



## CFTC MARKET RISK ADVISORY COMMITTEE MEETING

### OVERVIEW

For questions on the note below, please contact [Kwon Park](#) at (202) 547-3035.

Today, the CFTC held a [meeting](#) of the Market Risk Advisory Committee (MRAC). At the meeting, the CCP Risk Management Subcommittee (CRM) presented its [final recommendations](#) on how central counterparties (CCPs) can further enhance their efforts in preparing for the default of a significant clearing member (CM), and discussed the Bank of England's (BoE) coordinated CCP default fire drill.

### Key Takeaways

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- The CRM Subcommittee's final recommendation on CCP default management and porting was approved by the full MRAC Committee by a vote of 19 – 0, with one abstention.
- Kim Taylor, CME, agreed with the recommendation to standardize the terms used during the auction process, but warned that ex ante commitments as to the exact process is unwarranted as circumstances vary. She urged that guidelines were better than ex ante commitments.
- Some members called for relaxed anti-money laundering (AML) and know-your-customer (KYC) protocols for non-defaulting CMs during times of stress, so that they can better port customer positions and collateral from a defaulting CM. They also asked for leniency to capital requirements.

### SUMMARY

#### Opening Statements

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##### [Chairman Timothy Massad](#)

- The supervisory stress test results showed that clearinghouses had ample resources to withstand extremely stressful market scenarios on the test date, and further showed that risk was diversified across CMs – a loss at one clearinghouse did not mean losses at all.
- The report is an important first step, and there are many types of enhancements that can be incorporated into the program in the future. International cooperation will be key moving forward.

##### Commissioner Christopher Giancarlo

- It is important for clearing and non-clearing members to understand their role in a default situation and to address any obstacles during the process.
- Look forward to hearing about the Subcommittee's recommendation and the actions taken by BoE on fire drills.

### **Commissioner Sharon Bowen**

- The result of the Presidential election makes MRAC's focus on market risk even more important. Today's MRAC meeting is the 6<sup>th</sup> meeting in the past two years – we have made great progress.
- Look forward to the vote on the Subcommittee's recommendation and hearing about the BoE's coordinated CCP default procedures.

### **CCP Risk Management Subcommittee's Final Recommendation on CCPs**

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#### **Moderator: Susan O'Flynn, Managing Director, Morgan Stanley**

#### Default management committees (DMCs):

- CCPs should harmonize certain aspects of their DMCs, i.e. the number of participants required for a given asset class, 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.
- CCPs should maintain an up-to-date register of the individuals from each CM firm that they expect to be seconded to their DMCs, and these lists should be reconciled amongst CCPs.
- CCPs should actively consider the optimal composition of its DMCs.
- CCPs should expand the existing pool of representatives sitting on DMCs, including non-clearing member firms.

#### Auction process:

- CCPs should harmonize auction processes where feasible. A market 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 (APs) for participants. APs should outline rules and procedures including participation terms, implications for failure to participate, sequence of events, information to be communicated, methods of delivery, and timing of different steps in the process.

#### **Gerald Beeson, COO and CFO, Citadel**

#### Auctions:

- CCPs should encourage means for non-clearing members to participate in auctions, and set the terms and procedures up front. Customers are an integral part of the system and have vested interests to ensure the auction process is successful.

#### Porting:

- Further measures should be taken to ensure the most viable and efficient porting process.
- Customer onboarding requirements at the CM, timing mismatches of customer positions and collateral, bankruptcy laws, and industry-wide capacity constraints are challenges to an efficient porting process.
- The development of automated, on-demand, straight-through processing programs should be encouraged.

#### **Dennis McLaughlin, Group Chief Risk Officer, LCH Clearnet**

#### Communication:

- Industry should create and maintain a global directory of key individuals at CMs and non-clearing member firms 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, commencements and completion of customer porting, and start and completion of non-ported customer liquidations.

#### Fire drills:

- 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, and required participants.
- Fire drills should be conducted regularly and include multiple CCPs, CMs, and customers.

#### **Richard Miller, Consultant, American Council of Life Insurers**

#### Availability of FCMs:

- We should think about break the glass solutions for FCMs to emerge in a crisis to provide a safety net for customers who do not have preexisting relationships with multiple FCMs - to bring confidence into the markets and to reduce uncertainties.

#### Areas of disagreement:

- Whether capital relief should be provided to CMs on a temporary basis, at least temporarily, to enable them to take on more customer positions.

- Regulators and legislators should attempt to fix bankruptcy issues, as there is a disconnect in the timing of porting customer collateral and margin.

## **Discussion**

*Kim Taylor, CME Group:*

- CCPs have a strong history of good communication during times of stress, and conceptually support standardization of terms (i.e. auction types, inputs and outputs) and the idea of transparency to bring additional certainty to the market. However, ex ante commitments to define the exact process is unwarranted, as the best process to utilize depends on specific circumstances. Guidelines are better than ex ante commitments.
- CME supports the need to sensibly manage the impact of stress across CCPs, to broaden participation in DMCs and auctions, and to carry out joint fire drills.
- With porting, CME supports a safe harbor from KYC and AML rules, as well as to providing CMEs with reasonable capital relief during times of stress.

*Kevin McClear, ICE:* ICE has conducted joint fire drills with CME, and tested newly developed automated default management systems with standard default terms and a common auction playbook. Practice (i.e. auctions and porting) is important.

*Jerry Jeske, Commodity Markets Council:* AML and KYC rules should be relaxed during stressful times, as innocent customers have already passed these requirements. Capital leniency should also be considered.

## **Bank Of England's Default Fire Drill**

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**Moderator: Robert Steigerwald, Senior Policy Advisor, Federal Reserve Bank of Chicago**

**David Bailey, Director of Financial Market Infrastructure, Bank of England**

- Fire drills are important. In the U.K., CPMI-IOSCO default procedures are reviewed at least annually, and apply to participants and stakeholders alike. The E.U. requires CCPs to regularly test default procedures as similarly required in the U.S. Regulators should conduct testing across CCPs as clearinghouses are becoming increasingly important and interconnected.
- BaFIN and Bundesbank conducted coordinated fire drills with BoE last year. The procedures and documentations were sound, but there were deficiencies – more work needs to be done.
- This year, LCH and Eurex have worked together to align fire drill processes and to increase consistency. CME will join these efforts in 2017. It is vital to conduct idiosyncratic fire drills across CCPs and for regulators to collaborate.
- The timing and terms need to be further defined, and regulators should perform ex post reviews of auction bids to assess impacts on capital and liquidity.

## **Discussion**

*Steigerwald:*

Q) Are regulators assessing the overall benefits related to testing in relation to associated costs? *Bailey:* It is important to actively test the resiliency and preparedness of CCPs and CMs in default management situations. Where possible, we try to build and leverage existing industry practices. Rather than building new requirements, regulators are seeking coordination to run fire drills simultaneously and in parallel to testing already being conducted by CCPs.

Q) Are liquidity issues incorporated into fire drills? Any plans to incorporate realistic simulations of actual liquidity constraints in future fire drills? *Bailey:* Liquidity management is equally as important as credit and operational risks. Past fire drills have not tested liquidity, but it is something we intend to do. As to intraday variation margin (VM) payments, they may pose challenges from CCP to CCP, but the concept of calling VM to cover big market movements are inherent in CCP procedures and CMs and clients expect these margin calls.

*Miller:*

Q) How are fire drills conducted and programs arranged? *Bailey:* Individual CCPs organize fire drills. Multiple CCPs conduct fire drills by coordinating the timing and by ensuring parallel testing to test the capacity of CMs and CCPs

Q) Are regulators thinking about including end-users in fire drills? *Bailey:* With regard to porting, regulators are still defining the scope and scale of the testing for next year. Unclear whether to include clients in fire drills yet.

*Dr. Andrew Lo, MIT:*

Q) Are virtual fire drills feasible? *Bailey:* Virtual fire drills assess financial impacts, but do not account for important operational aspects that fire drills actually test.

Q) Is it possible to make data collected from fire drills available to academics? *Bailey:* Data is market sensitive and reveals CMs actual positions that are proprietary in nature. While I see the value in providing data to academics (for research purposes), legal barriers may prevent public dissemination.

*Dennis McLaughlin, LCH.Clearnet:*

Q) Any plans to test non-default losses? *Bailey:* We are considering it for future tests.

Q) Any structural reasons why a fire drill might fail? *Bailey:* CPMI-IOSCO is studying recovery assessments.

*O'Flynn:*

Q) We welcome the idea to test non-default losses and multiple products as they become subject to clearing mandates. *Bailey:* Regulators are cognizant of the complications associated with testing, and will continue to evolve testing methods moving forward.

*Taylor:*

Q) The assumption that auctions should be run simultaneously may not produce market stability with maximum outcomes – sequential auctions may be appropriate in certain circumstances. Any thoughts on sequential versus simultaneous auctions? *Bailey:* We are aware of this issue and analyzing it.