



BANK OF ENGLAND

Speech

Default management by central counterparties: the importance of preparation – introductory remarks to the CFTC’s Market Risk Advisory Committee

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Good afternoon.

I would like to thank Committee Chair Bowen for inviting me to speak to the Committee today on the important topic of CCP Resilience. As supervisors of some of the biggest and most systemically important CCPs that serve global markets, the Bank of England and CFTC have a strong history of collaboration on market infrastructure and clearing related issues, on which today's discussion can build.

The next evolution of CCP fire drills

I have listened with great interest to the previous panel discuss recommendations regarding CCP Default Management. Today I would like follow on from that discussion by focusing on one important element of CCPs' resilience – the way in which CCPs test their default management preparations and procedures via default management 'fire drills'.

We know from past experience that the default of a material clearing member is likely to be a stressful event for a CCP. Realistic fire drills therefore help maintain CCP and clearing member preparedness, and test the robustness of default management arrangements. Fire drills are exemplars of the importance of proper preparation in ensuring readiness for unlikely and potentially challenging events. Given that the default of a material clearing member is likely to be accompanied by a period of market stress, there is no scope for poor performance by CCPs in managing the default.

This is recognised in standards and regulations. For example, the Principles for Financial Market Infrastructures state that '*An FMI...should involve its participants and other stakeholders in the testing and review of the FMI's default procedures...at least annually....*'.¹ Note that preparedness extends beyond the FMI to its participants and other stakeholders. This is mirrored in European regulation which requires CCPs to '*...test and review their default procedures to ensure they are both practical and effective.*'² I understand that similar requirements exist in the Code of Federal Regulations as well.³

Furthermore it is clear that, as a result of regulatory initiatives such as mandatory clearing obligations, CCPs are becoming increasingly important to global financial markets, and are increasingly interconnected with many key market participants. It is therefore more likely than not that a material clearing member default will impact multiple CCPs at the same time.

Given this, at the Bank of England, we asked ourselves the question: to what extent does an idiosyncratic fire drill scenario, on its own, still constitute the scale of 'proper preparation' that we would expect to see? The answer we came to, is that regulators and CCPs must evolve some fire drills towards multiple CCP

¹ Principle 13: Participant-default rules and procedures.

² EU153/2013 Article 58.

³ CFR Title 17 § 39.16 (b)

scenarios in order to provide a realistic – and proper – simulation of a material clearing member default. The consequences of such a default would be visited upon a number of CCPs simultaneously, so it makes sense to test the response of multiple CCPs simultaneously. This is especially the case since CCPs rely on their members to provide bids and personnel in default management, and thus there is a risk that the demands of multiple CCPs could overwhelm available capacity at clearing members.

LCH.Ltd / Eurex Clearing fire drill

The Bank of England took a first step in this direction with the conclusion, earlier this year, of a fire drill exercise involving LCH Limited, which we supervise, and Eurex Clearing AG, which is supervised by our colleagues at the BaFin and Bundesbank. The scenario involved the default of a common hypothetical clearing member clearing interest rate swaps and futures and was integrated in the two CCPs' annual fire drills, which were held in parallel.

Along with colleagues from BaFin and Bundesbank, we observed the fire drills; carried out post-drill bilateral meetings with the two CCPs and seven of the largest clearing members participating in the drill; and also reviewed relevant procedural documentation. The exercise yielded some valuable findings, which I will move on to outline.

Aims and conclusions of the 2016 fire drill

Our overall objective was to identify, assess, and ultimately address weaknesses in default management arrangements, which may not be apparent when tested in a 'single CCP' default scenario. In particular:

- One area of focus was the extent to which clearing members' internal procedures support their ability to second traders to multiple CCPs, in parallel, in order to participate in default management groups. This matters because seconded traders bring valuable up-to-date market and trading experience to CCP default management groups, helping CCPs to return to a matched book as effectively as possible. Our findings on this point were broadly positive – our review of a range of CCP members' procedural documentation found generally sound arrangements in place, when considering their commitments across the two CCPs. There were a small number of notable exceptions, which we will follow up in due course to help ensure that best practices are broadly adopted.

We recognise that there are other factors potentially affecting seconded trader availability, and our findings are by no means the 'last word'. For example, demand for trading resource is likely to increase as more CCPs compete and clear similar products. This remains, therefore, an area we will need to keep under review.

- A second area we assessed was the operational capacity of clearing members to process auction files from two CCPs. This matters because auctions are a central part of the default management process – a successful auction with effective member participation helps return the CCP to a matched book. This requires members to price and assess the risk in the CCP’s data file, which can be thought of as its auction catalogue. This often contains tens of thousands of records describing the contract specifications for each cleared trade. We found considerable variation in clearing members’ ability to process these files in a timely manner. In a multiple CCP scenario this might throw in to question some clearing members’ capability to consistently submit competitive and timely auction bids, to participate effectively in the CCP’s auction – and therefore default management – process.

Our analysis attributes this variation to a combination of: insufficiently frequent testing of the process by some clearing members; under-developed operational systems; and the multiple auction file formats used by the CCPs. As a first step to dealing with this, I am pleased to say that LCH and Eurex have agreed to explore opportunities to more closely align auction file format and content, and report back to us. The outcome we are seeking to achieve here is to find a simple way of lifting some of the operational burden from clearing members of processing files in different formats and increase the likelihood of effective auction participation by members.

- As a third area of investigation, we also identified a number of prerequisites for running more effective fire drills across multiple CCPs. Among these are:
 - more tightly defining the timing of the CCPs’ hedging activity and auctions, to ensure that the exercise robustly tests clearing members’ capacity to participate;
 - ensuring defaulted portfolios are material in size with correlated risks above clearing members’ business as usual risk model assumptions, so that the exercise identifies and really tests the clearing member’s risk management capacity; and
 - enabling regulators to complete an *ex-post* review of clearing member auction bids, particularly to assess the impact of capital or liquidity costs on bids.

The Bank of England, BaFin and Bundesbank have communicated with the participating CCPs and clearing members, outlining our observations. We will be following up as necessary over the coming period.

Planning a 2017 multiple-CCP fire drill

We are building on the 2016 fire drill exercise, aiming for the next multiple CCP fire drill to take place in 2017. I am pleased to announce that, building on our close collaboration with the German authorities and CFTC, we have agreed to extend the 2017 exercise further to run across three CCPs – CME Inc has agreed to join LCH Limited and Eurex Clearing in a coordinated fire drill. We are looking forward to working with these

three CCPs, as well as our German and US regulatory colleagues, in continuing to build and evolve our approach.

We are in the process of defining the scenario and objectives of the 2017 drill. This will include testing hedging and auctioning procedures at CCPs and at members in stressed market conditions. We are also considering testing the capacity of client porting arrangements, which we recognise is a key area of focus on both sides of the Atlantic. I would be happy to discuss the outcomes of next year's test with the Committee at an appropriate point.

So to conclude, fire drills – both idiosyncratic and multiple-CCP – are part of the vital work that CCPs, clearing members and regulators should take forward collaboratively, in order to promote safety, soundness and financial stability. We will continue to refine and adapt the way in which they are run to ensure that they recognise the increasingly complex interconnections within global markets and systemic importance of the CCPs that serve them.

Thank you for your attention.