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

Bank for International Settlements
OICU-IOSCO

Basel, Switzerland
Madrid, Spain

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**Transparency and responsiveness of initial margin in centrally cleared markets – review and policy proposals**

**Two-tier Precautionary Facilities Solution as an example of Regulated Risk Management**

Ladies and Gentlemen,

M|E|W Consul (MEW) is honoured to participate in joint consultations by the Basel Committee on Banking Supervision (BCBS), the BIS Committee on Payments and Market Infrastructures (CPMI) and the International Organization of Securities Commissions (IOSCO) regarding "Transparency and responsiveness of initial margin in centrally cleared markets – review and policy proposals".

The problem of central clearing of derivative transactions, collateralization and pro-cyclicality is well analysed. Already in 2014 did Bank of England Research Department publish Financial Stability Paper No. 29 "An investigation into procyclicality of risk-based initial margin models" by David Murphy, Michalis Vasios and Nicholas Vause, a comprehensive report outlining structural deficiencies.

In 2016 Bank of England Research Department published "A comparative analysis of tools to limit procyclicality of initial margin requirements" also by David Murphy, Michalis Vasios and Nicholas Vause, Working Paper No. 597. Alternative tools are mentioned, which should be treated Pari passu to standard collateral if having identical risk profile. Although alternatives are known under different names – back-up, re-insurance, precautionary facilities – they are targeting same objectives and must fulfil same safety standards. Unfortunately, no follow up at that time by regulatory authorities.

Today, eight years later, it is extremely sobering that we are still discussing the very same problems. And winter 2021/ 2022 disruption in European energy markets and September 2022 UK LDI and gilt crisis confirmed, the issue is as relevant as ever.

It is MEW understanding, that the objective of current review and policy proposals is improving transparency of central counterparties (CCP) margin policy, thereby making it easier for clearing members (CM) and end clients of the whole spectrum – banks, non-bank financial institutions (NBFI) and non-financial corporations (NFC) - to manage collateral and liquidity risk.

Noticeable, structural problem of pro-cyclicality of collateralisation is still not addressed. Based on MEW assessment, if policy is executed as proposed, result will lead to substantial deterioration of CCP and financial system safety standard, seems entirely counterproductive. Please allow to explain.

Efficiency is a double-edged sword. The more efficient a system, the lower the margin of error! Efficiency is great if everything works as planned. But efficiency can also backfire badly in case of malfunctioning or mistakes by users, among others.

MEW is convinced that in the present instance improved transparency regarding CCP margin policy will help market participants, CM and end users, to manage collateral and liquidity risk. In so far objective will be achieved.

But at the same time, it will make it easier to manipulate collateral system and destabilise CCP and their users across the whole spectrum. It allows determining in advance which market action and resulting spike in volatility will have the greatest impact regarding collateral demand, and which business models, CCP users, etc. will be hit hardest. It allows volatility traders to create close to self-fulfilling strategies.

So far external factors and market movements are driving collateral levels. With full transparency, CCP policy will drive market action to trigger volatility events and collateral demand. This as a result could trigger further market action.

In the current set-up, CCP collateral model works fine during normal volatility levels. But in case of extreme spikes in volatility either CCP users get into trouble, or we can experience system wide problems if market cannot absorb mass liquidation of derivative transactions or collateral. MEW calls it a fair-weather system. See experiences in 2021 and 2022 mentioned above.

With full transparency, CCP collateral model is always at risk of malfunctioning, especially during stable and quiet environment. When market participants are not cautious, unforeseen events have greatest impact. Hence, system is permanently on the edge of disruption, we will never be more than one push of a button away from a financial crisis.

And during times of elevated volatility the risk to CCP collateral regime will be even higher than under current regime. As I have outlined in my letter to Stijn Claessens, former BIS Deputy Head of Monetary and Economic Department, on July 17, 2023, it is very easy to organise a collateral strike using social media (namely X formerly known as Twitter) and publicly available artificial intelligence. Social media per se is not a problem, but improved efficiency in distributing information. The example focussed on regional German utility sector, demonstrating that NFC also can pose systemic risk. Reference was upheaval in European energy sector at the beginning of the Ukraine war. Concurrent neglect by limited number of NFC to meet collateral request and subsequent liquidation of collateral or derivative transactions can tripper CCP disruptions, same as concurrent deposit withdrawals by limited number of NFC can trigger bank-runs. Parallels to UK LDI and gilt upheaval are striking. It is another example of the negative impact of better transparency.

Interim conclusion, improved CCP collateral model transparency will allow much more targeted action. It will be visible which users or user groups are most likely affected by potential volatility spikes and resulting heightened collateral demand, and which therefore shall be the prime targets.

MEW is very confident, that it could disrupt CCP collateral regime at will. Of course, within legal framework! Silicon Valley Bank and Credit Suisse failure were not triggered by fake news or breaking the law. And just because regulatory authorities or specialist are aware about risk in the system does not mean it is obvious to all market participants.

The distribution of warnings by regulatory authorities compressed into one single social media post written by publicly available artificial intelligent could be sufficient already to trigger volatility spike and collateral induced liquidity crisis. The same holds true for BIS and OICU-IOSCO publications such as current consultation paper going forward.

Silicon Valley Bank bank-run confirmed one basic approach how to disrupt financial institutions and system once more. Today all it takes is connecting some abstract macro risk directly to individual market participants' p & l with short and easy-to-understand arguments, distributed to targeted audience simultaneously and in real time.

On top, bank-runs in general can be contained, whereas CCP disruptions are systemic events without exception. If CCP collateral regime is broken just once, MEW believes there is no way back. That is why standard regulatory procedure, updating regime following disruption, won't be sufficient.

Certainly, not every attempt by volatility traders will be successful. But disruptors only must succeed once, whereas CCP and regulators must be successful every time. Other key differences are timing and interval of attempts. Under current regime disruptor must follow market developments one cannot legally influence. Under the proposed high transparency regime, disruptor can choose timing freely, prepare in advance. As a result, number and success rate will be higher, disruption even more economically attractive.

MEW has no preferential data or market position. Analysis based on publicly available information only. The hurdle to disruption is at best a minor hold-up. Others very likely have already figured out deficiencies as well. They just don't communicate them, because they intend to exploit flaws economically.

Conclusion, MEW considers "Transparency and responsiveness of initial margin in centrally cleared markets – review and policy proposal" not effective for the intended purpose.

The better way forward MEW believes is to finally address problem of pro-cyclicality and follow up on Bank of England 2014/2016 research: introduce counter-cyclical collateral solutions.

In March 2023, Federal Reserve Governor Michelle W. Bowman and Bank of England Executive Director Andrew Hauser jointly announced introduction of newly to be established precautionary facilities, standing central bank facilities providing banks and NBFI emergency liquidity.

Bank of England Governor Andrew Bailey during parliament hearing following Bank of England stabilization of UK pension funds LDI and gilt market in November 2022 explicitly mentioned good collaboration with the private sector.

Precautionary facilities according to MEW understanding means formalizing collaboration process with the private sector, which so far, we observed during times of stress only. New standing precautionary facilities means well-controlled, frictionless and safe collaboration.

Central bank precautionary facilities can be complemented with private precautionary facilities, to establish a comprehensive two-tier solution. Private precautionary facilities or re-insurances as Michael S. Barr, Vice Chair for Supervision for the Federal Reserve, calls them, guarantee all covered banks, NBFI and NFC real time access to liquid assets.

Liquid assets can be used in three different ways:

1. To strengthen balance sheet of covered businesses,
2. As additional cash reserve during times of stress, and
3. As collateral for derivative transaction – CCP/OTC.

That means, private precautionary facilities are one potential counter-cyclical tool implied in Bank of England Research Department report from 2016.

Central bank precautionary facilities in such a two-tier solution are providing liquidity tail risk cover only. They are activated solely in case of mass liquidation of derivative transactions or supporting collateral is overwhelming private markets.

Instead of continuously twisting CCP collateral regime, private precautionary facilities empower CM and end users of the whole spectrum to manage potentially fast changing collateral demand easily and independently.

Due to higher speed of digitized financial system in general, derivative users should be obliged to confirm that they can manage collateral challenges in advance. For active traders that should not be a problem, they are constantly holding necessary reserves in cash and/or high-quality liquid assets (HQLA). In case of opportunistic market participants, precautionary facility cover should be the better because more cost efficient and easy to apply alternative.

Precondition for successful implementation of comprehensive two-tier solution is certification and regulation of private precautionary facilities:

- Certification necessary for seamless integration into existing financial system infrastructure. Meaning technical standards such as CCP settlement, ISO 20022 messaging, etc.
- Regulation is necessary to prevent misappropriation for speculative purposes, supporting assets, distribution by regulated financial institutions only, etc.

As a result, although certification and regulation are implemented on financial contract instead of institutional level, decentralised precautionary facility altogether will be completely regulated. An example of regulated risk management, this needs to happen prior to launch.

To summarize, MEW is convinced further improving transparency of CCP collateral regime is counterproductive.

Structural deficiencies of financial system require structural solutions, which require public-private sector collaboration.

Complementing CCP collateral regime with two-tier precautionary facilities establishes new safety architecture capable to withstand major disruptions and volatility spikes. Instead of amplifying pro-cyclicality, it acts counter-cyclical. In overwhelming number of cases private financial sector should automatically return to stable equilibrium without public intervention. Providing CM and end user with basic simulation models to assess potential future collateral levels makes sense, further transparency and therefore risk of opening to external influence of destabilizing collateral levels certainly not.

Currently, regulatory authorities are closely looking into new technology and hi-tech risk such as cyber security and AI impersonation, etc. Rightly so! But that doesn't mean we can neglect low-tech risks as outlined above, which are posing a bigger thread than ever before.

If BIS and IOSCO proceed as outlined in the consultation paper, current CCP regime is at risk. Too much transparency is counterproductive, looks like an invitation to exploit the system. After that, there is no way back.

One cannot tell for sure how BIS and IOSCO will decide regarding "Transparency and responsiveness of initial margin in centrally cleared markets – review and policy proposals", that would be a prediction. But one can tell with confidence how some market participants will react to proposed changes. A non-prediction, since many are maximising short-term profits adapting as outlined above is plain rational. There will be strategies available offering virtually free money, so attractive that some market participants certainly will give it a try.

Naturally, comprehensive two-tier precautionary facilities are also applicable in case of non-centrally cleared derivative transactions. The more scenarios any solution can cover, the more cost efficient it will be naturally. In the current case, all varieties of short-term liquidity risk (cash, initial and variation margin) to all institutional members of the private sector (banks, NBFI and NFC) can get covered.

Best regards,

Manfred E. Will
Founder & CEO