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Optimal Bidder Selection in Clearing House Default Auctions

Rodney Garratt[*] David Murphy[†] Travis Nesmith[‡] Xiaopeng Wu[§¶]

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Abstract

Default auctions at central counterparties (or 'CCPs') are critically important to financial stability. However, due to their unique features and challenges, standard auction theory results do not immediately apply. This paper presents a model for CCP default auctions that incorporates the CCP's non-standard objective of maximizing success above a threshold rather than revenue, the key question of who participates in the auction and the potential for information leakage affecting private portfolio valuations. We show that an entry fee, by appropriately inducing members to participate or not, can maximize the probability the auction succeeds. The result is novel, both in auction theory and as a mechanism for CCP auction design.

1 Introduction

Central clearing has long been a ubiquitous feature of exchange-traded derivatives: all large futures exchanges have an affiliated clearing house, and trades are novated to this central counterparty (or 'CCP') after execution on the exchange. After the 2008 crisis, central clearing was mandated for OTC derivatives too, with the G-20 declaring that 'all standardized OTC derivative contracts should be ... cleared through central counterparties by end-2012 at the latest'. OTC derivatives clearing mandates have now been enacted in most leading jurisdictions. Major CCPs around the world have been declared to be systemically important financial infrastructures. Murphy (2012) and King et al. (2023) discuss the systemic importance and risks of central clearing.

The role of a CCP is to sit between market participants, guaranteeing their performance to each other and acting as the counterparty to all cleared trades. If one of their members defaults, the

[*] Bank for International Settlements, Centralbahnplatz 2, 4051 Basel, Switzerland. Email: rodney.garratt@bis.org

[†] Law School, London School of Economics and Political Science, Houghton Street, London WC2A 2AE, United Kingdom. Email: D.Murphy3@lse.ac.uk

[‡] Federal Reserve Board, 20th Street and Constitution Avenue N.W., Washington, D.C. 20551, United States of America. Email: travis.d.nesmith@frb.gov

[§] Rotman School of Management, University of Toronto, 105 St. George Street, Toronto, ON M5S 3E6, Canada. Email: xp.wu@rotman.utoronto.ca

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clearing house must close-out the defaulter's portfolio. Thus, they should make it far less likely that a failure of one market participant causes direct losses at another by acting as a buffer. In order to be able to do this, they must have sufficient resources to absorb any losses resulting from the default management process.

Different CCPs use different methodologies to size the various tranches of resources, subject to applicable regulatory minima. Given this, the sizing of CCP default resources has received a lot of attention in the literature, with a focus on their adequacy in various situations (e.g. Antinolfi et al., 2022, Capponi and Cheng, 2018, Cerezetti et al., 2019, Murphy and Nahai-Williamson, 2014, Rec, 2019a,b). Additionally, the important question of liquidity risk has been studied: see, (e.g. Cont, 2017, King et al., 2023). The close-out process, and particularly the problem faced by a CCP seeking to auction a defaulter's portfolio, is relatively less studied, and is the focus of this paper.

When the defaulter's portfolio is relatively small compared to available market liquidity, the default management problem is straightforward: in markets with central limit order books, the CCP can simply enter orders to liquidate the defaulter's portfolio. Similarly, in markets which trade largely on a request for quote basis, quotes will readily be available. The problem comes with large or concentrated portfolios, or portfolios of OTC derivatives. The former have been responsible for a number of incidents of CCPs stress,[1] as the CCP's ability to close out the defaulter near the market price is uncertain.

When the defaulter's portfolio is large or concentrated or both, it is common for the CCP to auction the defaulter's portfolio either as is, or after it has been hedged. Both Lehman's interest rate swaps portfolio cleared by the London Clearing House, and their exchange-traded futures and options portfolios cleared by Chicago Mercantile Exchange, were auctioned, for instance.[2] The analysis of CCP default auctions is therefore a practically interesting problem. It is also technically non-trivial, as clearing house default auctions have novel features.

CCPs have a fixed amount of funded resources to manage defaults, structured in what is known as their default waterfall. The first tranche of these resources are provided by the defaulter in the form of initial margin and the defaulter's contribution to a layer of mutualised resources, the CCP's guarantee or default fund. Then there is a (typically thin) layer of the CCP's own resources, known as skin in the game. After there comes the rest of the guarantee fund. Thus, first the defaulter pays, then the CCP does, then non-defaulting clearing members. Any resources from the defaulter that are not needed to manage the close-out are returned to the defaulter's estate. There are legal requirements in leading jurisdictions for CCPs to act reasonably in their close-out,[3] but these requirements leave substantial flexibility in the default management. All of this means that CCPs are much more concerned with getting an acceptable bid in a default auction than in the price of that bid. If it cannot close-out the defaulter's portfolio without suffering a loss bigger than the resources that they have provided, not only will it face financial loss, but also it will almost certainly suffer reputational damage.

Obtaining an acceptable bid is by no means guaranteed. For instance, in the 2018 default by

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[1] A good example is the stress at the New Zealand clearing house caused by the default of Stephen Francis described in Cox et al. (2016).

[2] See Fleming and Sarkar (2014) and LCH.Clearnet (2008) for LCH and Valukas (2010) for CME. For further analysis of Lehman, see (Wiggins and Metrick, 2019)

[3] See Braithwaite and Murphy (2017) for further details.

Einar Aas at the Nasdaq Nordic clearing house, the CCP's first attempt at auctioning the portfolio failed, and the second attempt resulted in a loss of €114 million in excess of the resources Aas had provided to the CCP, resulting in losses to both the CCP's own capital and the guarantee fund. Subsequently, it was revealed that the second auction had not liquidated the portfolio, but rather had just established hedges. In both auctions, Nasdaq Nordic limited participation to four firms that it selected.[4]

Standard auction theory suggests that revenue is increased by attracting as many bidders as possible to the auction.[5] However, this is not necessarily the best strategy in CCP default auctions due to a phenomenon known as information leakage. Typically, before the auction begins, only the CCP is aware of the size of the defaulter's portfolio. However, it has to provide this information to bidders and, once they know it, they can either choose to bid, or to trade against the CCP. Thus, there is a concern that inviting more and more bidders will lead to an adverse change in market prices between the portfolio being revealed and bids being submitted. This period cannot be very short, as defaulter's portfolios are large, and bidders need some time to price them. Nasdaq Nordic explicitly stated that it limited participation in its auction Aas' positions to avoid information leakage (Mourselas, 2019). The recent paper prepared by regulators, CPMI-IOSCO (2020), emphasizes both this topic and the question of who to include in an auction and how to incentivize bidders as part of its broader discussion of issues for CCPs to consider in default auctions; the paper raises these topics without providing guidance on how to simultaneously avoid information leakage, choose and incentivize bidders, and successfully conduct an auction.

To summarise, clearing house default auctions have two salient features that distinguish them from standard auctions. First, the CCP wants to minimize the probability of using its own or non-defaulting members resources, not to maximise income from the auction, and second, the possible negative effects of information leakage means that it is not desirable to attract bidders who are unlikely to submit competitive bids. These aspects make clearing house default auctions interesting from an auction theory perspective too.

Our contribution is to model the salient features of a clearing house default auction and to design an optimal process for conducting it. Different CCPs will have different rules for conducting auctions, and different strategies for recovering from an unsuccessful auction, so we focus on the common goals of the default management process across CCPs. We show how the opposing effects of information leakage – where more bidders tends to lower the value of the object and hence leads to lower prices – and the need to maximise the probability of a successful bid leads to an optimum number of bidders, that is strictly less than the number of available bidders. The key aspect from a mechanism design perspective is the use of an optimally selected entry fee to get good bidders to self-select.

Bidders use commonly known information about the likely size of the defaulted position, and private information about their own value of adding the position to their own portfolio, to decide whether to pay the entry fee, become more informed about the actual size of the defaulted position, and then decide whether or not to submit a bid.[6] We show that even with a reservation price, if the

[4] For details on the default and auctions, see (Clancy, 2018b,a), and (Mourselas, 2019). (Mourselas, 2021) covers the details that emerged later about the failure of the second auction and subsequent regulatory fine. Also, see Box A: Two defaults at CCPs, 10 years apart, by S. Bell and H. Holden (Faruqui et al., 2018, pp. 75–76) for more analysis

[5] Auction theory is covered in Milgrom (2004) and Krishna (2010); both cover standard models and equivalence results.

[6] The decision by each potential bidder *whether* to pay the entry is a key part of this process. A pre-committed fee, such as

cost of information leakage is high enough, a CCP maximizes its probability of receiving a bid above its reservation price by setting a non-zero entry fee. Although the entry fee limits participation, it does so in an equitable fashion in that it is set before the default occurs. Furthermore, the entry fee excludes bidders who are not likely to bid high enough to win the portfolio and consequently whose main impact is to increase information leakage.

2 Literature Review

In addition to the scholarship cited above, various authors explore aspects of CCP default management. Cont (2015) and Armakolla and Laurent (2017) both examine default resources but mainly to focus on the impact of loss allocation rules. Cerezetti et al. (2019) is closer to the spirit of this paper as it looks at how to optimize CCP default processes, but it focuses on hedging and does not analyze auctions at all.

There are however three papers that directly analyze CCP default auctions. The closest paper to this one, Ferrara et al. (2019), considers various designs of CCP default auctions theoretically, but makes the standard assumption that the CCP seeks to maximize revenue. As we detail below, that assumption ignores crucial features of the CCP's payoff. Their paper also assumes that the number of bidders is fixed, so it is silent on the question of who should actual be invited to participate in the auction. They do examine the possibility that poor bids can face a negative externality due to low competitiveness in the bidding process, which has some similarities to the externality driven by information leakage in our model. However, there is no endogenous entry in their framework, so the implications are more muted.[7]

In related research, Oleschak (2019) considers first price single item CCP default auctions where bidders have private value and share eventual losses with the CCP. He does look at the impact of being invited to the auction or not, finding that invited bidders are better off than those who are not invited to the auction, but this mechanism depends on the CCP being able to pick bidders with high private values. The inability to do so is exactly what we seek to study: whether a CCP can include bidders with high valuations and conversely exclude those with low valuations without knowing or even having a signal about private valuations.

Lastly, there are similarities between this paper and Huang and Zhu (2021), which builds on Du and Zhu (2017). However, that paper assumes that bidders are infinitesimal to avoid price impacts and, similar to the other two papers on CCP auctions, focuses on analyzing what happens if an auction results in losses that must be absorbed by the guarantee fund. It examines the benefits of juniorization of guarantee fund contributions in such circumstances.

Interestingly, all three papers focus on the impact of loss sharing among clearing members when the default auction goes poorly. But in each case, there is no reputational cost to the CCP

a default fund contribution at risk from a failure to bid, would not achieve the same effect.

[7] This is enough however to break the revenue equivalence between first and second price auctions: the authors find that a second price auction with loss sharing, rather than first price auctions with or without penalty, increases the liquidation value of the portfolio. This paper also uses a second price auction framework, but focuses on designing an effective mechanism to maximize the chance of success with strategic participation, rather than the impact ex post loss sharing when the auction is not as successful under fixed participation. Our approach, in contrast, captures the strategic decisions a CCP faces in designing an auction and is incentive compatible with participants that can choose whether to bid or not.

of such an poor outcome. In sharp contrast, we argue that a CCP is so strongly motivated to avoid such an outcome that it is their primary objective. We further tackle the question of how to construct the pool of bidders. Not only is this a key issue raised in CPMI-IOSCO (2020), but limited participation seems to be a common feature of the relatively few CCP auctions observe. Besides the prior discussion of Nasdaq Nordic, where the CCP selected four bidders only, evidence suggests the various auctions of Lehman portfolios had around five participants (Sourbes, 2015).

The institutional characteristics of CCP default auctions means our analysis is non-standard and arguably novel. But it does connect to certain strands of the broader auction literature. Levin and Smith (1994) endogenize entry and find that results can diverge from analysis that ignores the entry question. Similarly, in our paper entry takes a center stage in line with the discussion in CPMI-IOSCO (2020). Our model explicitly allows that more competition is not necessarily desirable which is in line with the empirical findings in Hong and Shum (2002), although private valuation is used rather than common. Our setup somewhat relates to Pinkse and Tan (2005), in that information leakage creates affiliation amongst independent valuations, although in a second-price auction rather than first price as in their analysis. Finally, Milgrom and Weber (1982) examined competition and entry fees, raising the possibility that monotonic equilibria might not exist. Landsberger (2007) extended this analysis to show that such existence becomes increasingly unlikely as the number of bidders grows. Our analysis is in the same vein as our structure implies non-montonicity so that adding more bidders is not optimal.

3 Derivatives Markets and CCPs

Modern derivatives markets are characterised by CCPs clearing standardised contracts and bilateral or uncleared contracting for bespoke ones. Dealers, and perhaps some other market participants, are direct, or 'clearing' members of CCPs. Thus a dealer's net risk position is composed of its cleared position and its bilateral one, and only the former is known to the CCP.

CCPs require that their members post initial and variation margin at least daily. Variation margin on each cleared portfolio or 'account' is determined based on the current mark-to-market, so it can be thought of as settling the value of the portfolio every day. Initial margin is based on the risk of the portfolio: it is intended to cover its potential change in value over a fixed liquidation horizon, known as the margin period of risk, to a high degree of confidence. Regulation sets minimum standards for the margin period of risk and the confidence level of margin. For over-the-counter (OTC) derivatives, initial margin is at least the amount required to cover 99% of five days changes in portfolio value. Figure 1 on the following page illustrates the idea.

The margin period of risk is intended to be long enough that the non-defaulting party can determine that an event of default has occurred, begin default management, hedge the defaulter's portfolio if necessary, and sell it. In our context, 'selling it' means conducting an auction, including determining who to invite to the auction, communicating the portfolio to them, receiving bids, deciding on a winner, and novating the defaulter's portfolio to them.

Bidders will use the market value of the portfolio at the point of bidding as a basis for their bids. Thus, the CCP is most at risk from losses in default management when the value of the portfolio has fallen between the last successful variation margin call with defaulter, at $t = 0$ say, and when bids are submitted, at $t = T$ say.

We will model a modern futures market subject to initial and variation margin, reflecting these

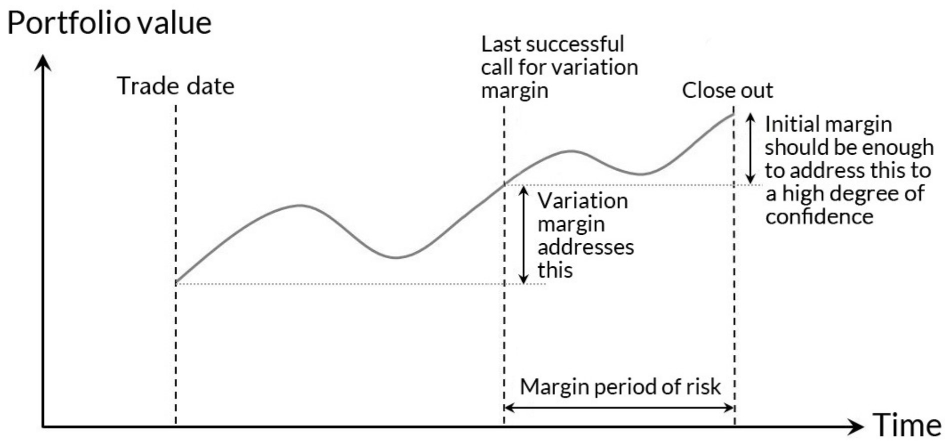

Figure 1: The roles of initial and variation margin

features. This means that market participants, when they enter into trades, only pay initial margin. Changes in value of their portfolios are settled day-by-day through variation margin. Before we develop our model of the derivatives market, the remainder of this section provides a concrete example of this situation.

Example. Suppose we are dealing with the front month London Metal Exchange ('LME') copper futures, and assume that a party bought 10 lots of this future on 19th May 2020. On this day the futures price was 5,314. The LME copper future is the right to receive 25 tonnes of copper and is priced in US dollars per tonne. Therefore this party locked in a price of 5,314 $\times$ 10 $\times$ 25 $=$ \$1,328,500 for 250 tonnes of copper at the expiry of the future. The closing price of this future on Friday 19th June 2020 of the front month was 5,855.50, meaning that someone who bought this future on that day, locked in a price of $25 \times 5,855.50 = \$146,387.5$ for 25 tonnes of copper at expiry. Suppose that our party defaulted at the close of business on Friday 19th June. The CCP will have paid a cumulative $(5{,}855.5 - 5{,}314) \times 25 \times 10 = \$135{,}375$ of variation margin to the defaulter. Note that if the future expires with this level, 5,855.5 as its settlement price, longs pay this amount per tonne and shorts receive this amount: the reason that the defaulter locked in the lower level of 5,314 per tonne is that they have received the difference as variation margin.

The use of variation margin means that if the futures price goes up, long position holders receive money; if it goes down, they pay money. It is only at expiry that the obligation arises to pay the settlement price and receive the commodity.

Now suppose that the initial margin was 500 points or \$12,500 per lot; the defaulter will have paid initial margin of \$125,000. Further suppose that their guarantee fund contribution was \$5,000 and that they default on Monday 22nd June, before the market opens. The CCP needs to auction the right to pay 5,855.50 per tonne for 250 tonnes of copper. If the bid is say a per-lot price of 5,200, then the CCP has lost $(5{,}855.50 - 5{,}200) \times 25 \times 10 = \$163{,}875$ and it only has initial margin of \$125,000 plus defaulter's guarantee fund contribution of \$5,000 so there is a loss of $\$163{,}875 - \$125,000 - \$5,000 = \$33,875$ to go first to the CCP's skin in the game ('SITG') then, if that was inadequate, non-defaulter's guarantee fund contributions. The CCP's desired per-lot auction price is at least $5{,}855.50 - \frac{125{,}000+5{,}000}{25\times 10} = 5{,}335.50$, as the defaulter's resources are sufficient to cover losses if the winning bid is at or above this level.

Note finally that the profits or losses of the auction are realised in the variation margin call at the end of the day. If the successful bid in an auction on Monday 22nd July was a per-lot price of 5,200 for a long position in 10 lots of futures, and the future closes at 5,800 (close to the previous Friday's close), then the CCP will pay the successful bidder $(5{,}800 - 5{,}200) \times 25 \times 10$ = \$150,000. There is no cash flow in the auction itself – just like the initial purchase, what is being agreed is not a price to pay but a level from which to base future variation margin payments.

Similarly, if the defaulter was short 10 lots, then bidders would rationally bid above the current price of 5,855.50. If the winning bid was, say 5,950, and the future closes on the evening of the auction at 5,870, the CCP would pay the bidder $(5{,}950 - 5{,}870) \times 25 \times 10 = \$20,000$.

4 A Model of a Derivatives Market

This section introduces the model of a derivatives market that we will use for the rest of the paper. We will model a single risk factor, to be thought of as the price of a commodity future.

There are two key features to this model. First, we assume that market participants are risk averse. This is modelled by a private value for position which reduces their value to the holder the bigger they are. Second, the model captures both OTC forwards and cleared futures positions, so the CCP does not know the net risk position of any market participant. Without this, the problem of selecting auction market participants is trivial, as it simply invites those with positions closest to and opposite in sign from the defaulter. It is also realistic to assume that OTC positions can be significant, and can have a material effect on the exchange-traded market.[8]

4.1 Positions

The net risk position of each clearing member is defined in terms of a single risk factor that can take positive and negative integral values. The risk factor trades both as a cleared future and as uncleared forwards, so the CCP does not know any clearing member's net position. The position is expressed as a futures equivalent. We will write s_i for the position of clearing member $i \in I$, where $s_i < 0$ denotes a short position and $s_i > 0$ denotes a long position. Because we are dealing with a derivatives market, the sum of the longs equals the sum of the shorts:

$$S = \sum_i \max(s_i, 0) = -\sum_i \min(s_i, 0) \tag{1}$$

4.2 The Futures Price and Variation Margin

We will write $V(t)$ for the quoted price of one lot at time t: think of this as the futures price. Because of variation margin, the public mark to market of all positions cleared by non-defaulters at the end of each day is always zero. Let $t = 0$ denote the end of one day. If the market participant acquires a new position of s at the close, and $t = 1$ denotes the end of the next day, then the total variation margin paid to the market participant will be $s(V(1) - V(0))$ if this is positive, or from them if this is negative.

After a default, the CCP have to continue to pay or receive variation margin on the other side of the defaulter's position. We denote the defaulter by D and therefore their position by s_D. Without

[8] See, for instance, LME's, Consultation 22/145, 2022, which notes that 'Recent events in the LME Nickel market have demonstrated the effects that OTC activity can have on the wider LME market.

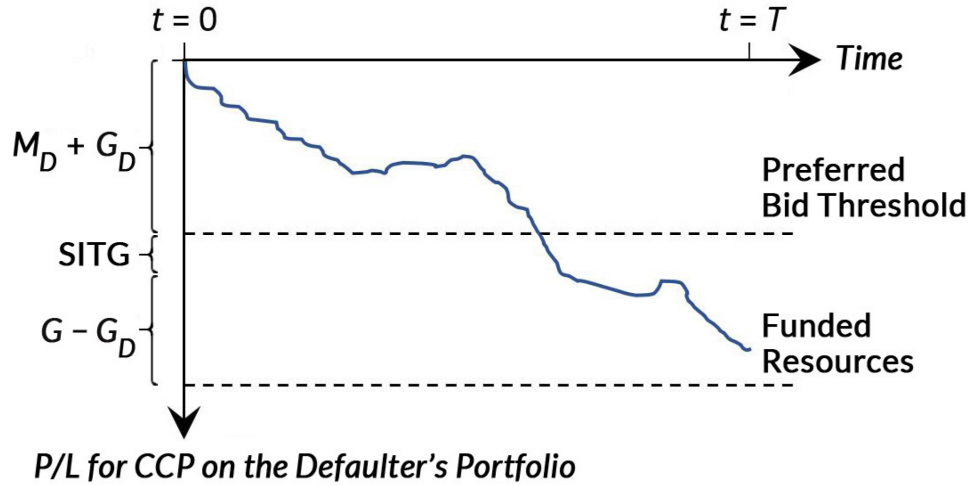

Figure 2: The value of the defaulter's portfolio through the margin period of risk and the use of resources in the default waterfall to absorb losses on it

loss of generality, denote the last time variation margin was exchanged prior to default by $t = 0$. Then if the per-lot price changes from $V(0)$ to $V(T)$ at the time T when the CCP novates the position to an auction participant, the mid-market profit or loss for the CCP on the defaulter's position is

$$(V(T) - V(0))s_D. \tag{2}$$

4.3 Funded Resources and a Successful Auction

We will denote initial margin posted by clearing member i by M_i, their guarantee fund contribution by G_i, and the CCP's skin in the game by SITG. The total guarantee fund G is $\sum_i G_i$. The resources contributed by the defaulter are $M_D + G_D$. After a default, the CCP can use these resources to cover any losses it incurs in closing out the defaulter's position.

Figure 2 shows an example path of the mark to market of the defaulter's portfolio through the margin period of risk. It starts at zero by definition as we assume a successful variation margin call at $t = 0$.

We assume that at $t = T$ the CCP transfers the position at a price b which could be either positive or negative: positive b represents cash coming into the CCP from the next variation margin call and negative, cash leaving, as usual. The CCP's total profit or loss on the defaulter's portfolio, after using their resources, and including variation margin, is therefore:

$$P = (V(T) - V(0))s_D + b. \tag{3}$$

If the CCP has to pay out b in the auction, then the profit or loss is b below $(V(T) - V(0))s_D$. The total funded resources are $M_D + \text{SITG} + G$. In general $(V(T) - V(0))s_D$ could take either sign, but the auction is more difficult when it is negative, so this situation is illustrated.

If the CCP does not make a loss on closeout, $P \geq 0$, it is obliged to return the defaulter's resources to the administrator of the estate. On the other hand, if it makes a loss, $P < 0$, it can absorb that loss with the available resources.[9] The CCP's total profit or loss on the defaulter's

[9] We assume that the CCP does not make any further recoveries in excess of the available collateral.

portfolio after using the defaulter's resources is therefore:

$$\begin{array}{ll} P & \text{if } P \geq 0, \\ 0 & \text{if} - M_D - G_D \leq P < 0, \\ P + M_D + G_D & \text{otherwise.} \end{array} \tag{4}$$

This can be simplified to

$$\max\left(P, \min(P + M_D + G_D, 0)\right). \tag{5}$$

The CCP's own resources are at risk if the cost of default management is larger than $M_D + G_D$. For simplicity, we assume that there are no other costs – such as hedge costs – and that an auction succeeds if the CCP can liquidate the portfolio without paying more than this.

The payoff function in equation (5) is one of the things that makes CCP default auctions novel. A standard assumption in auction theory is that the seller seeks to maximize revenue and most analysis of different auction characteristics focuses on the impact to expected revenue (Krishna, 2010). But in a default auction, the CCP does not actually profit from better bids b within the range

$$-M_D - G_D \leq P.$$

Consequently, there is little incentive for CCPs to care about increasing the bid within this range. In contrast, there is a considerable negative reputational impact associated with a default auction which eats into skin in the game. Consequently, a CCP is rightly much more concerned with maximising the probability that it will receive a winning bid that is high enough to ensure that losses are covered by the defaulter's resources than in maximising auction revenue. Put another way, the CCP can be viewed as largely indifferent to the level of revenue generated by the auction above the threshold illustrated in Figure 2, but as facing a discontinuous loss below it. This produces a particular form of risk aversion, so that CCPs focus on minimizing the downside risk rather than seeking to maximize revenues as a seller normally does. Rather than specifying risk aversion, we will assume that the CCP seeks to maximize the probability that its loss on the portfolio is covered by the defaulter's resources $M_D + G_D$.

4.4 Private Values

Following the set-up in Du and Zhu (2017), suppose that market participants have an aversion to risk, which affects their private value of positions. In particular the private mark to market of a position of size $s \in \mathbb{R}$ is

$$-\beta s^2 \tag{6}$$

for some positive β, i.e. the bigger positions got, the (quadratically) bigger holders discount them. For ease we will assume β is constant for all participants and this is known.

4.5 Private Values for Winning Bidders

The defaulting clearing member has a position s_D. If a clearing member wins the auction for this position at a price b, it will be netted with their existing position. If s_i was the clearing member's old position, the original position has a private value of

$$-\beta s_i^2,$$

and the new position is privately worth

$$-\beta(s_i + s_D)^2.$$

Hence, the clearing member is indifferent between buying the position s_D for b and not buying it when

$$-\beta(s_i + s_D)^2 - b = -\beta s_i^2.$$

We will write $\tilde{b}_i$ for this rational bid threshold for clearing member i:

$$\tilde{b}_i = -\beta(2 s_i s_D + s_D^2).$$

Clearly it is irrational to bid above this level, as $-\beta(s_i + s_D)^2 - b < -\beta s_i^2$ when $b > \tilde{b}_i$.

4.6 Desirable and Undesirable Bidders

Suppose the defaulter's position is big, $s_D \gg 1$, and all the bidders are on the same side of the market as the defaulter and big too, $s_i \gg 1$ for all i. Then $(2 s_i s_D + s_D^2)$ is always positive and large. Hence, unless β is very small, for all i, b_i will be negative and large, and the CCP will not get a bid above its threshold $-M_D - G_D$. Thus only having bidders in the auction on the same side of the market as the defaulter is damaging for the CCP's objective of having a successful auction.

Conversely, if there is a bidder with position opposite to the defaulter, $\mathrm{sgn}(s_i) \neq \mathrm{sgn}(s_D)$ and bigger than it, $|s_i| > |s_D|$. Then $2 s_i s_D$ is negative and $s_i^2 > s_D^2$, so $(2 s_i s_D + s_D^2) < s_i^2$, and hence winning the auction frees up private value. For this bidder, $\tilde{b}_i > 0$. Clearly, if instead $s_i = -s_D/2$, then $\tilde{b}_i = 0$.

Following on from this, if the number of auction participants is large and s_i is symmetrically distributed, then there will be some bidders for whom s_i and s_D are of opposite signs. Any of these participants who have $|s_i| > |s_D|$ will make positive bids, so unless $P < -M_D - G_D$, the probability that the CCP will get a bid above its threshold approaches 1 as the number of bidders increases. In this setting, inviting more participants to the auction is always better. This result is not surprising. Even with the change to the seller's objective, the folk theorem result that adding more bidders generally increases revenue intuitively suggests that adding more bidders will increase the probability that the CCP receives a bid above its threshold.

4.7 The Auction and Information Leakage

It is reasonable to assume that market participants know the sign of the defaulter's portfolio s_D – long or short – but not its precise size. This is revealed to auction participants by the CCP just before the bidding process opens.

Thus far, the market value of defaulter's portfolio at the time of the auction has just depended on the drift in the futures price $V(t)$. We assume this movement is determined by a standard normal random variable $Z \sim \mathcal{N}(0, 1)$ so that

$$V(T) = V(0)\,(1 + \sigma Z)\,,$$

where σ is a volatility-like scaling parameter. In addition, we will assume that information-leakage creates a risk that auction participants trade outside the auction against the defaulted position, which hurts its value. As noted above, regulators recommend that CCPs should balance the risk of information leakage and the aim of obtaining a competitive price when deciding on the most appropriate execution method.

In order to model information leakage, we assume that having N bidders with certainty reduces $V(0)$ by an amount $\gamma(N-1)^Q$ for fixed $\gamma > 0$ and Q. The constants $\gamma > 0$ and Q are known and abstractly account for the cost of information leakage or the cost of offloading a large position later. We assume that the impact of information leakage increases non-linearly in the number of auction participants. So for N bidders, the futures price at the moment bids are submitted is:[10]

$$V(T) = V(0)\left(1 + \sigma Z - \gamma(N-1)^Q\right).$$

The problem the CCP now faces is that there are two competing pressures: having more bidders increases the probability of receiving a good bid, but it also increases the size of the price moving against the CCP. The simple strategy of including everyone in the auction is no longer optimal. In the next section, we consider the CCP's auction strategy in this situation. The CCP would rather like to be discriminating in who it invites. As the CCP does not have the information available to fully discriminate, we examine whether it can use an entry fee to endogenously encourage the right participants and discourage the wrong participants so that it can induce the participants to balance the competing pressures.

4.8 Bidder Values

Bidder values at time T depend upon the price of the future $V(T)$, the number of bidders N, and the defaulter's position s_D. We assume that the CCP truthfully reveals s_D to all the bidders that enter the auction.

Bidder i's maximum value of bidding then is

$$v_i = s_D V(T) - \beta s_D(2s_i + s_D) = s_D V(0)\left(1 + \sigma Z - \gamma(N-1)^Q\right) - \beta s_D(2s_i + s_D).$$

We can take v_i to represent bidder i's private value. Interestingly, information leakage has made bidders' private values affiliated, so that competition is less intense than a bidder would have thought before the auction; the mechanism is different but the result is similar to that in Pinkse and Tan (2005). Nevertheless, if we assume s_i is independently and uniformly distributed then so is v_i.

Despite the unusual event in the benchmark US oil futures market in March 2020 when the front month futures price briefly turned negative, we assume not just that $V(t) > 0$ but also that $V(t) - \beta s_i > 0$ for all t and any s_i, i.e., long positions always have positive values.

5 Self-Selecting Mechanism

Without loss of generality, we take $V(0) = 0$, i.e., all mark-to-market fluctuations on the portfolio are settled continuously before the auction. The maximum willingness to pay, or value, of bidder i for the default portfolio is then

$$v_i \equiv -\beta s_D(2s_i + s_D). \tag{7}$$

[10] Note that the price move against the CCP depends on the number of bidders, so we are assuming that more bidders means more information leakage, regardless of their economic incentive to avoid a move against a portfolio they might win in the auction.

The timeline of the model is as follows:

- The CCP sets the entry fee $e \geq 0$ ex ante, before any default.[11]
- Default happens. The CCP announces the side of the default portfolio, $\text{sgn}(s_D)$, but not its magnitude. Bidders believe (correctly) that the magnitude of s_D is distributed according to a distribution with support from $[0, \infty)$.[12] Bidders decide whether they would pay e to observe s_D. Entry decisions are made simultaneously and only disclosed to the CCP.
- The CCP announces the number of bidders K who have paid the entry fee, and entered the auction and thus observed s_D.
- Bidders who enter the auction realize that their per-unit value of the default portfolio drops by

$$-\gamma(K-1)^Q, \tag{8}$$

reflecting the cost of information leakage or the cost of offloading the large position later reflected by $\gamma > 0$ and Q. Put differently, while the fair market value of the default portfolio remains $V = 0$ given the public information set, the private values of everyone in the auction just drop by $\gamma(K-1)^Q$.[13] Bidders who do not enter the auction do not see K and therefore do not observe the resulting drop in value.

Let $R = M_D + G_D$ be the resources the CCP has from the defaulter. The CCP conducts a second-price auction with reservation price equal to R. The CCP's objective function is

$$\max_e \text{Prob}(\mathcal{A}), \text{ where } \mathcal{A} = \{P + R + Ke \geq 0\}, \tag{9}$$

and K is a random variable that determines how many bidders enter the auction conditional on the entry fee e. The objective seeks to set the entry fee to maximize the probability that the profit or loss, P, which the CCP realizes after the auction from the variation margin payments it must make plus the winning bid, summed with available liquid resources that are non-negative. Note that the liquid resources now include not only the defaulter's initial margin and guarantee fund contributions but also the total revenue from entry fees paid by the K bidders, which is Ke. Importantly, P declines as the number of bidders increases.

We can solve the bidders' entry decisions. Conjecture that v_0 is the cutoff value, corresponding to a cutoff inventory level s_0 so that

$$v_0 \equiv -\beta s_D(2s_0 + s_D). \tag{10}$$

The bidder who is at the cutoff should be indifferent between entering and not, so the expected profit of entering is equal to the entry fee e.

Besides the non-standard objective function, our model has two features that are absent in conventional auction models. First, entry decisions are made without observing s_D, but the actual

[11] Setting the entry fee ex ante ensures that the entry fee reveals no information about the size of the defaulters position.

[12] The support could be restricted to have an upper limit smaller than the size of the market S; the larger support just simplifies the notation as the actual point when the cumulative distribution reaches one does not affect the results.

[13] Another mechanism that could result in such reduced private values would be communication amongst the participants; Agranov and Yariv (2018) show experimentally that communication can reduce bids. The impact would be captured by costs increasing as the number of participants rises.

bidding should depend on s_D that is learned after entry. Second, each entrant's value is lower if more bidders enter. These two features represent two shocks to bidders who enter the auction.

The threshold bidder who is indifferent wins if and only if she is the only one in the auction, in which case there is no cost of information leakage, i.e., $-\gamma(1-1)^Q = 0$. In the second-price auction, the winning price for the sole bidder is the CCP's reservation value, which is $-(R+e)$, i.e., the CCP gives $R+e$ to the sole bidder in return of getting rid of the default portfolio. The sole bidder's ex post profit, if she bids, is

$$v_0 + (R+e) = -\beta s_D(2s_0 + s_D) + R + e. \tag{11}$$

If s_D turns out to be very positive, then this "profit" can be negative, so the optimal action for the sole entrant is not to bid in that case. Therefore, the indifference condition for the cutoff-type bidder is

$$e = (1 - F(s_0))^{N-1}\mathbb{E}\left[\max(-\beta s_D(2s_0 + s_D) + R + e, 0) \mid e\right], \tag{12}$$

where F is the cumulative distribution function of s_i. Because the entry fee e is set in advance, it does not reveal s_D in equilibrium.

The CCP's objective is to minimize the probability that the auction fails, i.e., it receives no bids. Obviously, the auction fails if no one enters, which happens with probability $(1-F(s_0))^N$. The auction may also fail if bidders who enter refuse to bid after observing s_D and K.

If only the cutoff bidder enters, the auction succeeds if and only if

$$-\beta s_D(2s_0 + s_D) + R + e \geq 0. \tag{13}$$

Note that from the CCP's perspective, once e is set, the left-hand side is deterministic because e determines s_0 by equation (12).

In general, if $K \geq 1$ bidders enter, the auction succeeds as long as $\max_{i\in K} v_i \geq R$, or

$$-\beta s_D(2s_{\min} + s_D) - \gamma(K-1)^Q s_D + R + Ke \geq 0, \tag{14}$$

where $s_{\min}$ is the lowest inventory level of the K bidders.

Therefore, the auction succeeds if and only if a high-value bidder, who has a high willingness to pay, enters and also bids, i.e., it solves

$$\max_e \text{Prob}(s_{\min} \leq s_0 \text{ and } -\beta s_D(2s_{\min} + s_D) - \gamma(K-1)^Q s_D + R + Ke \geq 0), \tag{15}$$

where:

- s_0 is given by equation (12),
- K is a random variable, determined by the rule that entry happens if a participant's inventory is lower than s_0,
- e depends on the distributions of s_D and $\{s_j\}$, where for $j \in K$; $\{s_j\}$ represents the inventory levels of the auction participants, but do not depend on the realization of s_D.

The two inequalities in the Prob$(\cdot)$ expression (15) can be rewritten as

$$s_{\min} \leq \min\left(s_0, \frac{R + Ke - \beta s_D^2 - \gamma(K-1)^Q s_D}{2\beta s_D}\right). \tag{16}$$

The smaller of the two terms in $\min(\cdot)$ would be binding. Intuition suggests that we want the two terms to be "close". In one extreme with $e = 0$, equation (12) implies that $F(s_0) = 1$, i.e., s_0 is the upper bound of the inventory distribution and everyone would enter. But in this case the second term becomes $\frac{R-\beta s_D^2-\gamma(N-1)^Q s_D}{2\beta s_D}$ (as $K = N$), which is small if Q is large. In the other extreme of setting e to be very high, K would be small, so $\frac{R+Ke-\beta s_D^2-\gamma(K-1)^Q s_D}{2\beta s_D}$ is less binding but s_0 would be quite binding. As a result, there should be some intermediate values of e that maximize the probability of auction success.

To derive the analytical expression of $\text{Prob}(\cdot)$ in 15, note that the random variable K has a binomial distribution with probability of success $F(s_0)$. Let k denote a realization of K. Clearly, the condition $s_{\min} \leq s_0$ is equivalent to $k \geq 1$, i.e., at least one bidder has inventory below s_0. In addition, conditional on $k \geq 1$ bidders entering the auction, $s_{\min}$ is lower than s_0. Still conditioning on k, for any real value $x \geq s_0$, $\text{Prob}(s_{\min} < x \mid s_{\min} < s_0) = 1$; for $x < s_0$,

$$\begin{aligned}\text{Prob}(s_{\min} < x \mid s_{\min} < s_0) &= \frac{\text{Prob}(s_{\min} < x, s_{\min} < s_0)}{\text{Prob}(s_{\min} < s_0)} = \frac{\text{Prob}(s_{\min} < x)}{\text{Prob}(s_{\min} < s_0)} \\ &= \frac{1 - \text{Prob}(s_{\min} \geq x)}{1 - \text{Prob}(s_{\min} \geq s_0)} = \frac{1 - (1 - F(x))^k}{1 - (1 - F(s_0))^k},\end{aligned} \tag{17}$$

where in the last step we use the fact that if k bidders enter the auction, then the minimum inventory of the N potential bidders is equal to the minimum inventory of the k bidders who have the k lowest inventories and who actually enter. The auction success probability, conditional on s_D, is written as

$$\text{Prob}(s_{\min} \leq s_0,\ -\beta s_D(2s_{\min} + s_D) - \gamma(K-1)^Q s_D + R + Ke \geq 0 \mid s_D). \tag{18}$$

Because K is binomial, this probability can be made explicit. In particular, let

$$\phi(s_D, K) = \frac{R + Ke - \beta s_D^2 - \gamma(K-1)^Q s_D}{2\beta s_D}. \tag{19}$$

Then we have the following

$$\begin{aligned}&\text{Prob}(s_{\min} \leq s_0,\ -\beta s_D(2s_{\min} + s_D) - \gamma(K-1)^Q s_D + R + Ke \geq 0 \mid s_D) \\ &\quad = \text{Prob}\left(K \geq 1, s_{\min} < \underbrace{\frac{R + Ke - \beta s_D^2 - \gamma(K-1)^Q s_D}{2\beta s_D}}_{:= \phi(s_D, K)} \mid s_D \right) \\ &\quad = \sum_{k=1}^{N} \text{Prob}(K = k)\, \text{Prob}(s_{\min} < \phi(s_D, k) \mid K = k, s_D) \\ &\quad = \sum_{k=1}^{N} \binom{N}{k} F(s_0)^k (1 - F(s_0))^{N-k} \\ &\qquad \cdot \left[\mathbb{1}(\phi(s_D, k) \geq s_0) + \mathbb{1}(\phi(s_D, k) < s_0) \frac{1 - (1 - F(\phi(s_D, k)))^k}{1 - (1 - F(s_0))^k} \right],\end{aligned} \tag{20}$$

where $\mathbb{1}(\cdot)$ denotes indicator functions. Note that $\phi(s_D, k)$ is a decreasing function of s_D.

The final step to obtain the unconditional probability is to integrate over s_D. Let G denote the cumulative distribution function of s_D, then the probability of auction success, denoted as α, is

$$\alpha = \sum_{k=1}^{N} \binom{N}{k} F(s_0)^k (1 - F(s_0))^{N-k} \cdot \int_0^\infty \left[\mathbb{1}(\phi(s_D, k) \geq s_0) + \mathbb{1}(\phi(s_D, k) < s_0) \frac{1 - (1 - F(\phi(s_D, k)))^k}{1 - (1 - F(s_0))^k} \right] dG(s_D). \quad (21)$$

The function $\phi(s_D, k)$ is decreasing in s_D, so $\phi(s_D, k) \geq s_0$ if and only if $s_D \leq \zeta(s_0)$, for some function $\zeta(s_0)$ that is decreasing in s_0.[14] Then we can write the auction success probability as:

$$\alpha = \sum_{k=1}^{N} \binom{N}{k} F(s_0)^k (1 - F(s_0))^{N-k} \underbrace{\left[\int_0^{\zeta(s_0)} g(s_D) ds_D + \int_{\zeta(s_0)}^\infty \frac{1 - (1 - F(\phi(s_D, k)))^k}{1 - (1 - F(s_0))^k} g(s_D) ds_D \right]}_{:= H_k(s_0)}. \quad (22)$$

Based on equation (22), we have the following proposition:

Proposition 1. *If γ is sufficiently high, a small increase of entry fee from zero raises the probability that the auction succeeds.*

The proof of this proposition is provided in the Appendix.

This proposition shows that, in the face of information leakage, an entry fee can be an effective mechanism to encourage potential bidders to self-select whether to enter an auction or not so that the probability of a successful auction is maximized from the CCP's point of view. To our knowledge this is a novel mechanism. Many CCPs require potential auction participants to incur ex ante costs, for example by participating in default exercises ex ante, which could be viewed as an entry fee, but such implicit entry fees do not help the CCP maximize the probability it avoids needing to use its skin in the game or non-defaulters' resources.

The advantage of the entry fee mechanism developed here is that it is effective with low information requirements. In particular, the CCP does not need to know the complete positions of each potential bidder. If it did, a more efficient mechanism likely could be constructed. But without such information, the entry fee mechanism avoids the CCP needing to use its own judgment on who to invite and subsequently being open to criticism for its, like Nasdaq Nordic faced, after the auction.[15]

[14] Concretely, we have

$$\zeta(s_0) = \frac{-\gamma(k-1)^Q - 2\beta s_0 + \sqrt{\left[\gamma(k-1)^Q + 2\beta s_0\right]^2 + 4\beta(R + ke)}}{2\beta} > 0,$$

and thus

$$\frac{d\zeta(s_0)}{ds_0} = -1 + \frac{\gamma(k-1)^Q + 2\beta s_0}{\sqrt{\left[\gamma(k-1)^Q + 2\beta s_0\right]^2 + 4\beta(R + ke)}} < 0.$$

[15] Such criticism was reported in Clancy (2018b) and Mourselas (2019).

It should be clear that the result depends on an assessment of how costly information leakage will be. The model of information leakage cost is simple, but the key characteristic is that private values decrease as the number of participants increases. This characteristic seems intuitive and the results are likely to hold for other models of information leakage that maintain this feature.

The dependence on the cost of information leakage does, however, imply that whether or not an entry fee is an effective mechanism may vary from CCP to CCP. For example, CCPs clearing exchange traded products might be less concerned about information leakage; more generally, information leakage costs are likely higher in less liquid markets.[16] But ignoring the potential impact of information leakage, and the consequent difficult question of who to invite to a default auction, would be inconsistent with CPMI-IOSCO (2020), where the regulators devote significant attention to these issues.

6 Numerical Example

We present a numerical example to demonstrate Proposition 1. Without loss of generality, we assume that s_D and $\{s_j\}$ follow the same probability distribution, i.e., $F = G$. In addition, we set F to be Laplace, i.e., the probability density function such that for $\lambda > 0$ and $x \in (-\infty, \infty)$,

$$f(x) = \frac{1}{2}\lambda e^{-\lambda|x|} = \begin{cases} \frac{1}{2}\lambda e^{-\lambda x}, \ x \geq 0 \\ \frac{1}{2}\lambda e^{\lambda x}, \ x < 0 \end{cases}. \tag{23}$$

The algorithm for numerically calculating the probability of auction success as a function of e is as follows:

- Set $R = 1$, $\beta = 0.1$, $\gamma = 0.5$, $N = 10$, $Q = 2$, and $\lambda = 1$.
- Pick a non-negative e. We choose the grid such that $e \in [0,\ 0.01,\ 0.02,\ ...,\ 0.99,\ 1]$.
- Numerically solve for s_0 from equation (12).[17]
- Draw s_1, s_2, ..., s_N independently from F (the Laplace above). The number K is set to be the number of bidders whose inventory level s_j is lower than s_0 we have just solved. These bidders enter the auction and pay e. Set $s_{\min}$ to be the lowest inventory of those bidders who enter.
- Draw s_D from the same distribution F.

[16] The impact of market liquidity is also apparent in the analysis of transaction costs on CCP hedging strategies during a close-out in Cerezetti et al. (2019) and in the general price impact of large trades even in liquid equity markets (Bouchaud et al., 2009, Eisler et al., 2012).

[17] By plugging the Laplace density (23) into equation (12), solving that equation is equivalent to solving the following equation:

$$\begin{aligned} e = (1 - F(s_0))^{N-1} \Big[& \beta s_0 e^a (a-1) - 2\beta + \frac{1}{2}\beta e^a (a^2 - 2a + 2) + \frac{1}{2}(R+e)(1 - e^a) \\ & + \beta s_0 e^{-b}(b+1) + \frac{1}{2}\beta e^{-b}(b^2 + 2b + 2) + \frac{1}{2}(R+e)(1 - e^{-b}) \Big], \end{aligned}$$

where

$$a = \frac{-2\beta s_0 - \sqrt{4\beta^2 s_0^2 + 4\beta(R+e)}}{2\beta}, \quad \text{and} \quad b = \frac{-2\beta s_0 + \sqrt{4\beta^2 s_0^2 + 4\beta(R+e)}}{2\beta}.$$

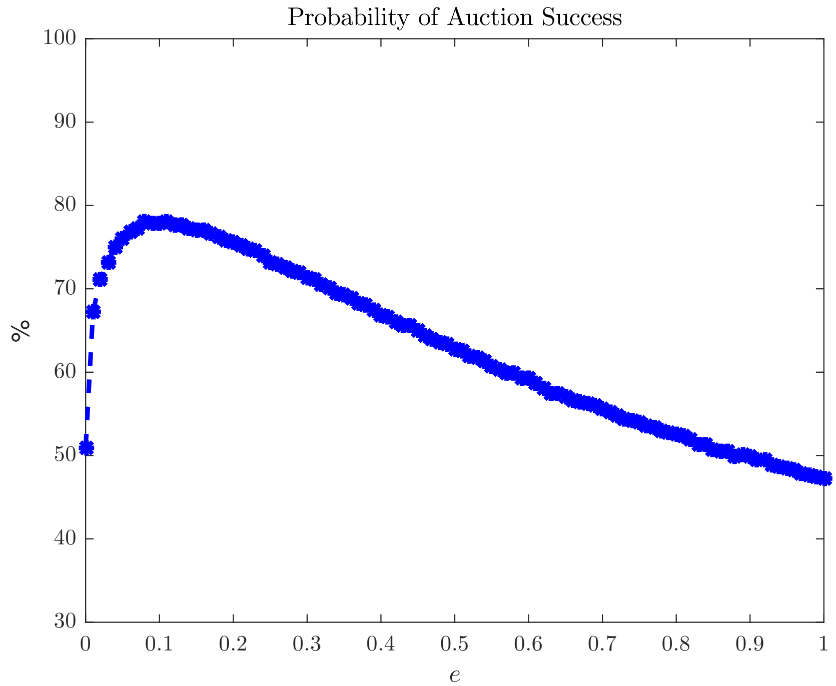

Figure 3: This figure illustrates the probability of auction success as a function of the entry fee e. Parameter values: $R = 1$, $\beta = 0.1$, $\gamma = 0.5$, $N = 10$, $Q = 2$, $\lambda = 1$.

- Check if both inequalities in $\text{Prob}(\cdot)$ in expression (15) hold. If both of them hold, then the auction is successful. Otherwise, it fails.
- Repeat the aforementioned three steps multiple times, set to be 100,000 times, to obtain the probability of auction success for each e.
- Plot the probability of auction success as a function of e.

The numerical result is shown in Figure 3. Clearly, if the entry fee e increases a bit from zero, the probability that the auction succeeds increases. This confirms our idea that imposing a positive entry fee is an effective mechanism for CCP default auctions through endogenizing potential bidders' entry decisions.

7 Conclusion

CCP default auctions are critically important. A CCP's main task is managing its risk such that a default does not spread. It is nearly a tautology to say that if a default auction is successful, the CCP's risk management is successful. Conversely, as suggested by Clancy (2018a), an unsuccessful default auction can cast doubt not only on the individual CCP but on central clearing more broadly. Nevertheless, CCP default auctions have received little attention in the literature.

We have addressed several unique aspects of CCP default auctions. First, that revenue maximization is not a reasonable objective for CCPs. Second, that one of the most common and fundamental questions CCPs face is who to include in the auction. Third, we have explicitly, albeit simply, modeled information leakage. These characteristics taken together result in a highly non-standard auction problem.

As a result, the reserve price and the entry fee perform differently in our framework. The impact of this is that a positive entry fee can be optimal precisely because of its effect on endogenous entry decisions. To the authors' knowledge, this result is novel. It focuses attention on the key question of how CCPs decide which market participants to invite to an auction, and provides an effective mechanism for resolving it.

There are other characteristics of CCP default auctions that we have not modeled. For example, we have assumed that all participants are clearing members, thus ignoring the question of whether it would be advantageous to invite clients or others to bid. Although, clients are formally excluded, clearing members are modeled rather generally, suggesting that the results likely could incorporate client in a similar way. In that sense, the entry fee mechanism may be even more useful as it may be able to effectively sort both clearing members and clients into participants and non-participants. Other characteristics, like the cost of preparing a bid, whether and how to split up the defaulting positions, the impact of hedging, or the chance for a limited number of participants to collude are not addressed. Hopefully, the model presented here, which incorporates some of the most unique characteristics of CCP auctions, will encourage more of these nuances to be addressed.

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Appendix

A Proof of Proposition 1

Proof. We want to show that if we increase e from 0 to something positive, then α increases. Equivalently, we can show that α is decreasing in s_0 for sufficiently large s_0, i.e., if we reduce s_0 from ∞ to something smaller, α increases.

We repeat equation (22), which specifies the auction success probability, here for convenience,

$$\alpha = \sum_{k=1}^{N} \binom{N}{k} F(s_0)^k (1-F(s_0))^{N-k} \underbrace{\left[\int_0^{\zeta(s_0)} g(s_D)ds_D + \int_{\zeta(s_0)}^{\infty} \frac{1-(1-F(\phi(s_D,k)))^k}{1-(1-F(s_0))^k} g(s_D)ds_D \right]}_{:= H_k(s_0)}.$$

Taking the derivative with respect to s_0, we have

$$\begin{aligned} \frac{d\alpha}{ds_0} =& F(s_0)^N H_N'(s_0) + NF(s_0)^{N-1} f(s_0) H_N(s_0) + NF(s_0)^{N-1}(1-F(s_0))H_{N-1}'(s_0) \\ &+ [N(N-1)F(s_0)^{N-2}(1-F(s_0)) - NF(s_0)^{N-1}] f(s_0) H_{N-1}(s_0) \\ &+ \sum_{k=1}^{N-2} \binom{N}{k} F(s_0)^k (1-F(s_0))^{N-k} H_k'(s_0) \\ &+ \sum_{k=1}^{N-2} \binom{N}{k} [kF(s_0)^{k-1}(1-F(s_0))^{N-k} - (N-k)F(s_0)^k(1-F(s_0))^{N-k-1}] f(s_0) H_k(s_0). \end{aligned} \tag{24}$$

We can show that

$$H_k'(s_0) = -\frac{k(1-F(s_0))^{k-1}}{[1-(1-F(s_0))^k]^2} f(s_0) \int_{\zeta(s_0)}^{\infty} [1-(1-F(\phi(s_D,k)))^k] g(s_D)ds_D < 0. \tag{25}$$

Therefore, to show that $d\alpha/ds_0$ is negative as s_0 is sufficiently large, it is sufficient to show that all terms not involving $H_k'(s_0)$ are negative, i.e., we want to show that

$$\begin{aligned} 0 > f(s_0) \Bigg[& NF(s_0)^{N-1} H_N(s_0) - NF(s_0)^{N-1} H_{N-1}(s_0) + N(N-1)F(s_0)^{N-2}(1-F(s_0))H_{N-1}(s_0) \\ & + \sum_{k=1}^{N-2} \binom{N}{k} [kF(s_0)^{k-1}(1-F(s_0))^{N-k} - (N-k)F(s_0)^k (1-F(s_0))^{N-k-1}] H_k(s_0) \Bigg] \end{aligned} \tag{26}$$

for sufficiently large s_0. Because density $f(s_0)$ is positive, we only need to show that the term within the square bracket is negative. But note that as s_0 becomes large, $(1-F(s_0))^{N-k}$ and $(1-F(s_0))^{N-k-1}$ both go to zero. So the sufficient condition for $d\alpha/ds_0$ becomes that

$$\lim_{s_0 \to \infty} [H_{N-1}(s_0) - H_N(s_0)] > 0. \tag{27}$$

As $s_0 \to \infty$, we have $\zeta(s_0) \downarrow 0$, so the sufficient condition is that

$$\int_0^{\infty} (1-F(\phi(s_D,N)))^N g(s_D)ds_D > \int_0^{\infty} (1-F(\phi(s_D,N-1)))^{N-1} g(s_D)ds_D. \tag{28}$$

The sufficient condition for the above condition is that

$$\Gamma(k) \equiv \int_0^\infty (1 - F(\phi(s_D, k)))^k g(s_D) ds_D \tag{29}$$

is strictly increasing in k. Ignoring the integral constraint on k and treating it as a real number, a sufficient condition is that $\Gamma'(k) > 0$ for $k \in [N-1, N]$. At $e = 0$, we need

$$\begin{aligned} 0 < \Gamma'(k) = &\int_0^\infty [1 - F(\phi(s_D, k))]^k \ln[1 - F(\phi(s_D, k))] g(s_D) ds_D \\ &+ \frac{\gamma k Q (k-1)^{Q-1}}{2\beta} \int_0^\infty [1 - F(\phi(s_D, k))]^{k-1} f(\phi(s_D, k)) g(s_D) ds_D, \end{aligned} \tag{30}$$

that is,

$$\frac{kQ(k-1)^{Q-1}}{2\beta}\gamma > \frac{-\int_0^\infty [1 - F(\phi(s_D, k))]^k \ln[1 - F(\phi(s_D, k))] g(s_D) ds_D}{\int_0^\infty [1 - F(\phi(s_D, k))]^{k-1} f(\phi(s_D, k)) g(s_D) ds_D}. \tag{31}$$

Note that the left-hand side goes to ∞ as γ becomes large. On the right-hand side, the term $-[1 - F(\phi(s_D, k))]^k \ln[1 - F(\phi(s_D, k))]$ in the numerator is bounded above regardless of γ; label this upper bound $M_k > 0$. For the denominator, we want a lower bound. Choose an ϵ independent of k. Then

$$\begin{aligned} \int_0^\infty [1 - F(\phi(s_D, k))]^{k-1} f(\phi(s_D, k)) g(s_D) ds_D &> \int_0^\epsilon [1 - F(\phi(s_D, k))]^{k-1} f(\phi(s_D, k)) g(s_D) ds_D \\ &> [\min_{x \in [0, \epsilon]} f(x)] \int_0^\epsilon [1 - F(\phi(s_D, k))]^{k-1} g(s_D) ds_D. \end{aligned} \tag{32}$$

Note that as $\gamma \to \infty$, $\phi(s_D, k) \to -\infty$. Thus, there exists an $\epsilon' < \epsilon$ and $\bar{\gamma}$ such that for all $\gamma > \bar{\gamma}$, $s_D \in [\epsilon', \epsilon]$, and $k \in [N-1, N]$, $(1 - F(\phi(s_D, k)))^{k-1} > 1/2$. So the lower bound of the denominator becomes

$$[\min_{x \in [0, \epsilon]} f(x)] \int_{\epsilon'}^\epsilon \frac{1}{2} g(s_D) ds_D. \tag{33}$$

The required inequality becomes

$$\frac{kQ(k-1)^{Q-1}}{2\beta}\gamma > \frac{\max_{k \in [N-1, N]} M_k}{[\min_{x \in [0, \epsilon]} f(x)] \int_{\epsilon'}^\epsilon \frac{1}{2} g(s_D) ds_D}, \tag{34}$$

which holds for sufficiently large γ. □