CPMI-IOSCO PAPER ON STREAMLINING VARIATION MARGIN IN CENTRALLY CLEARED MARKETS – EXAMPLES OF EFFECTIVE PRACTICES

LSEG RESPONSE TO THE CPMI-IOSCO PAPER ON STREAMLINING VARIATION MARGIN IN CENTRALLY CLEARED MARKETS – EXAMPLES OF EFFECTIVE PRACTICES

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Introduction

LSEG (London Stock Exchange Group) is a diversified global financial markets infrastructure and data business, headquartered in London, with significant operations in Europe, North America, and Asia. With extensive experience, deep knowledge and worldwide presence across financial markets, we enable businesses and economies around the world to fund innovation, manage risk and create jobs. At LSEG, we help to drive financial stability, empower economies and enable customers to create sustainable growth through three business divisions: data and analytics, capital markets and post-trade.

LSEG has majority ownership of the multi-asset global central counterparty clearing house ("CCP") operator, LCH Group ("LCH"). LCH has two licensed CCP subsidiaries – LCH Ltd in the UK and LCH S.A. in France. Both are leading multi-asset class and international clearing houses, serving major international exchanges and platforms as well as a range of OTC markets. They clear a broad range of asset classes, including securities, exchange-traded derivatives, commodities, foreign exchange derivatives, interest rate swaps, credit default swaps, Euro and Sterling denominated bonds and repos.

Executive summary

LSEG welcomes the opportunity to respond to CPMI-IOSCO paper on Streamlining variation margin in centrally cleared markets – examples of effective practices. We would like to make the following key observations:

- We support increased predictability of ITD margin calculation and collections to the extent practicable and follow that principle at LSEG when setting the CCPs' margin calls timings. Our margin calls are scheduled at set times during both quiet and stressed market conditions, to provide predictability not only to our members but to their clients as well. In addition, scheduled margin calls are useful for the CCP and its investment counterparts in understanding when there will be cash available for investment.
- We believe it is important to consider the regions and markets in which the CCP operates when setting timings to ensure that the likelihood of requiring an ad-hoc ITD VM is minimised, regardless of market conditions. As such it should be left to the CCP to determine the best way to do so, aligned with its risk management framework, products it clears and membership it serves.
- Whilst we agree with the effective practice for CCPs to assess the feasibility of passing through ITD VM, at LCH such assessment has been conducted several times over recent years and found to be unworkable. The multi-currency (19 currencies) nature of the markets LCH serves would mean that members/clients would need to have established Treasury operations in all those currencies to fully deploy such practice across all currencies.
- Excess collateral in any eligible currency, cash or non-cash, would be used to offset any ITD increase in liabilities in a given contractual currency.
- LCH provides all clearing members guidance on the timing and nature of ITD and EOD margin calls covering both IM and VM through member training, documentation, and rulebook provisions. We have also established mechanisms for obtaining feedback from clearing members on all aspects of the risk framework, including the VM practices. These include service specific risk working groups, collateral advisory group and default management groups all of which include clearing members' and meet regularly throughout the year.
- Although LCH only has a direct relationship to its clearing members (not end clients), we provide details of ITD and EOD VM margin requirements including timing and netting arrangements on the LCH client portal which is accessible to both clearing members and clients. In addition to this, the LCH rulebook, collateral haircuts and eligibility schedule is available freely on the LCH website to all.

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?

We agree with the eight effective practices identified in the report. At LCH, we apply all of the proposed practices; in relation to assessing the feasibility of VM passthrough, we ran that evaluation on different occasions over the years with the clear conclusion that it is inoperable, with any potential benefits heavily outweighed by the costs and drawbacks to members and the CCP. Notwithstanding the soundness of the listed effective practises, it is important to note that because CCPs operate in different markets/jurisdictions they should retain the flexibility to design their ITD margin call processes according to the products they clear and the specific market dynamics they serve.

In the section that follows we discuss each of those practices separately and where available we provide concrete examples of how those are currently implemented.

2. For each effective practice identified in this report:

a) **Do you agree that it is an effective practice?**
b) **What are the pros and cons (including unintended consequences) of the effective practice?**
c) **Please discuss any drawbacks or hurdles to implementing the effective practice.**
d) **Are there better, more efficient, more cost-effective alternatives to the effective practices? If so, please describe them.**

Effective practices

1. **Increasing the predictability of ITD margin calculations and collections to the extent practicable. This could be achieved by using, or increasing the frequency of, scheduled ITD margin calculations and collections where appropriate, after carefully considering the trade-off between the following:**
   a) **the increased operational burden associated with making more scheduled ITD calls, as well as the positive impact of using ad hoc calls when it is prudent; and**
   b) **the corresponding decrease in the probability of ad hoc ITD calls, as well as the positive impact on clearing members' operational readiness and financial capacity to meet the scheduled calls.**

2. **Giving participants sufficient time to manage the liquidity impact of an ITD call, while also considering the need to collect VM on a timely basis in order to mitigate the build-up of current exposures.**

3. **Where allowed, practical and efficient, offsetting VM calls against other payment obligations, such as initial margin calls and product payment flows (eg coupons), in order to reduce liquidity demands on participants.**

We are supportive of increased predictability of ITD margin calculation and collections to the extent practicable and follow that principle at LCH when setting the CCP's margin calls timings. Our margin calls are scheduled at set times, whether in a quiet or stressed market conditions, to provide predictability not only to our members but to their clients as well. In addition, scheduled margin calls are useful for the CCP and its investment counterparts in understanding when there will be cash available for investment. We support the paper's observations on the need to consider the trade-off between the number of ITD margin calculations and collections and operational burden. In this context, we find that it is important to consider the regions and markets in which the CCP operates when setting timings to ensure that the likelihood of requiring an ad-hoc ITD VM is minimised, regardless of market conditions.

There is not a 'one size fits all' model when assessing these trade-offs and scheduling ITD margin calculations and collections. The CCP should decide the best way to do so, aligned with its risk management framework, products it clears and membership it serves. At LCH, we also include member consultation as an input to our decisions to the greatest extent possible. With regards to the liquidity impact of ITD calls, at LCH CMs are expected to pay its margin calls within 60 min of a call being made. Such lead time has shown to be appropriate and sufficient in both calm and volatile times, with all margin calls having been met during recent stressed periods as e.g. 2020's Covid volatility or more recently 2022-2023 stressed markets conditions. ITD VM calls are scheduled several times a day, preventing the build-up of exposures. The time allowed to pay the ITD calls allows members to manage their liquidity. This was evidenced by the absence of missed calls in historically stressed environments. Importantly, delays in payment of margins calls beyond the 60 min are followed up promptly with the members and found to be driven by operational issues rather than liquidity management.

Finally, we support offsetting ITD VM calls against other payment obligations. At LCH intraday IM and VM calls are aggregated (with VM and IM called together), such that the aggregate increase in liability is called in each elected collateral currency and non-cash collateral can be used to meet ITD VM requirements.

4. **Reviewing its operational practices based on an evaluation of the feasibility and the pros and cons of passing through ITD VM to mitigate the liquidity impact of ITD calls on participants.**

Whilst we agree with the effective practice for CCPs to assess the feasibility of passing through ITD VM, at LCH such assessment has been conducted several times over the years and found to be unworkable. The multi-currency nature of the markets served by LCH is one of the many impediments to deploy VM passthrough ITD. Additionally, there are legal, funding and financial stability concerns that need to be considered both during BAU and stress periods which make pass through VM not practically possible; some of the operational challenges and negative impacts of a ITD VM passthrough are listed below:

- **Multi-currency CCP**: At LCH we settle VM pay-ins and pay-outs in currency of contracts as part of EOD cycle. However, ITD VM is called as a margin collateral requirement in each member's preferred collateral currency, with ability for that margin requirement be met either in cash or non-cash.
- **With regards to legal considerations**, those become explicit in some jurisdictions like the US, where Designated Clearing Organisation (DCO) cannot pass through customer property (client margin) unless it is a settlement proceed (i.e., it is the result of settle-to-market or

STM[1] – which occurs once per day as per market practice today). Setting up several settlement proceeds per day, with the involvement of all relevant infrastructures, would require all counterparties, including smaller members and all clients, to have the ability to manage those flows and reinvest the cash ITD, which can be a complex process to manage. It is noteworthy that all cleared customer OTC trades in the US have been STM since 2017.

- **Increased Liquidity Risk**:
  - *Members/Clients*: In the current model, VM is called intraday in one of three currencies (USD, EUR and GBP). Therefore LCH, its members and clients are only required to have intraday Treasury facilities in those currencies (even if they have cleared swap positions in the 19 other currencies). Further, in the current model the exposure to these intraday calls can be limited by pre-funding a buffer account. However, in a VM pass-through model the CCP would need to call in all VM amounts (in order to have enough funds in the correct currency to pay out on the other side). This would disallow netting and greatly increase gross cash movement by amount and by number. A VM pass-through is therefore likely to have a serious (negative) impact on a significant number of members and clients who do not have, or wish to have, full-scale Treasury operations in all regions at all times of day.
  - *CCP*: Under the existing arrangements, in a member's default scenario, the unmet calls on their account are not required to be met intraday (they effectively become unpaid receivables at the CCP). As long as VM is only called (not paid) there is no payment on the other side so no requirement for the CCP to raise cash intraday, only at the end of day. However, under a VM pass-through framework the CCP would be required to use the defaulter's collateral to raise cash in the relevant currencies to meet their intraday margin calls. This would be a significant extension of the CCP's current intraday cash management activities as would require significant amounts of cash/liquidity to be available across 19 currencies (vs currently 3 for intraday activity). The cost of these more demanding liquidity arrangements would need to be passed through to members and clients (see below)
- **Costs**: There will be additional transaction costs due to increased flows through settlement banks which would also lead to an increase in daily liquidity lines required, potentially used later in the day, increasing costs for the market.

5. Subject to agreement with the CM or client and where legally and operationally feasible, allowing the use of excess collateral to meet ITD VM obligations.

We have always supported and accommodated the use of excess collateral to meet ITD VM obligations. Intraday VM is called as a margin collateral requirement in the members preferred collateral currency and will utilise any collateral excess. Excess collateral in any currency, cash or non-cash would be used to offset any ITD increase in liabilities. If there is sufficient excess, it could eliminate the need for an ITD margin call. Alternatively, it could reduce the amount called.

6. Providing information regarding the CCP's processes and timing for ITD VM calls in order to facilitate its participants' ability to predict and manage liquidity requirements. This could be achieved by clearly defining and making available to participants (through the CCP's rulebook or other relevant documentation) the following:

[1]Where VM is treated as a settlement payment, upon payment of amounts due in respect of such VM, the outstanding exposure of the relevant contracts is discharged

a. **the circumstances and any related thresholds according to which the CCP may make ITD VM calls;**
b. **the timing and relevant notice periods for its ITD VM calls;**
c. **the CCP's processes and rules concerning the netting of payments across margin accounts for each type of margin call, where excess collateral can be used to meet VM requirements, and any other provisions which have an impact on the amounts to be called from CMs; and**
d. **granular information to help CMs understand the composition of VM calls, which may include items such as: a unique identifier to track the call across the CCP's systems, an indicator of whether the call relates to initial margin/variation margin/default fund/rights of assessment/other, a house/client account indicator, underlying unique portfolio/account identifiers, details of any offsets netted against other payments (such as other margin calls, securities deliveries and receipts or coupon payments), a breakdown of the calculation which sets out the individual elements comprising the total, the forms of eligible collateral or the quantity and forms of eligible excess collateral which may be used to satisfy the call, and details of the deadline(s) for meeting the call.**

LCH provides all clearing members with guidance on the timing and nature of ITD and EOD margin calls covering both IM and VM through member training, documentation, and rulebook provisions. Furthermore, detailed reporting is generated on all ITD and EOD margin runs providing a breakdown of the margin attribution.

The CCP retains the right to call for margin at its discretion at any point in time during the day however it is noteworthy that we have never invoke this right to this day. The individual clearing services will provide a schedule of their regular margin runs in their service description e.g. SwapClear having 3 Market Data Refresh (MDRs). The thresholds for ITD margin calls are not provided to the members.

For all ITD margin calls members have an hour to meet the call. Members are notified of the call once it is generated via email and the ITD reports. As not all members are called in every ITD margin run, there is no predictability of whether members will be called but that is of course a function of market movements which is beyond any CCP's control.

As stated previously, excess collateral will be used to cover ITD increase in liabilities and could eliminate or reduce the need to call for additional collateral ITD. Any netting of payments across margin accounts is indicated in the service description and would depend on the particular sub-account type.

The Banking reports do not provide details regarding the source of the ITD margin calls. However, depending on the clearing service their reporting could provide the breakdown between IM and VM but not the composition of the VM calls. The differentiation between house and client related calls is based on the collateral sub-account and is clearly visible to the members.

7. **Seeking feedback on the CCP's VM practices from its participants and other relevant stakeholders (eg through risk committees or other established mechanisms) in order to aid the CCP's assessment of the trade-off between managing its own risks and the interests of its participants**

LCH has a number of established mechanisms for obtaining feedback from clearing members on all aspects of the risk framework, including the VM practices. These include service specific risk working groups, collateral advisory group and default management groups all of which include clearing members' and meet up regularly throughout the year. In addition to this, the LCH Risk Committee consists of a selection of participants from the CCPs clearing membership.

8. **Providing transparency to clients regarding the CM's processes and timing of ITD VM calls, which may facilitate clients' ability to predict and manage liquidity requirements. This could be achieved by clearly defining and making available to clients details of the following aspects of the VM calls it issues:**
    a. **its practices and procedures for the calculation and collection/payout of VM;**
    b. **schedules for timely payment that its clients may be required to meet; and**
    c. **its rules and practices concerning:**
        i. **the usage and forms of excess collateral eligible for meeting VM calls;**
        ii. **acceptance and transformation of non-cash collateral for the purposes of meeting VM calls; and**
        iii. **netting arrangements across client accounts**

LCH has a direct relationship to its clearing members, but it does not have a direct relationship with the clients of its clearing members However, LCH does provide details of ITD and EOD VM margin requirements including timing and netting arrangements on the LCH client portal to which both clearing members and clients have access. In addition to this, the LCH rulebook, collateral haircuts and eligibility schedule is available freely on the LCH website to all.

3. 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.

We do not believe there are other effective practices, mechanisms or changes that would streamline VM processes in centrally cleared markets not covered in this report.