ISDA/FIA Response to ESMA's Consultation Paper
"ESMA's Draft Guidelines on Anti-Procyclicality Margin Measures for Central Counterparties"

Introduction and executive summary

ISDA, FIA and their members welcome ESMA's proposal for Draft Guidelines on Anti-Procyclicality Margin Measures for Central Counterparties. Risk sensitive margin models will always be pro-cyclical to a degree. CCPs' margin models should seek to mitigate such pro-cyclicality and make sure those models do not create undue movements as result of market shocks, at the same time also try to avoid over-margining in less volatile times. ISDA/FIA members however believe that riskier positions should continue to attract higher margins. A key issue for ISDA/FIA members is to have the benefit of transparency from CCPs in relation to the impact of anti-procyclicality ("APC") measures (and ISDA/FIA wish to have greater transparency from CCPs on margin models in general). This is because it is detrimental for market stability if sophisticated participants are unable to largely predict margin models in conducting their business. We would urge that the disclosure standards that ESMA produces ensure at a minimum the standards set out in the CPMI-IOSCO report on "Resilience of central counterparties (CCPs): Further guidance on the PFMI"[1] in relation to CCP disclosure and feedback processes are met. We are also of the view that once measures in compliance with published have been in place for a period, a further consultation should take place to consider best practice.

Responses to the questions consulted on

> **Q1. Do you agree that CCPs should develop and maintain a policy for regular assessments of procyclicality of margin based on quantitative metrics?**

Risk management in cleared markets will be improved if CCPs are required to develop and maintain regular assessments of procyclicality using quantitative metrics. The need to produce regular assessments will provide clarity to the market as to the effectiveness of APC measures and thus help CCPs and their participants consider improvements to these measures. This will also ensure compliance with the requirement in Art 28(1) of the RTS to ensure transparent procedures for adjusting margin. We believe that the majority of large CCPs already implement such policies (usually utilising a 10-year lookback period). We believe it should be left to CCP whether APC measures and their assessment are governed by a single policy or integrated into several policies. Such policy or policies and key reporting should be made public (or at least be disseminated to clearing participants so that APC measures can be integrated into their own risk models; the outcome that should be sought is one where participants do not face unexpected, significant changes in margin requirements as a result of APC measures, to the extent possible. Furthermore, in our view, the draft guidelines should also mention that APC measures should

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deliver forward looking, stable and prudent margin requirements that limit procyclicality to the extent that the soundness and financial security of the CCP is not negatively affected.

Q2. Do you find the examples of quantitative metrics for monitoring the efficiency of APC margin measures appropriate? Are there any additional metrics that could be mentioned in the guidelines?

We have no objections to the use of the quantitative metrics provided as examples. To a degree, CCPs should be able to use metrics appropriate to the clearing service they are providing, subject to minimum standards being met (e.g. defined periods) and there being transparency for participants both as to the process being applied to monitor efficiency and what the level of efficiency/effectiveness shown by such metrics. To the extent possible, the metrics used for monitoring purposes should be utilised in the back testing process.

We note that the metrics provided appear attached to a single margin model. However there may be substantial differences between margining models used by different CCPs and some may result in fewer margin offsets and correlations between contracts and margined assets than others, making them more APC efficient. Conversely, pro-cyclicality could actually be exacerbated where compensating margin add-ons are called for or discretionary action from CCPs are taken where such calls or actions are based on models that are potentially less APC efficient. Also, the fact that clearing members may be located in multiple time zones should also be considered.

We suggest consideration of such variations be taken into account where ESMA intends to provide metrics to analyse the effectiveness of APC measures.

We note that the CPMI-IOSCO Principles for Financial Market Infrastructure[2] (PFMI) provide that a CCP should analyse and monitor its model performance and overall and any European rules or guidelines should ensure at a minimum the standards set out in the PFMI are met.

We suggest that either summary indicators are provided by CCPs to participants or that CCPs provide access to data series and simulation tools (or a combination of either of these options). Additional metrics such as cumulative liquidity impact over a given time period (we would suggest rolling periods of up to 10 business days) and comparing to single-day impact could also be of interest. Comparing such metrics with simulated stressed situations including extreme but plausible circumstances would also be beneficial.

Requiring this from CCPs would enable participants to have better tools to conduct their own reverse stress tests or otherwise simulate margin requirements under stressed conditions in order to make sure that their liquidity resources are commensurate and adapted to potential future requirements.

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[2] https://www.bis.org/cpmi/publ/d106.pdf

Q3. Do you think that CCPs should apply the APC margin measures under Article 28 of the RTS to incorporate all risk factors? If appropriate and as necessary, please provide quantitative analysis to support your response.

Broadly, CCPs should apply the APC margin measures incorporating risk factors. As mentioned in ESMA's EMIR Report no.2[3], the outcome that should be sought is to have margining approaches that are discriminatory and look at the overall nature of positions as well as their directionality.

However, it is unclear how an increase on risk factors by 25% can apply to a VaR risk model and seems more appropriate to SPAN risk models. We are thus unsure if this proposal is intended to only increase the impact of risk factors on SPAN risk models (which are largely not used at large OTC CCPs, as far as we are aware) or is intended to apply to all risk models.

Since stressed implied volatility may be difficult to calculate, in general CCPs should disclose their methodology to participants.

Q4. Do you agree that CCPs that adopt Article 28(1)(a) should establish documented policies and procedures on the exhaustion of the margin buffers and the minimum level of details which should be included in such policies and procedures?

We strongly support the establishment of documented policies and procedures on i) how the margin buffer is utilised and ii) how and when it is replenished (including information on procedures for potential exhaustion of the margin buffers) which should be disclosed to participants. These will ensure that CCP margin policies are transparent and thus predictable for participants. Dependence on any current disclosures to risk committees is unsatisfactory for ensuring transparency both due to the specific role and duties of risk committees and also the limited membership of such committees.

Q5. Do you agree that CCPs that adopt Article 28(1)(b) should adopt a consistent definition and identification of stress scenarios in line with Article 30 of the RTS? If appropriate and as necessary, please provide quantitative analysis to support your response.

We support the adoption of consistent definitions and identification processes for stress scenarios. The use of consistent definitions will ensure consistent and thus predictable application of the relevant APC measure. We note that Article 28(1)(b) states "*assigning at least 25 % weight to stressed observations in the lookback period calculated in accordance with Article 26;*". This clearly indicates the use of historical stressed observations, but not hypothetical stressed scenarios. We support the use of hypothetical scenarios for CCPs that choose to do so, but not make the use of such scenarios mandatory. Where internal hypothetical scenarios are used, disclosure of information pertaining to them by CCPs to participants should be provided.

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[3] EMIR Review Report no.2 - *Review on the efficiency of margining requirements to limit procyclicality* – 13 August 2015

The development and application of stress scenarios for 'extreme but plausible' events by a CCP must also be appropriate both to the products and markets the CCP is clearing and the market for clearing services the CCP is operating in; it would be undesirable from both a cost and stability perspective if CCPs adjusted margin computations to take into account hypothetical scenarios that are inappropriate for a particular clearing service.

With regard to historical stressed observations, we see a potential discrepancy between (the 25% of) the minimum period of 30 years in Article 30(2)(a) and the 10-year lookback period in Article 28(1)(c) (potentially a substantial impact of the proposed change to current initial margin requirements). This potential quantitative impact of the proposed change should be investigated and assessed.

Thus, instead of referring to Article 30 which is part of the default fund framework, the draft guidelines could set out what is meant by "*stressed observation in the lookback period*" (Article 28(1)(b)) and "*a full range of market conditions, including periods of stress*" (Article 25(1)) or, preferably, require CCPs to make this transparent to participants.

Q6.Do you agree that CCPs that adopt Article 28(1)(c) should not use modelling procedures to alter the weights of the observations when computing the margin floor using the 10-year volatility estimate?

We believe that not applying volatility scaling makes sense for computing a margin floor; however we understand that several major CCPs which utilise VAR methodologies already have an approach of not applying volatility scaling to the VAR margin floor.

Q7.Do you agree that CCPs should calibrate the margin floor using the margin parameters used in the regular computation of margins and at the same frequency as regular margin computation?

We have no objection to this proposal but we note that most CCPs which use VAR-based risk models apply volatility scaling to regularize their margin models. We doubt that this is appropriate for a 10 year volatility floor to restrict pro-cyclicality.

If intraday volatilities are not used for regular computation of margins but could be used to calibrate the margin floor in a way that would provide a higher APC efficiency to the margin floor within reasonable orders of magnitude, this alternative should not be disregarded.

Q8.Do you consider it appropriate for CCPs to disclose information on the margin models and the parameters used therein to facilitate the replication of margin calculations and improve the predictability of margins for clearing participants?

Yes, we believe it is important for CCPs to disclose information on margin models and parameters. Greater disclosure ensure that there is transparency and thus predictability for participants as to margin requirements. In particular, disclosure of information and the scrutiny that it will generate of margin models will result in CCPs being able to more effectively improve their models with feedback from

participants and so risk management in cleared markets will be improved. Further, efficient simulators provided by CCPs are necessary for participants to: i) better monitor their own risks as member models are better if they are calibrated and benchmarked with the original CCP model and data; ii) upgrade their models in line with to CCP upgrades, and iii) ensure a minimum level of risk management for participants who may not have enough resources to establish independent risk management systems.

ISDA/FIA and their members therefore support the additional guidance set out in the CPMI-IOSCO report on "Resilience of central counterparties (CCPs): Further guidance on the PFMI"[4] and believe any new European policy should require transparency in line with these guidelines.

In addition, the decision criteria and process whereby stress events are incorporated into margin computations should also be disclosed.

It should be noted that we see the ESMA guidelines as a minimum standard and would ask for more detailed descriptions of the model, ideally to an extent that the model could be replicated by a suitable skilled third person so as to ensure predictability of margin models by participants (please see the Annex below a more detailed list of items we believe should be disclosed).

We do not believe IP concerns by CCPs are a meaningful basis to deny disclosure since disclosure to participants could be made conditional on non-disclosure agreements being signed by participants. Ultimately, participants should be enabled to replicate margin models and doing so requires the disclosure of granular information by CCPs.

Q9. Do you agree with the contents of the disclosures proposed by the draft guidelines?

Disclosures should include full documentation of current and proposed methodologies including exact mathematical specification of any models, including the calibration of all parameters used in methodologies, as well as access to all data used in marking the model. Disclosure should also enable participants, under a non-disclosure agreement, to discuss internally with relevant section within the bank: Risk, Legal, Trading, Quant. We would recommend that quantitative disclosures be provided in an Excel format version for purposes of review by Quant teams, alongside a "plain English" disclosure for non-Quant personnel (e.g. Legal) to digest. ISDA disclosures for SIMM, available on its website could also be taken as an example of a formulaic disclosure: https://www.isda.org/a/oFiDE/isda-simm-v2.pdf. Further, as stated above the decision criteria and process whereby stress events are incorporated into margin computations should also be disclosed.

Material disclosed should also (other than in emergency situations where the CCP must react quickly) be disclosed with sufficient notice before such changes become active. Ideally, participants should be able to provide the CCP a number of portfolios and get IM numbers under margin methodology both currently in effect and with proposed changed (so as to ensure impact of changes in practice is clear).

We include in the Annex below a more detailed list of items for which disclosure should on a general basis be provided in addition/alongside the ones specified in the guidelines.

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[4] http://www.iosco.org/library/pubdocs/pdf/IOSCOPD568.pdf

Annex

- **Value-at-Risk (VAR) or Expected Shortfall (ES) Initial Margin Methodology Disclosure:**
  - **Rationale for chosen approach**
  - **Tiering structure, such as maturity buckets and expiry groups for risk factors**
  - **Assumptions regarding factor changes (generally either absolute or relative changes)**
  - **Look-back period and specification of any weighting scheme, e.g., exponential weighting with a decay parameter of 0.94**
  - **Full specification of methodologies used to simulate profit-and-loss:**
    - **Full valuation (documentation for calculating initial margin with respect to interest rate swaps using full valuation would, for example, require documentation of the yield curves used for discounting and cash flow generation including data and methodology used for bootstrapping, as well as the method used to calculate discount factors)**
    - **Linear/quadratic approximation (specific parameters and their estimations)**

  - **For Monte Carlo and parametric VAR or ES:**
    - **Distributional assumptions in simulating risk factors , e.g., factor changes are assumed to be distributed normally**
    - **Disclosure of any models underlying Monte Carlo simulation (e.g., BlackScholes, Vasicek)**
    - **Strategies for estimating necessary parameters, e.g., estimating volatilities with mean absolute deviation**

  - **For Historical simulation VAR or ES:**
    - **Where applicable, filters for data and rationale for filtering**
    - **Specification of any volatility scaling scheme including**
      - **Estimation methodology of decay parameter used if an exponential moving average volatility updating scheme is employed**
      - **Precise implementation methodology (e.g., common decay parameter)**
      - **Magnitude of any volatility floor**

- **Parametric Approaches Initial Margin Methodology Disclosure:**
  - **Rationale for chosen approach**
  - **Description and discussion of the rationale of all parameters underlying initial margin**
  - **Full specification of the methodologies by which these parameters are determined, including:**
    - **Underlying data**
    - **Tiering structure, such as maturity buckets and expiry groups for risk factors**
    - **Holding period**
    - **Statistic(s) applied to the data (Volatility, min/max, VAR)**

- Look-back period and details of any weighting scheme, such as the decay factor for EWMA
- Confidence level
- Assumptions regarding factor changes (either absolute or relative changes)
- Documentation of algorithms used to apply these parameters (for SPAN, these algorithms would include how priorities and correlations are determined in applying inter-month spreads to tenor pairs and in applying inter-contract credits to commodity pairs)

  o Additions to IM driven by concentration, stress portfolio or other measurements within the default fund

- **Add-ons to Initial Margin Methodology Base Calculation Disclosure:**
  o **Thresholds**
  o **Liquidity Risk / Concentration Risk**
  o **Market Risk**
  o **Correlation Risk**
  o **Basis Risk**
  o **Model Risk**
  o **Wrong Way Risk (both general Wrong Way and specific Wrong Way)**

- **Aggregate CCP Level IM Summary Statistics**

- **Anonymous Member Portfolio Level Back Tests and Summary Statistics**

- **Hypothetical Portfolio Level Back Tests including Portfolio Composition**

- **Factor Level Back Tests and Statistics**

- **Product Level Back Tests**