WFE Response to the CPMI-IOSCO's Discussion Paper on Central Counterparty Default Management Auctions

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We are grateful for the opportunity to respond to the CPMI-IOSCO's discussion paper on central counterparty default management auctions.

The World Federation of Exchanges (WFE) is the global trade association for regulated exchanges and clearing houses. We represent over 200 market-infrastructure offerings, spread across the Asia-Pacific region (~37%), EMEA (~43%) and the Americas (~21%). This includes over 50 distinct CCP clearing services, with everything from local entities in emerging markets to stand-alone CCPs based in major financial centres.

With extensive experience of developing and enforcing high standards of conduct, WFE members support an orderly, secure, fair and transparent environment for investors; for companies that raise capital; and for all who deal with financial risk. We seek outcomes that maximise financial stability, consumer confidence and economic growth. And we engage with policy makers and regulators in an open, collaborative way, reflecting the central, public role that exchanges and CCPs play in an internationally integrated financial system.

The WFE welcomes this discussion paper and the associated work of CPMI-IOSCO and jurisdictions' regulatory authorities to develop frameworks for the sound regulation of derivatives markets and the supporting market infrastructure. We are particularly pleased to support the approach that CPMI-IOSCO has taken in summarising the relevant considerations, rather than proposing prescriptive standards. In this sense, the discussion paper is a fitting complement to the CPMI-IOSCO *Principles for Financial Market Infrastructures.* The paper does a good job of promoting good practice on a consistent basis internationally, to the benefit of the financial system worldwide as well as in individual jurisdictions.

The paper is thorough and proportionate, setting a baseline while recognising the importance of giving CCPs the ability to appropriately adapt practices to address the specific circumstances of a particular default. It also rightly takes into account the product that is being cleared and the local (or, as relevant, cross-border) market. These considerations will feed through into important decisions, such as the constitution of a default management group. The Risk Committee of a CCP, which may comprise clearing members and/or clients, will have input into a CCP's default management policies. As clearing members and clients will be participants in the default management process, they do not manage the execution of a specific default management process, given the potential for conflicts. It is important that all CCPs, whatever their size, adhere to similar standards of resilience. This should include not only operational resilience but also robustness in managing the credit risk exposures created by their direct clearing members. The close collaboration between a CCP and its primary regulator should not be complicated by overly prescriptive default management process requirements at the international level.

We would also note that any guidance on default management auctions should not only be directed to CCPs, but also to the clearing members, and potentially clients, as their participation will effectively determine the success or failure of the auction. In this context, preserving the incentive structure outlined in the international guidance to promote CCP recovery over resolution is of the utmost importance, as the prospect of loss mutualisation beyond the funded CCP waterfall is one of the strongest incentives on clearing members to provide competitive bids and return the CCP to a matched book. Any weakening of the appropriate level of mutualisation of losses in recovery and resolution (e.g. proposals around compensation post-recovery/resolution, or further tranches and/or overly large CCP skin-in-game contributions) could reduce the likelihood of a successful auction outcome and therefore should be avoided.

A CCP's role in mitigating systemic risk should be reflected in the governance structure it chooses for auctions. CCPs, as market-risk-neutral counterparties charged with holding direct clearing members accountable to CCP membership criteria, must retain independence from these risk-taking members, especially where the clearing member population is concentrated. Given the potential severity of stress events a CCP might face where multiple clearing members default, the principle of independence is fundamental to a CCP being able to effectively manage such events and should not be impaired by the commercial interests of its clearing members. While the default management process, in particular, risk/liquidity assessments, may naturally entail close cooperation with market participants (especially in certain, e.g. OTC, markets), this should not result in handing over control of managing a market stress event to its market participants.

Addressing cross CCP shocks such as clearing member or participant defaults is complicated, not least because CCPs operate worldwide from different time zones and are subject to local regulatory and bankruptcy regimes. This makes deference to home regulatory considerations essential with respect to cross-border supervisory planning and cooperation. It also highlights the criticality of monitoring and, if possible, addressing concentration in the clearing member population.

Questions

Roles and responsibilities (Chapter 3)

1. What are the considerations for a CCP's board when determining whether and how to assign tasks related to the planning and conduct of default management auctions within the CCP's risk management framework? How does the CCP's board identify potential limits to the assigned responsibilities?

The CCP's board (or executive board in jurisdictions with two-tier board governance) has ultimate oversight of the institution's risk management practices. The management of default auctions (i.e. default management groups) will almost always involve the delegation of responsibilities from this accountable governance body to executives with relevant expertise. It should accordingly be a prerogative of the board to decide how this responsibility is delegated.

While the board is accountable for the oversight of risk management and the activities of executives (and thus should be kept appropriately informed of the events in an actual default), it would be inappropriate to unduly limit the board's scope for manoeuvre based on the prevailing circumstances. Regardless of the circumstances of the default and the size of the institution, the board must have the discretion to delegate responsibility to senior executives with the appropriate expertise to manage the default, who in turn may delegate specific authorities and competences to employees or teams. In doing so, the board may wish to consider delegating responsibilities that would be subject to exposure limits agreed by the board; this will allow the board to retain stricter oversight under more extreme conditions. The board should be informed of material developments related to default management auctions by the senior executives, including design elements and results of default management drills in order to assess effectiveness and to recommend process changes and/or enhancements where necessary.

The delegation of responsibilities should occur ex ante to allow for a default to be managed in the most effective and efficient manner practicable.

2. What different considerations may apply when a CCP's board establishes procedures for consulting external experts, such as independent consultants or clearing members, when designing or conducting a default management auction? How does a CCP's board address such concerns?

While the board remains accountable for risk management oversight, it is incumbent on executives wielding delegated responsibilities to discharge default management processes, including with respect to the nature of participation of external parties in liquidation or default management.

The board of the CCP cannot and should not abdicate accountability for the success or failure of default management even when outsourcing some aspects to external parties, including clearing members and their representatives (e.g. seconded traders). Not least for this reason, it would be inappropriate for external parties to have overriding decision-making powers concerning the conduct of default management processes. As the risk-neutral entity charged with holding its clearing members accountable to its clearing membership criteria, the CCP must retain independence from these members that are risk-takers. Market participants' individual commercial interests may conflict with the aim of preserving financial stability, while a CCP's governance structure prioritizes supporting the stability of the broader financial system, making CCPs the preferred and optimal decision-making authority in managing a default. Moreover, a CCP is better placed than any one market participant to form a view on the state of the market in the products that it clears.

The board, or management acting with delegated authority, may choose to involve external parties in certain aspects of the default management process. When external parties are consulted or involved in the execution of the default management procedures, appropriate safeguards, including but not limited to non-disclosure agreements, should be put in place to forestall information leakage and concomitant suboptimal auction outcomes. As above, the board retains ultimate accountability for the default management and risk operations of the CCP, so the delegation of responsibilities or engagement of external parties should not negatively impact the board's considerations.

Given the potential severity of stress events that a CCP might face where multiple clearing members default, the principle of independence is fundamental to a CCP being able to effectively manage such events and should not be impaired by the commercial interests of its clearing members. While the default management process, in particular, risk/liquidity assessments, may naturally entail close liaison with market participants (especially in certain, e.g. OTC, markets), this should not result in handing over control of managing a market stress event to its market participants.

Client participation (Chapter 6)

21. For which markets, asset or product classes and client types would client participation be most feasible and/or desirable? What would be the incentives for clients to participate in auctions? Does this differ for direct vs indirect client participation? Please elaborate in your response.

Assessment of cleared-product liquidity is fundamental to a CCP's day-to-day risk management, though it takes on even greater importance during a stress event. The default management auction design should account for the liquidity of the product(s) in question. Product liquidity impacts not only possibilities for hedging the defaulted portfolio but also the optimal selection of auction participants. Additionally, CCP auction participation criteria should consider the type of underlying, the difference in risk factors, and reflect the nature of client activity in the relevant markets.

Where client participation is feasible, it may improve the likelihood of a successful auction outcome—this is particularly the case for exchange-traded derivatives markets. Requesting two-way prices from auction participants is likely to benefit the integrity of the auction process. Client participation in default management auctions should be determined at the discretion of the CCP, following discussions regarding the appropriateness of such participation with the clients' clearing members as well as demonstration of the ability to participate in terms of risk management and operational requirements (i.e., those that are inherent in clearing member requirements). It may be necessary for clients interested in participating in auctions to post additional margin via their clearing members as well as default fund contributions, as referred to below.

22. The discussion paper describes some ways to address the risks borne by a clearing member arising from its clients bidding in an auction. Are there additional ways to address the risks? Are there incentives that a CCP could employ to encourage client participation in an auction (eg ways to encourage clearing members to facilitate their clients' participation)?

a. One option for addressing a disparity in incentives between clearing members and clients is to require clients to contribute an established amount to the default fund prior to participating in an auction. What are the implications of this requirement (such as regulatory, economic or contractual implications) and how can a CCP address these implications?

As a general matter, additional incentives for client participation should not be required, in theory, since default management procedures are designed such that clearing members as well as clients have an interest in the successful management of a default - e.g., if the default management process fails to re-establish a matched book, CCPs would be forced to employ additional tools such as tear-ups that would impact the positions not only of clearing members, but also of clients. Nonetheless, CCPs should retain the flexibility to employ necessary incentives to clearing member and, as applicable, client participation.

25. Are there efficiencies or benefits to be gained from CCPs coordinating their respective default management auctions or hedging arrangements? If so, how?

a. Are there any arrangements that could be coordinated ex ante (eg cross CCP netting arrangements)? How could these arrangements be established? What would be the challenges with these arrangements? How could these challenges be mitigated?

There are clear potential benefits to coordinating default management activities across CCPs where feasible and efficient to do so. As such we believe that CCPs and market participants would benefit from authorities addressing related challenges, including the extent to which clearing member concentration exacerbates such challenges (including for example in their consideration of the bank capital regime). Because CCPs may operate in different time zones and are subject to different regulatory structures, there is a case for regulatory cooperation and information sharing to the extent possible when managing an actual default. However, due to the complex holding and entity membership structures of global market participants who are active members of multiple CCPs, such collaboration may prove to be extremely challenging in practice.

However, from an operational perspective, it may be appropriate for CCPs to coordinate and share information amongst themselves regarding the default of a common clearing member to the extent feasible. This may include coordination concerning auction file formats, joint hedging and procedures for porting of client positions. Unnecessary obstacles to such coordination ought to be addressed by CCPs and their regulatory authorities ex ante, where practicable.