

Default Management Best Practices



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1. Introduction & purpose

The purpose of this Default Management Best Practices document (“document”) is to support LME Clear Members by providing best practice observations for client default management. This document may be used by Members to benchmark their current practices and assist in determining how to best manage client defaults in a manner appropriate to their own circumstances.

This document has been compiled based on the responses to our questionnaires and subsequent Member engagements conducted in the second quarter of 2024, in relation to Member client default management procedures. Based on our observations, it summarises the best practices adopted in default management across the market.

This document is intended to assist Members in complying with Rule 3, 3.2 Ongoing Membership Requirements, and serves as a reference to support Members in assessing and enhancing their default management framework.

If a Member would like to discuss and/or clarify these best practice observations, please contact your LME Clear relationship manager or risk manager in the first instance.



2. Default management best practices

Establishing a robust default management framework, with clearly documented procedures may assist with the identification, mitigation, and resolution of client defaults.

2.1. Detection of emerging default risk

Effective default management generally begins with a timely identification of emerging default risk. Members are expected to adopt a structured, proactive approach to monitoring client exposures and behaviours, including:

- performing ongoing surveillance at both client and product levels through monitoring market indicators (e.g. CDS spreads, share prices), external credit ratings, covenant compliance and adverse news, in addition to conducting periodic reviews of client risk profiles;
- maintaining a client watchlist whereby clients exhibiting early warning signs are flagged and added to the watchlist;
- deploying real-time monitoring systems to assess clients' information such as margin coverage, net liquidation values, stress loss estimates, collateral sufficiency, delivery positions and payment obligations;
- compiling aged margin call reports, detailing all outstanding margin calls, age in days and actions taken to resolve the calls;
- predefining both mandatory triggers (e.g. limit breaches, missed margin calls) and judgment-based triggers (e.g. significant deterioration in creditworthiness, abnormal trading behaviours).

Having clearly defined procedures in place will also assist in managing margin calls. Any margin calls issued are expected to be addressed on the same day or within a reasonably short timeframe, subject to Members' risk appetite and internal arrangements. Repeated late margin calls within a defined period should trigger alerts, and it is important to establish systems to detect any changes in trading behaviours or collateral usage from established norms.

2.2. Responses to imminent default risk

A rapid and coordinated response to the risk of a client default enables Members to mitigate against potential financial and operational impacts. Upon confirmation of distress indicators and/or triggers such as payment failure, a formal assessment of default risk and potential implementation of protective measures are generally initiated. This includes, at least:

- assessing the materiality of default risks to determine the level of escalation and intervention;
- promptly engaging with the client to verify the status of outstanding obligations, obtain explanations for any delays and, where possible, request formal confirmation of any payments made, such as evidence of SWIFT payments;
- providing timely notification to the LME in accordance with the Member Guidance on Notification Requirement and/or other applicable central counterparties (CCPs) regarding a potential or actual client default.

In this scenario, consideration is given as to whether interim controls should also be applied upon identification of a potential client default to prevent the accumulation of additional risk. These controls include:

- restricting the client's trading activities, e.g. liquidation-only or risk-reducing trading restrictions;
- reducing the client's credit limit and/or positions;
- suspending the client access to trading systems;
- applying additional haircuts to collateral valuations.

Governance processes usually define clear responsibilities which ensures effective default management and timely decision-making. It is therefore important to have clearly defined internal escalation protocols with designated points of contact across all units (e.g. legal, risk, operations, business, senior management). Specific triggers and prescribed deadlines can be set for convening a Default Management Committee ("DMC"), or any equivalent panel / working group serving a same function, which is vested with appropriately



delegated authority to assume overall responsibility for the default management process and related strategic decision-making. Some additional key practical considerations include:

- having a standardised reporting template to ensure that aged margin calls and other critical risk indicators are promptly brought to the attention of senior risk and business management;
- outlining key stages of the default management process and stakeholders, which may be presented in a process-flow diagram, to enhance clarity;
- compiling a comprehensive executable runbook that, for each stage of the default process, specifies the trigger events, required actions, and measurable completion milestones (such as convening default management meetings, notifying clients of default, as well as initiating hedge meetings).

Roles and responsibilities should be clearly delineated across all functions involved in the default management process, for example:

- A credit risk team plays a central role in managing default situations, serving the lead coordinator throughout the default management process to align the risk management efforts across relevant departments and stakeholders
- A legal team reviews all relevant documentations Members have in place with the client and advise on the scope of Members' legal rights and remedies available under the circumstances.
- A market risk team conducts exposure analysis and formulates appropriate close-out strategies.
- An operation team provides support for collateral management and executes tasks throughout the default management process.

2.3. Liquidation of client portfolio once default risk materialised

Once it becomes evident that a client's distressed situation cannot be resolved, the DMC can be convened to assist Members to make decisive actions, to mitigate potential losses and contain any broader impacts. These actions may include:

- assessing the situation and determine whether to issue a default notification;
- deciding whether a close-out process should be formally initiated to terminate transactions with the related client;
- identifying the most appropriate strategies to manage the exposure, such as hedging any outright exposures, portfolio sale and/or liquidation;
- evaluating financial and operational impacts to capital and liquidity arising from the close-out, e.g. evaluating the need for impairment recognition, capital deductions, or provisioning, depending on the size and nature of related exposure.

Prior to any formal client default declarations, Members usually consult their legal team to confirm that a contractual default has occurred.

To minimise market disruption, the close-out of a client portfolio should be executed in a timely and orderly manner. To ensure a consistent and smooth execution, clearly documented close-out procedures outline the key steps involved. Upon declaration of client default:

- impacted clients are notified of the default decision;
- client's credit and position limits are set to zero;
- any give-up agreements are terminated;
- connections to CCPs are closed to prevent further trading activities;
- a trading desk will assess hedging costs and price the defaulted portfolio to optimize recovery.

The liquidation strategy should take into consideration the type and location of collateral, including whether it is held at the Member or a custodian. Operations and legal teams maintain records of the collateral status relating to the enforceability of the security and can indicate when to initiate liquidation. Legal and risk teams review the appropriate close-out steps, including tracking and collecting recoveries, returning excess collateral or charging close-out fees from clients to cover any remaining loss.



2.4. Default management fire drills

Preparing and regularly performing a default management fire drill is an important tool to evaluate the effectiveness of existing procedures and to ensure operational readiness across all relevant units in the event of an actual default. A well-structured framework will include:

- conducting default management fire drills at least annually, with full involvement from all relevant teams to simulate realistic decision-making process and cross-functional coordination;
- incorporating a variety of scenarios, such as single-entity failure, multi-entity stress, cross-border default;
- tracking key metrics during the fire drills, such as response times, communication efficiency, and adherence to escalation and governance protocols;
- documenting lessons learned, followed up by timely updates to internal procedures to reflect improvements and address any identified gaps.

3. Conclusion

Client defaults can result from multiple scenarios and are sometimes difficult to predict. This document provides a guide through some generic default management principles considered across the market.

It is the responsibility of Members to have well-defined and tested default management procedures in place to address any potential client default situations.

This document does not impose any legal or regulatory obligations on Members, and neither does it take the place of any existing regulation. In the event of any inconsistency between this document and applicable law, rules, and regulation, the applicable law, rules, and regulation will prevail.