CME Default Management

CME Group Inc.

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Managing Defaults

CME's Default Management Process (DMP) has benefited from an extensive experience over several decades of successfully managing defaults of broker dealers/clearing members such as Bearings, Drexel Burnham & Lambert, Lehman Brothers, Refco, and MF Global. Below are some of the critical lessons:

- Importance of a wider base of market participants for successful auctions
- Importance of detailed customer information to port large number of customers in the timely fashion
- Importance of default management drills
  - Removes operational risk and increases focus on hedging and auction
- Coordination with other CCPs

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Best Practices of Default Management Procedure

When a Clearing Member ("CM") defaults, the house portfolio of the defaulted clearing member and any of its defaulted customers need to be liquidated. Here are key steps to a successful Default Management Procedure ("DMP"):

- DMPs should be designed to reflect the market structure of the cleared products incorporating a set of well thought out strategies and tools while still allowing for enough flexibility and discretion to remain nimble and effective in the face of ever unpredictable distressed market conditions.
  - For listed derivatives where in general the market is liquid and has transparent central order limit books, DMP should use the markets and engage a broad set of market participants on a voluntary basis to auction off the portfolio
  - For OTC markets the market structure has not evolved to a large central market. Instead there are several pools of liquidity some on SEFs and others still transacted bilaterally. To account for these changes in market structure, DMP should be more structured, where a CCP should use the expertise of seasoned traders to formulate the appropriate hedging and auction strategies. The auction participation is generally an obligation for clearing members. However, we believe buy side should not be excluded from auction participation
- For OTC markets, it is imperative to execute macro level hedges to reduce large directional risk of the defaulted portfolio(s) as soon as practicable
- Once the risk of the defaulted portfolio has been neutralized or sufficiently reduced, CCP should auction it off.
  - CCP should develop and implement a number of auction styles that correspond to a particular asset class, product category, and the risk of the portfolio and the market conditions.
- Defaulted CM's collateral should be liquidated, as needed, to meet DM costs and variation margin
- The process of porting non-defaulted customers to healthy CMs should start simultaneously

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Coordination with other CCPs

CME believes that CCPs cooperation is one of the critical elements of prudent, efficient, scalable and effective DMP

- CME has reached out to other CCPs to discuss possible ways to coordinate
- Several initiatives have been identified
  - Joint default management exercises.
  - Coordination of traders secondment across CCPs
  - Finding a solution to risk offsetting transactions across CCPs with respect to the defaulted portfolio

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Default Management Drills – Preparation for IRS & CDS

- Creation of hypothetical defaulted portfolio
- Generation of simulated market data sets for all days of the drill
- Incorporation of simulated market data into CME systems for valuation and risk calculation
- Production of risk reports for ADMC traders and firms
- Production of hedge calculation worksheets for ADMC traders
- Developing and testing the new auction platform
- Multiple conference calls, and individual communication with all firms to educate participants on using the platform, for creating users, file download, and submitting bids
- Mock auctions for firms to test the auction platform for all its features
- Set up and testing of war room resources at New York and London offices
- Coordination of a pre-drill valuation exercise with the firms
- CME Internal dry runs
- Distribution of drill process timelines, scope, clarifications, and updates to firms

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CME Default Management Drills (IRS & CDS)

- CME conducts DM drills across all asset classes twice a year to test and continuously enhance
  - DM procedures
  - DM systems
  - Communication with CMs
  - Participation of CMs in hedging and auction phase
  - Bidding incentives
- DM Drills – Resources
  - War rooms equipped with laptops, telephones, internet, teleconferencing, secured email access, Bloomberg, and Reuters are set up at New York and London offices
- DM Drills – Hedging Phase
  - On Day 1 of the default, CME staff executes initial macro level hedges to reduce the main risk of the portfolio
  - ADMC traders are seconded to the secured CME offices in London and New York
  - Detailed risk reports are presented to the traders
  - ADMC formulate their hedging strategy and recommend further hedges
  - CME staff books the hedges into CME systems and re-run the risk reports
  - The hedged portfolio details are distributed to all firms using CME's web based application "CME Auction Platform" and via FTP

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Default Management Drills (IRS & CDS) - Continued

- DM Drills – Auction Phase
  - On Day 2, CME conducts an intermediate conference call with non-defaulting member firms to address any outstanding technical issues
  - On Day 3 or 4, Auctions are conducted on CME Auction Platform
  - This platform provides a very efficient, secure, and automated means of conducting auctions
  - Bidders from the CMs submit their bids using CME Auction Platform
  - Winners are determined and award notifications are sent by the Auction Platform
  - Clearing member firms are informed of the hypothetical impact of their bids on the seniority of their GF utilization
- DM Drills – Cost of DM calculations
  - Throughout the drill, CME staff keeps track of the costs mentioned below to calculate the following costs
  - Hedging cost
  - Variation Margin cost
  - Auction cost
  - The total cost of default management is then compared with the collateral on hand (given by initial margin) and the liquidation assumptions of the margin model.

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