ESRB response to the ESMA consultation on draft guidelines on anti-procyclicality margin measures for CCPs

This document presents the ESRB's response to the ESMA consultation on draft guidelines on anti-procyclicality margin measures for central counterparties (CCPs).[1] The ESRB strongly supports ESMA's efforts to improve the measures tackling the procyclicality of CCPs' margins, and welcomes the fact that the draft guidelines are broadly consistent with previous ESRB proposals. The ESRB's input to this consultation builds on its previous reports (see ESRB 2015, 2017a and 2017b). This response is structured as follows: Section 1 outlines the context and scope of the ESMA guidelines on the procyclicality of margin and haircut requirements, while Section 2 presents the responses to the specific questions included in the ESMA consultation paper.

1 Context and scope of the ESMA guidelines

The ESRB's previous reports consider collateral requirements in both bilateral and centrally cleared transactions. Following the recent financial crisis and as a result of regulatory reforms, financial transactions are increasingly collateralised. Collateral requirements, including margin and haircut requirements, therefore play an increasingly important role for market participants in both bilateral and centrally cleared transactions. In line with its macroprudential mandate, the ESRB has a wide perspective including the full range of collateralised transactions, both bilaterally and centrally cleared. At the same time, in the context of this consultation the ESRB understands the focus of the ESMA draft guidelines on centrally cleared transactions given the absence of legal provisions to limit the procyclical effects of margin and haircut setting in bilateral clearing arrangements. As described in ESRB (2017b), the ESRB identified this as a gap in the level 1 legislation.

Margin and haircut requirements may be procyclical and lead to the build-up of systemic risks. As described in further detail in ESRB (2017a), collateral requirements may be procyclical. In

[1] Available at: **https://www.esma.europa.eu/press-news/consultations/consultation-draft-guidelines-anti-procyclicality-margin-measures-ccps**

the ESRB's view, procyclicality leads to a mutually reinforcing mechanism that amplifies fluctuations in financial markets, which may then result in negative feedback loops with the real economy (ESRB, 2017a). Procyclical collateral requirements may lead to excessive leverage during times when asset prices rise (upswing phases) and enable market participants to borrow more cash to purchase further assets. This may lead to costly deleveraging when asset prices, and hence collateral values, fall (downswing phases) and counterparties are asked to provide additional collateral, which might require the closing out of trading positions and, potentially, fire sales (ESRB, 2017a).

The ESRB strongly welcomes ESMA's efforts to improve the measures tackling the procyclicality of CCPs' margins, which are broadly consistent with previous ESRB proposals. The ESRB previously proposed (see, for example, ESRB (2015) and ESRB (2017b)) that the three options in the regulatory technical standards (RTS) 153/2013 to limit the procyclicality of margin-setting practices should be further clarified. This would facilitate the predictability of margining requirements for clearing members and enable them to anticipate margin calls. In addition, further guidance on the procyclicality-limiting measures would lead to consistent application across CCPs, limiting their opportunities for regulatory arbitrage. This is also acknowledged in the guidance provided by the Committee on Payments and Market Infrastructures and the International Organization of Securities Commissions (CPMI-IOSCO) on this issue (CPMI-IOSCO, 2017). Therefore, the ESRB welcomes ESMA's efforts to improve the measures to limit the procyclicality of margin requirements, as set out in the ESMA consultation paper. At the same time, while the issuance of guidelines addressed to national competent authorities is appreciated, the ESRB recalls that its previous suggestion on the legal form for providing additional guidance was to rely on regulatory technical standards, given their greater legal weight.

Procyclicality in centrally cleared transactions is not limited to CCPs' margin requirements. As pointed out in ESRB (2017a), procyclicality can arise across the full range of CCP risk management policies, including initial margin, add-on margins, haircuts and, possibly, variation margin. The ESRB's concept of procyclicality goes beyond the scope of the ESMA draft guidelines. In its ongoing analysis, the ESRB focuses on the complete transmission channel, from margin and haircut changes to market participants' reactions, including various feedback loops, and ultimately to financial stability problems. ESMA's draft guidelines focus on the first steps in the transmission channels, i.e. on the reaction of CCPs' margin requirements to changes in certain market conditions (sensitivity). However, the ESRB also believes that potentially self-reinforcing feedback loops from changes in collateral haircuts and margins should be considered, while ensuring that a CCP's soundness and financial security is not negatively affected (Recital 68, European Market Infrastructure Regulation (EMIR)). This is important to bear in mind when designing guidelines, for example on quantitative metrics and on CCPs' regular assessments of procyclicality, as explained further below. The ESRB would, therefore, welcome the broadening of the ESMA guidelines to also include the determination of haircuts, in line with the provisions of the EMIR and RTS 153/2013, which point to their potential procyclical effects.

The ESRB response focuses on the specific guidance ESMA is developing on the procyclicality of margins, and outlines further areas where such guidance is needed. The ESRB takes the opportunity of this consultation to recall that, in its view, the procyclicality of margins is an important subcategory of a much broader issue that extends to various parts of and trends in the financial system and also beyond CCPs.

Beyond the scope of the ESMA consultation and the issues which can be addressed through guidelines the ESRB believes, in line with previous reports, that further guidance is needed in the EU legal framework on the measures to address procyclicality, for instance:

- **The current provisions in Article 41 of RTS 153/2013 may not be sufficient to ensure a harmonised and efficient framework to limit the procyclical effects of haircut-setting.** They are not clear on the inclusion of stressed conditions and which criteria to use when rating the issuers' creditworthiness. In addition, the RTS allow the CCPs some discretion and do not establish rules on lookback periods and predefined minimum haircuts (ESRB, 2015 and 2017b). The ESRB reiterates that it would welcome specific provisions in RTS 153/2013 on the procyclical measures to be used by CCPs when calculating haircuts.
- **The transmission of margin and haircut settings and procyclical effects to clients of clearing members deserves further attention.** The current measures limiting procyclicality in margin and haircut requirements only apply to clearing members of CCPs. Since procyclicality could be transmitted from clearing members to their clients, the ESRB suggests that the procyclicality of collateral requirements in client clearing transactions should be analysed further, and that the procyclicality-limiting provisions in RTS 153/2013 should be broadened to include clients of clearing members, as proposed in ESRB (2017b).
- **The effectiveness of the tool in Article 28(1)(c) of RTS 153/2013 may be impaired by restricting the lookback period to ten years.** Margins should be stable over the cycle, but this cycle may well be longer than ten years for some risk factors. In addition, a ten-year lookback period may not include stressed observations. Limiting the look-back period to ten years gives rise to the risk that stressed observations, like the global financial crisis of 2007-08, are phased out and eventually disappear from the look-back period without new stressed observations being added.

2 ESMA draft guidelines on anti-procyclicality margin measures for CCPs

The ESRB welcomes that the ESMA draft guidelines clarify how the EMIR tools on margin requirements should be applied. ESRB (2015) states that the provisions in Article 28(1) of RTS 153/2013 do not provide sufficient guidance on applying the three measures to limit the procyclicality of margin requirements. It was therefore concluded that the existing framework should be improved and include clear guidance on the parameters to be used by CCPs when calculating the margin requirements. This would ensure consistent application across CCPs and that the provisions do not result in insufficiently low margin levels. The ESRB is supportive of the ESMA draft guidelines for the application of the procyclicality-limiting tools regarding CCP margin requirements.

The ESRB welcomes ESMA's proposal to enhance transparency for clearing participants by requiring CCPs to publish information on their margin models. The ESRB welcomes the proposals in the ESMA draft guidelines, which would require CCPs to publish the parameters (and other information) of the models they use for computing margin requirements. These would enable clearing participants to better anticipate and manage liquidity strains which could be caused by unexpected margin calls, as described in ESRB (2015).

The ESRB would like to put forward proposals to improve the draft guidelines. While supporting ESMA's efforts to provide further guidance on applying the three procyclicality-limiting measures when calculating margin requirements, the ESRB welcomes the opportunity to provide input to the ESMA consultation on the draft guidelines relating to these measures. The ESRB responses to the specific questions raised in the ESMA consultation are presented below.

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

  The ESRB agrees that CCPs should develop and maintain a policy for regular assessments of the procyclicality of margins and appreciates efforts to increase transparency in the calculation of margin requirements. This is also in line with CPMI-IOSCO's further guidance for CCPs on establishing quantitative and qualitative criteria for evaluating procyclical effects (CPMI-IOSCO, 2017).

  In addition, the ESRB raises two further points on the procyclicality-limiting framework of margin requirements in EMIR:

  - Where CCP margin processes allow for a degree of discretion in addition to margin changes determined by CCP risk model computations, CCPs should exercise this discretion to the extent that it does not foster or amplify procyclical effects, and should clearly demonstrate to national competent authorities (NCAs) that they try to prevent and control possible procyclical effects.

  - Where CCPs take the creditworthiness of clearing members into account in calculating their margin requirements, they should: (i) do so in a transparent and predictable manner, in accordance with pre-established processes and while maintaining CCPs' soundness and financial security, (ii) avoid implementing large credit downgrades in a single big-step margin increase, and (iii) provide reasonable grace periods before applying this increase. In particular, CCPs should avoid imposing big-step margin increases on troubled clearing members whose financial situation is deteriorating, even if the clearing members are entering a recovery or resolution state, as long as they continue to fulfil their payment, delivery and collateral provision obligations.

- **Q2: Do you find the examples of quantitative metrics for monitoring the efficiency of APC [anti-procyclicality] margin measures appropriate? Are there any additional metrics that could be mentioned in the guidelines?**

  The quantitative metrics proposed by ESMA, in the ESRB's view, appropriately reflect the sensitivity of margin requirements to changes in market conditions and should therefore be used by CCPs. However, each of them addresses a specific dimension of procyclicality. In particular, the metric “margin changes over a defined period” measures potential big-step changes over a short timeframe (the short-term, liquidity-oriented dimension of procyclicality), while the metric “margin peak-to-trough ratio over a defined period” measures the stability of margins over the financial cycle (a more long-term dimension of procyclicality). Therefore, the guidelines should clarify that CCPs should use at least one metric for each dimension of procyclicality, either that proposed by ESMA or another relevant metric.

The ESRB sees some difficulties in calculating the proposed measures:

- In the ESRB’s view, the efforts to develop quantitative measures to assess the sensitivity of margin requirements are appreciated. However, the draft guidelines could better achieve their target if they provided a definition of the aspect of procyclicality which is addressed in EMIR, as set out in ESRB (2017a). In line with this suggestion, ESMA could consider including such a definition or concept of procyclicality in the guidelines. Without such a common understanding, it is unclear how using the proposed metrics could “indicate procyclical effects from margin requirements”, because different CCPs and/or the NCAs supervising them may have a significantly different understanding of procyclicality.

- Each proposed measure requires CCPs to identify a representative portfolio to which the measures are applied. The proposed guidelines remain silent on this issue and thus, in the ESRB’s view, give CCPs too much freedom. It is therefore proposed that the guidelines elaborate further on how to identify a representative portfolio. Furthermore, the representative portfolio underlying the calculations should be transparent, so market participants can judge how representative the respective portfolio is for their own clearing activities. In the absence of generally agreed representative portfolios, it will not be possible to disentangle margin variations that are due to changes in parameters (e.g. volatility) from those that are due to changes in portfolio size or composition, which would reduce the value of the exercise.

The ESRB proposes further metrics for monitoring the efficiency of the APC tools:

- How often clearing members were required to post additional initial margin and the amount of additional initial margin posted despite the tools included in Article 28 of RTS 153/2013 being in place.

- In order to allow clearing participants to improve their expectations about future margin requirements, a further measure could compare the sensitivity of total margins required by the CCP (aggregated over all clearing members) to suitable market-based indicators for liquidity risk (for example measures derived from the Euribor-OIS spread[2]) and volatility indices (for example, the implied volatility of the Euro Stoxx 50/VSTOXX). Using

[2] The Euribor-OIS spread includes a liquidity risk component and a credit risk component, as well as the co-movement of the aforementioned components. Therefore, it is not a clear measure of liquidity risk alone (see Dubecq et al., 2016).

this measure, the CCP and market participants could assess how margin requirements react in stressed periods and compare market-based indicators with measures on the level of a representative portfolio. Moreover, the representative portfolio should not only be described in terms of asset composition, but also in terms of size, in order to provide sufficient information on any potential margin add-ons. The proposed disclosure requirements (measures for a representative portfolio, information on the design of the representative portfolio and indicators that link margin requirements to market-based indicators) are, in the ESRB's view, expected to significantly increase the transparency of margining for both market participants and supervisors.

The ESRB also proposes that CCPs be required to disclose the time series of margins on single instruments cleared by the CCP.

- **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.**

  In the ESRB's view the APC margin measures should apply to all relevant risk factors in order to be consistent with the calculation of margin requirements and to include all risk factors a CCP is using. However, this guideline is unclear because the term "risk factor" is undefined, and the common usage varies depending on the type of model being used (standard portfolio analysis of risk (SPAN) or value at risk (VaR)). A definition of "risk factor" should therefore be included in the guidelines to ensure that it is interpreted consistently by all CCPs.

- **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?**

  The ESRB welcomes ESMA's proposal to establish documented policies and procedures on the exhaustion and replenishment of the margin buffer. This would also be in line with additional guidance from CPMI-IOSCO on CCPs' risk management, which suggest a documented policy for assessing and mitigating procyclicality (CPMI-IOSCO, 2017). Furthermore, CCPs should be required to disclose time series data of the buffer, including periods of exhaustion and replenishment (without disclosing data on individual participants), in order to improve transparency for market participants.

- **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.**

  The ESRB sees a need for the amount of freedom CCPs have when choosing stressed observations for the adoption of Article 28(1)(b) to be reduced, so as not to impair the effectiveness of the tool. The reference to the requirements of Article 30 of the RTS is an improvement in this regard. However, the ESRB notes that RTS 153/2013 lacks a quantitative definition of stressed observations. In order to fill this gap, the stressed observations could, for example, be defined as a percentile of the distribution of conditional volatilities.[3]

- **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?**

  The ESRB supports ESMA’s proposal that CCPs should not use modelling procedures to alter the weights of the observations used to calculate the margin floor. The guidelines may benefit from some clarifications, however, as computing correlations and volatilities with an exponentially weighted moving average (EWMA) procedure that is commonly used necessarily implies having decaying (and hence different) weightings for the different historical dates.

- **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?**

  The ESRB shares ESMA’s view that, to avoid the possibility of a regulatory loophole, the calibration of the margin floor should be comparable with the regular margin computation and scaling and decay factors should be applied only in a manner which favours the stability of the margin floor. With regard to the latter, the ESRB believes the formulation in the guidelines should be further clarified. For example, if a CCP usually computes volatilities and correlations using an EWMA procedure with a 1% decay factor, daily observations and a two-year lookback period, this implies that the last observation will contribute less than 1% to the total volatility. If the CCP does not alter the decay factor, it will essentially make no difference if the lookback period is increased from two years to ten years. In this particular case, the CCP should, therefore, specifically use different decay weights for the two-year and ten-year periods in order for the additional eight years of data to have an impact.

- **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?**

  There is a need to improve transparency for clearing participants, so the ESRB considers it appropriate for CCPs to disclose information on the margin model and its parameters to clearing members on a regular basis (see ESRB, 2017b). This is also confirmed in the proposal for the revision of EMIR (see Council of the European Union, 2017).

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[3] See, for example, Murphy et al. (2016).

- **Q9: Do you agree with the contents of the disclosures proposed by the draft guidelines?**

  As also stated in the response to Q2, CCPs should disclose information on the representative portfolio used to calculate quantitative metrics for monitoring the efficiency of APC margin measures. The ESRB proposes that CCPs be required to disclose to clearing participants time series of margins on single instruments cleared by the CCP, as this allows these participants to replicate the margin calculations and assess the liquidity risk of their respective positions with regard to initial margin requirements. Further, it might be helpful to require CCPs to offer clearing participants a margin calculation tool for cleared financial products and portfolios, as also suggested in the proposal for the revision of EMIR (see Council of the European Union, 2017).

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