I

(Resolutions, recommendations and opinions)

RECOMMENDATIONS

EUROPEAN SYSTEMIC RISK BOARD

RECOMMENDATION OF THE EUROPEAN SYSTEMIC RISK BOARD

of 25 May 2020

on liquidity risks arising from margin calls

(ESRB/2020/6)

(2020/C 238/01)

THE GENERAL BOARD OF THE EUROPEAN SYSTEMIC RISK BOARD,

Having regard to the Treaty on the Functioning of the European Union,

Having regard to Regulation (EU) No 1092/2010 of the European Parliament and of the Council of 24 November 2010 on European Union macro-prudential oversight of the financial system and establishing a European Systemic Risk Board ([1]), and in particular Article 3(2)(b), (d) and (f) and Articles 16 to 18 thereof,

Having regard to Decision ESRB/2011/1 of the European Systemic Risk Board of 20 January 2011 adopting the Rules of Procedure of the European Systemic Risk Board ([2]), and in particular Article 15(3)(e) and Articles 18 to 20 thereof,

Whereas:

(1) Central clearing and exchanges of margins for non-centrally cleared transactions are of significant benefit to financial stability, particularly in terms of counterparty risk management. Greater central clearing of derivatives and collateralisation of non-centrally cleared derivatives positions have significantly strengthened the resilience of derivatives markets since the 2008 financial crisis. These reforms – led by the Financial Stability Board, on the basis of agreements reached at the G20 level – helped to ensure that recent market stress has not resulted in widespread concern about counterparty credit risk. Central clearing also maximises netting opportunities, and thus liquidity savings, including in respect of variation margin payments that mechanically reflect movements in market prices.

(2) Market shocks, such as sharp drops in asset prices and high levels of market volatility, translate into increases in variation margins and may also lead to significant initial margin calls on positions in cash securities, commodities or derivatives. Margins are fundamental to how a central counterparty (CCP) manages counterparty credit risk and are an integral part of risk management and support systemic resilience.

(3) Such market conditions could have major implications for the liquidity management of market participants, for their funding needs, and possibly even for their solvency if the liquidity stress leads to systematic fire sales of assets.

(4) Ultimately, the externalities resulting from significant market movements and the corresponding margin calls may jeopardise the stability of the financial system.

([1]) OJ L 331, 15.12.2010, p. 1

([2]) OJ C 58, 24.2.2011, p. 4.

(5) The outbreak of the COVID-19 pandemic and the recent sharp increase in the volatility of the price of oil have resulted, among other things, in significant margin calls across centrally cleared and non-centrally cleared markets. Since the middle of February 2020, initial margins have increased – more significantly for listed derivatives than for over-the-counter (OTC) derivatives – in the wake of higher transaction volumes, and as a margin model's response to potentially higher future losses due to the heightened market volatility. Furthermore, CCPs have issued calls for and collected large amounts of intraday variation margin covering market movements, with the corresponding payout often occurring only the next morning, causing liquidity to be temporarily held on the accounts of the CCPs. A significant rise in the payment and receipt of the daily variation margin on bilateral portfolios has since been recorded in March.

(6) Many clearing members have seen a particularly marked increase in initial margins and some clearing members may have experienced increased liquidity constraints. However, no default has occurred in any CCP established in the Union. Margin calls may have had a significant impact on non-bank entities, via client clearing or in non-centrally cleared transactions, due to liquidity constraints. Looking ahead, the ability of market participants to cover margin calls will depend on future levels of volatility and the continuing resilience of their liquidity management.

(7) Overall, concentration at the level of CCPs and clearing members and the interconnectedness between CCPs through common clearing members, liquidity providers, custodians or investment counterparts may also exacerbate liquidity risk contagion.

(8) The technical standards and guidance on antiprocyclicality (APC margin measures) introduced pursuant to Regulation (EU) No 648/2012 of the European Parliament and of the Council ([3]) are directed at limiting the risk of procyclicality of CCP margin. Commission Delegated Regulation (EU) No 153/2013 ([4])contains specifications on the procyclicality of margins and collateral, which national competent authorities are required to observe. The amendments to EMIR, introduced by Regulation (EU) 2019/834 of the European Parliament and of the Council (EMIR Refit) ([5]), enhance the transparency of margin setting between CCPs and clearing members, yet the same level of transparency is not extended to the relationship between clearing members and their clients.

(9) The European Systemic Risk Board (ESRB) is responsible for the macroprudential oversight of the financial system within the Union. In fulfilling its mandate, the ESRB should contribute to the prevention and mitigation of systemic risks to financial stability, including those related to liquidity. In performing its task the ESRB evaluates the risks for the financial system that could emerge from large margin calls and proposes how these risks might be mitigated.

(10) The ESRB acknowledges the benefits in terms of liquidity savings for the whole financial system related to the multilateral netting benefit provided by central clearing; the ESRB also appreciates the systemic benefit of central clearing as a critical means to reinforce financial stability by ensuring and developing sound risk management practices in terms of credit and liquidity risk.

(11) The ESRB also acknowledges that policy action on margins must not jeopardise protection against counterparty credit risk. Counterparties, including CCP clearing members and their clients, should ensure that they maintain sufficient liquidity to meet margin calls in a timely fashion. It is, however, also beneficial, from a financial stability perspective, to ensure that CCPs' decisions in terms of risk management do not unnecessarily burden clearing members, clearing members' clients and other counterparties because of excessive procyclical features, thus unintentionally creating liquidity strains, that could develop into solvency issues. In response to these present recommendations, the ESRB anticipates that CCPs ensure that their risk management and resilience remain sound and continue to protect market participants against loss resulting from defaults.

([3]) Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories (OJ L 201, 27.7.2012, p. 1).

([4]) Commission Delegated Regulation (EU) No 153/2013 of 19 December 2012 supplementing Regulation (EU) No 648/2012 of the European Parliament and of the Council with regard to regulatory technical standards on requirements for central counterparties (OJ L 52, 23.2.2013, p. 41).

([5]) Regulation (EU) 2019/834 of the European Parliament and of the Council of 20 May 2019 amending Regulation (EU) No 648/2012 as regards the clearing obligation, the suspension of the clearing obligation, the reporting requirements, the risk-mitigation techniques for OTC derivative contracts not cleared by a central counterparty, the registration and supervision of trade repositories and the requirements for trade repositories (OJ L 141, 28.5.2019, p. 42).

(12) Recommendations A and D are aimed at ensuring that sudden and significant (hence procyclical) changes and cliff effects relating to initial margins (including add-on margins) and collateral are limited: (i) by CCPs vis-à-vis their clearing members; (ii) by clearing members vis-à-vis their clients; and (iii) in the bilateral sphere, where they result from the mechanical reliance on credit ratings and possibly from procyclical internal credit scoring methodologies. Liquidity planning should be predictable and manageable to the extent possible by limiting unexpected and significant margin calls. Providing reasonable and enforceable notice periods for any changes in the margin and haircut protocols could ensure that market participants adapt in an orderly fashion.

(13) Recommendation B is aimed at ensuring that CCPs capture comprehensively in their liquidity stress testing any events that could lead to them experiencing a liquidity shortfall, with a view to incentivising them to improve their management of their reliance on liquidity service providers. This will improve the overall market resilience, given that there is a large degree of concentration and interconnection among CCPs and their liquidity service providers, and that prudent liquidity management at individual CCP level in this regard would enhance risk management from a systemic and macroprudential, perspective.

(14) Recommendation C is aimed at ensuring that CCPs, while maintaining their financial resilience, limit the asymmetry in the payment of variation margins collected intraday – and that they design their margin frameworks and schedules so as to be predictable and avoid excessive liquidity constraints for clearing members that could lead to default events.

(15) This Recommendation is without prejudice to the monetary policy mandates of the central banks in the Union.

(16) Recommendations of the ESRB are published after the addressees have been informed, and after the General Board has informed the Council of the European Union of its intention to do so and provided the Council with an opportunity to react,

HAS ADOPTED THIS RECOMMENDATION:

SECTION 1

RECOMMENDATIONS

Recommendation A – Limiting cliff effects in relation to the demand for collateral

1. It is recommended that the competent authorities seek to ensure that CCPs analyse the performance of their policies required by Article 28 of Delegated Regulation (EU) No 153/2013 during periods of acute stress and report their findings to their competent authority.

2. It is recommended that the competent authorities seek to ensure, taking into consideration the findings of the analyses carried out in compliance with Recommendation A(1), that to the extent permitted by law and consistent with CCPs' financial resilience:

   (i) CCPs' models and parameters for setting margin requirements and CCPs' policies and procedures for the acceptance and valuation of collateral and for determining prudent haircuts do not unnecessarily and excessively result in sudden and significant changes leading to cliff effects in initial margins, including add-on margins, and collateral. CCPs should ensure that their models, parameters, policies and procedures:

      (a) use a granular scale for internal credit scoring models and adopt a progressive approach that implements changes to margin requirements, including add-ons, and collateral arrangements, without unduly delaying the reflection of these downgrades in their overall risk management practices;

      (b) adopt a comprehensive approach to limiting procyclical features pursuant to the regulatory requirements on procyclicality in Article 41 of Regulation (EU) No 648/2012, in particular in the event of downgrades of credit ratings;

   (ii) CCPs inform, without prejudice to Article 49 of Regulation (EU) No 648/2012, their competent authorities, and competent authorities inform members of the college established under Article 18 of Regulation (EU) No 648/2012, when they:

      (a) reduce the scope of eligible collateral;

(b) materially modify collateral haircuts;

(c) materially decrease the concentration limits applied in accordance with Article 42 of Commission Delegated Regulation (EU) No 153/2013.

To the extent that it does not interfere with the timely implementation of risk management decisions, this information should be provided sufficiently in advance of implementation.

3. It is recommended that, to the extent permitted by law, the clearing members' relevant competent authorities engage with the clearing members within the context of ongoing supervision to ensure that the application by the clearing members of their risk-management procedures when providing clearing services to their clients does not result in sudden and significant changes and cliff effects in margin calls and the collection of margins – unless these sudden and significant changes and cliff effects are an inevitable result of market events – and does not result in collateral practices in the event of downgrades of credit ratings, and does not materially curtail the soundness of the risk management practices adopted by the clearing members or affect their resilience.

4. It is recommended that, to the extent permitted by law, the relevant competent authorities of financial counterparties and non-financial counterparties that enter into non centrally cleared OTC derivative contracts and securities financing transactions seek to ensure that their risk management procedures do not result, in the event of downgrades of credit ratings, in sudden and significant changes and cliff effects in margin calls and collection and in collateral practices. This could be achieved, for example, by encouraging counterparties to:

(i) use a progressive and granular sequence when implementing downgrades of credit ratings, in their overall risk management practices;

(ii) maintain a comprehensive approach to limiting procyclical features in accordance with the regulatory requirements in Article 11 of Regulation (EU) No 648/2012, especially with respect to ratings downgrades.

Recommendation B – Stress scenario for the assessment of future liquidity needs

1. It is recommended that the European Securities and Markets Authority (ESMA) review the draft technical standards ([6]) developed under Article 44(2) of Regulation (EU) No 648/2012, and in particular Article 32(4) of those draft technical standards, to include provisions that require CCPs to include in their stress scenarios under Article 44 of Regulation (EU) No 648/2012 the default of any two entities that provide services to the CCP and whose default could materially affect the liquidity position of the CCP.

2. Until any action taken by ESMA to comply with Recommendation B(1) and the possible introduction of corresponding Union legislation, it is recommended that competent authorities, to the extent permitted by law, seek to ensure that the stress scenarios under Article 44 of Regulation (EU) No 648/2012 include the default of any two entities that provide services to the CCP and whose default could materially affect the liquidity position of the CCP; such entities could include the liquidity service providers, settlement service providers or any other service providers whose default could possibly affect the liquidity position of the CCP.

3. It is recommended that competent authorities, to the extent permitted by law, seek to ensure that CCPs' remedial actions to address any shortfall in resources available to cover liquidity needs that is identified by applying the additional stress scenarios referred to in Recommendation B(2) or Recommendation B(1), once corresponding Union legislation is in force, do not, when applied in times of market stress, place an additional burden on the clearing members. To this end, the competent authorities should ensure that CCPs seek additional liquidity from alternative market sources.

4. It is recommended that, to the extent permitted by law, ESMA, in cooperation with the competent authorities, engage with CCPs – and to the extent possible with relevant authorities in third countries – to conduct coordinated liquidity stress test exercises which also take into account the default of any two entities as referred to in Recommendations B(1) and B(2).

([6]) Draft technical standards under Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC Derivatives, CCPs and Trade Repositories (ESMA/2012/600).

Recommendation C – Limiting liquidity constraints related to margin collection

1. It is recommended that the competent authorities seek to ensure, to the extent permitted by law and consistent with CCPs' adequate risk management practices and financial resilience, that when CCPs issue margin calls and collect margins to limit their credit exposures, they aim to avoid creating unnecessary liquidity constraints for clearing members, including by ensuring that:

   (i) with respect to margins called and collected on an intraday basis, and to the extent operationally and legally possible, CCPs identify separately:

      (a) the margin covering potential exposures, including exposures resulting from positions entered into and novated on that day;

      (b) the margin covering realised exposures resulting from market movements on that day, which CCPs should consider collecting and paying out on the same day;

   (ii) when initial margin collateral has been provided by a clearing member in excess of the collateral required to cover the risk stemming from the positions registered in an account, including positions novated intraday and any increased exposure incurred intraday, CCPs prioritise, where operationally possible, the use of excess collateral over collecting additional collateral, unless the clearing member voluntarily posts the add-on margin. This process should be carried out in a predictable, transparent and scheduled manner;

   (iii) CCPs ensure that the process for collecting of initial and variation margins does not result in excessive operational constraints for the clearing member which may pose additional liquidity risk.

2. It is recommended that the clearing members' relevant competent authorities monitor and, where necessary and permitted by law and consistent with adequate risk management practices and financial resilience, engage with the clearing members within the context of ongoing supervision so that when clearing members issue margin calls and collect initial and variation margins from their clients, including financial and non-financial counterparties, in order to limit their credit exposures, they aim to avoid unnecessary liquidity constraints for their clients. This could be achieved, for example, by ensuring that:

   (i) when sufficient initial margin has been provided by a client to cover the risk stemming from the positions registered with the clearing member, including positions novated intraday and any increased exposure incurred intraday, clearing members prioritise the use of excess initial margin collateral over collecting additional collateral unless the client voluntarily posts the add-on margin;

   (ii) clearing members ensure that the process for the collection of initial and variation margins does not result in excessive operational constraints for the clients which may pose additional liquidity risk.

Recommendation D – Mitigation of procyclicality in the provision of client clearing services and in securities financing transactions

1. It is recommended that relevant competent authorities contribute to steer discussions at international level, through their participation in international fora and standard-setting bodies, where applicable, on means to mitigate the procyclicality in margin and haircut practices in the provision of client services related to exchange traded and over-the-counter derivatives as well as securities financing transactions, whether centrally cleared or not centrally cleared. These discussions should aim at developing global standards governing minimum requirements for the mitigation of procyclicality when providing these services.

2. If, such global standards are set, it is recommended that the European Commission considers proposing that Union legislation give them effect.

SECTION 2

IMPLEMENTATION

1. Definitions

1. For the purposes of this Recommendation the following definitions apply:

   (a) 'competent authority' means an authority designated by a Member State in accordance with Article 22 of Regulation (EU) No 648/2012;

   (b) 'CCP' has the same meaning as in Article 2(1) of Regulation (EU) No 648/2012;

   (c) 'clearing' has the same meaning as in Article 2(3) of Regulation (EU) No 648/2012;

   (d) 'clearing member' has the same meaning as in Article 2(14) of Regulation (EU) No 648/2012;

   (e) 'derivative' or 'derivative contract' has the same meaning as in Article 2(5) of Regulation (EU) No 648/2012;

   (f) 'relevant competent authority' means the competent authority referred to in the legislation referred to in Article 2(8) of Regulation (EU) No 648/2012 and the competent authority designated by a Member State pursuant to and for the purposes of Article 10(5) of Regulation (EU) No 648/2012;

   (g) 'financial counterparty' has the same meaning as in Article 2(8) of Regulation (EU) No 648/2012;

   (h) 'non-financial counterparty' has the same meaning as in Article 2(9) of Regulation (EU) No 648/2012;

   (i) 'client' has the same meaning as in Article 2(15) of Regulation (EU) No 648/2012.

2. Criterion for implementation

In implementing this Recommendation, due regard should be paid to the principle of proportionality, taking into account the objective and the content of each recommendation.

3. Timeline for the follow-up

In accordance with Article 17(1) of Regulation (EU) No 1092/2010 addressees must communicate to the European Parliament, the Council, the Commission and to the ESRB the actions undertaken in response to this recommendation or substantiate any inaction. Communications should be sent in compliance with the following timelines.

1. *Recommendation A*

   (a) By 30 November 2020, the competent authorities are requested to submit to the European Parliament, the Council, the Commission and to the ESRB the form in Annex I on the implementation of Recommendations A(1) and A(2).

   (b) By 30 November 2020, the relevant competent authorities are requested to deliver to the European Parliament, the Council, the Commission and to the ESRB the form in Annex I on the implementation of Recommendations A(3) and A (4).

2. *Recommendation B*

   (a) By 31 December 2021, ESMA is requested to deliver to the European Parliament, the Council, the Commission and to the ESRB the form in Annex I on the implementation of Recommendation B(1).

   (b) By 30 November 2020, the competent authorities are requested to deliver to the European Parliament, the Council, the Commission and to the ESRB the form in Annex I on the implementation of Recommendations B(2), B(3) and B(4).

3. *Recommendation C*

   (a) By 30 November 2020, the competent authorities are requested to deliver to the European Parliament, the Council, the Commission and to the ESRB the form in Annex I on the implementation of Recommendation C(1).

   (b) By 30 November 2020, the relevant competent authorities of clearing members are requested to deliver to the European Parliament, the Council, the Commission and to the ESRB the form in Annex I on the implementation of Recommendation C(2).

4. *Recommendation D*

(a) By 31 December 2021, the competent authorities and the relevant competent authorities are requested to deliver to the European Parliament, the Council, the Commission and the ESRB, the form in Annex I on the implementation of Recommendation D(1).

(b) By 31 December 2022 the Commission is requested to deliver to the European Parliament, the Council and the ESRB, the form in Annex I on the implementation of Recommendation D(2).

4. **Monitoring and assessment**

1. The General Board will assess the actions and justifications communicated by the addressees and, where appropriate, may decide that this Recommendation has not been followed and that an addressee has failed to provide adequate justification for its inaction.

2. The methodology set out in the Handbook on the assessment of compliance with ESRB recommendations [7], which describes the procedure for assessing compliance with ESRB recommendations, shall not apply.

Done at Frankfurt am Main, 25 May 2020.

Head of the ESRB Secretariat,
on behalf of the General Board of the ESRB
Francesco MAZZAFERRO

[7] Handbook on the assessment of compliance with ESRB recommendations, April 2016, available at https://www.esrb.europa.eu/pub/pdf/recommendations/160502_handbook.en.pdf

ANNEX I

Communication of the actions undertaken in response to the recommendation

1. **Details of addressee**

Recommendation	
Country of the Addressee	
Institution	
Name and contact details of the respondent	
Date of communication	

2. **Communication of actions**

Recommendation	Do you comply? (yes/no/not applicable)	Description of actions taken to ensure compliance	Justification for partial compliance or non-compliance
Recommendation A(1)			
Recommendation A(2)			
Recommendation A(3)			
Recommendation A(4)			
Recommendation B(1)			
Recommendation B(2)			
Recommendation B(3)			
Recommendation B(4)			
Recommendation C(1)			
Recommendation C(2)			
Recommendation D(1)			
Recommendation D(2)			

3. **Notes**

1. This form is used for the communication required by Article 17(1) of Regulation (EU) No 1092/2010.

2. Each addressee should submit the completed form to the ESRB via the ESRB Secretariat electronically via DARWIN in the dedicated folder or by email to notifications@esrb.europa.eu. The ESRB Secretariat will arrange for the transmission of the communications to the European Parliament, the Council and the Commission, on an aggregated basis.

3. If a recommendation does not apply, please select ‘non-applicable’ in the box ‘Do you comply?’.

4. Addressees are expected to provide all relevant information and documentation related to the implementation of the recommendations, including information on the substance and timing of the actions taken.
5. If an addressee only partially complies, it should provide a full explanation of the extent of non-compliance, as well as other details of partial compliance. The explanation should specify clearly the relevant parts of the recommendation which the addressees do not comply with.