

CCP Default Auctions Best Practices

Category 2 Issues:
CCP Governance, Default Management Groups, and Client
Participation

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1. INTRODUCTION

In the report “Central counterparty default management auctions – Issues for consideration”¹, the Committee on Payments and Market Infrastructures (“CPMI”) and the Board of the International Organization of Securities Commissions (“IOSCO”), CPMI-IOSCO described issues for CCPs to consider in the design and conduct of default management auctions. The paper builds on the Principles for Financial Market Infrastructures (April 2012) (“PFMIs”) and joint CPMI-IOSCO work on CCP resilience and recovery, with the aim of enhancing auction practices and procedures. The paper reflects current practices across the industry, as well as responses to a 2019 CPMI-IOSCO discussion paper. The report and its accompanying cover note² observed three areas for further work by the industry, which are directed at the objectives of the 2019 discussion paper. These objectives are, as listed by CPMI-IOSCO:

1. promoting a common understanding of key concepts, key processes (including information needs) and operational aspects that a CCP considers when planning and conducting default management auctions;
2. highlighting key issues and challenges in auctions for those who are looking to develop or to improve upon their auction procedures; and
3. providing context for industry participants to identify opportunities to foster closer collaboration.

The three categories of work where the Policy Steering Group of CPMI-IOSCO sought industry action are:

- The first category includes several terminology and operational issues (where there is broad industry consensus to support further development and where CCPs should be well-positioned to advance these issues, bringing such work to closure.
- The second category includes areas (governance of a CCP’s default management process, use of traders in default management groups, the scope of client participation) where there may be differing views among clearing members, clients, CCPs, and other stakeholders.
- The third category includes potential nascent and emerging practices (synchronizing default management processes, identification of potential hedges between CCPs) that may require further coordination and harmonisation among the default management processes of multiple CCPs.

¹ “Central counterparty default management auctions – Issues for consideration” – June 2020: <https://www.bis.org/cpmi/publ/d192.pdf>

² “Central counterparty default management auctions – Issues for consideration” – June 2020: https://www.bis.org/cpmi/publ/d192_covernote.pdf

This paper, developed by CCP12 and EACH addresses the governance of CCP's default management process and Default Management Groups ("DMGs") part of the second area of work.

This paper covers firstly the governance of a CCP's default management process. It reflects the CCP's commitment to the highest standards of governance, as outlined by the PFMI and substantiated by the role of the CCP's risk committee(s). Representatives of clearing members and clients in some cases form an integral part of these committee(s), being involved in matters relating to a CCP's risk management framework and playing a critical role in a CCP's risk governance.

The governance set up may differ between CCPs or markets, not omitting the responsibility and accountability for risk decisions but rather reflecting the CCPs rulebooks, regulations, or procedures, which may – although this paper is in English – be written in other languages using an appropriate translation of the concepts.

Furthermore, this paper outlines the governance, design, and composition of DMGs. A CCP's senior management should have discretion to consult with a broad range of market participants *ex-ante*, when in the CCP's judgment it deems such consultation necessary in designing its default management procedures, including for auctions. 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 the event a default occurs. DMGs may also be established to advise the CCP on the design of auctions, liquidation, and/or hedging activities to best manage portfolios of defaulting clearing members.

DMGs may be convened by CCPs so that guidance from external stakeholders may be used to complement a CCP's own expertise to enhance the design of auctions. When 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.

As outlined by CPMI-IOSCO in their 2017, 2019, and 2020 papers, different CCPs can and do adopt different auction structures that are best suited to a robust and suitable default management. As such, a "one-size-fits-all" approach to the auction process is inappropriate and it is critical to recognize that differences exist, such as product types, market structures and characteristics, regulatory and legal environments in different jurisdictions, and operational requirements. It is also imperative that a CCP retains flexibility in its default auction approach to react to the facts and circumstances at the time of the event.

2. GOVERNANCE OF A CCP'S DEFAULT MANAGEMENT PROCESS

CCPs are committed to the highest standards of governance, substantiated by the role of the CCPs risk committee(s). Representatives of clearing members and clients in some cases form an integral part of these committee(s), being involved in matters relating to a CCP's risk management framework and play a critical role in CCP's risk governance.

2.1. CCP GOVERNANCE STRUCTURE

Each CCP should have clearly documented governance arrangements in place that address decision-making during the auction process and provide clear and direct lines of responsibility and accountability for risk decisions.

CCP Board of Directors'

The CCP Board of Directors ("Board") is responsible for approving the CCP's default management rules including but not limited to the general process for conducting default auctions and generally delegates authority to the CCP's senior management to carry out auctions within those processes.

CCP Senior Management and dedicated default management team

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 be supported by the CCP's dedicated default management team. It is the CCP's senior management and default management team that is best positioned to provide expedient and timely expertise in planning and conducting auctions, while incorporating ex-ante guidance received from clearing members and other market participants where appropriate.

The senior management should keep the Board and other stakeholders, for instance, primary regulator of the CCP, informed of material developments related to the default auction. To ensure that the CCP functions as a neutral risk manager, process execution and ultimate decision-making must be at the discretion of the CCP.

CCP senior management should have broad discretion and authorized flexibility to consult with regulators, risk committees, clearing members and clients when in the CCP's judgment it deems such consultation necessary in designing and conducting a default management auction.

CCP Risk Committee

CCPs have independent risk committees that advise a CCP on certain risk-related matters affecting CCP risk management. The risk committee may be comprised of representatives from clearing members, clients, independent members of the CCP Board and CCP staff. Competent authorities may also be invited to participate. In particular, the risk management input provided by these bodies is independent from the management team of the CCP and, therefore, provides another layer of oversight. Through these forums, it also keeps the risk

committee members informed of the CCP's risk management practices. In this capacity, the risk committee, on an ex-ante basis, is responsible for advising the CCP (i.e., senior management and Board) with respect to the default management rules including the procedures for conducting default management auctions.

CCP Default Management Group

Some CCPs, especially those that clear over-the-counter ("OTC") markets with specialized products and significant risk, may establish a DMG that advises on the auction, liquidation and/or hedging of a defaulter's portfolio and typically is comprised of seconded traders who bring additional skills and market expertise.

In the exchange-listed instruments space, DMGs are less common, as these products benefit from a central limit order book, which provides enhanced market transparency. CCPs are therefore often well positioned in terms of expertise and direct market access to conduct hedging and liquidation activities and/or evaluate auction configurations.

Such groups may bring valuable advice and assistance to a CCP, but DMGs are not meant as a substitute for the CCP's own expertise.

DMGs are described in detail in section 3.

2.1.1. RESPONSIBILITIES AND ACCOUNTABILITY FOR RISK DECISIONS

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

A CCP's Board is ultimately responsible for establishing the CCP's risk tolerance, setting and maintaining accountability for the strategic direction of the CCP's risk management practices through the approval of the risk management framework, approving decisions with a significant impact on the risk profile of the CCP and defining governance arrangements for decision-making, including in crises and emergencies. The CCP senior management, with the support of staff, is responsible for implementing the risk management framework approved by the Board. This framework, where senior management is in charge of day-to-day activities, allows the Board to act as an effective check and balance on management.

A CCP's Board must provide oversight of the risk management activities and the senior management of the CCP, including the effectiveness of the overall default management process. The Board may be advised by consultative bodies, such as CCP risk committees and DMGs in such oversight.

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

2.1.2. ASSIGNMENT

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 be supported by the CCP's dedicated default management team. The CCP senior management and default management team are best positioned to provide expedient and timely expertise in planning and conducting auctions, while incorporating ex-ante guidance received from clearing members and other market participants where appropriate.

2.1.3. TESTING

In addition to default management testing exercises with market participants for operational, legal, logistical, and technological preparedness, CCPs should test and review auction roles and responsibilities (such as decision-makers) as part of these default management drill exercises.

2.1.4. REMOTE WORKING ARRANGEMENTS

In the case of a default during remote working arrangements, the adherence to compliance and information security protocols is paramount.

Roles and responsibilities as well as processes and procedures should be the same as under normal working conditions, however, back-up solutions should be implemented (i.e., in Business Continuity Plans, where necessary).

Remote working arrangement and/or other possible business disruption scenarios that could impact the default management process should be considered in regular testing exercises.

3. DEFAULT MANAGEMENT GROUPS (DMGs)

3.1. GOVERNANCE

CCPs have default management teams responsible for addressing default management events. A CCP's senior management should have discretion to consult with a broad range of market participants ex-ante, when in the CCP's judgment it deems such consultation necessary in designing its default management procedures, including for auctions. 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 the event a default occurs. DMGs may also be established to advise the CCP on the design of auctions, liquidation, and/or hedging activities to best manage portfolios of defaulting clearing members.

DMGs may be convened by CCPs so that guidance from external stakeholders may be used to complement a CCP's own expertise to enhance the design of auctions. When a DMG is convened, the convention of a DMG should not in any way change the ultimate decision-making capacity of the CCP 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 DMG members. CCPs may also require their DMG members to maintain confidentiality by signing a document attesting to their obligations as a member of the DMG, although this may only be required for external participants. Additionally, to avoid any conflict of interest, an agreed commitment should be established that a DMG participant's obligations are to the CCP and not to the DMG participant's clearing member.

3.2. DESIGN

The design and use of a DMG must take into account various considerations and interests, including the need for a CCP to take actions quickly and to efficiently liquidate and/or hedge the positions of a defaulting member in a way that protects the positions and resources of the CCP and its non-defaulting members.

A DMG is best placed when it is advisory in nature. In preparation for a default, the DMG may meet on a regular basis when the market is calm (peace time) in order to review and discuss market and product liquidity, industry initiatives, potential costs, timescales for the hedging and auction process, hedging strategies, and auction practices, including portfolio splitting and loss allocation. This advisory nature represents the optimal trade-off between agile decision-making and clearing member involvement.

A CCP must have the flexibility to determine the appropriate level of involvement of a DMG, depending primarily on the nature of the products cleared and the particular default scenario. In any default scenario, it is to be expected that time will be of the essence and the CCP will need to retain the ability and flexibility to close out the defaulter's positions as quickly as feasible. Otherwise, the CCP runs the risk that markets will move in a way unfavourable to the defaulter's portfolio while it spends time unnecessarily convening a DMG, which may

increase the risk to the CCP and the ultimate cost to the CCP and its non-defaulting participants. It may also not be clear prior to a default which particular products are at issue and what particular expertise may be needed from a DMG, if any. Relevant personnel may also be in different geographic locations and time zones, making mandatory coordination through a DMG difficult. Inefficiencies may arise both with a committee that is too small and one that is too big.

Some important considerations when contemplating the use of a DMG are:

- The ability and willingness of clearing members, and their personnel, to participate in a DMG;
- The particular expertise needed for the default management of certain products, and the availability of sufficient personnel at clearing members with such expertise during a time of stress;
- The speed at which a CCP must act, in light of market conditions, the location of the relevant markets and market participants, and other factors;
- The authority, responsibility, and duties of members; and
- The confidentiality, conflict of interest and resource allocation considerations that arise from clearing member participation in a DMG.

3.3. COMPOSITION

The constitution of DMGs should be relevant, considering the finite availability of trading resources at clearing members, and their role and governance must be set out ex-ante, so all members are aware of any potential responsibilities.

DMGs are generally composed of one or more of the following:

- CCPs' own staff
- External representatives where appropriate, which may include seconded traders from clearing members and their clients

Given that clearing members are often members of multiple CCPs, there may be overlapping demands for the same individual(s) from a given clearing member firm to participate in the DMGs of multiple CCPs in a default scenario. To address that, CCPs could maintain an up-to-date register of the individuals from each clearing member that they expect to be seconded to their DMGs, and the clearing member is expected to ensure that such individuals will be available to the respective CCP, i.e. individuals are not a member of the DMG of more than one CCP.

Clearing members should be obliged to update their representatives in the event that a representative leaves the clearing member firm. Specific consideration should be given to rightsizing the participation according to the complexity and/or liquidity of products. In

scenarios where clients of clearing members bring relevant skills and market experience, such participation could be considered in the composition of the DMG.

In particular circumstances, any existing relation of defaulting clearing members and potential bidders could conflict with the secondment arrangement and the advice provided. This would for compliance reasons dictate the CCP to decline one or even all of the seconded traders' advice and services.

4. NOTES TO THE EDITORS

4.1. ABOUT CCP12

CCP12 is the global association for Central Counterparties (CCPs), representing 40 members who operate over 60 individual CCPs globally across the Americas, EMEA and the Asia-Pacific region.

CCP12 promotes 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, while also actively engaging with regulatory agencies and industry constituents through consultation responses, forum discussions and position papers.

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4.2. ABOUT EACH

The European Association of CCP Clearing Houses (EACH) is a Belgian not-for-profit organisation (AISBL) founded in 1992 which represents the interests of central counterparty clearing houses (CCPs) in Europe. The membership is open to CCPs based in the European Union and in other European countries. The membership of EACH comprises 19 CCPs incorporated in 15 European countries. EACH is registered in the European Union Transparency Register with number 36897011311-96.

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