

CCP Risk Management Subcommittee of the Market Risk Advisory Committee of the CFTC

Following the April 2015 MRAC meeting, the CCP Risk Management Subcommittee was established to delve deeper into the CCP risk issues that were raised at that meeting. The Subcommittee was tasked with answering two questions, to which the Subcommittee provided responses in November 2015 and June 2016:

1. *Are there ways in which the CCPs' efforts, as outlined in their [April 2015] presentations, could be more reflective of actual market conditions in the case of the default of a significant clearing member? Or, in other words, what are the practical limitations to implementing these efforts in times of market stress? The Subcommittee put forth comments on interdependence, portability, auction (participation and porting) processes and default management committee considerations.*
2. *Are there ways in which CCPs can coordinate further in their efforts to prepare for the default of a significant clearing member? Or, in other words, in what ways can we make default management more effective and efficient across multiple CCPs? The Subcommittee put forth comments on communication, coordination of seconded traders, joint default drills, the auction process, and porting.*

This document combines and expands upon the Subcommittee's responses to form a comprehensive set of agreed upon recommendations. The document will also provide insight into some key issues where agreement has not been reached.

Recommendations¹

I. Default Management: Coordination, Harmonization and Enhancement

Successful default management requires meaningful coordination and cooperation amongst the industry players. The subcommittee recommends the following actions be taken to enhance the default management process to improve the chances of successful default management implementation.

A. Communication:

Communication channels should help promote collaborative work among market participants in their effort to minimize risks and promote market stability. This will also help facilitate information sharing during a market crisis.

Recommendation(s):

- Create and maintain a global directory of key individuals at clearing members and non-clearing member firms² involved in default management who will have regular communications with CCPs (and regulators) both during business as usual and market stress conditions.
- CCPs should provide one way updates about the movement of customer positions, following customer engagement. Updates should detail process steps regarding customer position movements, including opening and closing of the porting window; commencement and completion of the customer porting (whether segregated or non-segregated); start and

¹ Certain of the recommendations reflected in this document may not be applicable to all CCPs given differences in ownership structure, instruments cleared, business models or CCP rules and regulatory requirements.

² The term "non-clearing member firm" refers to all market participants who are not themselves clearing member firms, including a clearing member firm's customers.

completion of non-ported customer liquidations (where porting has not been successful, CCPs should have bilateral contact with each customer to update them as to the status of their portfolio, as to which positions have been liquidated.).

NOTE: In response to the first recommendation, the Default Risk Management Working Group (DRMWG)³ has created a global CCP directory, which contains contact information of decision-makers and risk management personnel. It was also agreed that each CCP will create a dedicated email address for CCP communications.

B. Default Management Committees:

CCPs' default management committees include seconded clearing member representatives who bring skills and expertise necessary to hedge risks associated with the defaulters' portfolio, structure the portfolio for auction, and liquidate the portfolio. Having active and experienced traders from clearing members participate in this process is an important element to its success. Nevertheless, given that clearing member firms 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 default management committees of multiple CCPs.

Recommendation(s):

- CCPs should harmonize certain aspects of their default management committees, for example the number of participants required for a given asset class (size of exposure a key indicator), tenure of participation, timing and frequency of rotation, and designation of seconded traders to ensure a fair distribution of responsibility across appropriate market participants.
- CCPs that clear the same or similar products and utilize traders in their default management processes should coordinate the periodicity, length and date of rotation of seconded traders in order to avoid requesting multiple traders from a single trading desk or clearing member firm.
- CCPs should maintain an up-to-date register of the individuals from each clearing member firm that they expect to be seconded to their default management committees, and these lists should be reconciled amongst CCPs. Clearing members should be obligated to update their representatives in the event that a representative leaves the clearing member firm or the relevant trading seat.
- In addition to administering and coordinating the participation of clearing member firms' trading staff, CCPs should actively consider the optimal composition of its Default Management Committees. Specific consideration should be given to rightsizing the participation according to the complexity and/or liquidity of products (e.g., more liquid products may require more participants).
- Consideration should also be given to including non-clearing member representatives in the Default Management Process, when:
 - The non-clearing member firm is active in the products include in the defaulting clearing member(s') portfolio(s); and

³ The DMRG is a voluntary group of eight CCP organizations, representing a total of 15 CCPs, whose goal is to improve the CCPs coordination around default management. Members include: CME Group, Eurex Clearing, ICE, DTCC, Minneapolis Grain Exchange Clearing House, the OCC, NASDAQ and the LME.

- The individual non-clearing member representative (and firm) agree to be subject to the same rules, restrictions and duties that govern the participation of individual direct clearing member representatives (and firms) that are seconded to the CCP to assist in the Default Management Process (including confidentiality agreements, the duty to act on behalf of the CCP, etc.).

Such inclusion should be considered as the non-clearing member firm may be able to contribute seasoned traders who bring to bear relevant market experience.

C. Fire Drills

A default of any large financial institution will have a profound impact on global financial markets and consequently on many CCPs, requiring a coordinated effort across CCPs in order to ensure stability. CCPs should consider coordinated testing for operational, legal, logistical and technological preparedness by organizing simultaneous/joint default management drill exercises (with regulators onsite observing the process). This would require clearing member firm traders to act and bid at multiple CCPs assuming a common scenario and using portfolios that includes complex / risky trades.

These joint drills will help CCPs, market participants and regulators uncover and resolve issues regarding multiple default management processes and procedures. Key areas requiring further attention and analysis include testing communications channels, testing risk management coordination, exploring coordination around customer porting, utilizing common trading resources, and also testing of clearing member preparedness (resource allocation and technological capacity) by requiring that they respond to multiple simultaneous default management inquiries from various CCPs.⁴

Recommendation(s):

- Joint fire drills should be formalized across CCPs where there is significant product overlap with agreement reached as to frequency of drills, scenarios and shocks tested in drills, and required participants
- Fire drills should be conducted regularly and should include multiple CCPs, clearing members and customers. Drills periodically should include simulations of the porting (and inability of porting) of non-defaulting customer portfolios, and include representative material customers in this aspect of the drills.

NOTE: The DRMWG decided that CCPs with similar product mix should endeavor to conduct simultaneous/ joint drills. That group is in the process of developing relevant details. This initiative requires significant cooperation and coordination amongst industry participants, including the CCPs, their clearing members, participants and regulators.

D. Auction Process

The timely and effective auction of a defaulting clearing members' portfolio could be the core element of a successful default management process. In many cases, this is the fundamental tool used to return a CCP to a matched book. To facilitate an auction's success, consistency and transparency into each CCP's auction plans and processes are required, including the sequence and timing of events, the information to be communicated and the methods of delivery.

⁴ Some non-derivative CCPs do not subscribe to a fixed strategy of joint default drills and CCP coordination.

Recommendation(s):

- CCPs should endeavor to harmonize their auction processes. While a single “one size fits all” approach may not be realistic, a general alignment of procedures and timelines is needed. A standardized approach would be particularly useful in a scenario where a significant clearing member has defaulted at more than one CCP. Further, the market as a whole will benefit from the ex-ante certainty about when different steps in the auction process will occur and when auction results will be made public.
- CCPs should develop Auction Playbooks for auction participants. Auction Playbooks should outline auction participation rules and procedures including participation terms (voluntary vs. mandatory), implications for failure to participate, the sequence of events, the information to be communicated and the methods of delivery (including the form and content of portfolio files), and the timing of the different steps in the process (including bid submission, determination of auction results, and publication of results to clearing member and customers of the defaulted clearing members).

NOTE: The DRMWG has ratified the *Uniform CCP Terminology for Default Management Auctions* document. The goal of the document is to improve consistency of terminology and conventions across CCPs, so that the market participants in CCP default management auctions find it easier to understand the rules and conventions of each auction in which they take part. While this is a welcome step forward, market participants would like to see this further developed into a playbook that harmonizes relevant aspects (e.g., file formats for uploading into risk systems) and provides greater clarity to market participants.

E. Customer Participation in Auctions

Clearing market infrastructure currently limits contractual relationships to a CCP and its direct clearing members and as a result, most CCP rulebooks look primarily to direct clearing members when considering default management. However, pursuant to existing rules, customers are able to participate indirectly in CCPs’ default management via their clearing relationship with their clearing brokers – who can bid for positions in auctions on behalf of their customers.

Customers of clearing members can also bring liquidity into default management processes, if they are permitted to bid in auctions

Recommendation(s):

- Non-clearing member firms should be considered for participation in the auction process, where appropriate. Expanding the ability to participate directly in default management auctions beyond the direct clearing member firms is essential to ensuring that more private sector capital can be committed to the process, which may yield more aggressive bids and better overall auction results. While direct 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).
- The necessary policies, procedures, rights, obligations, confidentiality protections, etc. for non-clearing member firms to participate directly in CCP default management auctions should be considered and stipulated.⁵

⁵ Some non-clearing member firms do not support the requirement that auction participation should be required to be supported by having financial contributions at risk. Correspondingly, some CCPs feel obligated to treat all market participants fairly and equally with respect to participation in an auction.

II. Porting

Market participants have unanimously highlighted significant concerns with the prospect of porting customers from a defaulted clearing member to a non-defaulted clearing member.⁶ At the same time, there is general agreement that 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. Legislative/regulatory action should to be undertaken to ensure successful porting.

Key issues that have been identified include:

- The non-defaulting clearing members are required to fulfill all KYC processes, which, in addition to being time consuming, are likely duplicative to what had been done at the defaulting clearing member. Standard KYC and AML protocols for onboarding a large number of customers during default may therefore be unrealistic given the timelines within which the porting is expected to take place.
- In certain jurisdictions such as the U.S., customer positions and related collateral do not always move together, resulting in a potentially under-margined portfolio being ported to the non-defaulting clearing members. This timing mismatch, while generally limited to a few days, could discourage a solvent clearing member from taking on a large customer portfolio due to resource implications particularly in times of market stress.
- In certain jurisdictions such as the U.S., 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.
- While many parties have suggested that 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, this option does not provide any guarantee that such customers will be ported due to either potential financial or operational resource capacity limits at their backup clearing member. The cost of multi-clearer relationships, together with the reduced clearing broker capacity in the market also restricts or even prevents smaller customers from having a back-up clearer.
- During periods of market stress, when CCP margin requirements increase, and when availability of bank capital may decline, portability will be more difficult as less capital is available to accept the cleared derivative portfolios from other clearing members. Without the ability to transfer client positions in an orderly manner, a CCP would be forced to liquidate the positions of clients' of a failed or distressed clearing member, creating a strain on the market, market losses for clients, and losses of clients' hedge positions, which would increase risk in the real economy.⁷

⁶ The DRMWG is drafting a document which would identify major regulatory, technological, judicial, and resource obstacles associated with customer porting and offer various tools and solutions which would make the porting process more effective and efficient. The issues identified by the DRMWG thus far have been included in these recommendations.

⁷ Many subcommittee members believe that temporary relief from capital requirements for the non-defaulting clearing member could help alleviate the risk of the trades and collateral moving at different times making portability more likely. Americans for Financial Reform and Better Markets however have fundamental concerns about the capital adequacy of market participants.

Recommendation(s):

- Develop mechanisms to enable the remaining clearing members to service the portfolios of non-defaulting customers on an interim basis post-clearing member default. Such mechanisms could include financial, legal and operational elements.
 - The non-defaulting clearing member should be able to “rely” upon the completed KYC conducted by the defaulting clearing member for customers that the non-defaulting clearing member has chosen and/or should benefit from certain indemnifications or regulators should allow for such reliance.
 - Further investigation into alternative ‘resource-lite’ clearing broker models and what barriers/limitations exist to introducing such models.
- Encourage the industry to continue to develop solutions to the operational burden of porting a non-clearing member portfolio and to establish a process for providing timely notification of porting to customers.
 - 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. Shared data resources, for example, could be helpful, particularly since CCPs often do not have customer information required for porting (such as the customer name or address).