ISDA® Safe, Efficient Markets

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BY E-MAIL

Dear Sirs,

Consultation Paper: Default Handling: Auction of Trades & Positions etc.

1. **Introduction:**
The International Swaps and Derivatives Association, Inc. ("**ISDA**")[1] welcomes the opportunity to respond to the Consultation Paper on *Default Handling: Auction of Trades & Positions of Defaulter etc.* ("**Consultation Paper**")[2] issued by The Clearing Corporation of India Limited ("**CCIL**") on December 5, 2014.

2. **Scope of the Consultation Paper:**
We commend CCIL for taking steps to introduce an auction process for the positions of a defaulting Clearing Participant. We support the introduction of an auction process to handle the portfolio of a defaulted Clearing Participant and we have provided our comments to the Consultation Paper. We would encourage CCIL to provide Clearing Participants with an opportunity to review and comment on any technical changes to its rules and procedures before such changes are implemented.

   It is our view that a default management process ("**DMP**") should be introduced for all segments of CCIL. We seek clarification that the proposals in the Consultation Paper will apply to all segments or if these proposals will only apply to the Rupee Derivatives and Forex Settlement segments. Further we strongly encourage CCIL to institute a formal DMP covering all segments of CCIL and to publish a consolidated default management handbook setting out comprehensive details for how a default will be dealt with. This should cover (i) the committee of Clearing Participants for default handling (or more commonly known as the Default Management Committee "**DMC**"); (ii) tranching methodology and hedging requirements for the defaulted portfolio; (iii) the auction process and mechanism; (iv) juniorization (i.e. the extent to

[1] Since 1985, ISDA has worked to make the global over-the-counter (OTC) derivatives markets safer and more efficient. Today, ISDA has over 800 member institutions from 66 countries. These members include a broad range of OTC 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 including exchanges, clearinghouses 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 web site: www.isda.org.

[2] https://www.ccilindia.com/Lists/LstDiscussionForum/Attachments/12/Consultation_Paper_Default_Handling_Auction_of_Trades_And_Positions_of_Defaulters.pdf, The Clearing Corporation of India Limited, Consultation Paper – Default Handling: Auction of Trades & Positions of Defaulter etc., 5 Dec 2014.

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which less competitive bidders within the auction process are subject to higher loss attribution); (v) the recovery procedures if the matched book is not re-established; (vi) fire drills; and (vii) portability and segregation of accounts (where client clearing is introduced). This will promote alignment with section 3.23.2 of the Committee on Payment and Settlement Systems (**CPSS**) and the International Organization of Securities Commissions (**IOSCO**) (collectively known as **CPSS-ISOCO**) *Principles for Financial Market Infrastructures*[3] (**PFMI**s), which states that "an FMI should adopt clear and comprehensive rules and procedures that are fully disclosed to participants"[4].

The headings used below correspond to the headings used in the Consultation Paper. Individual members will have their own views on the Consultation Paper and may provide their comments to CCIL independently.

3. **Paragraph 2.1: Auction for Closing-out Defaulter's Position:**
We support and encourage the establishment of an auction process, DMP and DMC for all segments of the central counterparty ("**CCP**").

Following a default and prior to any auction, CCIL's DMP should allow for hedges to be immediately put in place to stem the losses that may arise from the defaulted portfolio from the point of default to the completion of the auction process. While this may not be necessary for all defaults, depending on the size and segment involved, we are of the view that the requirement to hedge should still form part of the DMP procedure for all segments. The aim of hedging the defaulted portfolio is to eliminate as much market risk as possible that the defaulted portfolio may be exposed to.

We also wish to highlight that any move to an auction DMP, will likely require an increase to Clearing Participants' margin at risk requirements to account for the possibility of a longer closing out period. We would suggest CCIL considers increasing the margin at risk requirements to 5 days at a 99.5% minimum confidence level, which is in line with the requirements in Europe.

4. **Paragraph 2.2: Default Classification:**
In paragraph 2.2.1 of the Consultation Paper, it states that "for efficient handling of a default, it may be necessary to categorise the event of default into large and small default, depending on the likely impact on other members (clearing participants) and the market"[5]. We believe the DMC should be consulted for any default, regardless of size. It is unclear from the Consultation Paper what would constitute a "large" default and what would constitute a "small" default or even possibly a "medium" default. We do not believe there is a need to delineate between a "small", "large" and even possibly a "medium" default size. Further we strongly believe that the DMC should be involved in all defaults, regardless of the size of the defaults. In the event of any

[3] http://www.bis.org/cpmi/publ/d101a.pdf, Committee on Payment and Settlement Systems and Technical Committee of the International Organization of Securities Commissions, *Principles for Financial Market Infrastructures*, April 2012.
[4] http://www.bis.org/cpmi/publ/d101a.pdf, Committee on Payment and Settlement Systems and Technical Committee of the International Organization of Securities Commissions, *Principles for Financial Market Infrastructures*, Paragraph 3.23.2, Page 122, April 2012.
[5] https://www.ccilindia.com/Lists/LstDiscussionForum/Attachments/12/Consultation_Paper_Default_Handling_Auction_of_Trades_And_Positions_of_Defaulters.pdf, The Clearing Corporation of India Limited, Consultation Paper – Default Handling: Auction of Trades & Positions of Defaulter etc., Paragraph 2.2.1, Page 3, 5 Dec 2014.

default, the DMC will decide whether the defaulted positions should be sold either through the auction process or, for eligible products, through an anonymous trading platform. If a sale through an anonymous trading platform is selected, in order to avoid further market risk on the defaulted portfolio, CCIL should discuss with the DMC and be granted a limited amount of time to sell this position on such a trading platform. If there are residual positions, CCIL and the DMC, should then auction such positions.

5. **Paragraph 2.3: Committee of Clearing Participants for Default Handling:**
We support the proposal in the Consultation Paper to establish a DMC. The formation of the DMC should be mandatory and formed by the CCP in advance as opposed to "may be formed in advance"[6] as stated in paragraph 2.3.1 of the Consultation Paper. As noted above, we strongly believe the DMC should be involved in all defaults, regardless of the size. We seek further clarification on how this committee will be formed, the composition of the committee, the role and responsibilities of the committee and how Clearing Participants will be selected for this committee. Ideally, the representatives in such a committee will rotate amongst the Clearing Participants such that the onus of providing a representative would not reside solely with a single Clearing Member. It is equally important that any representative to this committee has the requisite experience and knowledge to handle the auction process and the default of a Clearing Participant. This will provide Clearing Participants the needed clarity on the composition of the DMC and whether or not Clearing Participants will have the obligation to second a trader to the DMC thereby allowing Clearing Participants to plan and manage their resources accordingly.

6. **Paragraph 2.4: Segment-wise approach:**
We support the proposal that the default of a Clearing Participant in a particular segment should be handled according to the rules of that segment. The default of a Clearing Participant in one segment will, most likely, result in the close-out of all transactions in all segments for such a defaulted Clearing Participant. In such an instance, transactions should be handled separately in each segment before being netted in accordance with the cross segment netting mechanism. As each segment of CCIL is comprised of different Clearing Participants, not every Clearing Participant will be a member in all the segments of the consolidated defaulted portfolio of the Clearing Participant. For example: a Clearing Participant who is a member of the FX Forward segment only may be required to bid on positions in the CBLO segment because the defaulted Clearing Participant's consolidated position may contain positions in CBLO segment as well as other segments of CCIL. Non-defaulting Clearing Participants may not have the necessary expertise or ability to bid on that portion of the auction portfolio as they may not have existing positions or the appetite to take on those positions. As a result, the defaulted positions should not be consolidated into a single, large, consolidated auction portfolio.

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6 https://www.ccilindia.com/Lists/LstDiscussionForum/Attachments/12/Consultation_Paper_Default_Handling_Auction_of_Trades_And_Positions_of_Defaulters.pdf, The Clearing Corporation of India Limited, Consultation Paper – Default Handling: Auction of Trades & Positions of Defaulter etc., Paragraph 2.3.1, Page 4, 5 Dec 2014.

7. **Paragraph 2.5: Compression of Portfolio of Defaulter or of all (including non-defaulters):**
   Compression of a portfolio may be used as a DMP tool, however, it should only be used if the compression cycle can be achieved within a very short time frame (i.e. overnight) and it is supported by the DMC. As the compression cycle may take some time to setup and run, a very short timeframe is required to avoid significant mark-to-market ("**MTM**") movements in the defaulted portfolio. We recommend that compression between members of their portfolios occurs as part of the on-going risk reduction process.

8. **Paragraph 2.6: Sale of Positions in the Market:**
   We believe there should be no delineation between the size of a default and all defaults should always be handled by the DMC. The DMC may then decide whether the defaulted positions should be sold through the auction process or for eligible products, through an anonymous trading platform.

   If the DMC decides to close out the defaulted portfolio through a private sale, such a sale should not be limited to the "three large non-defaulting market participants"[7] as stated in the Consultation Paper. To promote transparency, such a sale should be open to all non-defaulting Clearing Participants in that segment and not limited to certain Clearing Participants in that segment only.

9. **Paragraph 2.7: Auction Model:**
   a) **Auction model:** In the consultation paper, CCIL only requires Clearing Participants to submit bids and buy positions up to the portion of the auctioned position (referred to as the "**minimum portion of the auctioned position**") that is equal to the ratio of its contributions to the default fund for the segment to the total contributions of non-defaulters to the same default fund. Clearing Participants should be allowed the ability to bid for the entire defaulted portfolio, beyond the minimum portion of the auctioned position, if they have the risk appetite to take on a larger portfolio. We believe the auction process requires further clarity and details. This would provide Clearing Participants the clarity to manage their portfolios and their roles and responsibilities in the auction process and the DMC.

      We seek clarification if CCIL intends to adopt the modified Dutch auction format to address the winner's curse of paying the highest price for multi-unit auctions or if CCIL will adopt another type of auction format. The Dutch auction format is the auction format whereby there is a single uniform price determined after taking in all bids and determining the lowest price in which the total defaulted portfolio may be sold at. Another auction format is based on the highest bid whereby the highest bid wins the auction and will not address the winner's curse issue.

      In the Consultation Paper, the auction incentive focuses on forced allocation of positions if Clearing Participants did not buy positions in the ratio of their

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[7] https://www.ccilindia.com/Lists/LstDiscussionForum/Attachments/12/Consultation_Paper_Default_Handling_Auction_of_Trades_And_Positions_of_Defaulters.pdf, The Clearing Corporation of India Limited, Consultation Paper – Default Handling: Auction of Trades & Positions of Defaulter etc., Paragraph 2.6.1, Page 6, 5 Dec 2014.

contributions to the default fund to the total contributions of non-defaulting Clearing Participants in the same default fund. The Consultation Paper places an obligation on all non-defaulting Clearing Participants[8] to bid in the auctions, even in instances where a Clearing Participant may have dormant trading activity. We believe the auction incentive should focus instead on the appropriate level of bidding instead of focusing on the outcome of the bidding process. This would eliminate the risk that a large Clearing Participant, that bid market value may not reach its quota, because other Clearing Participants may have bid higher for the reason that such Clearing Participants' existing portfolio may be a better match with the defaulted portfolio. Instead CCIL may wish to consider an auction incentive that focuses on the level or price of the actual bid whereby juniorization/ seniorization is based on (a) Clearing Participants that did not bid; (b) Clearing Participants that did bid but such a bid would cause losses to the CCP beyond 1 to 2 times the initial margin of the defaulted member; (c) those who did bid but are not in groups (a), (b) or (d); and (d) the winning highest bid (the Clearing Participant with the highest bid which was received first).

b) **Minimum price:** We do not support the declaration of a minimum price based on the MTM price of the defaulted portfolio. Any bid should be encouraged. In addition, and as all Clearing Participants are conscious that very low bids will threaten the mutualized guaranteed fund, we believe this should serve as sufficient incentive for Clearing Participants to bid sensibly without the need for a minimum price. The bids submitted by a Clearing Participant will reflect the risk being brought to its portfolio and will be different for each Clearing Participant.

   We do not believe the CCP should set a minimum price for an auction and declare the auction as "failed" if the minimum price is not met. This is a concern because it may potentially result in the auction failure even though all Clearing Participants submitted bids and increases the propensity of an auction failure. The function of an auction is to set a market driven price for the defaulted portfolio.

c) **Forced Allocation:** We do not support CCIL's ability to allocate, on a random basis at a pre-decided minimum price, the positions not taken up by non-defaulting Clearing Participants who failed to buy positions up to the minimum level required through the auction as stated in paragraph 2.7.1 of the Consultation Paper[9]. Forced allocation of the defaulted portfolio to a Clearing Participant who may not have the ability or appetite to take on additional positions may further exacerbate the volatility in the market instead of minimizing it. Additionally, the ability of the CCP to force allocation of positions to non-defaulting Clearing Participants, set a minimum price and be able to declare an auction as "failed", may result in the liquidation of the defaulted portfolio at a price that is determined by the CCP as opposed to a market driven price. Forced allocation may lead to

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8 https://www.ccilindia.com/Lists/LstDiscussionForum/Attachments/12/Consultation_Paper_Default_Handling_Auction_of_Trades_And_Positions_of_Defaulters.pdf, The Clearing Corporation of India Limited, Consultation Paper – Default Handling: Auction of Trades & Positions of Defaulter etc., Paragraph 2.7.1, Page 7, 5 Dec 2014.

9 https://www.ccilindia.com/Lists/LstDiscussionForum/Attachments/12/Consultation_Paper_Default_Handling_Auction_of_Trades_And_Positions_of_Defaulters.pdf, The Clearing Corporation of India Limited, Consultation Paper – Default Handling: Auction of Trades & Positions of Defaulter etc., Paragraph 2.7.1, Page 7, 5 Dec 2014.

unquantifiable liabilities for Clearing Participants as they would not be able to determine what positions may be allocated back to them and at what price.

10. **Paragraph 2.8: Positions Carried Forward:**
If some positions of the defaulter could not be immediately closed out in the market or through auction, such positions should not be carried forward as this would result in the CCP having an unmatched book. Although this unmatched book may potentially be hedged, it is unlikely the hedge would result in a fully-matched book. If there are some residual positions, the CCP's rules should clearly how such residual positions will be resolved, for example: partial tear-ups. The CCP rules should cover any allocation of loss resulting from the handling of such closing out such positions; how such a loss would be handled in the default waterfall and the DMP tools the CCP may use to close out such positions.

11. **Paragraph 2.9: Residual Loss from Default:**
As the default waterfall is not applied across all segments or may require further details in some segments, we encourage CCIL to provide consolidated and comprehensive documentation with respect to how the DMP will be managed for all segments of CCIL. The DMP should also clearly outline the loss allocation process where loss will be attributed to CCIL and where loss will be attributed to the Clearing Participants. This would provide Clearing Participants with the much needed clarity regarding the DMP of the CCP.

A clearly defined cap should be introduced when the DMP process is implemented in certain segments of CCIL on the losses a Clearing Participant may face in the event of one or multiple defaults. It should be noted, the current cap of five times the contribution to the default fund is viewed by some as high.

12. **CCIL default rules, procedures, loss waterfalls and events of default:**
Although this is not part of the Consultation Paper, we encourage CCIL to adopt default funds that support each of its risk pools and to have significant skin in the game to absorb losses before utilizing the resources of non-defaulting Clearing Participants in the default waterfall. We encourage CCIL to adopt clarifications to its default management rules and procedures or issue clarifying guidance in areas where its Clearing Participants seek further clarity. In particular, CCIL events of default should be more clearly defined across all segments and the rules should include further detail in respect of a Clearing Participant's early termination rights and the methodology for calculating *termination* amounts. When establishing the default funds in other segments of CCIL, such as the CBLO and Securities segments, we encourage CCIL to place explicit limits on non-defaulting Clearing Participants' obligations to replenish such default funds (i.e. limitation of liability).

As noted under the CPSS-IOSCO PFMIs, a CCP "should have rules, procedures, and contracts that are clear, understandable, and consistent with relevant laws and regulations"[10]. We encourage CCIL to provide clarity and legal certainty of its rules and procedures to Clearing Participants such that they may avoid any confusion over their obligations in the event of a default in CCIL.

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[10] http://www.bis.org/cpmi/publ/d101a.pdf, Committee on Payment and Settlement Systems and Technical Committee of the International Organization of Securities Commissions, *Principles for Financial Market Infrastructures*, Principle 1, Key Consideration 2, April 2012.

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ISDA appreciates the opportunity to provide comments on the Consultation Paper. If you have any questions on this submission or would like to further discuss any other topics, please contact Keith Noyes at (knoyes@isda.org, at +852 2200 5909) or Cindy Leiw at (cleiw@isda.org, at +65 6538 3879) or Erryan Abdul Samad (eabdulsamad@isda.org, at +65 6538 3879) at your convenience.

Yours sincerely,

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