

Recommendations¹

1. Interdependencies Among CCPs and Key Intermediaries / Markets

Issue Description: CCPs may depend on their largest clearing members (or affiliates of those entities) for an array of products and activities that are also essential to the smooth functioning of the default management process. Clearing members (or their affiliates) may act in key capacities as providers of liquidity facilities, as counterparties in the repo markets, as counterparties to macro-hedging transactions, or as providers of cash or collateral custodian services.

Recommendation(s):

- CCP default management plans and drills need to also contemplate that the default of one or more significant clearing members could also result in the parallel loss of certain key services including liquidity facilities, repo lines, macro-hedging strategies, settlement services (for physically settled products), or custodial services.
- CCPs' liquidity stress testing should consider the possible material liquidity risk exposure from their relationships with liquidity providers / custodians / settlement banks. At a minimum, a CCP must maintain sufficient liquidity resources, as determined by its liquidity stress testing, to meet its liquidity obligations under a scenario where the clearing member creating the largest liquidity obligation defaults. Further, a CCP must consider a scenario where the clearing members creating the two largest liquidity obligations default. CCPs should disclose publicly² the roles that clearing members (or affiliates of clearing members) could be obligated to, or have elected to, participate in when managing a liquidity event (via liquidity facilities, repo lines, settlement and custodial services, etc.) to provide appropriate clarity with respect to any interdependencies.
- CCPs should demonstrate that they have access to sufficiently diverse liquidity resources that are highly reliable in extreme but plausible market conditions. Disclosure of this information should be limited to a defined universe (e.g. clearing members, their customers and relevant regulators) where the confidentiality of such information can be preserved. Such disclosures should also specify whether liquidity resources are maintained independently for different product clearing silos or whether any dependencies exist across silos. Rules should be explicit as to whether CCPs can rely upon non-defaulting member initial margin to meet temporary liquidity needs and it should be mandatory to replace such cash with equivalent value high quality securities.

¹ Please note that these recommendations focus primarily on CCPs for derivatives. In particular, auction processes may not apply to securities CCPs, given the different markets they support as well as the different regulatory framework that securities CCPs are subject to.

² Please note such disclosure will preserve the confidentiality of clearing members. Form of disclosure to be discussed with the CCPs

2. Portability and Clearing Member Resource Availability (Financial and Operational)

Issue Description: The ability to port the positions and related collateral of the non-defaulting customers of a defaulting clearing member to a solvent clearing member is one of the key customer protection features of central clearing and is essential to preserving market stability and liquidity. CCP default management plans and drills may not adequately consider the feasibility of porting customer accounts with respect to (i) the financial resource capacity (i.e. balance sheet, capital, etc.) or the willingness of the remaining solvent clearing members to absorb new customers and (ii) the operational, technological, legal documentation and communication challenges associated with the porting of customer accounts. In addition, porting customer positions and collateral from a defaulting clearing member is dependent upon obtaining requisite approvals from a bankruptcy court, which adds additional uncertainty with respect to timing and process.

Recommendation(s):

Financial Resources

- Mechanisms to continue to service the portfolios of non-defaulting customers on an interim basis post-clearing member default must be explored (i.e. is the margin adequate to facilitate a period where the CCP can continue to service the portfolios prior to finding another FCM and/or prior to closing out the portfolio in an orderly fashion).
- Progress in developing alternate CCP membership models (that comply with the Principles for Financial Market Infrastructures) should be evaluated to determine if there are viable alternative client clearing models to the current FCM model, and what barriers / limitations exist to introducing such models.

Operational Resources

- CCP default drills should include simulations of the porting of non-defaulting customer portfolios, and include actual customers in this aspect of the drills.
- Further investment in and development of robust and automated regular use (i.e. non-default scenario) customer porting capabilities should be pursued, as their existence and use would enhance stability in an actual default scenario through the ability of customers to transfer portfolios as needed.
- CCP default management plans and drills should address the process and timing for obtaining bankruptcy court approval to port customer positions and collateral from a defaulting clearing member, and the risks of any delays in obtaining requisite approvals.

Customers should consider having multiple and/or back-up clearing member arrangements to facilitate porting in the event of their primary clearing member's default (among others, this should minimize KYC, legal and operational challenges).

3. Auction Process Consistency & Transparency

Issue Description: The timely and effective auction of a defaulting clearing members' portfolio is the linchpin of a successful default management process. Further, consistency, and transparency into each CCP's auction plans and processes – in terms of the sequence of events, the information to be communicated and the methods of delivery, and the timing of the different steps in the process (including bid submission, determination of auction results, and publication of results) – is essential. While a one size fits all approach may be neither realistic nor desirable given the different products / markets that CCPs serve, a general alignment of procedures and timelines (not simultaneous timing of auctions), particularly if a significant clearing member has defaulted at more than one CCP, is needed. Further, the market as a whole will benefit from the ex ante certainty about when different steps will occur and when the results of those steps will be made public.

Recommendation(s):

- Minimum standards and a set of agreed upon best practices should be drafted to bring greater predictability, consistency and transparency to CCP auction processes and timelines.
- CCPs should outline auction participation rules / procedures through their rulebooks and their Principles for Financial Market Infrastructures disclosure documents. Through these forms of public documentation, a CCP should outline timing, participants, participation terms (voluntary vs. mandatory, implications of failure to participate, etc.), the format and content of the auction portfolio file, and the bidding process. CCPs should consider publishing "playbooks" that detail this information in an accessible format.
- The feasibility of a simultaneous auction / fire-drill across multiple large CCPs (together with regulators on-site observing the process) should be considered with clearing member traders required to act and bid assuming a common scenario and using a portfolio that includes complex / risky trades.

4. Auction Participation by Customers (i.e. by Non-Direct Clearing Participants)

Issue Description: Expanding the ability to participate in default management auctions beyond the direct clearing member community is essential to ensuring that the largest possible amount of non-correlated private sector capital can be committed to the process, which should yield more aggressive bids and better overall auction results. While customer auction participation is contemplated in select instances, it is not universal across CCPs or even across different cleared products at the same CCP (e.g., futures vs. swaps).

Recommendation(s):

- The necessary policies, procedures, rights, obligations, confidentiality protections, etc. for non-direct clearing participants to participate in CCP default management auctions should be

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considered and stipulated. This should include financial incentive / consequence structures that create properly aligned incentives, which may include fees/charges for non-competitive bids and/or a certain amount of capital at risk that can be juniorized/seniorized alongside direct clearing members).

- CCP default drills should also include non-direct clearing participants, subject to the parameters above, in default management auction simulations.

5. Default Management Committee Participation

Issue Description: CCPs' default management committees include representatives that are seconded from clearing members. These clearing member representatives bring skills and expertise necessary that assist the CCP with the default management process, including hedging risks associated with the defaulters' portfolio, structuring the portfolio for auction, and liquidating the portfolio. Given that individual clearing members are members of multiple CCPs, there may be overlapping demands for the same individual(s) from a given clearing member to participate in the default management committees of multiple CCPs. Additionally, the requirements by the CCPs across the globe with respect to number of traders that could be seconded industry-wide at the same time, could be detrimental to the overall risk management needed at the banks themselves during this time.

Recommendation(s):

- CCPs should maintain an up to date register of the individuals from each clearing members that they expect to be seconded to their default management committees, and these lists should be reconciled amongst CCPs. Clearing members will be obligated to update their representatives in the event that representative leaves the firm or the relevant trading seat.
- Harmonization of, and transparency, into default management committee requirements (number of participants on the default management committee, tenure of participation, frequency of rotation) and coordination amongst CCPs to minimize overlap amongst clearing firms that would have to second traders at the same time.
- CCPs should consider penalty incentives to ensure traders are seconded.