Auction Incentive for the Commodities Clearing Service

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

Hedges

Winning quote(s)

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

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

Auctions

Winning bidder(s)

High quality bidder(s)

➤ **Default fund contribution seniorized,** senioritization 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

Share of senioriziation from each cycle in a close-out
The proportion of senioritzation 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 text[1], 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), <u>times</u> 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

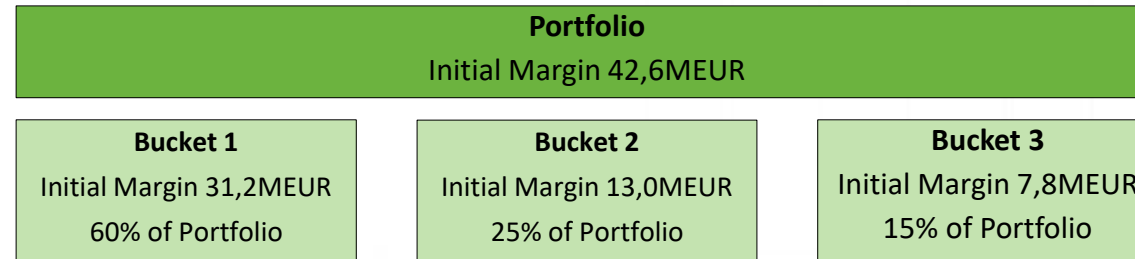**Example: A close-out with 3 cycles of hedges/auctions**

- *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 reaming 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)

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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

Portfolio
Initial Margin 42,6MEUR

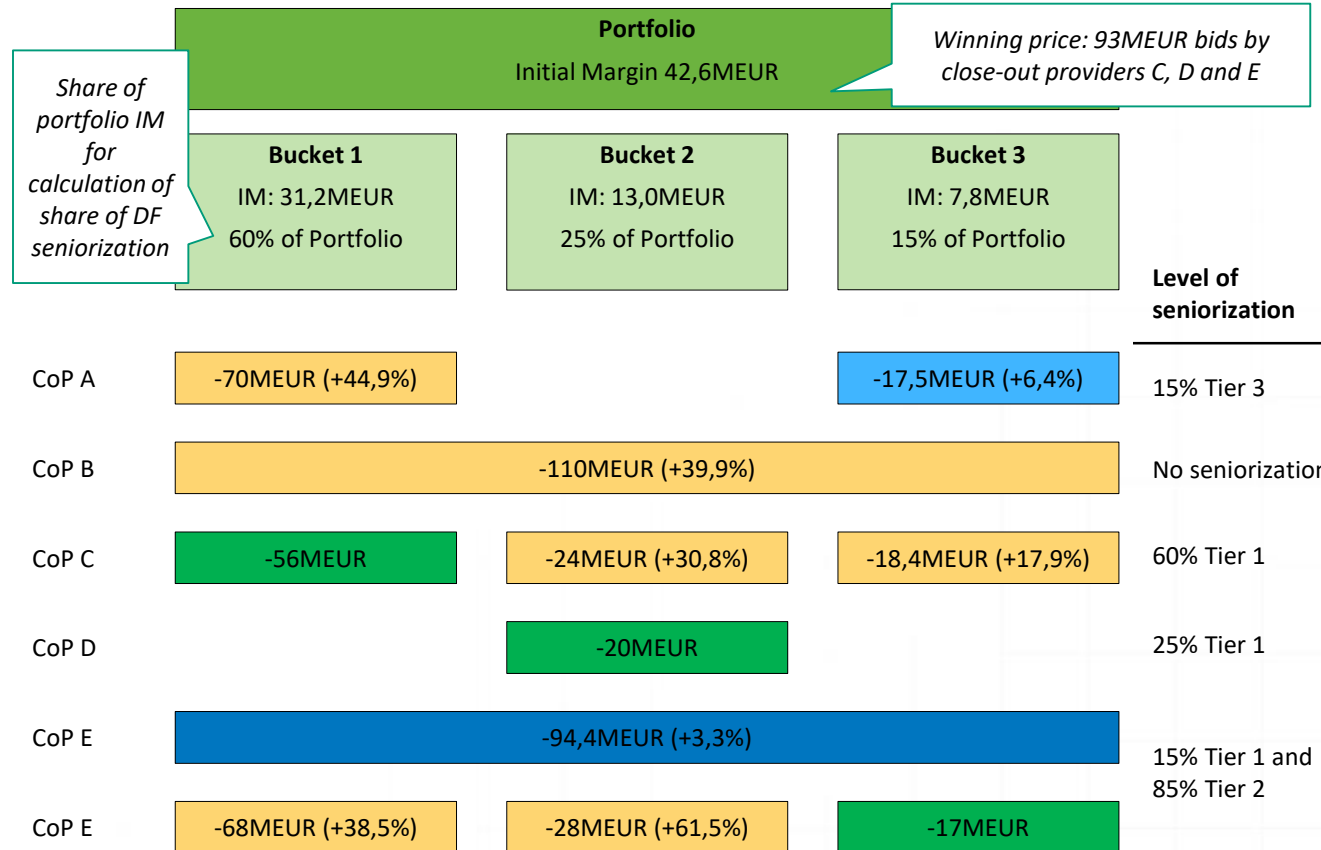| Bucket 1	Bucket 2	Bucket 3
Initial Margin 31,2MEUR	Initial Margin 13,0MEUR	Initial Margin 7,8MEUR
60% of Portfolio	25% of Portfolio	15% of Portfolio

- 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)

Portfolio
Initial Margin 42,6MEUR

Winning price: 93MEUR bids by close-out providers C, D and E

Share of portfolio IM for calculation of share of DF seniorization

	Bucket 1	Bucket 2	Bucket 3	Level of seniorization
	IM: 31,2MEUR 60% of Portfolio	IM: 13,0MEUR 25% of Portfolio	IM: 7,8MEUR 15% of Portfolio	
CoP A	-70MEUR (+44,9%)		-17,5MEUR (+6,4%)	15% Tier 3
CoP B	-110MEUR (+39,9%)			No seniorization
CoP C	-56MEUR	-24MEUR (+30,8%)	-18,4MEUR (+17,9%)	60% Tier 1
CoP D		-20MEUR		25% Tier 1
CoP E	-94,4MEUR (+3,3%)			15% Tier 1 and 85% Tier 2
CoP E	-68MEUR (+38,5%)	-28MEUR (+61,5%)	-17MEUR	

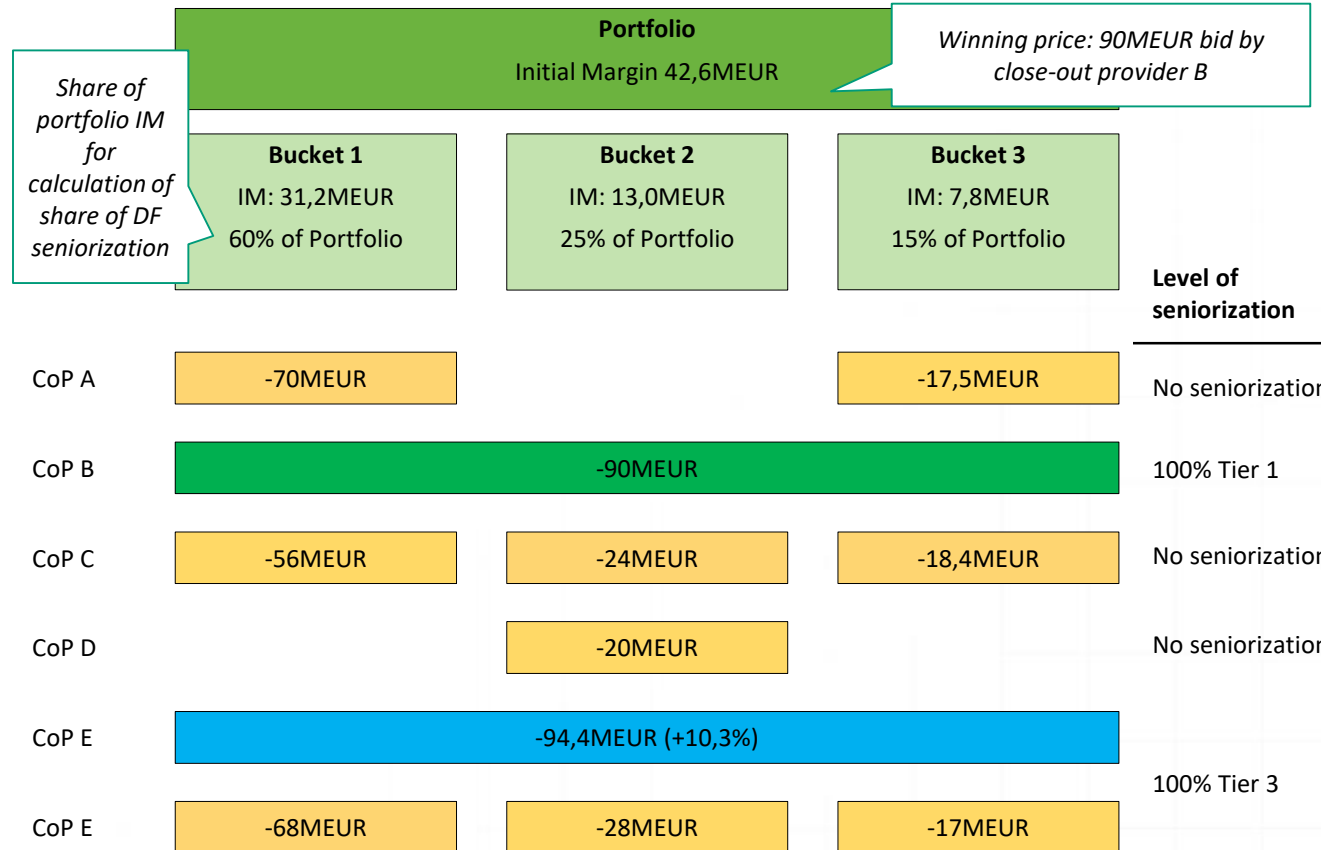**Legend** ■ Tier 1: Winner ■ Tier 2 ■ Tier 3 ■ Tier 4

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

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Case 2: Winning bid is a portfolio bid

	Portfolio Initial Margin 42,6MEUR		

Winning price: 90MEUR bid by close-out provider B

Share of portfolio IM for calculation of share of DF seniorization

Bucket 1 IM: 31,2MEUR 60% of Portfolio	Bucket 2 IM: 13,0MEUR 25% of Portfolio	Bucket 3 IM: 7,8MEUR 15% of Portfolio

Level of seniorization

	Bucket 1	Bucket 2	Bucket 3	Level of seniorization
CoP A	-70MEUR		-17,5MEUR	No seniorization
CoP B	-90MEUR			100% Tier 1
CoP C	-56MEUR	-24MEUR	-18,4MEUR	No seniorization
CoP D		-20MEUR		No seniorization
CoP E	-94,4MEUR (+10,3%)			100% Tier 3
CoP E	-68MEUR	-28MEUR	-17MEUR	

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)** – 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

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