EFET European Federation of Energy Traders
SO YOU CAN RELY ON THE MARKET

Keizersgracht 62-64
1015 CS Amsterdam

+31 20 520 7970
secretariat@efet.org
www.efet.org

Response to the OICV-IOSCO & BIS consultative report on

Review of margining practices (October 2021)

- EFET response -

EFET[1] welcomes this consultative paper and the data-led analysis of the events last year. We generally agree with the recommended follow-up actions and further analysis, which EFET is happy to support. However, we would like to make the following recommendations, further explained in the answers to report's questions:

- ***Increase transparency and accessibility of initial margin models and calculation tools:*** EFET recommends that the Central Counterparties (CCPs) should make margin models and calculation tools more transparent and accessible to the clients of the clearing members, in order to increase clients' ability to predict and plan for market stress scenarios and resulting impact on margin requirements.

- ***Disclose the usage of anti-procyclicality tools***: CCPs should disclose details on the extent of usage of anti-procyclicality tools in the current margin models, so that clearing participants and their clients can anticipate how initial margin (IM) and any additional margins requirements may evolve during market stress periods. Otherwise, clients have to cope with sudden, unplanned increases in initial margin.

- ***Extend the list of eligible collateral***: Non-bank financial institutions (NBFI), most EFET members, do not dispose of same access to money market as clearing members. Therefore, EFET recommends the extension of the list of eligible collateral, e.g. environment certificates or allowing the pass-throughs of standby letter of credit from client to CCP via the clearing member, in Europe, like in the US. Additionally, that would free up more resources for investment.

- ***Clients should be also actively consulted by CCP when designing and reviewing their risk model***: as their expertise on market evolutions and risks management could contribute positively to the improvement of risk model designs and APC tools to be applied.

Background of the status quo on energy markets

EFET appreciates that this consultative paper covers the Covid-19 market turmoil of March 2020 as the most significant test of the resilience of financial markets since the great financial crisis of 2008. However, energy firms are still experiencing, since the beginning of the last quarter of 2021, historical spikes in volatility of commodity derivatives. Therefore, the experience shared by the EFET members answers will also relate to more recent market events than the ones described in the consultative paper.

Energy firms hedge their asset positions in many ways and cleared markets play a key role. The recent spike of volatility in commodity derivatives has led to a sharp and fast increase on

[1] The European Federation of Energy Traders (EFET) promotes and facilitates European energy trading in open, transparent and liquid wholesale markets, unhindered by national borders or other undue obstacles. We build trust in power and gas markets across Europe, so that they may underpin a sustainable and secure energy supply and enable the transition to a carbon neutral economy. EFET currently represents more than 100 energy trading companies, active in over 27 European countries. For more information: www.efet.org

IM requirements. IM for cleared positions has sometimes increased by 10 times from September to December 2021, as seen in the chart below (Figure 1).

Figure 1. Increase of initial margin from 01 Jan 2021 to 31 Dec 2021

Source: EFET members

Knowing that IM is mainly posted as cash for the vast majority of commodity trading firms, sharp increases in margin calls, are mostly unpredictable on client level and given the increase in size and frequency of margin parameters updates have put pressure on treasury and liquidity management of non-bank or financial institutions. The cash amount required, especially related to hedge positions executed on exchanges, have reached peak levels for many market participants, large and small.

This consultation response covers the positions of our members active in Over The Counter (OTC) markets and at exchanges and are, for their largest majority, also clients of clearing members. Our answers are exclusively related to the trading of energy and commodities.

QUESTIONS:

1. *Does the report accurately describe the key market events of the Covid-related period of stress from February to April 2020 and its effects on the magnitude and frequency of the calculation and payment of margin in centrally and non-centrally cleared markets? If not, in what ways are the descriptions not fully representative of the events? Are there any other important events or effects missing? If so, please provide any information or data that are relevant to the missing events or effects to the extent feasible.*

Overall, EFET considers that the report describes well the key market events of the Covid-related stress period.

On centrally cleared markets, the high volatility experienced since October 2021, e.g. in some commodity prices like for European Gas Futures, has obliged CCPs to significantly increase frequency of intraday margin calls due to large VM calls within a trading day. Due to the increase in size of intraday VM calls, some clearing members have started to pass them more frequently to their clients who are, for their large majority, non-financial institutions and, therefore, have limited access to liquidity markets.

EFET members have already noticed that the process of updating and communicating initial margin parameters is not consistent across all CCPs with regards to level of increase as well as frequency of updates or time windows used for pre warning notices.

2. *Does the report draw appropriate conclusions from the presented observations and analysis of the various aspects of centrally and non-centrally cleared margin during the 2020 stress period?*
   If not, in what cases do you feel the conclusions are not justified by the included analysis? Are there any areas or specific topics of analysis you consider to be missing? If so, please provide any information or data that are relevant to the extent feasible. Please set out your views across the following sections:

a. *The drivers of margin calls during the period of market stress covered by the report.*

EFET particularly commends the following conclusions of the report:

- The link between CCP IM increases and model design's established level of confidence, which aim to offer maximum security for a CCP and related risk and default management coverage.
- The fact that the CCP IM increase was driven by model design and high market volatility.
- The impact of the margin calls on broader market stress.

b. *The current level of transparency in margin practices by CCPs and intermediaries.*

EFET welcomes the fact that the paper tries to identify the drivers of IM increases. The paper confirms that the majority of IM increase was driven by the reaction of the base margin model to market volatility, i.e. CCP model choices.

Initial margin models

EFET believes that the CCP should make initial margin calculations more transparent and invest more efforts to assist clients of clearing members for running corresponding scenario analyses based on tools provided by the CCP.

EFET notices that there remains a lack of clarity regarding the methodologies and calculations which are used by CCPs to determine Initial Margins. Furthermore, a majority of CCPs in the energy and commodity domain are developing their own and / or new calculations, e.g. moving away from SPAN methodologies. We consider that this will result in non-standardisation and will make it difficult for the client to monitor and check the calculation applied by their respective CCP and clearing members without having to invest significantly in resources and technologies.

While each model choice is important, margin models should be analysed as a whole, including potential offsetting effects, through corrective actions, contract level margining, impact on portfolio level margining and others, to allow optimized margin netting.

We also note that margin models are not *per se* designed to be resistant to stressed market conditions: predictably, margin may need to be higher in times of market volatility. What is important is the behaviour when the stress situation unfolds and the reaction of the margin model to increased volatility.

Timing of margin increases

The issue of transparency does not only relate to level of cash to be deposited, but also to time windows given to fulfil the payment, *i.e. restricted* by the timeline given by the client's commercial bank;

We noted cases of short-term significant updates of IM parameters, *e.g.,* doubling with a prior notice of just 24 hours, which results in a margin call on next day for an increase of 100% of IM already posted and significant amount of cash to be funded in short term by the client.

Adhoc margins and margin exceedances in general

EFET members noticed an increasing trend of additional margin requested by clearing members, especially during stressed volatility.

We recommend that the IOSCO working group should consider other potential drivers of increased excess margins in stressed market conditions. For instance, general margin models and better predictability on CCP & clearing members should also have limited the need for intra-day calls and avoided any passing through to the client. How excess collateral was managed across products and end-users deserves further analysis, including whether there were disparities across CCPs on same products and models used.

c. The preparedness of intermediaries and clients for meeting the increased margin calls seen during the period of market stress covered by the report.

Overall, preparedness could be improved with better transparency as indicated in our previous responses. As long as disclosed as aggregated data, the communication on current overall amount of IM, contribution to default funds or concentration margin, or overcollateralisation would give an indication to clearing members and their clients about CCP and clearing members preparedness on stressed market situations and potential increase in intraday calls or adhoc margin. As this data is not related to specific client data, we do not see reasons for keeping it confidential. CCPs should also provide clearing members and clients regular reports on historical adjustments of IM parameters and margin amounts posted with CCP.

We think that CCPs should develop more accessible tools and/or raise awareness of existing tools and information amongst clients. Real-time initial and variation margin calculation/estimates would help intermediaries' and clients' preparedness during market events. Tools which are currently available do also not allow to run "what if" scenarios that would help to predict the liquidity demand for the next day or week.

Clients (mainly depending on their size and related infrastructure) are generally more reliant on tools provided by CCPs and third parties to assess their margin requirements, whereas clearing members and larger clients usually have inhouse tools or direct connectivity via APIs. In-house tools have the advantage that they are able to provide flexibility in modelling and assessing impact on margin requirements, but, as this paper notes, there is a large degree of variability in terms of tools and functionality offered to clients.

As mentioned above, making user-friendly tools with a minimum standard of functionality publicly available would help clients, in particular smaller clients, who may be either new to clearing, or be considering clearing as a result of the uncleared margin rules, to be able to assess and prepare for the impact to potential liquidity demands in stress conditions. These tools or their APIs should ideally be standardised across the market.

d. The relationship between margin demands and other liquidity demands during the period February–April 2020.

Due to the natural profile of energy companies (non-financial institutions), most of EFET members, cash stays as the main form of collateral used to cover margin requirements originating from CCPs (IM) via the respective clearing members.

Even though CCPs offer longer lists of eligible collateral, most of the clearing members would only accept a limited list from their client, due to the complexity and cost of the transformation of non-cash collateral into the collateral form that clearing members post on CCP level.

For example EFET would welcome an extension of eligible collaterals to Environment Certificates e.g. EU Allowances to cover with IM requirements.

The use of non-cash collateral to cover Initial Margin Requirements is therefore very limited, although it would reduce the pressure on liquidity, especially in times where IM parameters get adjusted massively in a very short timeframe and without any prior notice.

On this matter, we also notice a significant difference between CCP rules on different continents. For example in the US, CCP offer pass-through standby Letter of Credits that a client can issue to their clearing members that are posted to cover at least partially the Initial Margin requirement of the CCP to cover the risk of this specific Client.

EFET members would welcome an analysis on the type of collateral used across the different product classes and their eligibility to cover different type of margin demands (IM, adhoc margin, over-collateralisation, non-centrally cleared markets).

3. *Do you agree with the proposals for further international work regarding good practices, metrics and disclosures concerning procyclicality in CCP IM models? Are there other aspects of CCP IM where additional disclosures should be prioritised for further work?*

Please find below a few proposals of transparency and disclosures concerning procyclicality in CCP IM models.

CCPs should disclose details on the extent of usage of margin models and anti-procyclicality tools so that clearing participants and their clients can better

Backward looking.

Calculation of these maximum margin increases needs to be standardised, so it is comparable between CCPs. Even though this consultation suggests that initial margin increases were mostly driven by changes in base margin, it could also be helpful to provide this calculation based on real portfolios and constant portfolios.

Forward looking

CCPs should share the margin increase (from current levels) if volatility increases by 10%/20%/50% and the impact on their APC tools of these moves.

- the total portfolio (total margin).
- flagship products – at least the three products with the highest volumes.

- asset classes if applicable.

Details of APC tools

CCPs should provide information to their clearing members and their respective clients whether current margin rates are driven by the model or by APC tools and to which extent. This information will differ for each CCP, depending on their APC tool, or mix thereof.

CCPs using floors should disclose whether the margin rates are driven by the floor or the shorter-term-model.

- If a CCP is using a margin buffer, the CCP should disclose the current size (in percent) of the buffer.
- If a CCP uses stressed scenarios in the lookback period, the CCP should disclose the percentage of losses driven by recent (non-stressed) scenarios outside the confidence interval.
- If a CCP uses filtered historical simulations, the CCP should disclose the current volatility to scale the value at risk (VaR) output with.

4. *Does the report identify appropriate aspects of transparency in centrally and non-centrally cleared markets for further international work, including identifying data gaps, enhancing disclosures to clearing members and increasing margin model transparency?*

a. *What specific areas of transparency would be most helpful? What (if any) are the barriers to providing those points of transparency?*

Enhanced transparency and predictability would significantly assist participants in preparing for and proactively managing margin calls. This transparency is provided already by some CCPs, with focus on clearing members, and should be made better accessible to the clients of the clearing members.

Disclosure of risk methodologies

One of the most critical pieces of information required from CM but also from the client perspective is documentation on risk methodologies– i.e., details on CCPs' margin framework, back testing and stress testing framework. With enough provided detail and dedicated support, market participants could replicate the methodology or at least have a deep understanding of likely margin consequences given a certain market move. This would benefit market participants by enabling them to conduct in-depth what-if analyses and allow an understanding of their membership risks and how liabilities may evolve in a variety of stressed market scenarios where margin and a Default Fund may be inadequate.

Detailed disclosure of the risk management framework would provide the following benefits to clearing participants:

- Understanding their risk.
- Predictability.
- Enhance the quality of clearing member participation in risk model designs and consultations (e.g. working groups and/or risk committees of CCPs).
- Enhancing liquidity risk management practices of CMs and clients including stress testing.

- Fostering communication between users and the CCP through distinct channels handling confidentiality issues at different layers.

We believe that the risk methodologies should not be seen as commercially sensitive information, but instead one that will create competitive advantage for CCPs with more robust approaches, driving improvements and best practices across all CCPs.

EFET also believes that clients could be part of CCP risk committees as their expertise on market evolutions and risks could contribute positively to the improvement of risk model designs. Clients especially in the commodity trading areas, are increasingly required, especially in a stressed market environment, to participate in liquidity risk that was previously covered by their clearing members and would therefore see justification to have at least an active consulting and feedback provider role in CCP risk committees.

One idea could be to introduce the need of having a sort of control for CCPs, maybe every two years, to perform a review and to have the model challenged by independent expert institutes. This would discover weaknesses and areas that are not covered well, e.g. avoiding to overcharge market participants.

Margin add-ons

Another critical area of transparency would be the calibration of various margin add-ons and how these interact with intra-day margin frameworks, so that members can better anticipate potential margin calls.

CCPs should also assess the impact of the APC measures available in CCP tools, which would then allow market participants to include the results in their liquidity stress testing and ensure that they provide for sufficient contingent liquidity should a stress event occur.

Margin simulators

Margin simulators are important tools for the preparedness of market participants. In a perfect world, clearing members and their clients would have access to real-time calculations of initial and variation margin. CCPs should at least give sufficient transparency on their margin models for clearing participants and their vendors to replicate their margin calculations.

However, to prevent their membership and clients from duplicated cost by replicating margin calculations, it would be best for CCPs to give their members timely, up to real-time estimates of current initial margin calculations. The tools need to include margin add-ons.

Ideally these margin calculators would have standardised application interfaces (APIs) to avoid prohibitive implementation cost for accessing margin calculators that could overwhelm medium sized and smaller clients if they had to develop links to many different simulators with different APIs. Standardised access would make it easier for all clients to simulate their liquidity requirements, including in times of stress.

Margin simulators are useful for several use cases:

- Planning, including liquidity planning;
- Historical Analysis;
- Analysing market participants' capabilities to provide collateral timely.

For liquidity planning, it is paramount that simulators not only provide margin levels for current margin rates, but also for margin under higher volatility ("What IF analysis"). There should be a minimum viable offering that at least allows firms to add and remove trades into a portfolio to be simulated and ideally stress tested. Development of standardised simulators and their APIs could be done in a phased approach to improve their functionalities and usefulness over time.

b. *Should any other areas of increased transparency be considered?*

The report does not cover any issues experienced in operational processes, which lead to delays in reporting from CCP and/or clearing members to their clients. This leads to erroneous margin call amounts and/or participants not benefitting from offsetting transactions.

Furthermore, the mutual credit risk to be covered between clearing members and their clients, due to the limit of credit lines, (CM risk carrying) or the necessity for clients to have fall-back solutions in place in the case of defaulting clearing members (client risk carrying), conducts clients to spread markets across different clearing members. Therefore, significant netting effects are lost, which may have a massive impact on liquidity. This is especially in case of stressed volatility, not only on VM but particularly on IM.

CCPs are in the best place to deliver corresponding information to clients of clearing members and support them in their decision, adding to potential gains in netting they would achieve by clearing a certain product class only via one single clearing member. Clearing Members and CC P would benefit from this margin synergy effect.

5. *Do you agree with the proposals for further international work to enhance liquidity preparedness in the NBFI sector, including the development of appropriate liquidity metrics and disclosures, analysis of liquidity provision robustness and expanded information sharing between intermediaries and clients? Have the proposals identified all key aspects of NBFI sector liquidity preparedness which should be included?*

EFET argues that the primary way to address liquidity should be through greater transparency to facilitate better preparedness. CCPs must be able to call for additional funds, also intraday, to maintain sufficient collateral from the clearing members.

However, this implies additional liquidity charges on the clearing members and their clients.

The solution proposed to this conundrum is for clearing members to pass sufficient information and details on to their clients which could enable them for better planning (as described above the clearing members themselves lack those information support by the CCP).

Generally, an analysis is needed on liquidity preparedness of non-bank affiliated clearing members and clients. However, repeated ad-hoc intraday calls can place funding pressures on some market participants.

Examples of information that could be valuable to clients could be standardised stress test results on their existing cleared portfolios, showing the impact of both initial margin requirements and the magnitude of variation margin calls in this environment.

Just as CCPs need discretion to raise margin during stressed periods to ensure they do not have uncollateralized risk, clearing members have also increasingly deployed their ability to pass-through intraday margin calls to ensure that the risk that they are guaranteeing is adequately covered. Intraday calls create a specific pressure on clients, especially for non-financial institutions, dependent on their commercial banks concerning the amount and time period within a day during which payment instructions can still be proceeded.

6. *Do you agree with the proposals for further international work to evaluate data gaps in regulatory reporting by banks and non-banks? Are there particular data gaps you would identify as being of material importance? If so, please provide any supporting information and data to the extent feasible.*

Highlighting the need for increase in transparency, EFET members would welcome enhanced disclosure and accessibility to data and reports that would help clients of clearing members to build up statistics and increase their ability to predict and cope with extreme market situations and volatility.

Therefore, EFET members would welcome the utilisation of international standards with regards to the format and content of data that could be disclosed by CCPs and clearing members to clients.

7. *Does the report identify appropriate proposals for further international work on streamlining VM processes in centrally and non-centrally cleared markets? Should any other aspects of VM processes be included in this work?*

In general, CCPs' applicability to issue intraday margin calls should be calibrated (intraday calls should be scheduled and defined, unless in extreme situations) to reduce undue funding pressures on clearing members. CCP rules for ad-hoc calls should be clear and give clearing members sufficient warning on when such calls may be made and sufficient time to act on the call.

Ideally intraday margin call projections could be added to margin simulators. CCPs should also be mindful that clearing members often cannot pass intraday margin calls to their clients as these clients, especially since non-bank financial institutions are limited in their access to their own cash to respond to large intraday calls. This creates additional liquidity requirements on the clearing member and adds uncovered risk to the client for the clearing member.

8. *Does the report identify appropriate proposals for further international work on the degree and nature of the responsiveness of CCP IM models to market stress? Should any other aspects of CCP margin models be included in this initiative?*

EFET strongly agrees that further work should be done on this topic. EFET members fully support the ability of a CCP to protect itself at all times.

We believe that the best way forward on margin procyclicality is for the whole market (CCPs, clients, clearing members) and regulators to agree a target level of procyclicality that balances the cost of clearing (margin levels) with stability (reduced procyclicality). These target levels of procyclicality (procyclicality risk appetite) could and should be different for different asset classes.

Existing APC tools

Most CCPs have already anti-procyclicality tools and measures in place, as recommended by the CPMI-IOSCO Principles for Financial Market Infrastructures (PFMIs) and largely implemented since the global financial crisis. But it remains unclear if these measures were effective; during the current volatility in energy markets, margins rose higher (relative to pre-crisis rates) than they did during the global financial crisis and, as markets recovered, have fallen faster.

EFET members would also welcome an analysis of the current high volatility of energy markets and whether APC tools have been used by the CCPs.

9. *Do you agree with the proposals in the report to evaluate the degree and nature of responsiveness of non-centrally cleared IM models to market stresses, remediation of IM shortfalls and the level of disclosure of non-centrally cleared IM model performance? Should any other aspects of non-centrally cleared IM models be included in this initiative?*

N/A

10. *Are there any other important aspects not covered by the report which should also be prioritized for further international work or policy development?*

N/A