Secretariat to the Basel Committee on Banking Supervision
Secretariat to the Committee on Payments and Market Infrastructures
The Board of the International Organization of Securities Commissions

Submitted via e-mail to: baselcommittee@bis.org; cpmi@bis.org; consultation-04-2021@iosco.org

January 26, 2022

Re: Review of margining practices

Dear Sir or Madam,

ABN AMRO Clearing Bank N.V.; Barclays; BlackRock, Inc.; Citigroup Inc.; Deutsche Bank AG; Goldman Sachs Group, Inc.; JPMorgan Chase & Co.; Société Générale S.A.; T. Rowe Price; UBS AG; and The Vanguard Group, appreciate the opportunity to comment on the Basel Committee on Banking Supervision (BCBS), Committee on Payments and Market Infrastructures (CPMI) and the Board of the International Organization of Securities Commissions (IOSCO) consultative document on "Review of margining practices" (the Consultative Report).

1. Executive Summary

We appreciate the joint effort and commitment of BCBS, CPMI and IOSCO's Joint Working Group on Margin (JWGM) to analyze the responsiveness of centrally cleared initial margin (IM) models to market stress, including the publication of the Consultative Report.

Our white paper, *A Path Forward for CCP Resilience, Recovery, and Resolution* (the White Paper), first published in October 2019, and now with 20 signatories across both buy-side and sell-side firms, highlighted the need for IM to be robust and stable, including *"limit[ing] the pro-cyclical effects of increasing margin in stressful conditions"* as one of its 20 recommendations. IM is the primary pillar of effective CCP risk management which ensures that those who bring risk into the system are required to cover it.

As identified in the Consultative Report, the unprecedented volumes and volatility observed during the onset of the COVID-19 pandemic in March – April 2020 provided the first true stress test of the post-2008 derivatives reforms, including the increased reliance on CCPs. While the clearing infrastructure remained generally resilient during this period, the extreme volatility and the unprecedented size and frequency of margin increases demonstrated the potential risks to the market when CCP margin methodologies are not sufficiently stable, and when there is insufficient transparency to the market on calibration of CCP IM models.

While IM requirements are expected to increase during periods of higher market volatility, the pace and size of increases during this period were extreme and had negative impacts on the broader market. CCPs should always have flexibility to raise IM requirements when required to ensure they are not under-collateralized and exposed to increased credit risk of their members. However, regulators should facilitate improvements to CCP IM models to reduce the need for such sizeable and rapid increases during periods of stress. In addition, regulatory action to drive enhancements to CCPs' transparency and disclosures related to IM models could enhance market participants' ability to predict margin calls and manage their own funding and liquidity preparedness, as well as better facilitate market participants' ability to provide feedback on the frameworks, all of which can improve financial stability.

We agree with many of the conclusions in the Consultative Report on CCP IM adequacy, IM model responsiveness, and disclosures and support further work on this important topic. In particular, we highlight the following next steps for action by policymakers and regulators:

- **Ensuring that CCPs maintain robust and stable base IM models** that include stressed periods in the look-back and margin periods of risk (MPOR) that are consistent with the time required to liquidate portfolios, such that IM levels that do not decline to imprudent levels during periods of low volatility.
- **Requiring CCPs to solicit feedback from subject matter experts across market participants** for consideration in the design of overall margin frameworks including in the calibration of risk appetites for procyclical margin increases and importantly, requiring CCPs to disclose to regulators, such feedback and rationale for action taken.

- **Instructing CCPs to provide market participants with sufficient transparency** on the calibration of margin models and their performance through adequate disclosure of back testing, particularly at a contract level, and mandating tools to allow market participants to predict how IM models would react to changes in market parameters and portfolios. Both of these would improve market participant preparedness to meet margin calls, thereby enhancing the overall resilience of the system.
- **Enhancing regulatory capital standards for CCPs so that they are sufficiently robust** to align incentives between clearing participants and CCPs' management, thereby ensuring prudent risk management.

2. Key Findings in the Report (Consultation Questions 1 & 2)

We commend the JWGM for engaging in an extensive data gathering exercise across the spectrum of stakeholders and undertaking detailed analysis to examine whether and to what extent margin calls were unexpectedly large.

This exercise and its conclusions have helped to substantiate some of the vulnerabilities that have been highlighted by market participants since March 2020. As it relates to CCP IM, the following findings in the Consultative Report resonate with our collective experiences:

- The differential performance of Exchange Traded Derivatives (ETD) and Over-the-Counter (OTC) CCP IM models, with ETD IM demonstrating significantly more volatility and accounting for two-thirds of the total IM increase (Consultative Report Figure 4, right panel and Figure 6);
- The majority of the IM increase was driven by core IM models and underlying volatility rather than margin add-ons (Consultative Report Figure 5);
- Market volatility and model reactions were the main drivers of ETD CCP IM increases, rather than portfolio rebalancing (Consultative Report Figure 13);
- The diversity of CCP IM models and regulatory regimes, such as differences in MPOR requirements and look back periods, gave rise to differential performance in CCP IM responsiveness (Consultative Report Section 3.2.1 and Figure 14);
- Procyclical CCP IM was one of several factors that exacerbated the broader market stress (Consultative Report Section 6, Page 36).

3. Transparency, Disclosure and Governance (Consultation Questions 3. 4 & 10)

One of the 20 recommendations in the White Paper was a call for regulators to require CCPs to provide enhanced disclosures on CCP risk methodologies, back testing and stress testing, amongst other things, to improve resilience. The volatility and the corresponding IM increases during March and April 2020 underscored the importance of such transparency in ensuring market preparedness to meet increased margin calls.

The Consultative Report correctly highlights the relatively low level of transparency in IM practices at some CCPs. It notes that only one-fifth of CCPs reported that they offer functionality for predicting margin that lets users see a "what-if" analysis under different periods of volatility (Consultative Report, Page 28). This is further supported by the market participants' standpoint; the Consultative Report notes that intermediaries reported "material gaps" in the information needed to perform accurate estimations of CCP margin call amounts or timing (Consultative Report, Page 29) and that clients faced "challenges in replicating CCP margin models and therefore challenges both in anticipating margin changes and performing risk management."

Major clearing firms entered this period extremely well capitalized and with ample sources of liquidity. More broadly, market participants were able to source the requisite liquidity to meet margin calls; however, this was a focusing event that demonstrates the need for greater transparency to enhance market preparedness. Enhancing the transparency and predictability of CCP IM models would be an important step in facilitating more effective management by market participants of their liquidity and funding risk to ensure CCP IM calls can be met in stressed markets.

Such enhanced disclosure should, at a minimum, include:

- Comprehensive documentation on risk methodologies, such as information and explanatory notes on CCPs' IM methodologies, and stress testing frameworks which have a direct impact on IM stress add-ons that may be levied on participants. This information would enable market participants to conduct in-depth "what-if" analysis to understand their counterparty credit and membership liability risks and to manage their liquidity and funding risk accordingly.
- Detailed documentation on the calibration of CCP IM add-ons, including how such add-ons interact with intraday margin frameworks, so that market participants can better anticipate potential margin calls.
- Disclosures on approach to back testing as well as back testing results. This should include information related to contract level margin breaches as this information can highlight methodology weakness that may otherwise be masked by portfolio level back testing.
- Regular disclosures on the usage of anti-procyclicality (APC) tools in current margin models to allow market participants to anticipate how IM may react during periods of market stress.

It is critical that such disclosures are provided in a timely manner in order to adequately inform participants on market resilience during stressed market conditions. In contrast, details of margin performance during April 2020 were unavailable until the publication of CPMI-IOSCO public quantitative disclosures in October 2020.In addition, the White Paper's recommendations call for greater standardization of disclosures and instituting audit requirements to ensure disclosures are accurate, clear, and consistent. It would also be beneficial to require that summaries of audit findings and similar independent validations of CCPs' systems and models for generating IM requirements be made available to market participants. More detailed, accurate and timely disclosures would facilitate a comprehensive understanding of the risk framework and enable effective feedback and challenge to CCP margin frameworks which we believe is to the benefit of the system overall.

The mechanism to facilitate the ability for market participants to credibly challenge CCP margin frameworks is through enhanced risk governance, another recommendation in the White Paper. CCPs' governance arrangements should require a formal process to obtain, consider and address market participants' feedback on any changes that materially affect the risk profile of the CCP, particularly as it relates to risk methodologies and financial safeguards. Such feedback should take place prior to CCPs making formal filings with the relevant regulators and must be disclosed to regulators. This would provide relevant authorities with important market views that could help improve overall resilience of CCPs.

4. CCP Margin Model Responsiveness (Consultation Question 8)

Margin rates are expected to increase during periods of higher market volatility as CCPs should not be under-collateralized and exposed to increased credit risk of their members. We also acknowledge that IM is not intended to fully cover every tail scenario. However, the size of margin breaches during the relevant period was significant, with more than 10 CCPs experiencing exceedances greater than 40% of average IM, and some exceedances as high as 160% (Consultative Report, Figure 1.6). Further, the pace and size of IM increases observed during the relevant period were in some instances higher than changes seen during the 2008 global financial crisis (GFC), as CCPs reactively sought to retrospectively cover the stress. This suggests that IM levels were too low going into the stressed period.

Regulatory enhancements to CCP IM frameworks could help reduce the need for such large and rapid increases in CCP IM during future periods of stress. This should include not only improving APC tools but also taking steps to fundamentally strengthen base IM models, placing less reliance on APC measures.

One way to reduce margin procyclicality and the frequency and severity of contract level margin breaches, is to ensure margin models incorporate fixed periods of historical stresses such as the GFC or COVID-19 stresses (or hypothetical stresses if historical stresses are not available) and minimum volatility assumptions suitable for the relevant asset class to ensure margin is maintained in periods of low volatility, based upon historical observations. Regulators should review the adequacy of lookback periods incorporated into CCP IM models and specifically consider how these lookback periods are calibrated and whether they appropriately capture and provide adequate weighting to periods of extreme market volatility relevant for the specific product.

The adequacy and appropriateness of the enhanced margin models and APC measures are currently tested in some jurisdictions by assessing IM models' performance against a targeted risk appetite for margin increases in stressed periods. For example, EMIR guidelines already incorporate such requirements[1] with the result that 40% of the sample CCPs in the Consultative Report note that they have established such a risk appetite. In line with Section 3 above, it is important that the IM increases targeted under such risk appetites are transparent to market participants to allow them to anticipate the extent of likely margin increases while recognizing that in exceptional scenarios margin increases could be higher to ensure CCPs are adequately collateralized. In addition, the range of IM increases considered acceptable at the surveyed CCPs (e.g., IM increase can be as high as 80% over a 5-day period as outlined in Section 3.2.2), highlights the need for enhanced governance. Market participants should have the ability to provide inputs into the risk appetite to ensure it is set at a reasonable level without causing undue stress to the broader market.

While the Consultative Report focuses mainly on responsiveness of margin models, it is equally important to revisit base IM models, as strengthening IM models reduces the need to rely on specific APC measures. Specifically, MPOR should be set at a level appropriate for the risk of the contract, based on market depth and product complexity, rather than as a function of whether the product is traded on an exchange or OTC. The products with lower MPORs, which are predominantly ETD, saw the largest IM increases during the relevant period. Across different jurisdictions we observe different MPOR requirements, ranging from one to five days for cleared products across listed and OTC. While the spirit of these minimum requirements is appreciated, in some instances they are not robust and should be reviewed accordingly.

In a similar vein, CCP IM add-on frameworks should be reviewed for appropriateness of usage and sizing. Concentration margin add-ons should not be considered as a substitute for appropriate MPOR; however, where relevant, margin buffers must be adequate to account for concentration risk embedded within large portfolios relative to product liquidity. While add-ons were not specifically the drivers of margin calls during March – April 2020, CCPs nevertheless need to provide clearing participants with sufficient information on these buffers to ensure they remain replicable and predictable.

5. CCP Capital Contributions (Consultation Question 10)

Notwithstanding the enhancements to margin frameworks, transparency, and governance mechanisms noted above, it is also important to revisit CCP capitalization frameworks. Increasing CCPs' own-funds contributions to the default waterfall to meaningful levels of "skin in the game" (SITG), to align CCPs' incentives and ensure prudent and effective risk management related to the CCP's clearing activities was another recommendation in the White Paper. A paper by two BIS economists entitled, *Model risk at central counterparties: Is skin-in-the-game a game changer?* which concludes that "a higher amount of skin-in-the-game is associated with a lower degree of model risk" reinforces this point. We believe that further regulatory focus is required on the development of an enhanced capital framework for CCPs that addresses all aspects of default losses, as well as non-default losses that may arise from management of margin posted at CCPs. While CPMI-IOSCO's guidance published in 2017 requires CCPs to contribute capital as part of the waterfall and to cover losses from custody and investment risk, it does not specify the amount of such capital. Therefore we encourage regulators to prioritize adequacy of CCP capital for further international work and policy development.

6. Conclusion

The Consultative Report raises a number of important topics related to CCP IM, many of which were also identified in our White Paper.

We share the goal of the JWGM to identify aspects of the regulatory regime for CCP IM that could be enhanced to make CCP IM more robust, stable and transparent and hence reduce the procyclical effects of margin during periods of stress.

We appreciate the opportunity to provide our input and look forward to ongoing engagement with the JWGM and other market stakeholders to strengthen the overall system. If we may provide further information or answer any specific questions, please do not hesitate to contact us.

Sincerely,

[1] Section V.13.a of ESMA Guidelines On EMIR Anti-Procyclicality Margin Measures for Central Counterparties

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