

Governance of CCP Default Management Processes and the Role of Default Management Groups

Introduction and background

The Futures Industry Association (FIA) and the International Swaps and Derivatives Association (ISDA, together the Associations) welcome the extensive efforts by CPMI and IOSCO to encourage the industry to reach consensus on the governance of default management auctions and the role of default management groups (DMG), including *“how CCPs can reflect appropriately the views of clearing members..... during the default management process”*¹.

CCPs currently utilise DMGs when they require skills they do not have in-house. These are in most cases traders that can provide up-to-date market knowledge and advise the CCP on hedging and liquidation of the defaulter’s portfolio.

In CCPs, clearing members (CMs) underwrite most of the tail losses that exceed the defaulter’s resources. In order to ensure these tail losses are minimised, CMs would like to ensure CCPs are assisted in the best possible manner with market and trading know how to avoid further losses these CMs themselves underwrite.

Governance of a CCP’s default management process

PFMI Principle 2, Key Consideration 7 states that the CCP’s board *“should ensure that the FMI’s design, rules, overall strategy, and major decisions reflect appropriately the legitimate interests of its direct and indirect participants and other relevant stakeholders. Major decisions should be clearly disclosed to relevant stakeholders”*².

Therefore, ex-ante, the CCP’s risk committees, including representatives of clearing members and (in some cases) clients, should be closely involved in advising on the design of default management processes (DMP) including default management rules and procedures for conducting default management auctions.

In addition to ex-ante involvement in the design of the DMP, risk committees, along with traders and/or relevant SMEs who are involved in DMP fire-drills (or actual defaults), should ex-post have the opportunity to review the performance of DMPs following fire-drills to advise on improvements. The design and functioning of DMPs should evolve and incorporate the experience of CMs and clients.

¹ CPMI-IOSCO - Central Counterparty Default Management Auctions – Issues for Consideration - June 2020. Cover note.

² CPSS-IOSCO – Principles for financial market infrastructures – April 2012.

To ensure the design of the DMP benefits from all relevant expertise of the CCP's member base, the risk committee representatives should be permitted to share the DMP with traders and/or appropriate subject matter experts (SMEs) from within their respective firms.

Where a default management group (DMG) with CM representation exists, the DMG should also be invited to opine on the design and functioning of the DMP ex-ante to ensure it appropriately reflects the trading conventions of the market(s) it serves.

The Associations agree that it is the CCP and its board of directors who are ultimately responsible for establishing a clear, documented risk management framework that includes the decision-making process for managing defaults and emergencies. Thus, the DMG acts in an advisory capacity, and it is at the CCP's discretion to deviate from the DMG's advice.

Default Management Groups

CPMI and IOSCO encouraged the industry to reach consensus on how to address the *"Governance of a CCP's default management process, including how CCPs can reflect appropriately the views of clearing members, clients, and other stakeholders during the default management process. In particular, further consideration may be warranted on the role of default management groups, across all asset classes...."* In the cover note to the June 2020 paper on *'Central Counterparty Default Management Auctions – Issues for Consideration'*¹.

We recognise that CCP bears ultimate responsibility, and therefore must overall be in charge of the default management process. Also, CCPs require flexibility within their rules on how to manage defaults to achieve the best outcome. At the same time, CMs bear the ultimate risk and therefore believe that the CCP's flexibility should be complemented by CMs having representation via DMGs, especially in situations where CMs default fund contributions could be at risk.

CCPs should offer CMs participation in a DMG in all asset classes for the following reasons, subject to the exceptions outlined below:

- DMGs can assist the CCP in peacetime in refining the DMP via participation in fire-drills to ensure that the process is tested and rehearsed with CMs so all parties are familiar with it, including the format of the information that CMs will be provided with by the CCP. This will provide an additional route for the CCP to encourage feedback to the DMP. Participation of the DMG in design and testing of the DMP will also give comfort to CMs.
- DMGs can assist the CCP, and the overall outcome of the DMP, complementing the CCP by bringing specific additional risk, trading and market expertise that CCPs can utilise when dealing with default situations which will complement the CCP's own expertise. Particularly where the defaulter's portfolio is large, complex, or prevailing market conditions pose challenges including limited liquidity or directional positioning.
- CMs, as the providers of the majority of the mutualised default funds and who can be subject to additional losses via powers of assessment and recovery tools, should have a forum where their views can be considered during the default event when the CCP is taking decisions that can impact the default fund and further default waterfall liabilities CMs are contractually subject to.

DMGs are the only forum for CMs to have their views considered during the default management process and challenge CCP management if they believe that the interest of the providers of mutualised resources are not sufficiently being considered. To be clear, CMs are not requesting a formal governance role via the DMGs, it is fully acknowledged that it is the CCP who is ultimately responsible for decision making and has discretion whether to take the DMG advice.

Exceptions where DMGs are not required

As noted above, DMGs increase the involvement of CMs in the ex-ante design and testing of the DMP, as well as providing additional expertise to the CCP, and thus improve CMs familiarity with and confidence in the DMP. Ex-ante preparation is of utmost importance and could be improved by involvement of DMGs.

There may be situations where CCPs should proceed with their default management processes without a DMG for practical reasons, particularly where it can be reasonably foreseen that the default fund will not be impacted. It is recognised that this can be nuanced and therefore it is important that exceptions be fully discussed and agreed between the CCP and CMs ex-ante. The main exceptions are time, absence of complexity and small size of a defaulting portfolio relative to market liquidity:

- *Timing:* If there is a delay in assembling the DMG, and the market situation is such that a delay could be foreseen to increase the cost of close-out, the CCP could proceed without a DMG. The decision to proceed should be balanced against the benefits DMG advice could bring when assessing the market situation. It should be noted that in volatile markets closing a position quickly may not always be optimal, particularly where pricing has been disrupted.
- *Size and/or complexity:* If the defaulter's position can be quickly and easily closed out, and it can be reasonable foreseen by the CCP that losses will be within the defaulter's resources and will not impact the default fund³, the CCP should be free to act without convening the DMG.
- *Ex-ante decision:* The majority of CMs (weighted by size of the default fund contribution) could decide that for a particular CCP, or a clearing segment of this CCP, no DMG is required. This could help CMs to balance the importance of having DMGs in CCPs that clear large or complex portfolios with the resource requirement for staffing DMGs at CCPs. This ex-ante decision should be reviewed and renewed on a regular basis. The decision process should be formalized and transparent, explaining the reasons for the decision.
- *Agreement at time of default:* CCP and CMs represented on the DMG could decide that for a particular default situation at hand no DMG involvement is required. This could be for the reasons above, but also for other unforeseen circumstances. For instance, at time of default a CCP arranges a call with DMG members, explains the situation and the manner in which it proposes to close out the default so that a formal DMG presence is not required, thereby, among other things, avoiding compliance related matters related to DMG

³ Other than the defaulter's contribution to the default fund.

representatives receiving privileged information. CCPs and CMs need to agree ex-ante an efficient decision-making process and update their policies and relevant documentation accordingly.

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. Any decision to act quickly should be balanced against the benefits DMG advice could bring when assessing the market situation.

The rules of the CCP should clearly outline the obligations and responsibilities of the DMG members. CCPs may also require their (external) DMG members to maintain confidentiality by signing a document attesting to their obligations as a member of the DMG. Additionally, to avoid any conflict of interest, an agreed commitment should be established that a DMG participant's obligations at the time of an actual default are to the CCP and not to the DMG participant's clearing member.

Remote working arrangements

Remote working arrangements will make participation of CMs in the DMP significantly more efficient, for CMs and the CCP.

In the case of a default during remote working arrangements, the adherence to information security protocols and all relevant rules and regulation is paramount. This includes for instance rules relevant to clearing member staff working from home.

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 arrangements and possible business disruption scenarios that could impact the default management process should be considered in regular testing exercises. Remote working arrangements for fire-drills will also help make participation more efficient by reducing the time commitment for both CMs and clients and therefore help maximise participation in these regular events.

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. This drill exercises should also extend to the DMG.

Dependable DMGs`

If a CCP and its CMs agree on the requirement for a DMG, CMs stand ready for seconding their pre-agreed representatives in case of a default⁴.

Secondees nominated by CMs will also be available during fire-drills to

- Test the DMGs involvement in the DMP.
- Support the CCP with refining the DMP.
- Get comfort in the CCPs capabilities and procedures.

Use of CM representatives in default management groups

Another area that the June 2020 IOSCO paper asks the industry to address is the *“Use of traders in default management groups, including potential methods to reduce the burden on clearing members if there are multiple, simultaneous auctions.”*

Where traders and other SMEs from CMs are seconded to the CCP as part of the DMG to advise on hedging trades etc., CCPs should ensure that the burden of providing traders or other SMEs is shared equally and no firm faces capacity constraints from being required to send traders or other SMEs to multiple CCPs for default management, for instance by coordinating DMG rosters. If requested by CCPs and CMs, industry associations stand ready to support this task such as by hosting a central record of DMG representatives.

The SMEs on the DMG must have appropriate expertise for any specific tasks the DMG is expected to perform.

CCPs should also ensure that DMG participants are only exposed to the information they need to execute their duties to avoid DMG members receiving privileged information that could impact them or their work on returning to their own firm. The guiding principle should be that information is shared with the DMG on a ‘need to know’ basis.

The impact of secondments and the resource burden that it creates could be one aspect evaluated during a multi-CCP default management fire-drill.

⁴ There may be circumstances, such as absence through illness, where a seconded trader may not be able to participate.

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Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 990 member institutions from 78 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's website: www.isda.org. Follow us on Twitter, LinkedIn, Facebook and YouTube.

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- support open, transparent and competitive markets,
- protect and enhance the integrity of the financial system, and
- promote high standards of professional conduct.

As the leading global trade association for the futures, options and centrally cleared derivatives markets, FIA represents all sectors of the industry, including clearing firms, exchanges, clearing houses, trading firms and commodities specialists from more than 48 countries, as well as technology vendors, lawyers and other professionals serving the industry.