

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?

In the BME CLEARING case, the CCP's board determines the planning and conduct of the process of liquidating the portfolio of a Clearing Member in default, when the board approves the regulation that sets the mentioned process.

Liquidating defaulting Clearing Member portfolio is a process which on the one hand must have predictability (the default management process tools, governance arrangements and obligations of the Clearing Members as defined in the CCP regulations) but on the other hand must be done quickly. That is the reason BME CLEARING's board delegates in the internal Default Management Group the decisions that must be made to liquidate the mentioned portfolio. We understand that this approach is similar in most CCPs.

Questions 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?

Although it is important that there is ex-ante predictability through the CCP rule book, it is equally important that the CCP has flexibility to make what it considers appropriate decisions in the liquidating process. Taking in mind this need of flexibility, according to its rule book, BME CLEARING has the ability "to obtain any kind of professional advice or assistance which the Member or BME CLEARING may reasonably require in relation to the management of the Default, including a mandate to another firm to manage the Closing-out of the Positions".

What it is important is to have the ability. Depending on the specific case, either the External Default Management Group (in the cases where some Clearing Members participate in the DMG) or the Internal Default Management Group (in the cases where only internal staff of the CCP participate in the DMG) have the ability of consulting external experts.

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?

Our definition of a successful auction would be slightly different: 'A successful auction liquidates entirely the defaulting portfolio at a reasonable estimate of its market value within a reasonable short period of time'.

The problem with the above definition is that it contains a binary factor ('liquidates entirely'), a time factor ('within a reasonable short period of time') and a qualitative factor ('at a reasonable estimate of its market value') and, so, it is worthwhile to analyze each factor in more depth.

In our opinion the first factor is the most important one; the objective of the auction is to liquidate entirely the defaulting portfolio. The time factor can be measured reasonably, as this time should be related to the liquidation period used by the CCP to calculate the Initial Margins required.

The third factor, the qualitative factor, is the most difficult to assess. In our opinion "a reasonable estimate of its market value" implies that the winning prices of the auction are in line with the market prices prior to and after the auction taking into account the conditions of the auction (the market situation, size and complexity of the auctioned portfolio, etc.). That is, if the effective market value of the auction is far from the market values after the resolution, degree of reversion to the market, then in this case the auction could not be considered successful. For the sake of clarity, a CCP loss set in the auction process, doesn't necessarily mean that the auction was unsuccessful, because the underlying cause may have been insufficient margins (Initial Margin, Default Fund, etc.) called previously by the CCP. If the prices obtained in the auction can be considered 'market prices', then in relation to this qualitative factor, the auction should be considered successful.

Limiting markets disruptions to the extent possible is a bonus. CCPs main concern is to liquidate the portfolio, although it is true that it will be easier to liquidate the portfolio if there are not market disruptions.

An unsuccessful auction is an auction where there are not sufficient winners to liquidate entirely the defaulting portfolio. The reasons why there are not sufficient winners (not enough bidders or not enough bids for certain parts of the portfolio) are well described in the discussion paper.

We are not sure that prices not good enough is a reason to consider an auction unsuccessful. BME CLEARING considers compulsory reserve prices problematic. 'Not good enough prices' as bids that are lower than reserve prices, may represent a situation where the CCP needs a bit more time to make decisions than the time set in its regulation, but it is questionable that the DMG can set a low 'market price' (that would be the reserve price) specially in stressed situations. However, as BME CLEARING recommends that the CCP has flexibility, we consider it is convenient that a CCP has the ability to set reserve prices, although, for the moment BME CLEARING hasn't used reserve prices in the Fire Drills.

Question 4: What are the primary challenges in 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?

The main challenge to achieve a successful auction is to be sufficiently prepared. In our opinion, to be sufficiently prepared means:

- Having performed successful Fire Drills in the past similar to the products that would be auctioned in real default situation.
- To identify the hedging strategy.
- To identify the auction format:
 - o Whether to split the defaulting portfolio or not. If the portfolio is going to be split, how this is done.
 - o Whether the format is a single winner or multiple winners.
 - o Whether to submit bids to both buy and sell.
 - o Whether to apply a reserve price.
- To identify the auction participants (either Clearing Members or clients).
 - o This includes the contact details.
- To identify the timing considerations.
- To identify the auction format (means of communication, time limits, etc.)
- In relation with some products, to have bidding requirements or incentives.

When we say 'To identify' we mean that before a default occurs in a specific product, the CCP has a planned normal decision in relation to all the aspects mentioned above. Specifically, Clearing Members of the CCP, in particular the risk committee should be involved in the design of the default management process and the default management rules ex-ante.

In case of a real auction, and depending on the specific characteristics of the portfolio, these planned normal decisions may be changed by the Default Management Group. But it is very important that a planning exists and that this planning has been run periodically. That is the reason why Fire Drills are so important.

Question 5: 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?

As commented, it is important that the CCP has the ability to be flexible in the process of liquidating a defaulting portfolio. This question addresses the situation where the auction has not had a good result.

One cause could be that the bids were not enough to close completely the defaulting portfolio (i.e. the volume auctioned was 100 and there were only bids for 70). In this case, it is clear that the CCP must continue working to close entirely the defaulting portfolio and running an additional auction can be a good tool to achieve such goal.

Another cause could be that the volumes of the bid are good enough to close the defaulting portfolio, but the prices are not good enough. This is a tricky situation, because although the DMG may consider the prices not suitable, the prices obtained in the auction may be the best possible prices they are going to get (see for instance our answer to question 3). But again, we consider that it is important that the CCP has the ability to be flexible. It is very difficult to rule precisely this kind of situations.

The decision whether to run an additional auction would be taken by the Default Management Group.

Question 6: 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?

ETD products are different from OTC Derivatives products. If there is a liquid exchange, and depending on the size of the defaulting portfolio and the complexity of the products it contains, liquidating the portfolio (or parts of the portfolio) using the exchange is probably a better solution than an auction.

The same happens with cash products. Depending on the size of the defaulting portfolio, liquidating the portfolio (or parts of the portfolio) on the exchange is normally a better solution than an auction.

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?

As commented in the discussion paper the sooner the hedge is done, the better. However, when there are clients in the defaulting portfolio and especially when the net of the client's position is opposite to the house position of the defaulting Clearing Member, then the situation is more complex because the porting feasibility must be also evaluated. In this case, there may be different hedging moments while the porting is being carried out.

Question 8: How do you incorporate cross-margining arrangement considerations in the hedging strategy and in the broader auction design process?

BME CLEARING does not have any interoperability arrangements with other CCPs.

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?

Basically, BME CLEARING would hedge the delta of a portfolio.

It will depend on the product, if there is a liquid exchange, the CCP would try to hedge the portfolio on the exchange. In other cases, we would ask for prices to three important participants. The number of three is set because on the one hand you need several bids to get a reasonable price, but on the other hand selecting a small number of hedging counterparties reduces the risk of information leakage during the hedging process.

BME CLEARING considers that using an arranging broker to hedge a portfolio is not a good solution. Our reasoning is that an arranging broker makes its living by serving its clients. A CCP cannot be considered a broker's client as Clearing Members' defaults are so sporadic. Therefore, we consider that it is better to avoid situations when an arranging broker may be tempted to inform its natural clients while the CCP would prefer to keep this info as strictly confidential.

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.

One important factor, different than those identified in the discussion paper, is whether there are incentives to bid or not. If the CCP rules establish juniorisation; for instance, by first using the default fund contributions of the Clearing Members that do not bid or that bid with low prices, then it is important that portfolios can be split or that the auction permits multiple winners.

If there is juniorisation, and a medium Clearing Member defaults, if the CCP does not split the portfolio or permits multiple winners, a small Clearing Member may be in big danger of losing its default fund contributions, because, in practice, they won't be able to bid for the whole portfolio. The firms that bid in the auction must have the capacity to absorb, within its own portfolio, the auctioned portfolio. If they don't have the capacity they should not be invited to the auction. That is the reason why if there is juniorisation, splitting (or allowing multiple winners) is a good solution.

Finally, BME CLEARING considers that it is not so relevant to define the factors that determine whether a portfolio should be split or not. What is important is that the CCP has the ability to split the defaulting portfolios when the CCP deems it appropriate, either in real life situation or in the Fire Drills carried out.

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?

No comments.

Question 11. A: 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.

It will depend on the markets and/or the products. In some cases two-way pricing will be better but in other cases it will be more convenient to have a one way pricing model, because in those markets or participants, the CCP won't get a good auction result with a two-way bid.

Many traders (of certain products) have commented us that they know more or less the direction of the portfolio of each important participant. Therefore, although BME CLEARING normally asks the Fire Drill participants to submit both buy and sell bids, if the market knows the name of the defaulter, this subtlety is not so relevant.

Question 11.B: 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.

In relation to the reserve price, on the one hand, it makes sense that if the CCP receives what it considers very low bids it should have the ability to not accept these low bids. On the other hand, the interest of the CCP is to liquidate the defaulting portfolio as soon as possible, and a badly set reserve price set by the CCP may hinder the speed of the liquidating process. See our answers to questions 3 and 5.

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?

It seems that the objective of this question is to try to find out if a minimum time that a CCP should provide to auction participants could be set or to look for factors that would allow quantifying this minimum time.

We consider this is not a relevant issue. The important issue is that the CCP has the ability to set this time.

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?

Theoretically, an important contributor to the Default Fund should be an auction participant. However, reality may be different. BME CLEARING has an Energy Segment where all the participants that have positions are clients of Clearing Members and the Clearing Members do not have any house position (because they don't carry an energy proprietary business). In this particular case, although the CCP invited the Clearing Member to participate in the auctions (given that they are the entities that contribute to the Default Fund), in practice they wouldn't be able to bid because they don't have traders. We consider, that in this case, the CCP has just to inform the Clearing Members. If a Clearing Member is not comfortable with some of its clients participating in the auction, then the CCP wouldn't invite these clients.

The Clearing Member participants in the action process must have the capacity to absorb the defaulting portfolio and must be active in the products auctioned.

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 (eg establishing rules and conditions to govern the determination of auction parameters)?

The trade-off between flexibility and predictability should be calibrated to ensure that the CCP auction can be as predictable as possible to its Clearing Members without losing the efficacy in the auction process that a certain degree of flexibility within predictability can offer.

BME CLEARING agrees with the need to be prescriptive in certain areas (e.g. ensuring there is a public statement about the auction, auction terms, etc.) and also to avoid prescription on execution details of the auction process.

However, it is important that the CCP regulation is flexible enough to allow the CCP to adjust to the respective market and trading participant's structure and the characteristics of the product as there might not be one size fits all.

Question 15: If a CCP uses juniorisation 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 juniorisation to the clearing participants who were not invited?

In our opinion if there is juniorisation, then all the clearing participants must be invited because this is the fair way of behaving. That is the reason why juniorisation may not be the good solution in some products where not all the clearing participants may be able to bid (see our response to question 13).

See also our answer to question 10.

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 having during BAU, what information (and at what level of detail) or tools would be most useful for calculating these estimations and why?

No comments.

Question 17: The sharing of confidential information (ie 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 (eg sharing sufficient information for a successful auction), and what are the measures the CCP uses to address such risks?

As commented in our answer to question 11.a, it is important not to share the name of the defaulting participant, although in many circumstances this info may be well known by the market at the moment of the auction.

We consider that internal sharing (within the company that is participating in an auction) is ineludible for a variety of reasons (check that the position fits with the current house position, valuation purposes, internal permissions, etc.). The real danger is that a trading firm who knows the portfolio that is being auctioned, intends to take advantage of this knowledge and this is very difficult to avoid. Probably the only effective tool is speed up the process.

For the same reason, we consider that it is very unlikely that a defaulting portfolio is leaked to another firm that does not participate in the auction.

Question 18: CCPs use various modes of information transmission during a default management auction (eg 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?

We consider that very complex portfolios, i.e. those with many trades or with products with many different characteristics (as an IRS big portfolio) should be auctioned through more formal models, as web-based portals.

On the other hand, from our Fire Drill experience, non-complex portfolios (i.e, with not many trades and with products with few

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different characteristics) are well managed by sending Excel files.

Formal models like web-based portals take more time to implement to auction participants. As the CCP it is interested in having as many participants as possible it is important to avoid complex formalities because it would be a handicap for some participants.

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?

What is a realistic default management testing exercise? We have to acknowledge that, as there are so few default processes involving CCPs, it is very difficult to create a realistic testing exercise, because we won't know whether the exercise is realistic or not until a default has really happened.

We are not saying that, as it is very difficult to design a default management testing exercise, Fire Drills are not important. On the contrary, BME CLEARING believes Fire Drills are significant. The issue, in our opinion, is the focus. The scenarios used or the prices bid in the Fire Drills are not so important. The importance of the Fire Drills lies in the processes and in the training.

BME CLEARING believes that the importance lies in trying to bring as many participants to the Fire Drills as possible and auctioning a portfolio that has many of the products that may be auctioned in a real life auction and inform all clearing participants of the Fire Drill process. Ideally Fire Drills should be as close as possible to a real life auction in the products, number of trades, processes, procedures, etc.

The importance of the Fire Drills is that the eventual bidders and the CCP are sufficiently prepared in case a real situation happens.

Question 20: There may be benefits in pursuing greater standardisation and harmonisation across CCPs in relation to certain operational elements which support execution of an auction.

We don't believe in pursuing greater standardization and harmonization across CCPs.

Question 20.A: For example, should auction portfolio files be in a standard (or partially standardised) format (for different product types)? If so, which aspects of the portfolio file would benefit the most from cross-CCP standardisation (eg file type, layout, order of information or content)?

No comments.

Question 20.B: Besides CCP portfolio files, which other operational elements would benefit (the most) from greater standardisation and harmonisation across CCPs?

No comments.

Question 20.C: Are there specific operational elements or areas where standardisation and harmonisation may not be helpful?

No comments.

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.

In BME CLEARING's case, in its Energy segment we have a structure of many Non Clearing Members or Clients, cleared by Banks that do not trade any energy contract at all. All the Fire Drills we have made in this segment have been with the Non Clearing Members; the main utilities clearing in our CCP. Of course, Clearing Members should allow its NCMs to participate in the auction.

In the Fire Drills we have made in this Energy segment so far, we have had a good participation (around 10-15 different bids). In real life and being naive, we think their incentive would be whether they could get a good position at a nice price. In our opinion it would be difficult for the CCP to set incentives because probably the incentives should be set by the Clearing Members.

We don't foresee differences between direct and indirect client participation. The only issue is that the bidder should have a relevant size and that in indirect clearing, the bid should be done by the indirect client.

In the case of ETDs, client participation can benefit the auction process as market makers or dedicated asset class specialists, who may be clients of Clearing Members, are specialists on the products auctioned. Consequently these kind of clients should be allowed to provide competitive prices.

In the Cash Equity Segment, BME CLEARING has Non Clearing Members (NCMs) that are part of a group which has another firm

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who clears the trades. These NCMs could be considered similar to Clearing Members, because its sister company do have incentives to have a successful auction.

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 (eg ways to encourage clearing members to facilitate their clients' participation)?

The ways to address the risks are confidentiality (asking non-disclosure agreements) and Clearing Member approval. Additionally Clearing Members could also benefit from client participation. This could be done, for instance, counting the bids provided by clients in case there is compulsory bidding.

Question 22.A: 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?

BME CLEARING doesn't like this idea of clients contributing an established amount to the DF prior to participating in an auction, because it would mean changing the CCP model. BME CLEARING strongly believes that the CCP model is pretty good and has proved very robust. Any significant change to the CCP model must be done with extreme care and after an important consensus has been achieved.

Having said that, and prior to the auction, it would make sense to ask for a certain amount of money to the clients that would eventually participate in the auction, in order to avoid that clients have a free look at the defaulting portfolio. This amount of money would be given back in case the client participated in the auction with a reasonable price.

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?

BME CLEARING is approximately the 9th largest CCP in Europe; it is a medium-to-small CCP. Due to this position we have mixed feelings answering this question. We consider that common Fire Drills between the largest (having a small number in mind) CCPs makes sense. But BME CLEARING considers very difficult to exercise a Fire Drill with multiple CCPs (more than 3). Therefore, BME CLEARING recommends going step by step, for instance, first beginning multiple CCPs Fire Drills with two or three CCPs and then continue increasing the number of CCPs participating in the experiment, or just making Fire Drills according to the size of the CCP or the Clearing Members participating in them.

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?

No comments.

Question 25: Are there efficiencies or benefits to be gained from CCPs coordinating their respective default management auctions? If so, how?

No comments.

Question 25.A: Are there any arrangements that could be coordinated ex ante (eg cross-CCP netting arrangements)? How could these arrangements be established? What would be the challenges with these arrangements? How could these challenges be mitigated?

No comments.

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?

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No comments.

Question 27: What are the potential areas in the context of default management auctions where additional guidance might be most welcome?

In our opinion this discussion paper is too much focused in default management auctions which we consider, are just a part of the process of liquidating a defaulting Clearing Member portfolio. We consider that client porting is an important part of the mentioned process and guidance in client porting could be welcome.

Any other comments/feedback on areas not mentioned above:

BME CLEARING is a Qualified CCP authorized under EMIR in September 2014.

BME CLEARING would like to thank CPMI-IOSCO for the opportunity to participate in this discussion paper.

BME CLEARING has five segments, Financial Derivatives, Cash Equity, Repo, Energy and IRS. Each segment is different not only in the products cleared but also in the kind of participants each segment has. BME CLEARING believes these differences condition the CCP's responses to a situation of a clearing default. Based on that experience, BME CLEARING considers that it is not possible to have a single response for all the segments.

BME CLEARING would like to point out that default management auctions are not the only way to liquidate a defaulting Clearing Member portfolio. BME CLEARING has several segments (Financial Derivatives, Cash Equity and to a certain extent the Repo Segment) which have access to liquid markets. BME CLEARING considers (also depending on the specific case) that closing-out the defaulting portfolio through the market or bilaterally in these markets may be a better solution than conducting an auction.

BME CLEARING thinks that the CCP rulebooks currently regulate sufficiently enough the liquidating process of a defaulting Clearing Member portfolio. Furthermore, the CCP believes that it is very difficult to define precisely all the steps of the process and therefore, it is vital that the CCP has the ability to be flexible coping with this default situation. BME CLEARING believes that while discussions with authorities, Clearing Members and clients are extremely useful to brainstorm about potential ways to further improving the functioning of the market, we do not think there is a need for additional granular standards on CCP auctions.

In the same line, we would like to stress here that in a defaulting portfolio liquidation process there is a trade-off between flexibility and predictability. It is important that the CCP auction can be as predictable as possible to its Clearing Members without losing the efficacy in the auction process that a certain degree of flexibility within predictability can offer. It is essential that the portfolio liquidating process is flexible enough to allow the CCP to adjust to the respective market, trading participant structure and the characteristics of the product as there might not be one size fits all. As a summary, BME CLEARING considers it is very important that the CCP retains enough flexibility to liquidate a defaulting portfolio as the CCP considers convenient and within its own regulation.