level of detail) or tools would be most useful for calculating these estimations and why?

CCP12 Response:

Clearing members should have access to self-service tools offered by their CCP that would provide information on margin estimations.

Ideally for larger CCPs, such margin calculation tools can be integrated into a web-based auction portal where available or into an application program interface (API) in order to reduce the number of front-end systems used during the default management process.

Question 17:

The sharing of confidential information (i.e. the defaulted participant's portfolio) carries potential risks, as discussed in the paper. What are the potential risks associated with information leakages, how does the CCP balance such risks with other objectives (e.g. sharing sufficient information for a successful auction), and what are the measures the CCP uses to address such risks?

CCP12 Response:

In some cases, two-way pricing and a staggered information disclosure via preliminary auction packs represent key elements in securing the CCP's position in the market before the auction has commenced.

A two-way bidding auction process may mitigate the risk of information leakage and prevent front running, as it does not disclose to auction participants whether the CCP trades on the bid or on the offer. The total size of the portfolio (i.e. number of auction units) also remains undisclosed to the auction participants.

A CCP could address the trade-off between sufficient transparency and data security by publishing preliminary auction file packs that include adequate portfolio specifics for auction participants to operationally prepare data loads and perform portfolio analysis, but at the same time, omit sensitive information, which is designed to protect market integrity by not disclosing the CCP's side.

A further safeguard to protect the integrity of the default management auction, is using an access-restricted web-based auction portal, where available, to which only predefined clearing members or approved client representatives have access.

Selection of the appropriate number of hedging counterparties for a given asset class reduces the risk of information leakage. In addition, the CCP's or Exchange's market surveillance team will monitor the market activities of auction participants, who received such confidential information.

Question 18:

CCPs use various modes of information transmission during a default management auction (e.g. email, web-based portal). Can you elaborate on which modes are the most effective in which circumstances and whether it varies depending on the type of information, and why? Would you consider web-based portals a best practice? If so, why?

CCP12 Response:

Communications prior to and during an auction can be streamlined with IT infrastructure such as web-based applications and chat-based messaging applications, among other things., which can limit operational risk and delays in information distribution. Where such IT infrastructure is not available, CCPs should have a tested email-based auction process in place.

Question 19:

What are the challenges and trade-offs of creating a realistic default management testing exercise? What processes are used to create the scenarios used in such exercises?

CCP12 Response:

While conducting a default management testing exercise, the assumption of distressed market conditions may be challenging to simulate. This is due to uncertainty surrounding the market liquidity at the time of distress, and the risk appetite and trade flow pattern which are dependent on a particular event. On the other hand, a CCP could make the drill more realistic by including: (1) surprise elements; (2) multiple role default assumptions; (3) cross-CCP defaults; and (4) multiple product class defaults.

However, it should be taken into account, that the simulation of hypothetical scenarios causes some efforts which would not apply in a real event as hypothetical market data has to be used to analyze P&L outcome. Also, certain operational activities can only be tested if the portfolio is set up in the CCP's production system environment.

The achieved results may only yield partial value as participants do not all equally apply stress add-ons to auction prices or hedge quotes. Prices received during default management drills may be rather limited indicators for real crisis scenarios. Therefore, it is also possible to separate procedural elements of a drill from fictive scenarios and cover these with stress testing.

CCPs should maintain the flexibility to run default management under various market assumptions to test key operational aspects. Using the distressed market assumptions may allow CCPs to approximate the cost of default management process and assess the adequacy of the financial safeguards held against a defaulted portfolio. On the other hand, to eliminate the subjective nature of interpreting the distressed market assumptions, asking for real-time quotes in current market conditions may allow CCPs to directly compare the premiums applied by market participants to hypothetical portfolios. Also, using current market conditions may allow a CCP to test the operational aspects of a default management auction by simulating the actual practices that would be performed by its participants.

Question 20:

There may be benefits in pursuing greater standardization and harmonization across CCPs in relation to certain operational elements which support execution of an auction.

CCP12 Response:

During the auction process, a CCP needs to deliver portfolio and valuation-related information to its participants that will be bidding on the defaulter's portfolio. It is critical that CCPs work with market participants to standardize key aspects of this process. In particular, it may be endeavored to standardize the type of information contained within the auction portfolio and valuation files for each asset class, as well as the file format types. The formatting used should be adaptable so that a CCP and its participants are able to leverage only the components that are relevant for the particular products that are cleared at the CCP. Standardization, however, may not be necessary for certain other aspects of the auction process, where the CCP must maintain appropriate discretion to respond to each unique default scenario, such as the time given to participants to submit a bid or the time at which curves are captured for valuation purposes.

Question 20a:

For example, should auction portfolio files be in a standard (or partially standardized) format (for different product types)? If so, which aspects of the portfolio file would benefit the most from cross-CCP standardization (e.g. file type, layout, order of information, or content)?

CCP12 Response:

In order to support stability and reduce the effort needed for auction participants to price portfolios received from different CCPs simultaneously, auction file formats for a given asset class may be standardized across CCPs. Standardization between CCPs will need to be balanced with business-as-usual reporting standards within a CCP. Often clearing members encourage CCPs to use file formats

and interfaces that are as close to business-as-usual as possible to encourage the smooth consumption of the files, although there are generally vast differences with how clearing members utilize the files into their portfolio reporting interfaces. Different product types, which require different information for pricing should also be taken into consideration. Additionally, the targeted format should be machine readable or ready to be proceeded by automated API interface.

Question 20b:

Besides CCP portfolio files, which other operational elements would benefit (the most) from greater standardization and harmonization across CCPs?

CCP12 Response:

CCPs should seek alignment on the granularity of price details requested during an auction (e.g., on asset class level) and on the general terminology of the auction process to the extent possible under the constraints of applicable laws and regulations (e. g. the Default Risk Management Working Group has established common terminology and conventions across CCPs in its “Uniform CCP Terminology for Default Management Auctions” paper²). According to the feedback received from clearing members, current input requests vary between one price and various other additional information. In order to facilitate cross CCP communication and interaction, any applicable legal obstacles should be addressed. Furthermore, cross CCP alignment may address customer porting as well. More generally, to shorten porting timeframes during times of crisis, regulatory involvement (e.g. KYC, capital requirements, etc.) may be required to enhance the likelihood of successful porting.

Question 20c:

Are there specific operational elements or areas where standardization and harmonization may not be helpful?

CCP12 Response:

Alignment of the default management process execution schedules across CCPs is not feasible. CCPs need a certain level of flexibility for preparing a portfolio for auction and executing the default management process. A portfolio is suitably prepared for an auction only after analysis and subsequent

² https://www.cftc.gov/sites/default/files/idc/groups/public/@aboutcftc/documents/file/mrac062716_uniformccp.pdf

hedging activities, where applicable, are finalized. The required time for preparing a portfolio for auction may vary across CCPs.

Furthermore, predefined timelines (e.g., margin period of risk) are not identical across CCPs, and govern the default management process execution schedules and have implications for hedging and auction schedules.

CLIENT PARTICIPATION

Question 21:

For which markets, asset or product classes and client types would client participation be most feasible and/or desirable? What would be the incentives for clients to participate in auctions? Does this differ for direct vs indirect client participation? Please elaborate in your response.

CCP12 Response:

A one-size-fits-all approach should not be applied to client participation in CCP default management auctions. Any decisions on the details of the individual CCP's default management processes should be left to the discretion of those best able to make a judgement on this, i.e. the relevant CCP, with consultation from its clearing members and other stakeholders where applicable.

It is not possible for all CCP12 members to categorize "markets, asset, or product class" as being desirable for client participation in a default auction. No two markets cleared by different CCPs are identical, and therefore it needs to be the responsibility of the individual CCP to make the determination as to whether client participation would add value and result in the achievement of a more favorable auction outcome. For example, clients would be incentivized to participate by the prospect of potentially obtaining the defaulting clearing member's portfolio at a discount. However, incentives for participating clients would need to be carefully constructed to ensure that clients are not voluntarily participating purely to gain a "free look" at the defaulter's portfolio.

Facilitating client participation in an auction can produce more competitive bids and better auction results by expanding the potential risk capacity that can be absorbed and enhancing the price discovery process of the defaulter's portfolio. Also, client participation can increase the probability of a successful liquidation process (hedging, independent sale and auction execution), thus returning the CCP to a matched book.

When identifying suitable clients to potentially participate in an auction, the three primary considerations for a CCP are: i) a clearing member's willingness for its client to participate; ii) the client's ability to price and risk manage large exposures in a compressed timeframe; and iii) the client's commitment to allocate resources to prepare for a default as demonstrated through participation in default management drills. CCPs may consider multiple factors in determining if a potential client has the capacity to participate in an auction, including successful participation in previous default management drills, assets under management versus the potential exposure from the defaulter's portfolio, existing positions and margin at a CCP, gross monthly trading volume, licensing, credit worthiness and overall trading activity.

Though it could be true for OTC markets, client participation may be critical in exchange traded markets where liquidity providers, who would be well-placed to absorb and risk manage a defaulter's portfolio,

often act in the capacity of clients of clearing members. In such cases, the clearing member of the client should be supportive of such involvement. Additionally, another natural incentive for client participation is to protect against the invocation of a CCP's recovery tools, such as variation margin gains haircutting and partial tear-ups.

Client selection should consider their size, expertise and operational capacities to price the defaulted portfolio in a given timeframe. Operational readiness and expertise of providing competitive bids of participating clients should be tested during regular default management drills.

A CCP should evaluate whether, via drills and market due diligence, they have a sufficient number of potential bidders, which may include clients, across all products it clears. For CCPs that clear a broad range of asset classes, they may require participation from clients with broad market exposures, as well as more specialized clients that can bid on specific product types.

For indirect client participation, clearing brokers should consider consolidating the client's bids prior to providing the bids to the CCP to better alleviate time constraints.

Question 22:

The discussion paper describes some ways to address the risks borne by a clearing member arising from its clients bidding in an auction. Are there additional ways to address the risks? Are there incentives that a CCP could employ to encourage client participation in an auction (e.g. ways to encourage clearing members to facilitate their clients' participation)?

CCP12 Response:

A client's decision to offer a bid in an auction, and being approved to do so by its clearing member, is established generally between the clearing member and its clients. CCPs may assist in this process by promptly disclosing the auctioned portfolio information to the participating client and its clearing member. Clearing members can use this information to make an informed decision as to whether to allow a particular client to participate in a given auction. Such permission should be explicitly required by a CCP before a client submits a bid.

Concerns about confidentiality and other risks should be addressed ex-ante as part of the auction design where possible. For example, a CCP can split a defaulter's portfolio or ask for two-way pricing so that the directionality and composition of the portfolio is not disclosed. Additionally, all potential bidders could be bound by NDA agreements and/or regulatory provisions preventing them from acting on the information they learned through their participation in an auction. Lastly, the type of client potentially eligible to participate in an auction may be deterred by the potential reputational or other damage associated with trading on the information acquired through participating in an auction.

Question 22a:

One option for addressing a disparity in incentives between clearing members and clients is to require clients to contribute an established amount to the default fund prior to participating in an auction. What are the implications of this requirement (such as regulatory, economic or contractual implications) and how can a CCP address these implications?

CCP12 Response:

Requiring clients to contribute to the default fund as a prerequisite for being invited to an auction will disincentivize them from participating. Additionally, it would create a double counting of the default fund contribution as the default fund contribution of the clearing member would have already taken the client exposures into account. This requirement would also eliminate some clients from participating as their corporate charters and/or regulatory requirement may explicitly forbid them from contributing to a default fund – e.g., being subject to the risk of mutualization. The profit opportunity and the potential avoidance of the invocation of a CCP's recovery tools already provide strong incentives for clients to bid competitively. Further, as members of the larger financial system, clients have a vested interest in the success of the auction process and preservation of the cleared markets in which they participate.

For certain OTC markets some CCPs require clients who wish to bid directly in an auction to contribute to the default fund and to be subject to juniorization in order to incentivize the clients to bid and to bid well. But other CCPs might consider such a requirement inappropriate for their auctions.

DEFAULT OF A COMMON PARTICIPANT ACROSS MULTIPLE CCPS

Question 23:

The discussion paper suggests that the conduct of multi-CCP default management exercises may provide useful insights into the hedging and auction procedures, should these be conducted by multiple CCPs concurrently. Can you elaborate on what specific insights could be obtained in relation to hedging and auctions via these multi-CCP default management exercises, if possible, with concrete examples?

CCP12 Response:

Where appropriate, it is beneficial for members and CCPs to simultaneously conduct default management drills, as in times of crisis, it's likely that multiple CCPs will be impacted and will run their default management process in parallel. Members having memberships at multiple CCPs will have to meet requests, in particular for bidding in auctions, from multiple CCPs simultaneously.

However, simultaneous default management drills should only be performed where there is a specific rationale for doing so, such as the clearing of similar products combined with a significantly overlapping clearing memberships.

Due to the dynamic element of the default management process it is rather unrealistic to consider having detailed timelines for managing a default in a real event. A portfolio is suitably prepared for auction only after analysis and subsequent hedging activities, where applicable, are finalized. In a crisis situation this will largely depend on prevailing market circumstances and disable detailed time planning in advance. Therefore, general timelines are more appropriate and helpful for the default management participants.

Question 24:

Feedback from the industry suggests that introducing a cap on the number of traders that can be seconded to multiple CCPs from a particular common clearing participant at any one time may mitigate the potential burden on clearing participants' participation in DMGs. How could such caps be instituted and implemented in practice? What could be the challenges of introducing such caps? Apart from caps, are there other options a CCP could consider to mitigate this potential burden?

CCP12 Response:

CCPs should work to mitigate the operational burden on auction participants and DMG members as much as possible, including testing and improving operational readiness through robust default management drills.

However, we would not advise implementing an arbitrary cap on the number of traders that a CCP can second. This requirement is strongly dependent on the size and the range of each CCP's cleared markets. For example, a smaller market may only require a single trader, but the hedging of a large portfolio in the USD/EUR/GBP/JPY IRS markets may require multiple traders to ensure hedging is designed and conducted in an efficient and orderly way.

While we understand the intent of capping the number of seconded traders across CCPs from a particular clearing member, CCPs do not have a way to effectively manage such a cap due to confidentiality limitations, as some CCPs don't disclose publicly their DMG compositions.

A more practical solution would be for CCPs to work with their members to assemble an appropriate DMG. Clearing members that receive requests to participate in DMGs from multiple CCPs are best positioned to report on conflicts, over-utilization, and other operational burdens. CCPs should have the option to waive such participation if selected nominees can evidence participation in a DMG, or similar function, for a particular asset class at another CCP during the same timeframe.

We suggest, in order to reduce the burden, to define a minimum assignment period and the option to be released from DMG participation once the minimum assignment period is over.

Question 25:

Are there efficiencies or benefits to be gained from CCPs coordinating their respective default management auctions or hedging arrangements? If so, how?

CCP12 Response

There may be opportunities for some CCP coordination during the default management process, in terms of risk offsets and timing of the auctions. These initiatives are still being explored but are seen as limited based on different regulatory regimes and potential conflicts of interest.

Question 25a:

Are there any arrangements that could be coordinated ex-ante (e.g. cross CCP netting arrangements)? How could these arrangements be established? What would be the challenges with these arrangements? How could these challenges be mitigated?

CCP12 Response:

There needs to be a specific rationale for coordinating default management processes across CCPs. Each CCP is under pressure from their stakeholders to resolve a default as quickly and efficiently as possible. If the default management processes at two CCPs are "linked" then it creates a further

constraint on an already complicated process. A CCP would then potentially be constrained by the slowest member of the coordinating CCP group.

Potential cross CCP coordination would most likely be limited to CCPs located in the same time zone and clearing overlapping asset classes. It could be likely that coordination across drastically different time zones could impair the default management auction results and the impact could be very unbalanced for one CCP over another.

Arrangements should not force CCPs to delay the process and prevent prompt execution of the default management within the individually parametrized period of risk defined within the margin methodology.

In order to facilitate cross CCP communication and interaction, potential legal obstacles would have to be overcome. Regulators must also take care to ensure that any coordination or public reporting requirements do not disclose information that could damage or create a conflict with a CCP's default management process. For example, any sensitive data should not be publicized during the default management process, even if these are subject to the public reporting requirements on an anonymous basis.

It could be beneficial for a global industry organization, such as CCP12, to provide a platform for CCPs to share information about schedules of their default management processes. This could allow CCPs and their regulators to passively coordinate their processes, without the need for direct multi-lateral communication between CCPs. Such a centralized approach would significantly reduce any additional burden on CCPs and their regulators.

General

Question 26:

Are there any additional points of consideration that would contribute to a successful auction that are not mentioned in this discussion paper? If so, what are they?

CCP12 Response:

N/A

Question 27:

What are the potential areas in the context of default management auctions where guidance might be most welcome?

CCP12 Response:

The recent regulatory guidance and interaction which was provided on this topic has been useful and effective and CCP12 Members therefore believe that any further prescriptive requirements are not necessary.

CCP12 MEMBERS

