Energy Traders Europe's response to the CPMI–IOSCO discussion paper "Streamlining variation margin in centrally cleared markets – examples of effective practices"

Overarching questions

1. **Do you agree that the eight effective practices identified in this report foster market participants' preparedness for above–average VM calls through the efficient collection and distribution of VM in centrally cleared markets?**

Energy Traders Europe members, the majority of whom are clients of Clearing Members (CMs) when acting on centrally cleared commodity markets, and in rare exceptions act as CMs themselves, welcome the proposed practices which are consistent with what was asked for in previous consultations. Energy Traders Europe had, indeed, already expressed the strong wish for both central counterparties (CCPs) and CMs to calculate any margin requirements, may it be initial margin (IM) or variation margin (VM) more transparent and make more efforts to assist clients of CMs, by increasing the ability to predict VM calls.

Higher governance is necessary to find proper alternatives to the issuance of – unscheduled – intraday (ITD) ad hoc VM calls within a business day. This is particularly true in situations where the applied IM parameters are not adequate to cover the observed market, in the event of extreme price spikes during a specific trading day. CCPs issue those extraordinary VM calls to CMs which in most cases forward them 1:1 to their clients. Market participants, therefore, incur serious operational issues in responding to those calls, especially due to the magnitude of the amounts and the related very short payment deadlines. Additionally, market participants depend on the ability of their commercial banks to meet those extraordinary VM calls.

The application and forwarding of those ITD ad hoc VM calls are also questionable given that the extreme price movement, observed within the first hours of trading, may go in the other direction by the close of business. In this case, the extraordinary VM calls create unnecessary pressure on cash liquidity management for CM and their clients.

CCPs need the discretion to raise margins during stressed periods to ensure they do not have uncollateralied risk; similarly, CMs increasingly deploy the ability to pass–through multiple ITD ad hoc VM calls to ensure that the risk that they are guaranteeing is adequately covered. Those intraday ad hoc VM calls create specific pressure on cash liquidity planning and sourcing, especially for non–financial institutions. They depend on the credit lines granted by their commercial banks for what concerns the amount, especially considering

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the very short deadline to transfer the margin (~ 2 hours). Generally, market participants prefer scheduled intraday VM calls, as these are easier to predict, at least in terms of timing.

Nevertheless, given the possibility that a CCP makes unscheduled calls, guidelines should be also published which explain the conditions under which extraordinary VM calls are made and whether those are made across all participants or for specific participants only. In general, for scheduled and ITD ad hoc VM calls, CCPs should provide near–real–time transparency about the accumulated risk and the call thresholds to each participant, so that all participants can anticipate the size of intraday VM and/or IM calls.

Providing market participants with sufficient time can help with liquidity management. A notice period to meet ITD VM calls should be part of a CCP policy on ITD VM, developed in consultation with clearing participants. We however note that the time between margin call and payment cannot be too long, otherwise the CCP would not be sufficiently covered against risk.

2. **Are there any other effective practices, mechanisms or changes that would streamline VM processes in centrally cleared markets which have not been covered in this report? If so, please describe such practices.**

In the commodity and energy centrally cleared environment, cash remains the main collateral form that CM clients use to post VM calls. The experience made in centrally cleared markets in commodity area is that under normal market conditions, margin calls made by CCP and passed through by CM to their clients follow a clear schedule defined in the rules of the CCP and in the clearing services agreements made between the CMs and their clients.

In most cases and for all major CCPs:

- VM calls are issued in the morning of a specific Business Day (BD), based on an EoD margin calculation of the previous business day (BD–1) and are due by the Clients on the same day (BD) around lunchtime. Therefore a few hours after CMs have delivered themselves the margin due to the CCP (in the morning of that BD).
- VM calculations (credit or debit) are netted against any other type of cash flow expected on the same BD, e.g. IM adjustments due to positions or parameter changes, settlements, fees, or any other rebates.

The most common practice is to proceed with netting of margin cash flow per currency, but some CMs even offer margin accounts and related requirements consolidated into one single base currency which means even a cross–currency netting of daily margin requirements and other cash flow.

As indicated in the results of the survey, CCPs highlighted that their legal frameworks were quite different and, because of some regulations, CCPs either are not required (and therefore may be unable) to distinguish between client and house accounts or are prohibited from netting VM requirements between a CM's house and client accounts. Some CCPs cite operational barriers to distinguish between CMs' house and client flows.

Knowing this, the margin collected from the CMs and passed through to the CCP may result in an excess of collateral held by the CCPs or the CMs. In the case of elevated volatility, the excess of collateral held at any level could be used to cover unexpected observed risks and therefore prevent the issuance of ITD ad hoc VM calls and, at the same time, avoid unnecessary pressure made on liquidity sourcing and planning for Clients of CMs.

Effective practices

3. For each effective practice identified in this report:

a. Do you agree that it is an effective practice?

Energy Traders Europe's members believe that among the eight practices identified in this report, most of them are certainly effective to foster market participants' preparedness via higher predictability for above–average VM calls through the efficient collection and distribution of VM in centrally cleared markets.

In particular, we considered effective the following ones:

- Increased transparency and predictability about ITD Margin Calls;
- Sufficient time on ITD Calls payments;
- Offsetting of VM Calls with other payment flows;
- Pass–through of VM;
- Information regarding the CCP's processes and timing for ITD VM calls;
- Feedback on the CCP's VM practices from its participants;
- Transparency to clients regarding the CM's processes and timing of ITD VM calls;

We see also the necessity to increase transparency and increase usage of excess collateral for ITD VM obligations and we will further explain the details of our requests in the answers below.

b. What are the pros and cons (including unintended consequences) of the effective practice?

Increased transparency and predictability about ITD Margin Calls

This practice could, indeed, help Clearing Members (CMs) to better arrange for frameworks with their clients on how to provide payments or other collateral and to lower overall funding costs and/or pressure on liquidity planning and sourcing.

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Altogether, the number of ITD calls could increase though – at least for the CMs – leading to more workload which might offset funding benefits.

Sufficient time on ITD Calls payments

Funding deadlines are crucial, especially in stressed market conditions. Particularly, as CMs tend to pass on calls to clients, less pressure on CMs would result in less burden for clients and, therefore, more flexible solutions.

Maximum use of netting with other cash flows and more effective collateral excess should be applied by CCP and CMs to reduce pressure on liquidity, especially when ITD ad hoc calls are scheduled due to elevated price volatility. In that situation, in fact, the client of CMs may have to respond to sudden multiple VM calls within a day without receiving any ITD return if the price direction changes during a specific business day. We believe that the full potential of netting with excess collateral e.g. IM or other expected cash flow should be looked at and applied by the CCPs and the CMs.

Offsetting of VM Calls with other payment flows

Energy Traders Europe members believe that offsetting VM Calls with other payment flows might cause fewer monetary bookings between CMs and CCPs and thus optimise CMs funding costs towards their clients. Additionally, this practice might also be effective in beneficially offsetting scheduled ITD calls.

Pass–through of VM

Pass–through of VM is a key requirement for both CMs and Clients to get relief on liquidity pressure resulting from their commodity trading positions.
This will be particularly effective in very volatile market conditions where prices surge in the morning but then in the afternoon, in line with the opening of the oversea markets, might drop down. In these conditions, CMs see a high rate of cash outflows whereas the "refund" only happens the next day. Because CMs pass on calls to clients, these latter can find themselves in a particularly critical situation, which may involve significant funding costs.

Excess collateral for ITD VM obligations

As previously stated, we are not completely sure about the effectiveness of this practice. Where feasible and if regulation allows, we agree that CCPs should certainly gain more freedom in using excess collateral. However, as noted and as commonly known in the market, major stakes of collateral are pledged as non–cash collateral means.

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It should be addressed if certain positions can be used as a “guarantee" for outstanding margin calls and thus buffer liquidity stress.

Information regarding the CCP’s processes and timing for ITD VM calls

As already broadly remarked by Energy Traders Europe members, a major increase in transparency about CCP processes, in particular when affecting Clients of CMs via any kind of pass–through arrangements, is needed.

Feedback on the CCP’s VM practices from its participants

Where appropriate, market representatives should be consulted to get further insights. In addition, any changes to the market environments will lead to a change in how clients and CMs look at certain aspects (e.g.: similarly to what happened with the need to better understand Initial Margin setups).

As clients of CMs, we would be glad to attend and support existing or newly created user discussion forums and to support the development of solutions on more effective margin practices. Those latter should indeed aim at imposing a limited burden for CCP and CM and at mitigating cash liquidity risks arising from short-term extraordinary margin calls. This can be done by improving existing tools, designing new functionalities enriched with CMs Client aggregated information in order that CCP data is broken down to client data level.

Transparency to clients regarding the CM’s processes and timing of ITD VM calls

Due to the lack of common frameworks/agreements based on which CMs and their Clients operate, as Energy Traders Europe we do believe that Clients must have access to any measures which may help them with the fulfillment of their business obligations towards CMs.

The design of simulators should also consider that simulators will be used by different functions/departments. Different departments will have different requirements: For instance, the Operations department wants to see payments, the Treasury wants to anticipate liquidity requirements and Risk Management is interested in stress results. We however believe that functionality to anticipate liquidity requirements is relevant for all the above departments and is therefore absolutely key.

User–friendliness is paramount. Explanations within the tool of the different components of Margin (at the close of business and Intra–day), including margin, additional CCP Margin Components and their triggers.

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The simulator has a key purpose to help the prediction of possible outcomes liquidity–wise and to help the user understand margining (COB and Intra–day). Simulators should be provided via APIs, as this would allow firms to generate a fuller picture of shocks stemming from several CCPs and be able to combine these simulators with their margin simulators or dedicated VM call forecast calculation.

c. Please discuss any drawbacks or hurdles to implementing the effective practice.

Increased transparency and predictability about ITD Margin Calls

As Energy Traders Europe, we believe that issuing regulatory guidance for Clearing Houses (CHs) is necessary. This will facilitate the implementation of that effective practice while allowing the fulfilment of their obligation to secure sufficient risk coverage. Increased scheduled calls should be accompanied by lower ad–hoc calls. Consequently, for the practice to be fully effective, the aforementioned guidance needs to highlight the maximum number of ad–hoc calls "allowed" during a tighter scheduled framework.

Sufficient time on ITD Calls payments

According to our opinion, longer payment deadlines would, theoretically, expose CCPs from more short term (minutes to hours) to uncovered risk exposure, provided that outstanding margin calls also exceed excess collateral provided by the CMs.

Offsetting of VM Calls with other payment flows

To be fully effective, we believe that this practice requires an in–depth analysis as well as a well–designed framework which will allow alignment between different products and booking categories.

Pass–through of VM

In line with other proposals on effective practices (e.g. more scheduled calls and more lead time of payment requirements) CCPs might be unable to pass through – positive – VM payments to respective CMs given that they might still wait for other CMs to make underlying payments. We, therefore, believe that the regulation should lay down that CCPs have to pay out in advance which would, overall, make them under–secured.
Additionally, CCPs should also not be obliged to transform collaterals or other assets to provide pass–through VM to CMs. This practice might, in fact, lead to scenarios where CCPs can't fully pay VMs but would need to do so on pro–rata basis.

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Information regarding the CCP’s processes and timing for ITD VM calls

We don't see as an issue the request for higher degrees of documentation and publication of procedures, given that those same are certainly already documented within each CCP.

Transparency to clients regarding the CM’s processes and timing of ITD VM calls

Many Clients already have bilateral clearing service agreements in place with their CMs to address various aspects of cash flow netting, margin schedules and payment deadlines, collateral transformation, and other tools to mitigate the risks and burdens out of cleared positions.

d. Are there better, more efficient, more cost–effective alternatives to the effective practices?

As indicated above Energy Traders Europe members are happy to support existing or newly created user discussion forums in cooperation with CCPs and CMs to make sure that best practices around netting of cash flows, usage of collateral excess or solution for non–cash collateral can be developed as a market standard to best respond to the demand on more effective margin practices.

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