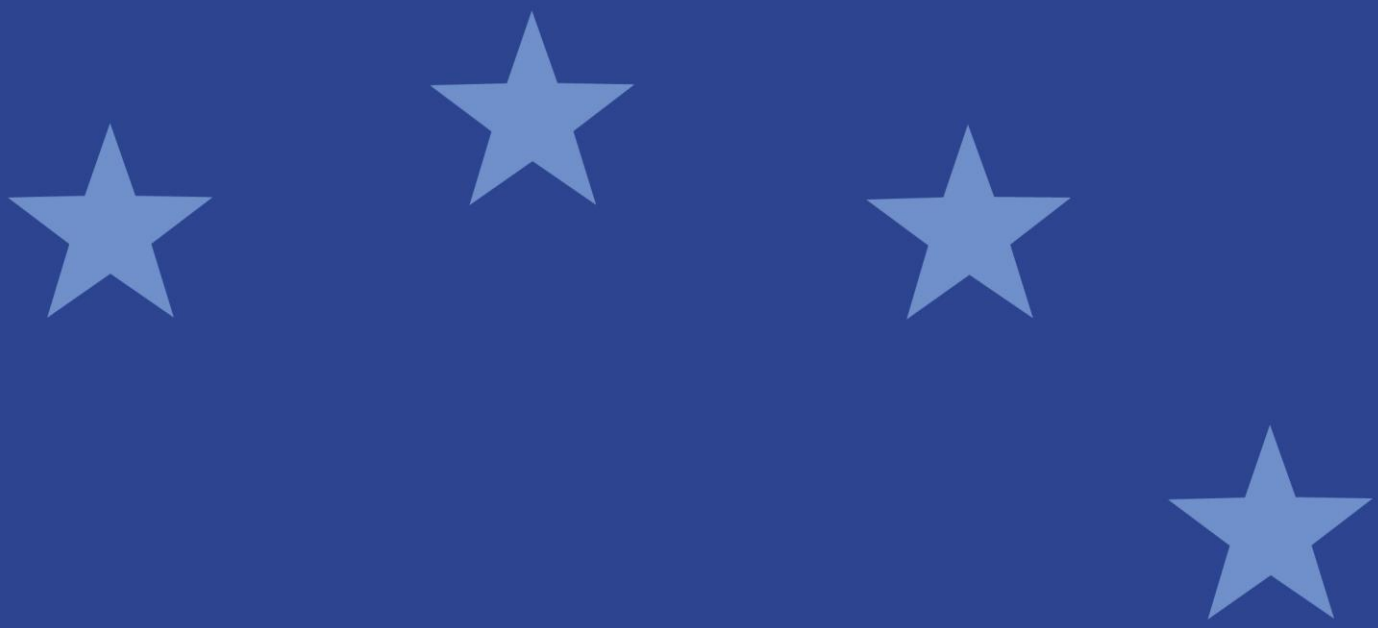
esma European Securities and Markets Authority

Response Form to the Consultation Paper

Review of RTS No 153/2013 with respect to procyclicality of margin



27 January 2022 | ESMA91-372-1977

Responding to this paper

ESMA invites comments on all matters in this consultation paper and in particular on the specific questions summarised in Annex III. Comments are most helpful if they:

- respond to the question stated;
- indicate the specific question to which the comment relates;
- contain a clear rationale; and
- describe any alternatives ESMA should consider.

ESMA will consider all comments received by **31 March 2022.**

All contributions should be submitted online at www.esma.europa.eu under the heading 'Your input - Consultations'.

Instructions

In order to facilitate analysis of responses to the Consultation Paper, respondents are requested to follow the below steps when preparing and submitting their response:

1. Insert your responses to the questions in the Consultation Paper in the present response form.

2. Please do not remove tags of the type <ESMA_QUESTION_APC_1>. Your response to each question has to be framed by the two tags corresponding to the question.

3. If you do not wish to respond to a given question, please do not delete it but simply leave the text "TYPE YOUR TEXT HERE" between the tags.

4. When you have drafted your response, name your response form according to the following convention: ESMA_APC_nameofrespondent_RESPONSEFORM. For example, for a respondent named ABCD, the response form would be entitled ESMA_APC_ABCD_RESPONSEFORM.

5. Upload the form containing your responses, in Word format, to ESMA's website (www.esma.europa.eu under the heading "Your input – Open consultations" → "Consultation on the review of RTS 153/2013 with respect to procyclicality of margin").

Publication of responses

All contributions received will be published following the close of the consultation, unless you request otherwise. Please clearly and prominently indicate in your submission any part you do not wish to be publicly disclosed. A standard confidentiality statement in an email message will not be treated as a request for non-disclosure. A confidential response may be requested from us in accordance with ESMA's rules on access to documents. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by ESMA's Board of Appeal and the European Ombudsman.

Data protection

Information on data protection can be found at www.esma.europa.eu under the heading Legal Notice.

Who should read this paper?

All interested stakeholders are invited to respond to this consultation. In particular, this paper may be specifically of interest for EU central counterparties, clearing members and clients of clearing members.

General information about respondent

Name of the company / organisation	FIA
Activity	Choose an item.
Are you representing an association?	☒
Country/Region	USA

Introduction

Please make your introductory comments below, if any

<ESMA_COMMENT_APC_00>

FIA appreciates the opportunity to comment on the Review of RTS No 154/2013 with respect to procyclicality of margin. We applaud ESMA's leadership on studying CCP margin, its potential for procyclical impacts and for proposing ways to strengthen ESMA's anti-procyclical (APC) tools.

FIA has been a longstanding advocate for CCP margin to be robust and lessen, where possible, procyclical impacts. In October 2020, FIA issued a paper reflecting on the lessons learned from the market turmoil in the spring of 2020, which highlighted the role that steep and rapid increases in CCP initial margin requirements played in creating and exacerbating stress in the market. As we have previously stated, initial margin is the first line of defense against losses from a default by members as well as customers. Initial margin should increase during market stress periods to ensure CCPs are not uncollateralized, but frameworks should also employ safeguards against unnecessary procyclical impacts of margin. We are encouraged to see ESMA moving forward with proposals to strengthen APC tools for CCPs.

ESMA's tools are intended to limit procyclicality to help prevent margin requirements from falling too low during periods of low volatility and thus, help manage the liquidity constrains that sometimes occur when markets are highly volatile.

We understand transparency of margin is being handled at the global level and this consultation focuses on the calibration of the ESMA APC tools. However, we note that the effectiveness of APC tools is intrinsically linked with the need for transparency and participant involvement in the governance process and have raised this throughout our response. We

hope that as thought leaders in this space, ESMA will prioritize addressing governance and transparency once the global standard setters have completed their work. <ESMA_COMMENT_APC_00>

Questions

Q1 : Do you agree that CCPs should be able to explain and justify their APC tool choices?

<ESMA_QUESTION_APC_01>

Yes, we agree that CCPs should be able to explain and justify their APC tool choices. FIA encourages ESMA to review the usefulness of CCP disclosures by seeking views from CMs and clients on how useful they find the disclosures.

Usually, CCPs disclose the APC tools that they use but do not explain the rationale for their choices or provide details on the calibration of the tools. Providing a justification for the choice of APC measure would ensure greater scrutiny and oversight over the tool choices and demonstrate how CCPs are comparing and studying different approaches, providing greater confidence to the market on the rationale for the choice of measure and the CCP's risk management capabilities.

ESMA's APC tools should be viewed as a minimum standard for APC measures that CCPs take into account. CCPs through their risk governance process should also consider other tools that may be appropriate, outline the tools that a CCP has considered or has actually implemented in addition to the ESMA APC measures.
<ESMA_QUESTION_APC_01>

Q2 : Do you agree that CCPs should define their own APC thresholds for margin changes based on their risk appetite/tolerance? Should the RTS explicitly require that CCPs seek the advice of the risk committee, when setting or reviewing its APC policies, including defining the risk appetite?

<ESMA_QUESTION_APC_02>

We agree that CCPs should define their own APC thresholds, as procyclicality has a certain level of subjectivity and different CCPs that clear different products may experience different market behaviours from their participants.

However, it is unlikely that CCPs clearing similar products would have significantly different risk appetites or tolerance for procyclicality. Nevertheless, there was wide discrepancy between CCPs clearing similar products during Covid Crisis. To ensure consistency in approach, a given CCP's APC thresholds could be structured depending on the type of product being cleared, credit profile of market participants, data availability, amongst other things. Importantly, these should be developed in

consultation with market participants. Feedback from market participants is critical to sizing the risk tolerance for procyclicality, as the CCP needs to know what the market participants can tolerate in terms of liquidity needs during a period of stress. The effectiveness of a CCP's APC thresholds and risk appetite can then be stress tested to see how the margin models perform against the stated goal.

We also agree that the CCP's Risk Committee should be involved in setting and reviewing the APC policies and defining the risk appetite. However, the justification and explanation of APC thresholds and the associated risk tolerance should not just be made to the regulators and the CCP Risk Committee members but also shared with market participants who are impacted by these decisions, many of whom do not have representatives on the Risk Committee. <ESMA_QUESTION_APC_02>

Q3 : Do you agree with ESMA's proposal to draft a new Article 28a? What other requirements should ESMA consider introducing in relation to the CCP APC policies and procedures?

<ESMA_QUESTION_APC_03>

Yes, we agree with the drafting of a new Article 28a that requires CCPs to justify their APC measures, define a risk appetite, assess its adequacy and establish a mechanism to take action.

APC measures should consider the management practices, characteristics of the products cleared, structure of market participants and how often the model is reviewed. Providing justification for the APC measure(s) used and how such measures fit the CCP's risk appetite may avoid big discrepancies between CCPs due to different characteristics stated above and improve the transparency and level of disclosure to clearing members (CMs).

In addition, FIA recommends that

- Article 28a(1) should state that the review should not just be periodic but should also occur during periods of market volatility when there are significant margin changes.

- Article 28a(b) should include a requirement that the CCPs define "big step changes" in margin requirements.

- Finally, in Article 28a(1)f, as noted above, transparency and governance is key for the market to understand what they can expect in terms of margin increases.

We encourage ESMA and EU policymakers to move forward as thought leaders at a global level on margin anti-procyclicality, with enhanced transparency that should accompany these tools to make them successful. Transparency would not only ensure the measures are indeed EMIR compliant, but also better enable CMs to plan for the margin to be paid under stress. CMs should be able to replicate the margins on their side to avoid liquidity stress due to margin calls.
<ESMA_QUESTION_APC_03>

Q4 : Do you agree with ESMA's proposed amendment to require CCPs to assess margins based on quantitative metrics in the context of procyclicality?

<ESMA_QUESTION_APC_04>

Yes, we agree with the general requirement that CCPs should be required to assess procyclicality of margins based on quantitative metrics.

We do believe that such metrics should be defined and established ex-ante. For example, we recommend comparison of 1 day, 2 day, 5 day margin moves against the risk appetite of the CCP which should have been set based on the liquidity profile of the participants clearing the relevant product. The CCP can then back-test the margin model against the risk appetite for that product. Such testing will inform the CCPs of whether margin increases could create liquidity pressures on participants. We recognize that setting these risk appetites will require engagement with market participants but believe this should be done in the interest of market stability. It is equally important that the CCP discloses details of performance of the margin framework relative to the metrics to market participants to inspire market confidence.

Disclosure of back testing results and margin breach information at both the account level and the contract level is important. This could include the frequency of margin breaches, the largest margin breach, and the average margin breach. These metrics should be calculated against the same baseline, such as 1-day profit/loss, for comparability across CCPs with different margin periods of risk. For significant products, these metrics should be expanded to include margin breaches over 1-day, 2-day, and 5-day periods as well as maximum 1-day, 2-day, 5-day, and 1-month margin increase over the prior quarter with a comparison of volatility change in the same period. Some CCPs currently offer this analysis. Margin breach transparency will equip participants to better evaluate the effectiveness of margin models and ensure core margins are calibrated appropriately. We recognize that CCPs may be reluctant to release some of this information into the public domain. We therefore suggest that this information could be provided to clearing participants through secure portals with limited access.

The goal of transparency is not to penalize deviation from a target, as we acknowledge that CCPs will have margin breaches, but rather to trigger appropriate governance action. As example, CCPs explaining what happened, why the CCP thought model behavior was appropriate (e.g., breaches were due to unprecedented market moves), worrisome (e.g., the model was not expected to act this way and needs to be reconsidered) or poor model choice (e.g., the model needs to be changed), will assist the CCPs Risk Committee in recommending suitable changes to the framework to ensure robust margining. <ESMA_QUESTION_APC_04>

Q5 : Do you agree with ESMA's proposal to introduce these three dimensions? Should these be mandatory or optional? How do these compare to the quantitative metrics that CCPs currently consider in practice?

<ESMA_QUESTION_APC_05>

Yes, stability, conservativeness and over-collateralization are relevant dimensions of APC measures. They should be evaluated to ensure a degree of consistency between CCPs. However, the effectiveness will depend on how they are deployed. For example, excessive overcollateralization should be avoided during a stressed period, but perceived overcollateralization during low volatile times may be necessary to ensure that increases under stress are less procyclical. Ultimately, effectiveness will require an appropriate degree of transparency and engagement with members.

In addition, it is challenging to precisely measure over-collateralized margin and requires further disclosures, as explained in Q4. <ESMA_QUESTION_APC_05>

Q6 : Do you agree with ESMA's proposal to include in the RTS a requirement for CCPs which clear products whose price/yield can vary significantly to perform the assessment of the procyclicality of its margin model across different price/yield levels?

<ESMA_QUESTION_APC_06>

Yes. This could be especially revealing for CCPs which set margins at an absolute level and can see sharp increases which can be avoided if assessment based on margin rate/yield is undertaken. <ESMA_QUESTION_APC_06>

Q7 : Do you agree with ESMA's proposal to introduce into the RTS the requirement on CCPs to calculate APC margin requirements at all material risk factors?

<ESMA_QUESTION_APC_07>

Yes, we agree with the requirement on CCPs to calculate APC margin requirements at all material risk factors.

It is important to calculate APC requirements on all material risk factors as there could be a wide range of risk factors that could be the cause of the procyclicality of certain products. Hence ensuring each risk factor is being treated separately would be the most comprehensive way of addressing procyclicality.
<ESMA_QUESTION_APC_07>

Q8 : Do you agree with ESMA's proposal to consider the impact that the risk factor change will have on the margin, including for products with non-linear dependence on risk factors?

<ESMA_QUESTION_APC_08>

Yes, we agree. When dealing with non-linear products, the impact on the risk factors will not be proportional to the impact on the margins, so it is even more important to tackle these risk factors impact on non-linear products.

Nevertheless, given the relevant risk factors may vary across CCPs, the introduction of this impact may not be transparent and standard across CCPs, making it more difficult for CMs to accurately assess it. We would therefore recommend that the CCPs provide transparency on the risk factors considered and the extent of impact of each. <ESMA_QUESTION_APC_08>

Q9 : Do you agree with ESMA's proposal on how to apply the APC options for different risk factors?

<ESMA_QUESTION_APC_09>

Yes, we agree on ESMA's proposal on how to apply the APC options for different risk factors. <ESMA_QUESTION_APC_09>

Q10 : Do you agree with ESMA's proposal that CCPs using the APC tool under Article 28(1)(a) should develop policies and procedures detailing the use of the buffer and its replenishment as included in the draft RTS test? Are there other items that the procedures should consider in the RTS?

<ESMA_QUESTION_APC_10>

Yes, we agree with the need for policies around the use of the buffer and scenarios under which the buffer will be eroded. The more detailed information provided the

better in order to ensure adequate transparency for clearing participants to understand impact of these tools. For instance, the percentage for the top products, for instance, top 10 products, on each CCP should be disclosed daily.

In addition the replenishment of the buffer by product type should be considered and detailed, as not all products react the same way in the market, hence specific products and the reaction of those products needs some consideration in developing the buffer. Replenishment should only take place after the stress event has subsided, otherwise replenishment of the buffer itself could add to procyclicality. This is subject to the CCP not being under-margined or under-collateralized, which must never happen. In addition, back-testing the usage of buffers would be helpful in assessing the effectiveness of these procedures. <ESMA_QUESTION_APC_10>

Q11 : Do you agree that CCPs should set predefined thresholds but also be granted a degree of discretion when triggering the exhaustion of the margin buffer subject to appropriate governance arrangements?

<ESMA_QUESTION_APC_11>

Yes, we agree that the CCP should set pre-defined thresholds through appropriate governance arrangements including through consultation with market participants on how they propose to use the buffer. However, once thresholds are set in a systemic way, there should be limited discretion in varying from these as it would impact ability of market participants to predict margin calls. <ESMA_QUESTION_APC_11>

Q12 : Do you agree with ESMA's proposal to set the minimum buffer to 25% while requiring CCPs to assess if a higher buffer would be needed and justify / regularly check the appropriateness of their choice?

<ESMA_QUESTION_APC_12>

Yes, we tend to agree with 25% as the minimum although there should be an assessment by the CCP on the buffer that would be appropriate considering the volatility for the relevant product. However, a deeper analysis would need to be performed in order to understand if the 25% minimum is in fact the optimal value and we believe CCPs should provide rationale for the level of buffer adopted rather than just defaulting to the minimum of 25%.

Having said that, we fundamentally do not believe that the 25% buffer is the most robust tool to address procyclicality considering it was inadequate during recent volatility shocks. Further, once a 25% buffer is added to the margin, there is no guidance in how to "deactivate" or take the 25% buffer off. Thus, the buffer is not an effective APC tool.

ESMA acknowledges in paragraph 68 of the consultation that the buffer could exacerbate margin changes and further fuel procyclicality:

Having these limitations in mind, the results confirm that an increased size of the buffer would improve the conservativeness (smaller margin shortfalls) and also increase the average (and peak) margin. Concerning stability, an increased buffer would reduce the big-step margin changes under the “optimal exhaustion strategy” assumption. However, even in this case, it seems that the marginal benefit starts to deteriorate when the buffer is set at very high levels. Moreover, if the buffer is not exhausted when needed, this tool would exacerbate margin changes and further fuel procyclicality. <ESMA_QUESTION_APC_12>

Q13 : Do you agree with ESMA’s proposal on how to apply the APC options for different risk factors?

<ESMA_QUESTION_APC_13>

There would likely be operational issues for CCPs as CCPs would have to regularly assess if the buffer is adequate or not. For some CCPs this is already common practice but not for all of them. <ESMA_QUESTION_APC_13>

Q14 : Are there cases where ESMA’s proposal to modify Article 28(1)(a) RTS would present difficulties for CCPs in practice?

<ESMA_QUESTION_APC_14>

Yes, the inclusion of these extreme market moves will allow the CCP to be more prepared for future similar scenarios.

For historical stresses, the CCPs should look at least 30-years of history or longer (where available). In addition, CCPs should also include hypothetical and theoretical stress scenarios, for all products although these are particularly critical for products with insufficient price history. <ESMA_QUESTION_APC_14>

Q15 : Do you agree with ESMA’s proposal that CCPs should also consider including the extreme market movements from the potential future stress scenarios identified under Article 30(2)(b)?

<ESMA_QUESTION_APC_15>

The stress testing should include historical scenarios. In addition, historical scenarios should be supplemented with hypothetical and theoretical stress scenarios.

To conclude, CCPs should find an equilibrium between historical scenarios and non-historical stress scenarios to prepare for possible unseen market volatility and providing transparency in the scenario(s) used. <ESMA_QUESTION_APC_15>

Q16 : Do you agree to require that CCPs ensure the set of extreme market movements includes an adequate number of extreme market movements for all margined products, including the ones that could expose it to the greatest financial risks?

<ESMA_QUESTION_APC_16>

Yes, we agree that it is important to include stress scenarios for all products, particularly for ones that could expose the CCP to the greatest financial risks, even if these are extreme. The scenarios that expose the CCP to the greatest financial risk will likewise pose the greatest risk to the system in terms of procyclicality and therefore should be included. <ESMA_QUESTION_APC_16>

Q17 : Do you agree with ESMA's proposal not to include a specific time restriction on when CCPs should add new stress observations in the set of extreme market movements used for the purpose of the APC tool, but instead add a provision to consider reviewing more frequently taking into account the procyclical effects from such revision?

<ESMA_QUESTION_APC_17>

We agree with ESMA's proposal on not including a time restriction but rather including recent stress events in the margin models as soon as is reasonably practicable to ensure the CCP is not under collateralized at any point. One never knows if the current period will be more or less stressed than the period to come. Hence, not reacting immediately in adding the stress scenarios may lead to an underestimation of the IM and an increase in VM which will increase the liquidity stress.

Typically, long lookback periods may dilute the stress scenario in the model. On the other hand, including large moves too quickly in the stress scenarios may in itself increase margin during a potentially stressful period. While recent stress events may already be incorporated in the base margin lookback period, to prevent sharp fluctuations in margin, CCPs must ensure that the stress event is incorporated in the APC tool before it drops off from the look back of the base margin model.

Periods used to calibrate margin floors must be long enough to include periods of significant market stress, such as the 2008 global financial crisis and/or the spring of 2020, as well as being appropriate for the particular asset class. CCPs should justify appropriateness of their stress look-back periods, which may include selecting both a long lookback period and a shorter recent period depending on which produces the higher result.

We agree that the CCP should review its margin model frequently and at least shorter than 1 year. Today, some sophisticated CCPs have more frequent reviews of the model's stress observations and implement the measures in a way that does not disrupt the market. <ESMA_QUESTION_APC_17>

Q18 : Do you agree with ESMA's proposal that CCPs should calculate the stress margin using the same model and parameters in compliance with Articles 24, 26 and 27, except for the time horizon under Article 25?

<ESMA_QUESTION_APC_18>

Yes, CCPs should be able to use liquidation horizon for stress testing scenarios that is longer than the one used for margin calculation in order to model restricted levels of liquidity. The stress testing framework would be generally more severe than what should be used for margin calculation. This would allow to fully capture historical events without diluting observations. This would also bring stability to the model.
<ESMA_QUESTION_APC_18>

Q19 : Do you agree that for the purpose of calculating the stress margin to be used for the calibration of the APC tool, CCPs should recompute the stress margin at least daily and shall avoid using scaling techniques that can affect the severity of observations or calculated stressed margin?

<ESMA_QUESTION_APC_19>

Yes, we agree that margin should be calculated daily and without scaling techniques.
<ESMA_QUESTION_APC_19>

Q20 : Do you agree with ESMA's proposal to include the provision to allow CCPs to temporarily increase the weight that is applied to the unadjusted margin and equally reduce the weight applied to the stress margin? Should there be a time limit on this provision?

<ESMA_QUESTION_APC_20>

We agree with ESMA's proposal, essentially, the higher of unadjusted margin and margin weighted for stress periods should be used.

The 25% stressed observations make margins more conservative in less volatile times. As ESMA rightly observes in more stressed times this tool leads to a lower margin requirement if the unadjusted margin is higher than the stressed margin.

However, if the stressed observations are well selected and the unadjusted margin is conservative, this should not be an issue. <ESMA_QUESTION_APC_20>

Q21 : Are there cases where ESMA's proposal to modify Article 28(1)(b) RTS would present difficulties for CCPs in practice?

<ESMA_QUESTION_APC_21>

Yes, CCPs would have to closely monitor the right timing to reduce the stressed buffer and would need to avoid leading to even more procyclical margins.
<ESMA_QUESTION_APC_21>

Q22 : Do you agree with ESMA's proposal that the margin floor should include stress market movements in addition to the 10-year lookback period? Do you agree with the methodology used to identify these extreme market movements?

<ESMA_QUESTION_APC_22>

Generally speaking, we agree. It would have to depend on the type of observations that are being used in the 10 years. In case the 10 years already include stress observations, then the CCP should only use the 10 years, if not, stressed observations should be added. Keeping in mind, however, that this inclusion should be done at a level to avoid having diluted stressed observations with almost no weight. As in this case, the problem of under-calibrated margin would still persist and would be worsen throughout time in case stressed observations would occur in the short term.

In addition, overlapping observations should be avoided as this could bias the distribution and hence lead to an over or under charged margin. CCPs should be transparent on the stressed observations being used and lookback.
<ESMA_QUESTION_APC_22>

Q23 : Do you agree that the margin floor should be calculated in compliance with Articles 24, 26 and 27 of the RTS?

<ESMA_QUESTION_APC_23>

Yes, we agree as it is the most conservative and reliable measure to be taken.
<ESMA_QUESTION_APC_23>

Q24 : Do you agree that the margin floor should be recomputed at the same frequency than the baseline margin requirements?

<ESMA_QUESTION_APC_24>

Yes, it can, however, more frequently than just annually. While it makes sense to compute a kind of 'model' margin floor daily, a margin floor that needs frequent or even daily recalibration would not seem an efficient anti-procyclicality tool.

While frequent computation is desirable, implementing very frequent, but often small, changes to margin floors may not always be desirable from an operational perspective, particularly where SPAN type models are used.

However, FIA does believe that there should be some recomputation of the floor more frequently than annually but less than daily. <ESMA_QUESTION_APC_24>

Q25 : Do you agree that, when calculating the margin floor, CCPs shall avoid using scaling techniques that can affect the severity of observations, extreme market movements or calculated floor margin?

<ESMA_QUESTION_APC_25>

We believe that scaling techniques should be left to the Core IM computation. Nevertheless, in case the margin floor is only using 10 years lookback period or few stressed observations, these should have a proper weight in order not to be diluted in such a way that they would not be playing their role.

Meaning, stressed observations should be used in the margin floor and should have the proper weight to guarantee that the floor in not under-estimated. Hence, losing its purpose and not contributing as an APC measure.

Whichever method is used by a CCP to calculate margin floors, the CCP should demonstrate that resulting floor is meaningful in that it prevents margin requirements dropping to excessively low levels during periods of low volatility.
<ESMA_QUESTION_APC_25>

Q26 : Are there cases where ESMA’s proposal to modify Article 28(1)(c) RTS would present difficulties for CCPs in practice?

<ESMA_QUESTION_APC_26>

FIA believes CCPs are best suited to answer whether this would present difficulties.
<ESMA_QUESTION_APC_26>