

## Cover note to the CPMI-IOSCO discussion paper on central counterparty default management auctions

### Background

The Committee on Payments and Market Infrastructures (CPMI) and the International Organization of Securities Commissions (IOSCO) (together, the “Committees”) are today publishing for public comment a discussion paper on central counterparty (CCP) default management auctions.

### Scope and purpose of the discussion paper

In response to the public consultation that resulted in the revised report on Recovery of financial market infrastructures (2017), the Committees agreed that follow-up work should be conducted in the area of CCPs’ default management auctions.<sup>1</sup> This discussion paper is intended to facilitate the sharing of existing practices and views on default management auctions and to advance industry efforts and foster dialogue on the key concepts, processes and operational aspects used by CCPs in planning and executing effective default management auctions. The paper focuses on five key aspects of a CCP’s default management auctions: (i) governance; (ii) considerations for a successful default management auction; (iii) operational considerations; (iv) client participation; and (v) default of a common participant across multiple CCPs.

The paper presents a number of questions and invites comments on the benefits and challenges of various approaches, as well as potential ways to overcome challenges inherent in default management auctions. The discussion in this paper reflects the current practices at one or more CCPs and identifies the types of factors that one or more CCPs take into account when planning and conducting default management auctions. Additionally, the discussion paper identifies certain considerations that may be useful for CCPs to take into account when planning for auctions.

### Inputs to the paper

In developing this paper, the Committees considered input from:

1. An industry information session conducted in September 2018.
2. A stocktake of current industry practices in place in the area of CCP default management auctions based on responses to a questionnaire on default management auctions distributed to CCPs.
3. The Committees’ working knowledge of practices currently used by CCPs.

<sup>1</sup> Cover Note to Recovery of financial market infrastructures (revised July 2017), [www.bis.org/cpmi/publ/d162\\_covernote.pdf](http://www.bis.org/cpmi/publ/d162_covernote.pdf). The report itself can be found at [www.bis.org/cpmi/publ/d162.pdf](http://www.bis.org/cpmi/publ/d162.pdf) (Recovery Report). [www.iosco.org/library/pubdocs/pdf/IOSCOPD569.pdf](http://www.iosco.org/library/pubdocs/pdf/IOSCOPD569.pdf).

The Committees would like to express appreciation to the industry participants in this process, who attended the information session and/or responded to the Committees' CCP default management auctions questionnaire.

## Further work

The Committees are seeking comments on the different elements covered in this discussion paper from interested stakeholders – including CCPs, clearing members, clients of clearing members, buy-side, market participants, academics and the general public. In addition, the Committees request views on the specific questions noted below. Please support your comments with detailed arguments and evidence, where applicable. Responses are requested by 9 August 2019.

## Content of the discussion paper

### 1 Governance

An effective auction process includes specifying the roles and responsibilities of the CCP's board of directors, management and other personnel who may be involved in the auction process, as well as those of the auction participants. Chapter 3 discusses the roles and responsibilities of key stakeholders in a CCP's default management auction.

- A. *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?*
- B. *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?*

### 2 Considerations for a successful default management auction

Chapter 4 outlines considerations of a successful default management auction and, by contrast, identifies scenarios in which a CCP may determine an auction unsuccessful. It then identifies key elements that a CCP considers when designing its auction process, including the structure of the portfolio and the format of the auction (including how bids are submitted, how the winning bid is chosen and how the portfolio is allocated), participation in the auction (whether mandatory or by invitation), and bidding requirements or incentives to participate. It also discusses activities that take place before the auction (ie hedging) and the potential options available to a CCP in the event of an unsuccessful auction.

- A. *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?*
- B. *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?*
- C. *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?
- D. What are the considerations for CCPs in choosing to utilise 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?
- E. 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?
- F. How do you incorporate cross-margining arrangement considerations in the hedging strategy and in the broader auction design process?
- G. 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?
- H. 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.
- I. 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?
- (i) 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.
- (ii) 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.
- J. 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?
- K. 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?
- L. 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)?
- M. 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?

### 3 Operational considerations

Chapter 5 describes the operational issues a CCP considers when planning and executing a default management auction. In order to maximise the likelihood of a successful auction, a CCP can take steps under business-as-usual (BAU) conditions to prepare for a potential auction. Effective communication of information between relevant parties prior to and during an auction is also an important element that can influence the auction's success. Testing exercises in relation to default management auctions during BAU also serve as preparation for a live auction.

- A. 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?

- B. *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?*
- C. *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?*
- D. *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?*
- E. *There may be benefits in pursuing greater standardisation and harmonisation across CCPs in relation to certain operational elements which support execution of an auction.*
  - (i) *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)?*
  - (ii) *Besides CCP portfolio files, which other operational elements would benefit (the most) from greater standardisation and harmonisation across CCPs?*
  - (iii) *Are there specific operational elements or areas where standardisation and harmonisation may not be helpful?*

## 4 Client participation

Client participation in an auction, as discussed in Chapter 6, can be either direct (where clients submit bids independently of clearing members) or indirect (where clients submit bids through their clearing members). A CCP and its clearing members may take into account several considerations when deciding whether to permit or facilitate client participation, including liability of the clearing member, incentives of clients to bid competitively, the level of legal and operational readiness at the client, and the risk of information leakage.

- A. *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.*
- B. *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)?*
  - (i) *One option to address 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?*

## 5 Default of a common participant across multiple CCPs

The default of a participant common to more than one CCP is considered in Chapter 7. This chapter identifies potential issues inherent when two or more CCPs conduct auctions concurrently, thereby creating further operational and/or financial strains on auction participants. This chapter also discusses the use of multiple-CCP default management exercises.

- A. *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?*
- B. *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?*
- C. *Are there efficiencies or benefits to be gained from CCPs coordinating their respective default management auctions? If so, how?*
  - (i) *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?*

## 6 General

- A. *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?*
- B. *What are the potential areas in the context of default management auctions where additional guidance might be most welcome?*

Comments on the report (supported with detailed arguments and evidence, if available) should be sent by 9 August 2019 using the link [here](#). As noted above, comments are welcome on any aspect of the report and need not be restricted to the indicative questions that are highlighted in this cover note.

All comments may be published on the websites of the Bank for International Settlements and IOSCO unless a respondent specifically requests confidential treatment.

After the consultation period, the Committees will take into account the comments received and determine whether to publish a final version of the paper or conduct further consultation, as needed.