The Global Association of Central Counterparties

28 February 2018

European Securities and Markets Authority ("ESMA")
CS 60747, 103 rue de Grenelle,
75345 Paris Cedex 07, France

RE: Draft Guidelines on Anti-Procyclicality Margin Measures for Central Counterparties – Consultation Paper

The Global Association of Central Counterparties ("CCP12") is a global association of 36 major organizations, which operate more than 50 central counterparties ("CCP") in the EMEA region, Asia-Pacific and the Americas. CCP12 was formed to share information, develop analyses and policy standards for common areas of concern. CCP12 members work toward the common purpose of creating conditions in which a global CCP solution can emerge to meet the needs of the marketplace.

This letter represents our response to the Consultative Paper ("the consultation") published by ESMA regarding anti-procyclicality ("APC") margin measures for CCPs. CCP12 appreciates the opportunity to provide these written comments and look forward to our continued collaboration.

Overview

CCP12 supports the objective of assessing and managing procyclicality holistically and agree that a CCP should control the procyclical effects of its risk management practices in a manner that does not negatively affect the CCP's soundness and financial security. We appreciate the opportunity to emphasize that the most effective and efficient manner to accomplish this goal is to adopt a framework that is principle-based and outcome-focused. A principle-based approach recognises that risk sensitive margin frameworks will always have some elements of procyclicality, and an outcome-focused perspective aligns with ESMA's guidelines to have regular assessments of APC measures. However, CCP12 cautions against an overly prescriptive approach as there is risk that the suggested level of detail could unintentionally lead to a "model monoculture" among CCPs. Such an approach may also undermine existing measurement and governance standards that are appropriate for each CCP's risk models, market(s) served, products cleared, margin period of risk, and ownership structure. Finally, CCP12 supports efforts to enhance transparency around risk management practices as this strengthens the financial system. To this end, CCPs currently work with their stakeholders (board, risk committee, regulators, clearing members, indirect members, and general public) to develop the appropriate transparency without potential unintended weakening of risk management standards. CCP12 believes this approach aligns with the APC disclosure objectives suggested by ESMA.

While the regulatory guidance will not apply directly to CCPs that have or seek recognition under EMIR ("third-country CCPs" or "TC-CCPs"), different approaches to addressing procyclicality should be recognised where outcomes are consistent with the regulatory objective. For example, many jurisdictions also share similar regulatory objectives to manage procyclicality, however employ an approach that is most appropriate to the characteristics of their markets and jurisdictional nuances. Accordingly, a principle-based and outcome-focused framework would provide jurisdictional flexibility while still addressing shared objectives of limiting the procyclicality of margins.

Response to Specific Questions

Q1. Do you agree that CCPs should develop and maintain a policy for regular assessments of procyclicality of margin?

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

CCP12 supports the overall effort to address the procyclicality of margin in the course of prudent risk management. We agree that efforts to prevent and control procyclical margin requirements are important for market stability, and we are committed to finding solutions that will meet these goals to the extent that they do not negatively impact the soundness and financial security of the CCP. It is critical that the guidelines are holistic and principles based - focused on an assessment of the CCP's overall risk framework rather than a prescriptive path narrowly directed at initial margin. In practice, CCPs already take actions to mitigate potential procyclical effects. For example, some CCPs use transparent processes for calling intraday margin which have been well tested with clearing members. Other CCPs explore cross-margining arrangements within their clearing services or with other CCPs that recognise appropriate margin offsets that may exist across products. And still other CCPs have explored shorter settlement cycles or other measures that reduce risk and margin requirements that may mitigate procyclical impacts.

In focusing on initial margin, the guideline proposes prescriptive quantitative metrics for monitoring the efficiency of APC margin measures, which may unintentionally lead to a model monoculture. We fear such a guideline may result in CCPs sharing the same blind spots, particularly if these prescribed solutions are required across wide markets and asset classes. In this case, the level of procyclicality may accumulate systemically but stay undetected, which undermines the effort of managing procyclicality.

Instead, CCPs must have the flexibility to design their own quantitative metrics to measure procyclicality by considering their unique asset classes, product lines, risk frameworks and market practices. For example, some products are more seasonal in nature and therefore, it is not necessarily more effective to utilize long lookback periods in setting margin rates, as they may not be appropriate when entering into periods of seasonal volatility. In other words, there are many ways in which CCPs can address procyclicality and thus must maintain the flexibility to employ the most suitable measure for their given market.

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.*

CCP12 agrees that it is important to address procyclicality issues holistically. To this end, and as described above, we believe that approaches to managing procyclicality should be principle-based and outcome focused. An overly prescriptive requirement to incorporate all risk factors has the potential to inhibit a CCP's ability to holistically manage their APC margin measures by requiring an excessive amount of re-balancing across multiple risk factors.

The application of APC margin measures at the risk factor level requires further definition and supporting analysis in order to avoid any type of blanket implementation. It is not yet clear how such measures should be implemented for different APC approaches (certain APC measures are relatively straight forward to implement at a risk factor level while others will require more sophisticated analysis). In addition, the application of buffers or floors on different risk factors may result in unintended consequences such as under-margining in certain circumstances as buffers and floors could alter the interdependencies within portfolio and across asset classes.

Depending on a CCP's margin methodology and product scope, CCPs may require very granular risk factors. Some of these risk factors may not materially contribute to procyclicality and therefore measurement at an individual risk factor may not be an efficient or effective. CCP12 would recommend that similarly effective APC assessments can be achieved through CCPs' own measures or tools tailored for each CCP's risk models, market(s) served, products cleared, margin period of risk, and ownership structure.

Furthermore, relying on an overly prescriptive solution to procyclicality will ultimately discount the expertise and skills of a CCP's risk management and judgment of the board as well as the need for flexibility in the model to account for unprecedented market changes. CCP12 would be concerned by guidelines that would restrict CCP's risk management tools during times of market stress as it could unintentionally exacerbate such stress which could have systemic risk implications. CCP12 believes that a principle-based and outcome focused framework, on the other hand, better balances the interests of all relevant market participants. It is worth noting that this expertise and flexibility has successfully demonstrated prudent judgment in designing reliable margin models that ensure margin coverage sufficient and seek to limit procyclical impacts across extreme but plausible market conditions.

CCP12 appreciates this statement in the proposal and requests it be made clear in the final guidance that this is an appropriate approach for the CCP's to follow: *For the avoidance of doubt, a CCP may apply APC margin measures at a product or portfolio level as long as the application addresses all risk factors used in the margin computation.*

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?

CCP12 agrees that there should be documented policies and procedures related to anti-procyclicality that are responsive to the markets it clears and that those should be transparent and known through its respective governance process.

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.

CCP12 would support an approach that establishes broad guidelines for definitions and identification of stress scenarios which can be further developed through outreach with industry participants and regulatory authorities.

Such input may result in more comprehensive stress scenarios - for example "a movement of various asset classes on a particular day should be consistent with their respective asset class correlation observed in the market over an observed stress period" (extreme-but-plausible) rather than a scenario that "moves all prices down by 50%" (not necessary plausible under all circumstances). We believe that CCPs should retain flexibility on the approach to measure portfolio stress scenarios. This will allow the CCP to provide results that are consistent with its margin model and risk framework rather than use an alternative third-party benchmark.

In addition, the margin outcomes depend not only on which and how many stress scenarios are taken, but also on how they are combined with "normal" scenarios. Current example given in the footnote suggests the combination as a weighted average. We would request clarification that it is not the only way to combine "normal" and stress scenarios.

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?

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?

CCP12 generally agrees with setting the calculation frequency, observation weighting and liquidation period for the margin floor consistent with the margin calculations but it may be appropriate to adjust them based on the modelling approach, parameter calibration, margin period of risk, and backtesting results, subject to the APC efficiency assessment using the quantitative metrics mentioned in Q2 of the guideline. Simply forcing parameters to be the same might not be appropriate under all circumstances.

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

Disclosure of information on the margin models and parameters is important to ensure clearing participants are made aware of the CCP's approach towards APC margin measures. However, it should be reinforced that CCP's ultimately retain the obligation to their markets to ensure suitable margins for their products are set to a level which appropriately reflects the current levels of volatility, activity in their markets, and exposures in member portfolios. Disclosure of information which allows for the replication of margin calculation to improve the predictability of margins could be helpful on one hand during periods of normal activity, but it should remain clear that these disclosures – no matter how granular - will never provide 100% certainty and predictability of future performance and calibrations of initial margin.

We believe that current quantitative and qualitative disclosures exercised by CCPs in accordance to *CPMI-IOSCO public quantitative disclosure standards for central counterparties* and the disclosure framework pursuant to the *Principles for financial market infrastructures,* respectively, are sufficient for clearing participants to understand and evaluate CCPs' risk framework, including margin models. CCP12 has developed and officially released an industry template to achieve greater global harmonization to improve transparency. Additionally, CCP12 has also set up a dedicated webpage to facilitate easier access to our members' public quantitative disclosure reports.

CCP12 believes that a balanced, transparent approach to disclosures has been achieved and a significant level of information is already provided through CCPs' CPMI-IOSCO quantitative/ qualitative disclosures, stakeholder engagement on risk management changes, and periodic member meetings. CCP12 cautions that any further disclosure requirements must balance the benefits of transparency with the risk of unintentional weakening of the CCP's risk management framework. In particular, the guideline suggests that disclosure on margin models should facilitate the replication of margin calculations. There is a risk that the suggested level of detail could enable market participants to reverse engineer and game CCPs' margin models.

Conclusion

We appreciate the continued efforts of ESMA in working towards a stronger financial system and a sound approach to manage the procyclicality of margin. We appreciate the opportunity to comment on this consultation and look forward to continuing to work with ESMA towards our shared goal of secure and efficient markets.

Sincerely,

Lee Betsill
Chairman, CCP12