EFAMA

European Fund and Asset Management Association

EFAMA's REPLY TO BCBS-CPMI-IOSCO CONSULTATIVE REPORT "REVIEW OF MARGINING PRACTICES"

26 January 2022

Rue Marie-Thérèse 11 | B-1000 Bruxelles
T +32 2 513 39 69 | info@efama.org | www.efama.org
EU transparency register: 3373670692-24

EFAMA's REPLY TO IOSCO's CONSULTATIVE REPORT ON THE REVIEW OF MARGINING PRACTICES

INTRODUCTION

EFAMA members greatly value the opportunity to comment on IOSCO's report on margining practices. We commend the work that IOSCO has undertaken to date on this topic including the survey work and the summary findings in the form of the report currently under review. It is fair to say that the conclusions of the report and areas for further work gave rise to detailed discussions within our industry, yielding ultimately firm views on the priority areas that we support and see value in, and areas we felt were not reflected in the study and thereby building risk into margining models in future crisis scenarios. These areas are further elaborated below, but include:

- The need for greater transparency and predictability of CCP margin models
- Related to the above, the need for review and consistency of CCP margin models across entities
- Need for analysis of repo-market performance for the buy-side during crisis
- Need for expansion of eligible CCP collateral list

QUESTIONS FOR CONSULTATION

QUESTION 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.

The report does provide an accurate overview of key market events during the period of greatest market upheaval from February to April 2020. The data on magnitude and frequency of the calculation and payment of margin in centrally-cleared and OTC markets is particularly revealing.

However, there are two additional areas where we think the report could have usefully focused its analysis, namely on the performance of the repo market accessible to the buy-side, and on the operational issues experienced on ETD execution and clearing.

<u>Repo Market Accessible to Buy-side</u>

The report reflects a fair picture of the functioning of the interbank repo market, but fails to bring out the very different experience of non-bank entities. During times of crisis the demand for cash increases from both banking and non-bank entities to meet both cash margin calls and other liabilities. However non-bank entities reply on access to the repo markets via the banking entities. As an ICMA report states, non-bank entities suffered during the crisis period with banks retreating from repo-lending just as demand for cash increased. This calls into question the well-functioning of the repo market and points to potential regulatory reform (bank rules) to better incentivise banks to provide liquidity during periods of stress.

<u>Operational issues experienced during March 2020 relating to ETD execution and clearing</u>

The report makes no reference to the operational issues experienced in the ETD market during the early stages of the pandemic which resulted in a number of trades not being 'given up' by executing (EB) to clearing brokers (CB)/end clients. This resulted in EBs and clients having mismatched positions

and unexpected margin calls. The issues are further explained below:

- Operational stability in industry processes in volatile periods in OTC and ETD markets is crucial to avoid further potential margin volatility via operational risk;
- Operational risk often translates into counterparty credit risk in volatile markets or exacerbates liquidity risk;
- Significant issues were experienced during early pandemic stages due to operational issues impacting on timely 'give up' of executed ETD trades to clearing brokers and manual nature of T+1 trade processes;
- Impact on executing brokers – required to post margin (IM and VM) on trades where 'give up' had not taken place; and
- Buy-side firms and underlying client net ETD IM and VM margin position was significantly impacted where trades were not given up to clearers in addition to increased IM requirements.

Significant work is now underway across clearing members & CCPs - via the Futures Industry Association (FIA) working group - to improve and standardise processes for trades not cleared before T+1. This needs to be delivered to ensure that this is not repeated in a future crisis.

QUESTION 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.

Given the divergence between ETD and OTC model performance, and the fact that as the report states 2/3 of increases in margin calls came for the ETD markets, it would be timely to review model assumptions already defined by PFMI, with a necessary focus on: i) margin period of risk (MPOR), ii) look-back period, iii) margin add-ons and iv) margin offsets.

Ultimately, we would like to raise the standards of risk models, and ensure consistent global implementation of the IOSCO-PFMI rules where there is divergence.

Another important element in the margin call analysis is the list of eligible collateral. Currently there is a need to hold excess cash to weather future periods of volatility. For buy side clients, without central bank access, holding onto cash is costly and carries credit risk as cash can only be held as bank deposits or short-term financial instruments.

We recommend reducing the demand for cash in stressed periods and also strengthening the repo markets (as explained in question 1). While variation margin must be in cash format for cleared trades due to operational reasons, we believe reducing the pressure for variation margin to have to be in cash for non-cleared derivatives would be helpful to reduce the overall demand for cash in the market in stressed conditions. Currently, certain bank capital rules strongly incentivise banks to require variation margin in cash for non-cleared trades as well, which we think could be reconsidered by global regulators with the intention of bringing greater financial stability to the markets in stressed periods.

Finally, and as detailed in the response to Q1, operational issues in ETD markets resulting in the late give up of trades resulted in unexpected margin calls for both EBs and clients which added to existing liquidity stresses.

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

Firstly, we note that there is a wide level of diversity in the level of transparency and quality of margin model information provided by CCPs. As such we unequivocally see room for improvement on CCP margin transparency, which to be clear is not the same as calling for standardisation of models. Quite simply, we need improved data on margin model disclosures, and improved risk management processes enhancing the ability of CCPs to receive, consider and react to feedback from market participants. This feedback would then be notified to the regulators through the CCPs' formal filings, providing for an improved monitoring of CCPs' risk models. The lack of consistency in margin practice transparency by CCPs makes it more difficult to replicate margin calculations. In our experience some CCPs see commercial value in the underlying data and the model they have developed, meaning that they do not allow open access. We think this is misguided behaviour as margin models are an important pillar of risk management and they support overall financial stability.

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

As entities that were in the first line interacting with the CCPs' margin models, we can refer to our reply above (b): the priority is to enhance the transparency and predictability of CCP IM models. The information sharing asset managers are rightly responsible for (with clearing members) can only be as good as the information we receive from CCP themselves on the behaviour and sensitivity of their IM models.

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

No specific comments.

QUESTION 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?

Yes, this seems like the most appropriate approach given the global nature of clearing. Using the available margin data from 2020, it seems clear that some CCPs have much higher procyclicality than others, despite operating in the same region under the same regulatory rules.

Any further work should also consider the expansion of CCP eligible collateral list to avoid the 'dash for cash' effect experienced during the crisis. The initial margins spikes experienced in the spring of 2020 would have caused a less severe impact on financial stability if, for instance, high quality sovereign bonds had been eligible for collateral (with the appropriate haircuts) and if the repo markets had functioned more smoothly.

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

There is no doubt for EFAMA members that one lesson of the crisis has been the need for improved CCP model transparency to enable asset managers to better anticipate liquidity and margin stress. In our experience CCP disclosures lacked detail and were inconsistent across entities. Enhanced CCP disclosure requirements should encompass an explanatory text to market participants regarding CCP risk methodologies, back testing, stress testing, and clearing member and end-user loss allocation. Auditing of disclosures would also likely lead to greater quality and consistency in disclosures.

QUESTION 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?

We have some concerns with the proposals on proposed liquidity obligations where one-size-fits-all liquidity metrics would be redundant and duplicative, given that in Europe funds (whether under UCITS or AIFMD) are already subject to liquidity management rules.

To note, asset managers within the NBFI sectors are usually the agents and not the counterparty to the derivatives transactions. The clients that we service are diverse and are already regulated by their respective regulators which takes into account their business function and risks. A one-size-fits-all approach is therefore not sensible for the NBFI sector.

More importantly the evidence from 2020 demonstrates that the NBFI sector, despite the malfunctioning of repo markets, was prepared in terms of liquidity and its ability to meet margin calls. In Europe, due to provisions in UCITS, MiFID II, and ESMA's liquidity stress testing guidelines for AIFs and UCITS (including MMFs), the regulators are already monitoring and assessing the ability of asset managers to deal with stressed market conditions. Again, for us, the real issue lies further up the chain with the lack of transparency and predictability of CCP margin models.

QUESTION 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.

We believe that EU EMIR reporting sufficiently captures daily data on collateral and margin postings by asset managers. Where there could be improvement is therefore not on the reporting burden on asset managers (already significant), but rather on what is done with the data, and the way in which securities regulators aggregate the received data and provide useful information back to the broader market on developing market conditions.

QUESTION 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

Yes. However, we would not be in favour of moving to an intra-day margin process for cleared trades as operationally we do not have the capability to do this. Asset managers and our clients are also generally deemed to be creditworthy by our clearing brokers meaning that daily exchange of margin is normal.

QUESTION 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?

Yes.

We have already pointed to the need for improved transparency and predictability of CCP margin models, and the rationale for an expanded list of eligible CCP collateral. These measures could be usefully combined with further work on minimum margin floors and ways to strengthen these, and more consistent use of adequate look-back periods.

QUESTION 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?

The uncleared market fared well during the crisis, demonstrating lower levels of cyclicality and volatility. This is attributable to the design of the SIMM model which is less reactive in times of volatility given the longer MPOR (margin period of risk). We would advise against any changes to the regulation on uncleared markets to make them more “risk sensitive”, which would undoubtedly bring further pro-cyclicality risk in times of stress, similar to the cleared markets. Important to note that we expect some increases to the number of clients expected to post margin for non-cleared derivative after September 2022.

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

We would reiterate the need to carry out extensive analysis in the following areas:

- Behaviour of repo markets for non-banks during periods of extreme stress
- Need for an expanded list of eligible CCP collateral, including government bonds, MMFs and ETFs holding eligible assets.
- Operational issues experienced by ETD markets, with need for more standardisation and best practices across exchanges and CCPs.

***

About EFAMA

EFAMA is the voice of the European investment management industry, which manages over EUR 27 trillion of assets on behalf of its clients in Europe and around the world. We advocate for a regulatory environment that supports our industry's crucial role in steering capital towards investments for a sustainable future and providing long-term value for investors.

Besides fostering a Capital Markets Union, consumer empowerment and sustainable finance in Europe, we also support open and well-functioning global capital markets and engage with international standard setters and relevant third-country authorities.

EFAMA is a primary source of industry statistical data and issues regular publications, including Market Insights and the authoritative EFAMA Fact Book.

More information is available at www.efama.org.

Contact

Susan Yavari
Regulatory Policy Advisor – *Capital Markets*
Susan.yavari@efama.org | +32 2 513 39 69