

Overview of Default Management Fire Drill

Presentation at CFTC Market Risk Advisory Committee Meeting

April 2nd, 2015

Scope

- ❖ A fire drill is a test for the end-to-end coordination of the default management process.
- ❖ Each Clearing Service must conduct regular fire drills to test the procedures and processes in place to manage a member default.
- ❖ In addition, LCH.Clearnet runs a Group-wide fire drill exercise at least once per year that assumes the default of a member that has exposure across all Clearing Services in all LCH CCPs. It covers areas such as:
 - Gathering of default management group for each Clearing Service
 - Simulation of liquidation strategy, hedging strategy, close out auctions
 - Client porting
 - (LCH.Clearnet Limited Only) Non-default loss process for managing a loss arising from treasury activities resulting from the default of a non-clearing member or sovereign default

Design

- ❖ The fire drill is designed so that the steps taken in the default management match, to the extent practicable, those that would be taken in the event of a real default. Some of the decisions that need to be made include:

Timeline

- The entire timeline from pre-default, declaration of default, default management to closeout

Default exposures

- Services that are impacted
- Exposure sizes
- Types of client accounts (e.g., LSOC)
- Other interdependent relationships (e.g., investment counterpart of one of the CCPs)

Default fund waterfall

- The stages of the default fund waterfall that will be tested (e.g., assessment, VM haircut, service closure)

Other considerations

- Operational processes that can be tested in real systems vs. those that need to be simulated
- Extent of external clearing members' involvement

Planning

- ❖ Group Risk is responsible for the overall planning, design, general coordination, and evaluation of the fire drill.
- ❖ Regulators are invited to observe the fire drills. The most recent LCH fire drill was attended by CFTC, Bank of England, AMF, ACPR, and the Banque de France.
- ❖ Functional lines involved in the fire drill includes:



- ❖ Each group is responsible for having a set of up-to-date Default Management Procedures that details the step-by-step processes it will take to managing a default.

Execution

❖ Typical activities during a fire drill are as follows:

Identification and activation/Analysis of situation

- Internal update on potential default of the hypothetical member
- Preparation for a default

Stabilization and close out preparation

- DMG meet to determine hedging, client porting, and liquidation strategies
- Execute hedges
- Daily and intraday updates of risk, collateral, and liquidation positions

Assessment of default fund waterfall (assume prior layers of resources are used)

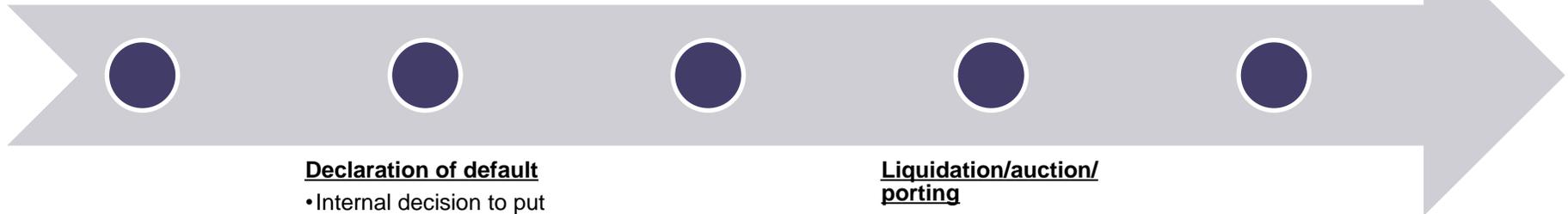
- Test procedures for calling unfunded assessments and VM haircutting

Declaration of default

- Internal decision to put the hypothetical member in default
- Internal and external communications to all relevant parties
- Update of risk, collateral, and liquidity of house and client positions

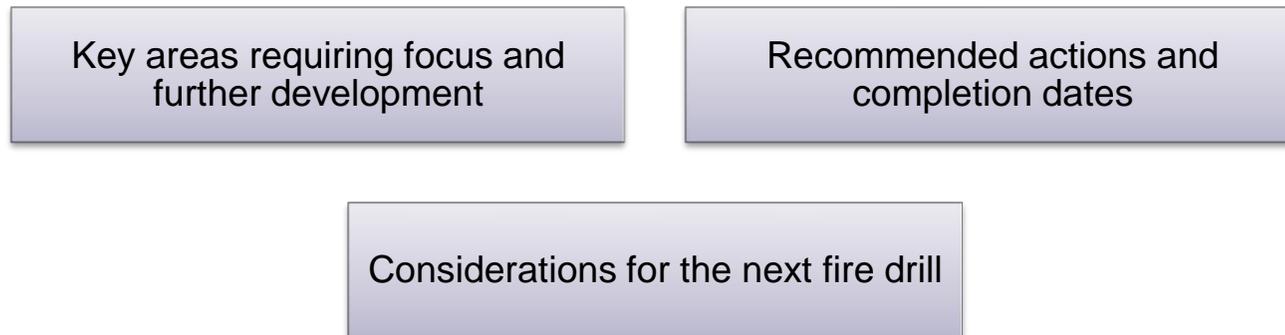
Liquidation/auction/porting

- Execute liquidation, auction/client porting strategies
- Daily and intraday updates of risk, collateral, and liquidation positions



Evaluation

- ❖ A formal report is produced to summarize findings from the fire drill exercise.
- ❖ The report is presented to each CCP's management committee and also the Group Audit Committee
- ❖ The report includes the following:



- ❖ The success of the fire drill is evaluated based on how well default management procedures are executed and implemented by the business and functional lines.

Appendices

Default Management Principles

Maintain ongoing performance of LCH.Clearnet obligations vis-à-vis all other non-defaulting clearing members

- LCH.Clearnet continues to meet its obligations, including those of the defaulter, such as meeting payment and delivery obligations (if any)

Preserve LCH.Clearnet capital and default fund(s)

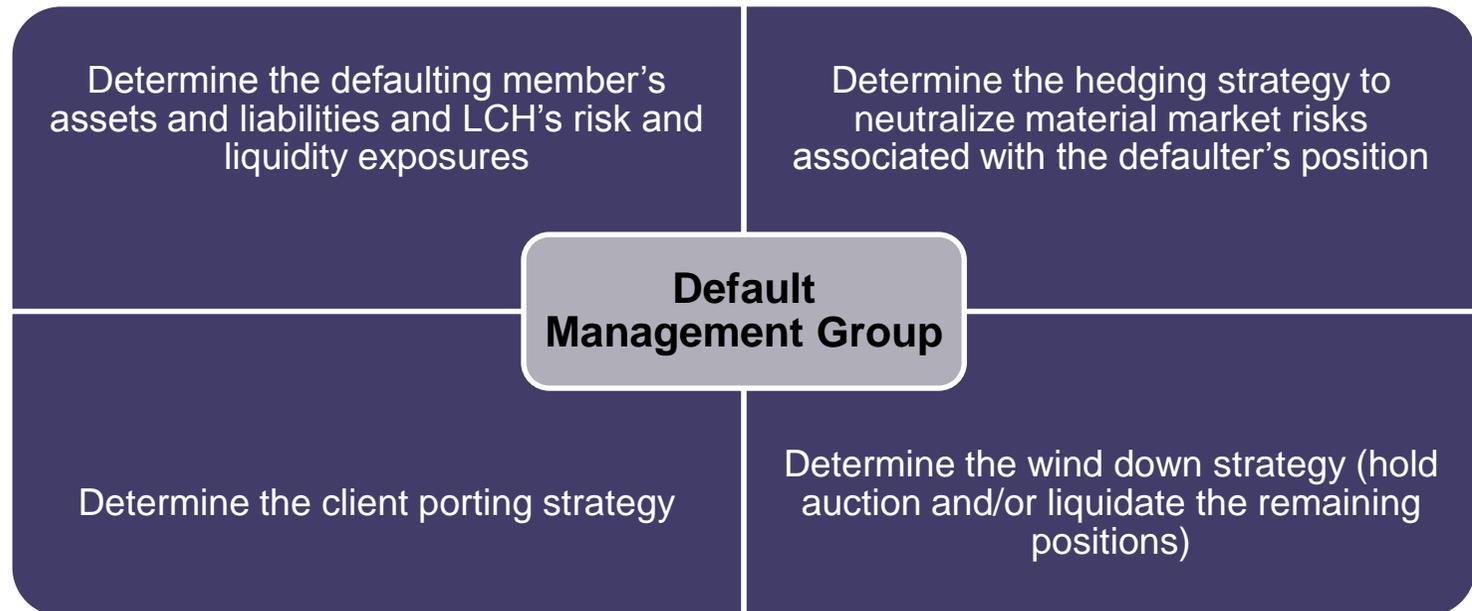
- LCH.Clearnet will seek to preserve the LCH “Skin-in-the-Game” capital and mutualized resources contributed by non- defaulting members to the default fund(s)

Manage the transfer of all segregated client positions

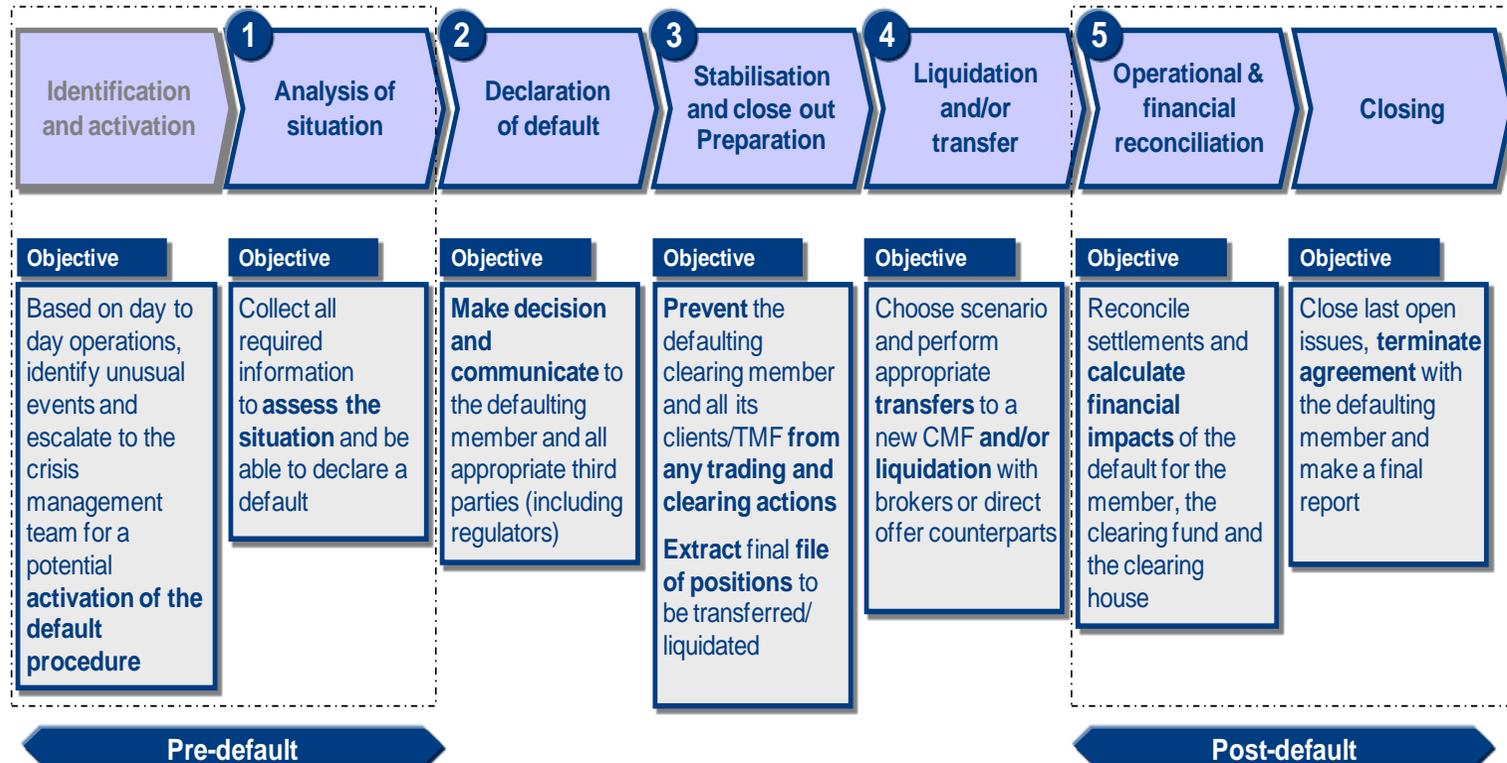
- LCH.Clearnet will seek to facilitate the transfer of the defaulting member’s client positions and segregated collateral to other clearing members

Default Management Group (DMG)

- DMGs are convened within the first few hours of the Default Notice being served and are responsible for the day-to-day management of the default process.
- Members of the DMG may include seconded trading representatives from clearing members in advisory roles.
- Example of activities conducted by a DMG:



Default Management Phases



TMF – Trading Member Firm
 CMF – Clearing Member Firm

Non-Default Loss Fire Drill

- ❖ Non-default loss refers to the loss arising from treasury activities that is incurred as a result of a non-clearing member default or sovereign default.
- ❖ Examples of non-default loss include:
 - Unsecured deposit loss as a result of the default of the depository institution;
 - Secured reverse repo loss as a result of the default of a reverse repo counterparty
 - Sovereign loss as a result of the default of a sovereign in which treasury has securities exposures
 - In LCH.Clearnet Limited, non-default loss is allocated to members after the CCP absorbs the first EUR15mm of losses.
- ❖ Functional lines involved in the non-default loss fire drill includes:



- ❖ After the completion of the fire drill, a log of all areas that requiring further attention is produced. Owners and targets dates are assigned to each action to ensure the issues are resolved and embedded in the future.

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