M E M O R A N D U M

Date 2019-01-09 FI Ref. 18-24345

Finansinspektionen
Box 7821
SE-103 97 Stockholm
[Brunnsgatan 3]
Tel +46 8 408 980 00
Fax +46 8 24 13 35
finansinspektionen@fi.se
www.fi.se

Discussion paper on CCP default management auctions

Summary

The intention with this short discussion paper is not to provide specific "lessons learned" or general recommendations on CCP default management auctions, but rather to share some general reflections on this topic in order to support a discussion on potential areas for development in this field. It should not in any way be regarded as an evaluation of a specific event or legal entity. Also, the information contained herein does not entail any obligation on the part of Finansinspektionen.

As part of its default management procedures, a clearinghouse may use an auction to manage the risk associated with the default. The determination of what constitutes a successful auction is not an easy question to answer since the success depends on the individual circumstances surrounding the event. However, some of FI's key reflections in this paper include:

- The size and risk profile of the defaulting member's portfolio vs. underlying market liquidity have a very substantial impact on the auction and its outcome.
- The liquidity in the market, the risk appetite and the number of active market participants could substantially be impacted by the default. This in turn can, among other things, affect the auction participants' risk appetite and ability to accurately price the portfolio.
- Operational challenges need to be thoroughly understood in advance of an auction and responses rehearsed by all parties involved.
- Potential risk premiums required by auction participants are closely linked to the comparative size and risk profile of the defaulting portfolio (as well as the auction participants' current portfolios and risk appetite).
- The incentives for taking part in an auction are key to its success, and the incentives can (and perhaps should) vary for each participant.
- The selection of auction participants includes a trade-off between potentially maximizing economic output and minimising potential information leakage.
- Participating in a default management auction may lead to operational constraints for the participant. Having detailed information about the

default situation may negatively affect the day-to-day trading and risk mitigation operations conducted by the auction participant due to the signing of a non-disclosure agreement with the CCP.
- In a default situation, the CCP wants to mitigate the risk related to the portfolio as quickly as possible. At the same time, the auction participants need time to evaluate the default event and the affected portfolio.
- To allow participants to bid on part of the portfolio as well as the whole portfolio is one way for the CCP to handle a large portfolio. However, selling parts of the portfolio to different participants might create a situation where the participants race to the market after the auction is complete. The participant that comes last to the market may not have the same possibilities for offloading its part of the portfolio. This in turn could create market instability and price volatility.

Based on the reflections made in this paper, one potential description of a successful auction could be:

> *A process in which multiple potential buyers with strong incentives to participate in the auction in a timely and efficient manner can and will offer fair prices (with reasonable risk premiums) for the defaulting member's portfolio based on well-informed decisions and within their defined risk mandates.*

Size matters – and its impact is most likely not linear

The size and risk profile of the defaulting member's portfolio have a very substantial impact on the auction and its outcome. A portfolio that is large in relation to the underlying market liquidity and/or the auction participants' own portfolios and risk appetite might significantly affect the participants' ability and willingness to bid on the portfolio. This in turn may affect the risk premiums required to make an offer on the portfolio in addition to delaying the auction process.

The bigger the portfolio, the more complicated it will be for the CCP to manage the risk. If an auction results in losses that need to be shared among clearing members, it is likely that a large part of those losses will be derived from the complications relating to the size of the portfolio.

Expect price volatility and liquidity squeezes

Regardless of the status of the market prior to the default, it is likely that the conditions will change during the default management auction. The liquidity in the market, the risk appetite and the number of active participants could be substantially impaired, and prices might not be at the same level as they were the day before. However, if a member defaults for reasons unrelated to market

events, and the defaulting member's portfolio is relatively small, normal market conditions might still apply.

These conditions affect the auction participants' risk appetite and ability to accurately price the portfolio as well as the CCP's ability to hedge market risk at prices that prior to the default were considered reliable. This is also true when the defaulting party is not one of the top three largest members and the default occurs in relatively benign market conditions.

Experience and practice helps – prepare in peacetime to minimise uncertainty in wartime

An auction process involves several time-critical and complex elements, and it requires participants to have the capability and operational readiness to quickly determine what they believe to be the fair value of the portfolio (such capabilities and operational readiness is however not sufficient to ensure that they have incentives to bid fairly). Operational challenges need to be thoroughly understood in advance and responses rehearsed by all parties involved. One way to increase the likelihood that an auction will be successful is to make sure, for example through comprehensive and regular "fire drills", that all potential auction participants and the CCP know what to expect during the auction process.

Expect to pay a risk premium – and possibly a very large one

The auction participants may require significant risk premiums to bid on the portfolio, and these premiums might consume substantial financial resources for the CCP. The required risk premium is closely linked to the comparative size and risk profile of the defaulting portfolio (as well as the auction participants' current portfolios and risk appetite). A major objective of the auction design should be to minimize this premium.

Inviting participants with different incentives, taking potential risk premiums into account in risk models, and allowing enough time for auction participants to correctly evaluate the situation/portfolio are examples of aspects that should potentially be considered to reduce risk premiums.

Incentives are key – and they might differ between participants

The incentives for taking part in an auction are key to its success, and the incentives can (and perhaps should) vary for each participant. In addition, it should also be considered that incentives potentially could vary also within the organisation of a specific participant.

One of the main incentives for bidders in an auction is likely to protect their own assets in the default fund waterfall. In general, the waterfall is designed in such a way that it aims to create incentives for the participating members (as well as the CCP) to avoid loss mutualisation through the default fund.

Another, likely major, incentive for taking part in an auction is an interest in supporting the survival of the CCP. This support is not merely related to the

CCP’s financial situation; the outcome of an auction could affect confidence in not only the CCP but also the underlying market that the CCP serves. In a market with many fundamental players, confidence in the CCP and the market it serves is important for the core business of the market participants (for example, the ability to hedge prices on future production). Another incentive for taking part in an auction could be the possibility of making a profit on the defaulting portfolio itself, potentially by requiring a substantial risk premium.

Selecting auction participants – maximising economic output while also minimising information leakage

When it comes to CCP default management auctions, one of the key issues is to ensure that the number of participants is sufficient for increasing the potential demand for a specific portfolio. However, the number of participants needs to be balanced against the need to protect sensitive market information (for example the default and related positions). If information about the default is spread too widely among market participants, the CCP may hinder the effectiveness of its risk reduction measures. At the same time, though, the CCP might need to also consider other aspects such as market transparency and equal treatment of members.

In a market where the appropriate participants with the right capabilities consist of a relatively homogenous group, for example with regard to risk mandates and business models, it might be difficult for the CCP to auction the defaulted positions, especially in a stressed or illiquid market. When contemplating auction design in a default situation, a CCP could benefit from considering an appropriate spectrum of participants and aim to include different types of participants with diverse business models, risk appetites and risk mandates. This might also facilitate an actual *auction,* where parties bid against each other, which in turn could lead to a reduction in the liquidation costs for the CCP and its members.

Participation comes with constraints – day-to-day business activities might be impacted

Participating in a default management auction may lead to operational constraints for the participant. First of all, prior to receiving any information about the default event and the affected portfolio, auction participants might be required by the CCP to sign non-disclosure agreements (NDAs). The signing of an NDA enables participants to receive detailed information about the default but also limits their possibility of acting freely in the market since it effectively puts them in an insider position. The incorrect handling of the received information could have potential market abuse/insider trading implications (the same is true, of course, for the CCP and its staff).

Having detailed information about the default situation may thus negatively affect the day-to-day trading and risk mitigation operations conducted by the auction participant. For example, the participant might be required to erect Chinese walls between staff members with insider information about the

portfolio and the default event and staff members without. The effect could be that certain staff members (for example, senior traders, risk management experts, senior management, etc.) may not be able to take part in the normal operations of the company. There is also a complicating factor in that the scope and timeline of the insider position is unclear at the point in time when the NDA is signed.

Time is of the essence – and it is a balancing act

A default management auction is time-sensitive. The CCP would like to act as quickly as possible and hedge/close out the portfolio in order to reduce its exposure to the risks associated with the defaulted portfolio (for example, market or liquidity risk). The gains/losses in the portfolio will vary as market prices fluctuate during the auction process. On the other hand, the auction participants, which before signing the NDA most likely had no information at all about the situation, need time to properly evaluate the default event in general and the portfolio in particular in order to post bids. Depending on the size of the portfolio, the participants may lack a suitable risk appetite and/or risk mandate to post bids. Even if they theoretically could obtain a sufficiently large risk mandate to handle the portfolio (for example through board/CEO approval), this process may be time-consuming or lead to a large risk premium.

The risk of being the rotten egg

Allowing participants to bid on parts of the portfolio as well as the whole portfolio is one way to digest a large portfolio where only a few (if any) participants are likely to be able to buy the whole portfolio. This may also facilitate the determination of the fair value for the portfolio as it makes it possible to have broader participation in the auction.

One aspect to consider with this approach is whether it might create a situation where the participants race to the market after the auction is complete. Although the winning participants will have obtained the positions and associated risks at prices they consider to be acceptable, they may want to sell off their acquisitions in the market as soon as possible. The participant that comes last to the market – and thus is the "rotten egg" – may not have the same possibilities for offloading its part of the portfolio. This could create market instability with significant price volatility. This issue may not be as problematic if there is only one winner, particularly if this winner has the capacity and willingness to keep the portfolio for some time, offloading the positions in such a way as to not affect the market negatively.