Auction Incentive for the Commodities Clearing Service

April 2020
Close-out providers have the chance to get their default fund contributions seniorized when contributing to a portfolio close-out.

### Hedges

- **Default fund contribution seniorized**, seniorization in proportion to share of risk (measured in IM) taken out through the hedge

### Auctions

- **Default fund contribution seniorized**, seniorization in proportion to share of risk (measured in IM) taken out or sufficiently high quality bid:
  - Tier 1 (Senior): Auction winner(s)
  - Tier 2: Bid differential to winning bid less than 10% of IM of auction bucket / auction portfolio
  - Tier 3: Bid differential to winning bid between 10% and 20% of IM of auction bucket / auction portfolio

Other bids and other market participants (e.g. non-close out providers) will be more junior than Tiers 1-3.

A GCM’s default fund contribution will be seniorized if one of their NCM being a close-out provider provides a winning hedge quote, winning auction bid or a bid of sufficient quality.
Share of seniorization from each cycle in a close-out
The proportion of seniorization from each specific hedge / auction depends on the amount of risk reduced by the hedge / auction

Definition

- For each auction / hedge, the level of seniorization offered from that auction / hedge is defined as the Actual Auction Proportion or the Hedging Proportion
- The Actual Auction / Hedging Proportion relates the risk (measured in IM) of the remaining portfolio before the specific auction / hedge, to the amount of risk closed-out of after that hedge or auction, also considering the amount of risk taken out since the default management process started
  - In definitions similar to the rulebook text¹, this is given as; The proportion calculated as 100% less the Hedging Proportion / Actual Auction Proportion (if any) for any completed hedging / auction cycle (Default Cycle), times the proportion calculated by the aggregate of the net IM for each successfully executed Hedge / Auction Bucket in the Default Cycle divided by the aggregate net IM of each successfully executed Hedge /Auction Bucket in the Default Cycle and the risk of the remaining portfolio

Example: A close-out with 3 cycles of hedges/auctions

- First hedge or auction – Default Cycle 1: Say that the pre-auction / pre-hedge IM is 100 and there is one auction portfolio / hedge request that has an isolated IM of 80 and the remaining portfolio has an IM of 30 (80+30>100 due to lost netting effects), then the Actual Auction / Hedge Proportion is given by (100% - 0% (no previous cycles)) * 80/(80+30) = ~73%
- Second step hedge or auction – Default Cycle 2: Say that from the remaining risk of 30, the second hedge/auction covers risk of 25 and that remaining portfolio is 10 (again 25+10>30 due to lost netting effects), then the Actual Auction / Hedge Proportion for the second hedge/auction is calculated as; (100% - 73%)*(25/(25+10) = ~27% * ~71% = ~19%
- Third step hedge or auction – Default Cycle 3: For the remaining 10, one auction/hedge is performed to close-out the remaining risk, in this case the Actual Auction / Hedge proportion is given by (100% - 73% - 19%)*(10/(10+0)) = ~8%

Note: Any part of the portfolio closed-out in an order-book close-out will be excluded from the calculations of seniorization (clause 2iv in Schedule 2)

¹ Refer to Schedule 2 for exact definitions
Share of seniorization within an auction cycles (1 of 3)
Let us assume that a portfolio will be offered through three different buckets

Portfolio example

- The portfolio of the defaulted member can be split up into buckets, for example by market or product type to be able to get bids from close-out providers that only trade in certain markets, etc.
- A new initial margin is calculated for each bucket, the sum of initial margins for the buckets is likely to be larger than the portfolio’s initial margin due to lost netting effects
- To calculate the size each bucket represents of the portfolio, each bucket’s initial margin is divided by the sum of IMs for the buckets
- Close-out providers can choose to bid on the portfolio and/or any buckets they are interested in
- The examples on the following pages determines how large share of the seniorization from one specific auction that should be attributable to each close-out provider (i.e. the total level of seniorization from the specific action is given by the share of seniorization in the cycle times the Actual Auction Proportion)
Share of seniorization within an auction cycle (2 of 3)

Case 1: Winning bids are placed on auction buckets

- **Bucket 1**: IM: 31,2MEUR, 60% of Portfolio
  - 70MEUR (+44,9%)

- **Bucket 2**: IM: 13,0MEUR, 25% of Portfolio
  - 24MEUR (+30,8%)

- **Bucket 3**: IM: 7,8MEUR, 15% of Portfolio
  - 20MEUR

- **Portfolio**: Initial Margin 42,6MEUR
  - CoP A
  - CoP B
  - CoP C
  - CoP D
  - CoP E

**Legend**
- Tier 1: Winner
- Tier 2
- Tier 3
- Tier 4

**Description**

- **Sum of best bids across buckets is compared with best portfolio bid to identify winner(s)** — individual bids by close-out providers C, D and E gives best price

- **Allowed seniorization of default fund contribution is calculated for each** bid by comparing winning bucket bids vs. comparable bucket bids and portfolio bids vs. the sum for the winning portfolio

- **Default fund seniorization is identified based on price deviation** with winning bids (max. 10% to qualify for Tier 2 and between 10%, but less than 20% for Tier 3); for bucket bids, share of seniorization is based on share of bucket IMs

- **For close-out provider E**, where both portfolio and bucket bids are provided, the most beneficial seniorization is given
Share of seniorization within an auction cycle (3 of 3)

**Case 2: Winning bid is a portfolio bid**

<table>
<thead>
<tr>
<th>Bucket 1</th>
<th>IM: 31,2MEUR</th>
<th>60% of Portfolio</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bucket 2</td>
<td>IM: 13,0MEUR</td>
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<tr>
<td>Bucket 3</td>
<td>IM: 7,8MEUR</td>
<td>15% of Portfolio</td>
</tr>
</tbody>
</table>

**Portfolio**
Initial Margin 42,6MEUR

**Level of seniorization**

- No seniorization
- 100% Tier 1
- No seniorization
- No seniorization
- 100% Tier 3

**Description**

- **Sum of best bids across buckets is compared with best portfolio bid to identify winner(s)** – portfolio bid by close-out provider B is the best bid

- **Allowed seniorization of default fund contribution is calculated only for close-out providers providing portfolio bids**

- **Default fund seniorization is identified based on price deviation** with winning bids (max. 10% to qualify for Tier 2 and between 10%, but less than 20% for Tier 3); for bucket bids, share of seniorization is based on share of bucket IMs