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Basel Committee on Banking Supervision
Board of the International Organization of Securities Commissions

Bank for International Settlements
OICU-IOSCO

Basel, Switzerland
Madrid, Spain

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Streamlining VM process and IM responsiveness of margin models in non-centrally cleared markets

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 consultation by Bank for International Settlements (BIS) and International Organization of Securities Commissions (IOSCO) “Streamlining VM processes and IM responsiveness of margin models in non-centrally cleared markets”.

In principle, when evaluating progress in regulation and risk management two different approaches are common: (1) classic approach, progress defined as improvements over time, and (2) comparison what is achieved vs what is needed, target-actual comparison. MEW as risk manager always follows second approach. Objective, to get as close to absolute safety standard as possible, with secondary condition economically sensible. If necessary, that includes developing entirely new and innovative risk management tools.

One of the key developments and challenges to the financial system globally is speed of change and speed of transactions. Due to (1) ultra-high-speed trading, (2) availability of twenty-four-seven real time payment including central bank retail instant payment systems, (3) high-speed information sharing on social media platforms, and (4) publicly available artificial intelligence, risk management also must be capable to cover real time challenges. That of course also includes collateralisation of derivative transactions – centrally and non-centrally cleared, initial and variation margin. Trend to ever higher speed expected to continue over coming years, see for example tokenization, DLT based transactions or CBDC.

As outlined in MEW´s comment from February 21, 2024 regarding BIS and IOSCO joint consultation "Transparency and responsiveness of initial margin in centrally cleared markets: review and policy proposals", the current set-up only works in relatively stable environment. During times of severe stress or malfunctioning of financial institutions or financial system, margining regime is not capable to cope. Plus, improving efficiency of established margin regime would be counterproductive. As described earlier, market participants could exploit upheavals economically, even create artificial volatility events using public statements by regulatory authorities such as research and consultation papers, financial stability reports or just publicly available speeches by representatives of regulatory authorities.

It seems obvious, adjusting current safety architecture to real time standard is not possible. What is needed are additional risk management solutions covering the initial reaction likewise in real time, meaning fully automated. Adjusting existing collateral regime as suggested in the current proposal to improve efficiency is commendable and necessary, but certainly not sufficient by far considering new challenges.

Fortunately, also described in MEW comments February 21, 2024, the solution is known already: two-tier precautionary facilities – public plus private.

Essentially, precautionary facilities are insurance structures. That is true for central bank and private precautionary facilities. Rather than actively managing clearly defined risks, insurance structures can cover uncertainty and non-quantifiable risk as well.

Day-to-day risk management, including collateral management, is not affected. Market participants are still required to apply existing regime. Precautionary facilities will solely be utilized during times of severe stress on corporate level or expressed as enormous spikes in volatility. Important, reason or trigger of spikes are not relevant, structures are economically driven. Precautionary facilities are pure technical solutions to allow real time preparedness, giving covered market participants enough time to adjust to changed environment. No humans involved during initial times of stress, since they are too slow, too error-prone and in general not available 24/7 for economic reasons.

Precondition for fully automated execution in all environments is seamless integration into existing financial system infrastructure. That should be guaranteed via technical certification. All parties involved – insurance takers, capital providers, FMI providers and central banks – know from signing all private precautionary facility procedures: general terms & condition, documentation, settlement, reporting, etc. These are identical for all transactions. Certification also means, no technical changes allowed without prior approval by among others central banks. From operational risk perspective, it is certainly the safest approach.

Private precautionary facilities must be open solutions. Meaning among others, no limitations who gets cover – banks, non-bank financial intermediaries, non-financial corporations – and are capable to support all kind of derivative transactions – centrally and non-centrally cleared. Businesses take out one cover, can use it for all transactions and counterparties frictionless.

MEW believes, precautionary facilities are maximal efficient, fulfil all requests outlined in BIS-IOSCO consultation report. It is the safest solution and the most economic. Standardisation and maximal scalability will cut costs so far, even smaller and less sufficient market participants can easily apply. MEW is strongly convinced, only solutions applicable by all market participants provide the standard needed for the whole financial system finally to be considered safe again.

Plus, authorities will always have consistent, reliable and comparable data – in peacetime and in stress – in close to real time. MEW calls this function "real time-risk-radar" (R3), telling where and when authorities should take a closer look.

Federal Reserve Board and Bank of England last year already announced newly established central bank precautionary facilities. In his speech published March 12, 2024 “Market resilience, non-bank financial institutions and the central bank toolkit – practical next steps” Nick Butt, head of the Future Balance Sheet Unit at the Bank of England, provided latest update regarding development status.

Following a few eclectic thoughts re implications regarding two-tier solution, without claim of comprehensiveness. A full analysis would be beyond the scope of current consultation yet can be provided upon request.

Initially, Bank of England will focus on UK insurance companies, pension funds and LDI funds (ICPFs), as interim solution. ICPFs are active during market hours mainly, and at least currently less affected by real time risk. Therefore, it might be advantageous to simultaneously start work on private precautionary facility as well. That would allow a test phase with manual back-up, to gain necessary experience in a safe and controlled manner.

According to Nick Butt, “Just as it is the case with banks, it is unrealistic (and arguably undesirable) to ask firms to insure against the most severe, system wide stresses.” While MEW fully agrees, one should keep in mind that probability of most severe, system wide stress can be reduced significantly via two-tier solutions. The reason being early-stage counteraction, before full-blown crisis develops. Experience tells us, the earlier the counteraction the easier and less expansive it is – for individual ICPFs and whole economy.

Regarding permanent vs temporary central bank facilities, two-tier solution means central bank only getting involved in case of private precautionary facilities are overwhelmed. Experiences of the last five years suggest it is a rare and short-lived exception.

Two-tier solution allows fast track retraction of central bank precautionary facility. Return to normal can be structured as semi-automatically, to keep balance sheet impact in size and time confined, strictly separated from monetary policy.

Two-tier precautionary facility structure as designed by MEW is a passive solution, meaning no active management. Once in place, facility goes into hibernation, and will lie dormant until maturity, unless severe disruption erupts. Central bank back-up facility is in place, but not part of the private insurance contract. One could argue, result is analogue to “Schroedinger's Cat” thought experiment by Erwin Schroedinger (1935): from the outside back-up can be considered availabe and not available at the same time. This ambiguity keeps the private sector alert.

For overwhelming number insured businesses, it will stay that way until maturity or roll-over into new contract. Due to low regular premium, back-up will run permanently in the background. MEW calls it “sign-and-forget" strategy. That is especially attractive and prerequisite for smaller and less sophisticated market participants.

According to Nick Butt, Bank of England precautionary facility will be priced of quality of collateral. Hence, risks that market participants will integrate facility into internal risk and business decisions. Market standard is two-factor pricing: (1) probability of insurance case times (2) anticipated payout. Two-tier structure by MEW will also use market standard two-factor pricing at private precautionary facility, plus single-factor pricing at central bank precautionary facility level. The regularly to be paid individual insurance premium will differentiate by business model, way of execution and level of default risk, meaning liquidity and collateral insurance is like capital-based credit rating. Insured businesses are economically motivated to not increase risk, otherwise they get penalised directly via deteriorating insurance conditions, including rising premiums.

Bank of England’s concern regarding negative feedback loop gets addressed on structural level. Waterproof, if structure is protected from manipulation by market participants. Self-regulation is wishful thinking, central reason why MEW decided not to launch in-house developed solution unless certified and regulated to similar tight standard as insurance companies.

According to the internet presence, development of financial contract, nucleus of private leg of two-tier precautionary facility solution, should fit into BIS Innovation Hub London Centre mandate. Since liquidity and collateral risk is pressing in many jurisdictions, MEW believes BIS involvement from early on would fasten cross-border rollout. Therefore, although Bank of England initial focus is on UK ICPFs following LDI upheaval, MEW believes BIS Innovation Hub participation now makes a lot of sense.

To summarize, updates to collateral regime as proposed under "Streamlining VM processes and IM responsiveness of margin models in non-centrally cleared markets" must prove to cover disruptive situations in the past, plus, is capable to cover all current risks. That is necessary, but not sufficient. Additionally, already known trends and resulting challenges lying ahead likewise must be taken into consideration, for the new regime not to be outdated at inception already.

The biggest trends we observe since years are digitization and ever faster speed of transactions. Therefore, MEW is convinced coming update is the right time to update collateral regime from analogue and static to sustainable digital and dynamic. The fact, that new digital regime would be far simpler and cost efficient than analogue and static one makes transition even more persuasive. Important, two-tier precautionary facility solution is no replacement for current active collateral management by market participants, but addition to cover highly dangerous but so far completely uncovered ultra-short-term time-frame.

Best regards,

Manfred E. Will

Founder & CEO