OCC THE FOUNDATION FOR SECURE MARKETS

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International Organization of Securities Commissions (IOSCO) Secretariat
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Re: *Consultative Report: Review of Margining Practices*, October 2021

Dear Sirs/Madams:

The Options Clearing Corporation ("OCC") appreciates the opportunity to comment on the *Consultative Report: Review of Margining Practices* ("the Report") issued by the Basel Committee on Banking Supervision ("BCBS"), the Committee on Payments and Market Infrastructures ("CPMI) and the Board of the International Organization of Securities Commissions ("IOSCO"). OCC applauds the efforts undertaken by BCBS, CPMI, and IOSCO to prepare the Report. We fully agree that the pandemic-related market turmoil of March 2020 was the most significant test of the resilience of our global financial markets since the Global Financial Crisis of 2008 ("GFC"). While the post-GFC regulatory framework performed well during March of 2020, we believe that a comprehensive review and dialogue about margin practices during this period is valuable. As a member of CCP12 and the World Federation of Exchanges, OCC's responses to the Report can be found in the letters submitted to BCBS, CPMI and IOSCO by those organizations. In this letter, OCC offers supplemental comments and observations on some of the key issues presented by the Report.

About OCC

OCC, founded in 1973, is the world's largest equity derivatives clearing organization. OCC operates under the jurisdiction of both the U.S. Securities and Exchange Commission ("SEC") and the Commodity Futures Trading Commission ("CFTC"). As a registered clearing agency under SEC jurisdiction, OCC clears transactions for exchange-listed options. As a registered derivative clearing organization ("DCO") under CFTC jurisdiction, OCC clears transactions in futures and options on futures. OCC also provides central counterparty clearing and settlement services for securities lending transactions. In addition, OCC has been designated by the Financial Stability Oversight Council as a Systemically Important Financial Market Utility ("SIFMU") under Title VIII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). As a SIFMU, OCC is also subject to oversight by the Board of Governors of the Federal Reserve System. OCC operates as a market utility, is owned by five exchanges, and is governed by a Board that includes clearing member, exchange and public directors.

Introduction

Central counterparties ("CCPs") performed exceptionally well during the GFC, and, as noted in the Report, international policy makers expanded the prevalence of and reliance on the CCP model in the years following GFC as a part of their efforts to support the stability and resiliency of the global financial system. CCPs are interposed between counterparties to a transaction and have a wide array of risk management tools that are used to ensure the performance of open contracts. These tools include a CCP's ability to establish initial margin ("IM") requirements at a level that is designed to cover potential future losses over a closeout period in the event of counterparty default. During periods of high market volatility, CCP margin models typically establish a higher initial margin requirement to account for the increased risk of price and implied volatility changes. Most CCPs, including OCC, also employ measures that are designed to mitigate initial margin procyclicality during periods of stress.

The increased reliance on the CCP model to support the stability and resilience of global financial markets has proven effective, including during the pandemic-related market turmoil and economic contraction that occurred in March of 2020. CCPs managed the risk of the positions that they cleared, took appropriate mitigating actions to reflect the dramatic increase in market volatility, and prevented any systemic shocks to the system.

While we agree that it is important to review lessons learned in the aftermath of a shock to the financial system, OCC is concerned about the recommendations for future international work on CCP transparency, the responsiveness of CCP initial margin models and the anti-procyclicality measures implemented by CCPs. OCC believes that the efforts of international standard setting bodies and regulators to improve CCP transparency have been successful. As a result of these efforts, CCPs currently disclose a significant amount of information regarding their margin methodology and provide far greater transparency than clearing member firms typically provide to their customers and potential customers about their own methodologies. CCP margin methodology transparency benefits all market participants and enables them to better assess risk. OCC cautions, however, against establishing prescriptive standards, guidance or requirements related to margin models and anti-procyclicality measures and drawing comparisons to the nascent margin practices in the less transparent market for products that are not cleared through a central counterparty. These concerns are described more fully in the responses to questions 3, 4 and 8 set forth below.

Q.3 Do you agree with the proposals for further international work regarding good practices, metrics, and disclosure concerning procyclicality of CCP IM models? Are there aspects of CCP IM where additional disclosure should be prioritized for future work?

Since 2008, international policy makers, including BCBS, CPMI and IOSCO, have implemented a framework of international standards that have strengthened CCPs and the central clearing model. This framework includes, *inter alia*, the Principles for Financial Market Infrastructures ("PFMIs")[1] and Resilience of Central Counterparties (CCPs): Further guidance on the PFMIs.[2] These international standards expressly address CCP margin requirements and provide recommendations on addressing and limiting procyclicality. Most CCPs have, in turn, enhanced their margin practices and implemented anti-procyclicality measures, particularly those that are designated as systemically important in their jurisdiction.

For example, OCC's initial margin model is based on a Monte Carlo methodology using 10,000 scenarios that forecasts volatility on a daily basis with a two-year lookback of historical volatility, which is augmented by a ten-year lookback window to mitigate procyclicality. OCC has implemented this anti-procyclicality measure in accordance with international standards even though such measures are not expressly required by OCC's regulators. OCC's margin models are also calibrated daily based on the most current market information. In the weeks leading up to the pandemic-related spike in volatility that occurred primarily in March 2020, OCC's margin models responded to the uptick in price and implied volatility changes by incrementally and automatically increasing initial margin requirements in February of that year in anticipation of further market volatility. The daily calibration of OCC's margin models combined with its procyclicality measures helped mitigate the margin impact of the drastic increase in volatility that ultimately

[1] Principles for Financial Market Infrastructures

[2] Resilience of central counterparties (CCPs): Further guidance on the PFMI - Final report (bis.org)

occurred. OCC's use of anti-procyclicality measures is not unique, as noted in the Report, most of the CCPs surveyed used one or more anti-procyclicality tool(s).

OCC notes that Principle 6 of the PFMIs contemplates the public disclosure of a CCP's margin system. In its Disclosure Framework for Financial Market Infrastructures, OCC, like many other CCPs, provides an overview of its margin models and procyclicality measures.[3] The Public Quantitative Disclosures (PQDs) provide data on how the models perform.[4] OCC's procyclicality measures are described more fully in a margin methodology document that is available to clearing members. This detailed margin methodology document has a complete description of all inputs, parameters, and model characteristics and is available to clearing member firms and clients to promote a thorough understanding of OCC's margin calculations. OCC also discusses and seeks feedback on potential changes to OCC's margin methodology and procyclicality measures with market participants, including both clearing members and clients, through its Financial Risk Advisory Council ("FRAC"). The FRAC is a forum that meets at least on a quarterly basis to instruct participants on all risk management and model changes and to provide an opportunity for feedback, which is shared with OCC's Board of Directors. Quarterly PFMI disclosures, which are publicly available, are also reviewed by the FRAC so that clearing members and clients can better understand the data and the performance of OCC's models.

Although some market participants have anecdotally asserted that certain CCP models were overly procyclical resulting in higher initial margin requirements during March of 2020, these claims are not supported by the data. As noted in the Report, between February and mid-March 2020, the total amount of initial margin required by CCPs increased by 40% while the predominate measure of volatility in equity markets (*i.e.*, the VIX) increased by 400%.[5] These numbers do not indicate an overreaction of CCP IM models to the market stress and as noted in the Report, almost all CCPs reported that their clearing members did not express to them any concerns with respect to meeting margin requirements in March 2020 and even increased excess collateral at that time.[6]

Initial margin models are inherently risk sensitive, which creates a need to balance mitigating potentially procyclical effects with preserving the financial integrity of a CCP. CCPs are best suited to achieve this balance by maintaining margin models that are appropriately calibrated to reflect the level of volatility and other market conditions. Existing international standards and related regulatory requirements implemented by many jurisdictions already require CCPs to adopt efficient margin systems that establish margin levels commensurate with the risks and attributes of the markets they serve.[7] CCPs should continue to develop, enhance and disclose information about their margin

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[3] OCC - PFMI Disclosures

[4] OCC - PFMI Disclosures

[5] BCBS-CPMI-IOSCO, *Review of Margining Practices,* p. 13

[6] BCBS-CPMI-IOSCO, *Review of Margining Practices,* p. 20 and 28

[7] See, e.g., PFMI Principle 6, Key Consideration 1; 17 C.F.R. § 240.17Ad-22(e)(6).

models and the tools they use to mitigate procyclicality in accordance with existing international standards. Accordingly, OCC does not believe that further international work regarding good practices, metrics and disclosure concerning procyclicality of CCP IM models should be a high priority.

Q4: 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?

CCP transparency has drastically increased pursuant to the international standards and jurisdiction-specific regulatory requirements arising from the GFC. Most CCPs are required to create and maintain comprehensive PFMI qualitative disclosures that include a description of the CCP's margin methodology as well as quarterly quantitative disclosures. This disclosure framework has improved clearing members' ability to assess risk and estimate potential liquidity needs.

In addition to its PFMI disclosure, OCC has created a detailed description of its margin methodology that is available to clearing members that enter into a non-disclosure agreement. OCC's margin methodology document provides a detailed overview of OCC's margin model and its key assumptions, inputs, components and characteristics. It also describes OCC's ongoing model performance backtesting, parameter monitoring and anti-procyclicality measures. As noted above, OCC presents information related to its margin model, and any potential changes to it, to the FRAC, which includes both clearing members and clients. Like many other CCPs, OCC also provides a margin analysis tool that helps market participants understand the details of the margin calculations and anticipate future margin changes.

The PFMI disclosure framework combined with CCP efforts to increase transparency have improved clearing members' understanding of CCP's margin models as well as their ability to forecast liquidity needs in stress events. In fact, CCPs currently provide far greater transparency on their margin methodologies than clearing member firms typically provide to their customers and potential customers about their own methodologies. CCP margin methodology transparency benefits all market participants and enables them to better assess risk. As noted above, in the Report almost all CCPs reported their clearing members did not express to them any concerns with respect to meeting margin requirements in March 2020.[8] Intermediaries also indicated that they were "relatively unaffected" by changes in margin, and "made few, if any changes to counterparty margin call policies and procedures."[9] Moreover, clearing members actually increased the proportion of collateral held as cash during the crisis.[10] The majority of intermediaries also

[8] BCBS-CPMI-IOSCO, *Review of Margining Practices,* p. 28
[9] BCBS-CPMI-IOSCO, *Review of Margining Practices,* p. 31
[10] BCBS-CPMI-IOSCO, *Review of Margining Practices,* p. 31

reported that they did not "experience or observe material issues when converting high-quality liquid assets into cash during the Covid-19 period."[11] Finally, as the Report states, "while margin calls increased during the first half of March 2020, the total margin (VM plus IM) outflows as a percentage of total liquidity resources for even the top third quartile of respondents most affected (relative to their liquidity resources) did not exceed 2.5%."[12]

Q8. 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?

We do not believe based on the analysis in the Report and OCC's own experience, that the degree and nature of the responsiveness of CCP IM models to market stress requires additional international work at this time. As expected, margins increased due to increased risk posed by the increase in market volatility, among other factors, in March 2020. Decreasing the risk sensitivity of margin models could interfere with the model's ability identify and mitigate risk, lead to more margin back-testing exceedances and interfere with the expected 99% margin coverage regulatory standards, which could threaten the financial integrity of the CCP in the event of a clearing member default.

As independent risk managers for the market, CCPs work tirelessly to ensure that their initial margin models are appropriate for the products they clear, market participants they serve and the unique characteristics of the jurisdictions in which they operate. The degree and nature of the responsiveness of margin models should differ across CCPs, as market stresses do not have a uniform impact across all products, participants and markets served by CCPs across the globe. We are concerned that prescriptive requirements arising from additional international work on responsiveness to market stress, may limit a CCP's ability to balance risk sensitivity with anti-procyclicality or implement measures that address their specific circumstances.

OCC is also concerned about certain of the comparisons set forth in the Report that appear to be driving this finding. For example, comparing the percentage increase in initial margin across CCPs may not appropriately account for the distinct risks arising from the asset classes, market participants and home jurisdictions of each CCP. In addition, OCC encourages BCBS, CPMI and IOSCO to consider the quality and availability of data and the nascent and relatively static nature of the model used for products that are not centrally cleared in future comparisons of centrally cleared and non-centrally cleared products.

In our view, recalibration of CCP initial margin models is not the most appropriate solution to reducing liquidity pressure in a stressed market. As noted in the Report, variation margin

[11] BCBS-CPMI-IOSCO, *Review of Margining Practices,* p. 32
[12] BCBS-CPMI-IOSCO, *Review of Margining Practices,* p. 33

increased by 460% between February and March 2020 and pressure on liquidity resources arising from variation margin would not be reduced by adjusting the degree and responsiveness of initial margin models. In this regard, we welcome the BCBS,-CPMI-IOSCO proposal for additional international work to further enhance the liquidity preparedness of market participants.

Conclusion

We thank BCBS, CPMI, and IOSCO for the opportunity to provide comments on the Report. As described more fully above, OCC firmly believes that CCPs and their margin models performed exceedingly well during the pandemic-related market turmoil of March 2020. In response to existing international standards, CCPs have already adopted anti-procyclicality measures and provided increased transparency to market participants. Accordingly, OCC believes that international work arising from the Report should focus on the liquidity preparedness of market participants. We would be pleased to further discuss our comments. If you have any questions, comments, or need any further information, please do not hesitate to contact me at +1-312-322-6220 or JDavidson@theocc.com.

Sincerely,

John P. Davidson
Chief Executive Officer