



**EACH response to CPMI-IOSCO 'A
discussion paper on central counterparty
default management auctions'**

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1. Introduction

The European Association of CCP Clearing Houses (EACH) represents the interests of Central Counterparties Clearing Houses (CCPs) in Europe since 1992. EACH currently has 19 members from 15 different European countries and is registered in the European Union Transparency Register with number 36897011311-96.

EACH welcomes the opportunity to provide input to the CPMI-IOSCO discussion paper ‘A discussion paper on central counterparty default management auctions’¹ (hereafter ‘the discussion paper’). Several EACH Members will provide their individual responses to the specific questions included in the discussion paper. This EACH response complements those individual responses.

This response is structured in line with the sections of the discussion paper. It does however not aim to respond to any specific question of the discussion paper. The individual responses of EACH Members should provide more detail on this.

2. Roles and responsibilities (Chapter 3)

- **Transparency though rulebook:**
 - **Ex-ante predictability**
 - EACH considers it appropriate that the CCP’s rulebook includes clear documentation on the default management process tools, governance arrangements and obligations of the clearing members. This represents a safeguard to CCP stakeholders as rules and procedures are known to stakeholders and have predictable implications during a member default.
 - EACH considers it appropriate that the clearing members of the CCP, and in particular the risk committee, be involved in the design of the default management process and the default management rules ex-ante.
 - **Ex-ante testing** - EACH considers it appropriate that all default management process steps, including governance and execution, be tested by the CCPs and clearing members involving all relevant internal and external stakeholders during fire drills organised on a regular basis.
 - **Flexibility for unexpected market conditions**
 - In line with Principle 13 of the Principles for financial market infrastructures (PFMIs), due to unpredictable market conditions at the time of a CCP member default, predefined rules have to allow certain flexibility for CCPs to act appropriately and to ensure the best possible liquidation outcome while disrupting the market to the least extent possible.
 - The PFMIs note that ‘*An FMI should be well prepared to implement its default rules and procedures, including any appropriate discretionary*

¹ <https://www.bis.org/cpmi/publ/d185.pdf>

procedures provided for in the rules’ (Paragraph 3.13.5 of the PFMI). The execution of the default management process in a specific case should therefore be at the discretion of the CCP. The executive board of the CCP should be the ultimate responsible body for the decision.

- **Default Management Groups (DMGs)**

- **General** - EACH Members have default management teams responsible for addressing default management events. The discussion paper refers to DMGs involving clearing members. In this section we differentiate between the default management teams of the CCPs which are already in place and DMGs involving clearing members which may be in place in some markets.
- **DMGs on a case-by-case basis** - While some CCPs have DMGs that involve clearing members (e.g. seconded traders), CCPs should have the flexibility to decide on asset class level if the convention of such a DMG is required or not. Seconded traders may or may not be needed, depending on e.g. if an order book or clear prices exists.
- **Involvement of clearing members** – EACH suggests that a flexible approach is applied as to the establishment of DMGs with clearing members, because of the potential for this to slow decisions at a critical moment. The time required to make a decision is particularly critical for clearing members that are bidding. The more time spent discussing the bid leaves them exposed to market moves. For the eventual winner, the longer it takes to confirm their success is a period when they cannot trade to hedge the portfolio. Therefore, the time taken to confirm the auction results is critical.
An optional consultative role rather than a decision-making one for the eventual DMG involving clearing members could represent the optimal trade-off between agile decision-making and clearing member involvement.
- **Default management team and clearing members’ DMG** - The default management team of the CCP (in consultation with the eventual DMG that involves clearing members) should provide recommendations on the liquidation strategy to the CCP’s executive board and execute required liquidation steps. The convention of a DMG including clearing members should not in any way change the ultimate decision-making powers of the CCP’s executive board, which may delegate certain functions to the CCP’s senior management, or the responsibilities of the CCP.

3. Considerations for a successful auction (Chapter 4)

- **Definition of a successful auction**

- While most EACH Members generally agree with the definition of successful auction, EACH observes that there are some challenges in introducing a prescriptive definition of what constitutes a successful auction. Prescribing too many details about what constitutes a successful auction could jeopardise the balance between flexibility-predictability.
- CCPs cannot control the end result of an auction in monetary terms, so EACH considers it appropriate that a successful auction be also based on the factors that

are under the CCP’s control (e.g. number of participants invited, as the CCP cannot directly influence the quality of the bids received) rather than on the end result in monetary terms (e.g. degree of depletion of the default fund).

- **Objective of the auction** – EACH believes that the discussion paper may consider what the objective and restrictions of the auctions may be. The ultimate objective of the auction may be to establish a balanced book and safeguard the market or rather to protect clients and non-defaulting clearing members. The objective of the auction may shift along the default management process.
- **Hedging as a first desirable step** – Depending on the context and the strategy that the CCP may want to follow in a default event, CCPs may hedge the portfolio before triggering an auction. For the purpose of hedging listed derivatives for example, most CCPs have direct access to liquid futures markets, which typically exhibit increased volumes during stressed markets and therefore allow swift risk mitigation at least on a macro level. For the purpose of hedging swaps books, entering into OTC transactions is operationally more suitable. It allows a more precise hedging with limited market impact and requires a smaller number of transactions to be entered.
- **Incentives for a successful auction**
 - Taking into account asset class specifics, in order to increase likelihood of a successful default management process, EACH considers it appropriate that CCPs have properly balanced incentives. This may include:
 - Juniorisation of the default fund – EACH Members generally agree that juniorisation seems to be one of the most effective incentives.
 - Mandatory participation in auctions
 - Fines
 - Transparency - EACH considers it appropriate that the CCP rules provide transparency regarding auction incentives and consequences in case of non-compliance with them.
 - No incentives needed? – CCPs disagree with the suggestions made by some stakeholders during the CPMI-IOSCO workshop that took place on 1st July 2019 in Berlin that no incentives may be needed for clearing members to participate in auctions. In the experience of EACH Members, the incentives described above successfully contribute towards auctioning off the defaulting clearing members’ portfolio and reducing market risk in a time of stress.
- **Flexibility Vs. Predictability**
 - As indicated above, in line with Principle 13 of the PFMI, EACH considers it appropriate that the trade-off between flexibility and predictability 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 predictability within flexibility can offer (e.g. to adjust to the respective market and trading participant structures and the characteristics of different product).
 - EACH agrees with the need to be prescriptive in certain areas (e.g. ensuring there is a line of communication between the CCP and auction participants on relevant auction terms) and also the need to avoid prescription on execution details of the action process.

- **Reserve prices** – EACH Member CCPs do not generally see the need for reserve prices in auctions. Some CCPs might use a reserve price (likely internally and not communicated to auction participants) to have an indication on auctions price to be accepted for the auction portfolio.
- **Auction risk**
 - The discussion paper should consider that CCPs need to ensure that surviving clearing members are able to participate in the auction (e.g. CCP able to divide/split portfolio; clearing members able to deal with concentration risk).

4. Operational considerations (Chapter 5)

- **Continuous testing**
 - CCPs and their clearing members should continually improve the default management process by regularly exercising the process.
 - CCPs should particularly test their clearing members for operational capability and readiness (e.g. auction file import and price determination).
- **Confidentiality** - Non-disclosure agreements (NDAs) with auction participants represent a regular practice to promote confidentiality. In certain markets, a two-way pricing and staggered information disclosure via preliminary auctions packages may represent key elements in securing the CCP's position in the market before the auction has commenced. Furthermore, the selection of a minimum number of hedging and auction counterparties for a given asset class could reduce the risk of information leakage.
- **Separation of procedural issues and fictive scenarios** - Simulation of fictive scenario causes some efforts which would not apply in a real event as fictive market data has to be used to analyse the profit and losses outcome. The achieved results only yield partial value as not all participants equally apply stress add-ons to auction prices or hedge quotes. Prices received during fire drills are rather limited indicators of the participants' ability to provide competitive bids in real crisis scenarios. Therefore, for future fire drills EACH proposes to separate procedural elements of the test from fictive scenarios and cover these with stress testing.
- **Standardisation of auction file formatting** - To increase the stability and reduce the efforts required for clearing members to price portfolios received from different CCPs simultaneously, EACH considers it appropriate that auction file formatting be standardised across CCPs. It should however be noted that standardising this file formatting may prevent it from being harmonized with each CCP's business as usual (BAU) data/reporting structure, which clearing members have called for in the past.
- **Timing to confirm results of the action to winners and losers** – As stated above, the time required to make a decision is particularly critical for clearing members that are bidding. The more time spent discussing the bid leaves them exposed to market moves. For the eventual winner, the longer it takes to confirm their success is a period when they cannot trade to hedge the portfolio. It is therefore important to ensure a speedy process to confirm the results of the auction to winners and losers.
- **Communication through web and email** - To limit operational risk and delays in information distribution, EACH considers it appropriate that pre- and during auction

communication be streamlined to the extent possible through proper IT infrastructure such as web-based application in order. Flexibility should be allowed for CCPs to use other communication tools such as a tested email solution where a full IT infrastructure may not be needed (e.g. for residual positions where a full IT infrastructure may not be needed).

5. Client participation (Chapter 6)

- **Generally in favour of client participation**
 - EACH believes that client participation increases the probability of a successful liquidation process returning the CCP to a matched book. In the case of listed derivatives for example, client participation can benefit the auction process as market makers or dedicated asset class specialists, who are usually clients of clearing members, would be allowed to provide competitive prices.
 - It should be noted however that managing a large number of clients as well as all clearing members during an auction process may present logistical challenges. Client participation may therefore depend on whether the CCP believes there is a need to get client bids (e.g. if the clearing members are only ‘clearers’ and have no proprietary risk-taking capability).
- **Safeguards** - To address the potential concerns of clearing members, several safeguards are implemented (e.g. clearing member permission for its clients to participate, signature of non-disclosure agreements, etc.)
 - **Confidentiality** – To prevent that voluntary client participants have a free look at the portfolio without having any consequences from non-participation in auctions, client participation in certain asset classes (e.g. listed derivatives) could be structured through a multi-unit two-way bidding format subject to non-disclosure agreements.
 - **Client selection process** - Client selection should consider their size, expertise and operational capacities to price the portfolio in a given timeframe.
 - **Additional incentives not needed** - Additional incentives (e.g. contribution to the default fund) for clients participating in auctions may not be required. EACH believes that it is in the interest of clients to have a successful auction, as otherwise if the default management process measures fail to re-create a matched book, CCPs would employ forced matched book tools (e.g. tear-ups) affecting also the positions of clients.
- **Clearing Members benefits**
 - Clearing members of participating clients should also benefit from client participation. This could for example be done by counting the bids provided by clients towards the fulfilment of mandatory bidding obligation of their respective clearing members.
- **Continuous testing** - EACH considers it appropriate that operational readiness and expertise of providing competitive bids of participating clients be tested during regular default management exercises.

6. Default of a common participant across multiple CCPs (Chapter 7)

- **Testing though multi-CCP drills** - It is beneficial for members and CCPs to simultaneously fire drill a global event across multiple CCPs as in times of crisis most likely multiple CCPs will be impacted and may run their default management process in parallel. The latter may however be prevented if CCPs are based on different time zones. Members having memberships at multiple CCPs will have to meet requests, in particular for bidding in auctions from multiple CCPs simultaneously. Therefore, EACH considers it appropriate that global drills be continued to further improve the alignment across the various regulators and infrastructure providers as well as challenge operational capabilities.
- **Regulators’ involvement** – To facilitate cross CCP communication and interaction, legal obstacles would have to be overcome. EACH in particular sees the need for regulatory intervention to facilitate porting (i.e. to shorten porting timeframes).
- **Avoidance of rigid timelines** - From an operational perspective, EACH does not consider it appropriate for CCPs to publish pre-agreed detailed timelines on the exercise upfront. Due to the dynamic element of the process it is rather unrealistic to consider having detailed timelines in a real event. A portfolio is suitably prepared for auction only after analysis and subsequent hedging activities are finalised. In a crisis situation this will largely depend on prevailing market circumstances and disable detailed time planning in advance.
- **Cross-CCP coordination of DMG** - In order to avoid multiple DMG assignments across CCPs, EACH considers it appropriate that rules be in place to rotate the allocation of traders temporarily if selected nominees can evidence participation in a DMG, or similar function, for a particular asset class at another CCP during the same timeframe. Cross CCP coordination of DMG assignments or an introduction of a cap on the number of traders that can be seconded from a particular clearing member is rather difficult due to individual assignment timeframes and unknown capacities of clearing members for a particular product scope.
- **Global cap for all CCPs?** – EACH Members do not support this idea. Some CCPs limit the number of traders they can get from a given clearing member, but that is different than imposing a global cap for all CCPs which could unnecessarily restrict the potential for market flexibility.

7. General

- **Need for new standards on auctions?** - EACH believes that while discussions with authorities, clearing members and clients are extremely useful to consider 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. The CCP rulebooks currently intend to balance the need for predictability of auction processing and flexibility.

- **The importance of adequate client arrangements before an auction** – While this discussion paper refers to auctions, there are several steps before the auction takes place that would have an impact on it. In order to have a successful default management process concluded by a successful auction, it would be important to ensure sufficient client porting fire-drills, availability of back up clearing member arrangements for clients and compliance with KYC requirements.

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