

ISDA response to the ESMA consultation paper**“Review of RTS No 153/2013 with respect to procyclicality of margin”****Executive Summary**

We welcome this consultation and ESMA’s analytical work on anti-procyclicality (APC) tools shared in the appendix. We are encouraged by ESMA’s focus and thought leadership on this important topic.

We appreciate that ESMA wants to await further international work and is therefore not providing rules on transparency and disclosure. Nevertheless, transparency, disclosure, and governance are critical components in making APC tools effective, and so we encourage ESMA to move forward on these components when the international work concludes.

As stated in ISDA’s response¹ to BCBS/CPMI/IOSCO’s consultation on margin practices², we propose that the whole clearing market (CCPs, clients, clearing members) and regulators agree to a target level of procyclicality that balances the cost of clearing (margin levels) with stability (reduced procyclicality), acknowledging that margin calls during some tail situations may have to exceed this to ensure CCPs are not under-collateralized. A precondition of this approach is a standardized measure of procyclicality so that regulators and market participants have transparency about how well each CCP has implemented the agreed risk appetite for procyclicality.

Many of ESMA’s proposals are in line with recommendations we make in our response to BCBS/CPMI/IOSCO on margining practices. We also understand that ESMA wishes to update the APC tools in EMIR. In this light, we provide our thoughts to ESMA’s questions.

We also propose for ESMA to review APC tools in conjunction with regulations and practices in relation to CCP base margin.

This consultation response covers the positions of our members that are clearing members and their clients. The paper does not reflect the views of many CCPs, and many of the CCPs are in disagreement with the views expressed herein.

¹ <https://www.isda.org/2022/01/26/iif-and-isda-respond-to-the-bcbs-cpmi-iosco-consultation-on-margin-practices/>

² <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD686.pdf>

Questions

Question 1: Do you agree that CCPs should be able to explain and justify their APC tool choices?

ISDA members believe that it should be left to each CCP to adapt its models to achieve an agreed level of risk appetite for procyclicality. We therefore agree that the CCP should be free to implement the APC tool or a set of tools that will work best for the products and markets cleared by the CCP. Ideally these APC tools should be chosen and implemented in order to achieve an outcome agreed by relevant stakeholders (i.e., the CCP, its clearing members, and clients).

However, while we agree that CCPs should be able to determine the appropriate APC tools, we also agree with ESMA that it is imperative that CCPs are able to explain and justify their choice of APC tools, not only to supervisors but also to clearing participants so that participants have sufficient understanding of the framework to be able to anticipate margin calls during stressed periods. This is critical to make the APC tools effective.

Question 2: 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?

We note that a CCP mostly does not operate only with its own financial resources, but rather with resources provided by clearing participants. If a CCP's margin is overly procyclical, the risk is to its clearing participants, not to the CCP. The losses to the CCP from procyclical margin will be limited to the extent of its SITG contribution and only in the scenario where a clearing member defaults. A CCP's risk appetite in relation to procyclicality inextricably linked to liquidity risk for its participant. We therefore believe that the risk appetite in relation to procyclicality should be defined in close consultation with the CCP's users, not by the CCP alone. Seeking advice and approval of the risk committee would be an absolute minimum. A risk committee however is a governance body of the CCP and representatives of clearing participants on the risk committee have to act in the interest of the CCP, not their own firms. It is therefore imperative that the CCP also consults its users more broadly when setting a risk appetite for procyclicality as the CCPs' users are best placed to provide feedback based on how they manage their own liquidity.

We do agree that "speed limits" cannot be part of any APC tool. A CCP needs to be able to protect itself at all times. This includes calling for a sufficient amount of margin as uncollateralized risk essentially translates to credit risk for the clearing participants.

As noted in paragraph 97, the objective of the regulation is "not to make margins stable at any cost" and we believe that the implementation of speed limits would significantly affect soundness and financial security.

While not explicitly in scope of this consultation, there would be benefit in monitoring the performance of a CCP's APC tools in a standardised way to evaluate performance of the tools relative to the risk appetite set, provide visibility to participants on when they can expect margins to increase and allow for comparison between CCPs.

Question 3: 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?

We agree in principle with the new Article 28a.

The new Article should acknowledge that it is not the CCP's risk appetite for procyclicality, but the collective risk appetite of the CCP and its users and that therefore requires meaningful involvement of clearing participants in setting the risk appetite.

We propose to strengthen item (g) by requesting detailed disclosure of information to the market. We propose the following change:

“(g) the public disclosure of **detailed** information on the functioning and performance of the CCP's choice between the options mitigating the potential procyclical effects of its margin revisions as provided for in Article 28(1).”

This new Article should be revisited if international work results in standards on market wide risk appetites and disclosures.

We also propose that ESMA explicitly addresses the use of the lambda factor for filtered historical simulations. At minimum the CCP should analyse and explain the interdependencies of the lambda factor and the AP tools and their overall effect on procyclicality.

Question 4: Do you agree with ESMA's proposed amendment to require CCPs to assess margins based on quantitative metrics in the context of procyclicality?

We believe that any APC tools for which a CCP is unable to provide quantitative metrics would not be fit for purpose. We note that most CCPs have such metrics.

We however believe that these metrics should be standardised for disclosure purposes. ESMA could lead regulation on this topic by requiring a base metric that every CCP should provide in a standardised fashion. The rules could include a review clause should international work develop different rules.

We note that the approach suggested in question 2 could form part of such quantitative metrics for disclosure.

Other disclosures based on quantitative metrics should be:

- The extent of usage of APC tools in their IM models so that market participants can predict IM calls during stress periods – e.g. whether margin levels are model driven vs. floor driven, extent of usage of margin buffers.
- CCPs should disclose the maximum margin increase over one day and over one month in the past, based on a suitable long lookback period (for instance min 15 years).
- CCPs should share the margin increase (from current levels) if volatility increases and decreases by 10%, 20% or 50% and the impact on their APC tools of these moves. CCPs should provide one-day, one-week and one-month forward view on IM would be under different volatility assumptions.

We also propose for ESMA to collect standardised procyclicality measures from CCPs so ESMA can compare performance of margin models and APC tools across the market.

Question 5: 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?

We support these three proposed dimensions.

Conservative margin models are a bedrock of clearing. We believe that conservativeness could be improved for some CCPs, for instance by not sticking to regulatory minimums in all cases.

Setting the right level of procyclicality will always be a trade-off between the cost of clearing (margin levels) and stability (reduced procyclicality). Hence, looking at stability of margin models and the potential for margin to be set at an excessive level is a good approach.

Question 6: 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?

We do agree with this proposal. We have often highlighted the issue in models that solely use absolute or relative measures.

Question 7: 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?

If a risk factor is material, this risk factor will have an impact on margin, and volatility in this risk factor can lead to procyclicality. We therefore agree with the proposal to introduce into the RTS the requirement on CCPs to calculate APC margin requirements at all material risk factors.

Question 8: 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?

We do agree that the margin buffer should apply to risk factors and not the margin amount for non-linear risk factors. We however would propose that the CCP could be allowed to use a margin buffer that is calculated at the margin levels and not at the risk factor level, if the CCP sizes this margin buffer with non-linearity of risk factors in mind.

CCPs should disclose how changes in non-linear risk factors could impact margin requirements.

Question 9: Do you agree with ESMA's proposal on how to apply the APC options for different risk factors?

We agree in principle with the proposal that a CCP may use different APC tools for different risk factors, as long as the CCP can show why it picked a particular APC tool for a risk factor and show the efficiency and effectiveness of the APC tool at reducing procyclicality without setting excessive margins.

We also agree with the proposal that APC tools can be applied on portfolio or product level. This choice needs for instance be available for APC tools to work with VaR models.

Question 10: 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?

We agree that CCPs using the APC tool under Article 28(1)(a) (margin buffer) should develop policies and procedures on the use of the buffer and its replenishment. We are mindful that there should be a degree of flexibility for this tool to work under all market conditions. However, the CCP should have done research regarding conditions under which different buffer depletion strategies would work best, so as not to have to consider these issues only at time of high procyclicality.

Predefining thresholds would be a good start in developing these procedures. The plans for depleting the buffer and the thresholds should be developed in consultation with clearing participants so that it ensures predictability for clearing participants.

The CCP should also define in their policies and procedures the scope of flexibility. This should also be disclosed.

We agree that using the buffer requires such subjective decisions that this tool might not be appropriate for all CCPs.

In terms of replenishment, we do not think that the CCP should replenish the buffer in stressed periods as it will add to procyclicality. The buffer should be replenished at the end of the stressed period. As the stressed event will be part of the lookback period of the margin model, adding the buffer while still in the stressed period could be procyclical.

Question 11: 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's analysis has shown that there is no single optimum buffer depletion strategy. Based on this we agree that the CCP should have flexibility in the way it utilised the buffer, based on previous planning. Please see also the response to the previous question, especially the point on disclosure to of the extent of the CCP discretion.

The fact that there is no optimum strategy for the CCP and that the CCP has to act without any knowledge regarding how much volatility will increase further might mean that a margin buffer might not be the most suitable tool for most CCPs.

We would also note that when looking at historical data, it is relatively easy to assume a practice where the buffer is slowly left to exhaust as the market approaches the peak of a crisis. In practice this is significantly more challenging to predict and it is important to ensure that CCPs do not create approaches that exhaust the buffer too rapidly and then have to react to continuing increases in market stress with replenishments which further exacerbate the procyclical moves.

Question 12: 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?

We agree that there should be a regulatory minimum for the buffer, especially as a large number of CCPs uses this APC tool. We agree that a CCP should assess if a higher buffer should be used, as 25% is an arbitrary number for the buffer and therefore CCPs should assess whether a larger buffer would be appropriate based on its target for procyclicality. We note that the 25% buffer would not have been sufficiently large to mitigate procyclicality during March 2020 for many instruments.

Question 13: Are there cases where ESMA's proposal to modify Article 28(1)(a) RTS would present difficulties for CCPs in practice?

We leave it to CCPs to provide examples where the proposals to modify Article 28(1)(a) RTS would pose any practical difficulties. If these reasonable proposals make this APC tool not practical, one has to wonder whether this tool is suitable to mitigate procyclicality.

Question 14: Do you agree that CCPs should consider the extreme market movements from the historical stress scenarios identified under Article 30 of the RTS?

Stress scenarios identified under Article 30 are selected for default fund sizing, ensuring the survivability of the CCP. If ESMA wants to be more prescriptive in the selection of stressed scenarios, it might however be helpful to streamline regulation and use the same definition of stress scenarios for APC tools and default fund sizing.

Question 15: 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)?

We agree with the proposal that a CCP could also consider including the extreme market movements from the potential future stress scenarios identified under Article 30(2)(b).

Question 16: 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?

We do agree with the requirement 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.

While the stress scenarios used by the CCP should include, but not be exclusively be formed by stress scenarios identified under Article 30, we would assume that the CCP will also review whether the number of the stress scenarios used for default fund sizing is appropriate. If the number of these scenarios is so low that the CCP needs a lot of additional stress periods for this APC tool, the CCP might not have a sufficient number of stress scenarios.

Question 17: 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?

We do agree that the CCP should have flexibility as to the timing of updates of stress scenario in the margin lookback period to ensure that these updates are not procyclical in themselves, but welcome that ESMA proposes a regulatory minimum. We agree with an annual review in general, but believe that of the CCP uses a shorter lookback period, the review should happen more often.

We also note that the most recent stress scenarios will already be part of the lookback period of the unstressed model. Should the same scenarios be added to the stressed set of scenarios, there might indeed be procyclical effects.

Question 18: 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?

We agree with this proposal in principle but note that we understand that at present a CCP can decide to calculate two different margin amounts (one stressed and one unstressed based on recent observations) and then aggregate these, but to use one margin calculation, where 25% of the lookback period consists of stressed scenarios. Such CCPs would become non-compliant with the proposed rules.

We understand that ESMA is concerned that tools like filtering could affect the APC tools if margin is determined as part of the same VaR calculation. We however believe that CCP should be able to continue the use of such margin models, as long as the choice of such margin models is consistent with the procyclicality policies set by the CCP following Article 28a.

Question 19: 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?

We agree that the stress margin needs to be computed at least daily. While the scenarios might not change from day to day, the sensitives of the portfolio for which margin is calculated will change over time.

We also agree that any scaling techniques could defeat the objective of having a stressed margin component. Such techniques should not be used for calculating the stressed margin.

Question 20: 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?

As the CCP does not know how much volatility will increase in the future, we are very sceptical of allowing the CCP to temporary increase the weight that is applied to the unadjusted margin. Such a change might smooth out margin increases but can backfire if the CCP misjudged the overall volatility spike. During the time the CCP does not have the full set of information to judge how much of the buffer should be depleted and the outcome might be more or less dependent on whether the CCP guessed correctly.

Question 21: Are there cases where ESMA's proposal to modify Article 28(1)(b) RTS would present difficulties for CCPs in practice?

We leave it to CCPs to provide examples where the proposals to modify Article 28(1)(b) RTS would pose any practical difficulties, but do not expect difficulties.

Question 22: 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?

The proposal that the floor should include stressed market movements in addition to the 10-year lookback period was made also in ISDA's response to BCBS/CPMI/IOSCO's consultation on margin practices, so we naturally agree with ESMA's proposal.

Question 23: Do you agree that the margin floor should be calculated in compliance with Articles 24, 26 and 27 of the RTS?

Yes, the margin floor should be calculated in compliance with Articles 24, 26 and 27 of the RTS without using scaling tools.

Question 24: Do you agree that the margin floor should be recomputed at the same frequency than the baseline margin requirements?

We agree that the margin floor should be recomputed at the same frequency than the baseline margin requirements, as the scenarios included in the floor will change daily and the portfolio for which margin is calculated could change even more often.

Question 25: 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?

Yes, we agree that scaling techniques should not be used, as the whole idea of a floor is to be a baseline that does not change often - at least in terms of the scenarios, not necessarily of the portfolio for which margin is calculated.

Question 26: Are there cases where ESMA's proposal to modify Article 28(1)(c) RTS would present difficulties for CCPs in practice?

We leave it to CCPs to provide examples where the proposals to modify Article 28(1)(c) RTS would pose any practical difficulties, but do not expect difficulties.

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