European Association of CCP Clearing Houses

EACH Response – CPMI-IOSCO report on Streamlining Variation Margin in centrally cleared markets – examples of effective practices

May 2024

1. Introduction

The European Association of CCP Clearing Houses (EACH) represents the interests of Central Counterparties (CCPs) in Europe since 1992. CCPs are financial market infrastructures that significantly contribute to safer, more efficient and transparent global financial markets. EACH currently has 18 members from 14 different European countries. EACH is registered in the European Union Transparency Register with number 36897011311-96.

EACH appreciates the opportunity to provide feedback to the CPMI-IOSCO report 'Streamlining variation margin in centrally cleared markets – examples of effective practices'[1]. We particularly appreciate the indication by CPMI-IOSCO that this report is not intended to create additional standards for financial market infrastructures (FMIs), nor to provide guidance on existing standards, and rather suggest the report is used as a set of examples of processes or behaviours which illustrate how the related international standards and guidance may be met.

While we detail our views in the answers to the different questions, the main ideas included in this response are summarised below:

- **Frequency, scheduling and timing** – EACH notes that it is important for CCPs to judge when the use of scheduled and unscheduled margin calls is best. Unscheduled calls may be necessary if e.g. a threshold is breached and waiting for the next scheduled is deemed inappropriate.

- **Offsetting collateral and providing sufficient time to market participants may also be effective means of aiding liquidity preparedness** - Allowing collateral offsetting for VM means that if a CM has sufficient excess then this could eliminate the need for an ITD call or reduce its size.

- **EACH questions where an ITD VM pass-through is an effective practice** - Whilst ITD VM pass-through would appear to support market liquidity, there are several liquidity, operational and legal implications that need to be considered both during business-as-usual (BAU) as well as during stress periods. These affect all European CCPs, even more so for those CCPs which are multi-currency, multi jurisdiction and near 24 hours in operations where it quickly becomes unworkable.

- **Transparency of ITD VM processes already in place today** - Several of the provision suggested on this matter are already provided in CCP rulebooks, for example circumstances related to when ITD-VM calls are made, their timing and the notice periods. For disclosures of processes such as the ITD margin call performance, the preference is to not disclose these publicly due to the potential and unintended market distortion effects they may have.

[1] https://www.bis.org/cpmi/publ/d221.pdf

- **CM to client transparency important** – EACH agrees that CMs transparency on their processes and timings of their ITD VM processes to clients are as important as the existing CCP transparency measures, as these may shed further light on the clearing chain in full.

2. General Questions

Q1: Do you agree that the eight effective practices identified in this report foster market participants' preparedness for above-average VM calls through the efficient collection and distribution of VM in centrally cleared markets?

EACH considers that some proposed practices may indeed be effective but notes that some, such as passing through VM intraday, may appear to support liquidity preparedness when in fact they introduce liquidity, operational and legal issues. We agree that the question of scheduled vs unscheduled margin calls requires careful consideration. In particular, we consider that it is important for CCPs to react immediately should internal tolerance levels be breached. The disclosure of VM-related details such as ITD margin call performance or pre-defined market events have the potential to distort markets if disclosed to CMs generally, especially in a stress scenario. We also agree with the effective practice that CMs should ideally provide transparency on their processes and timings of their ITD VM processes as it may help client preparedness.

Q2: Are there any other effective practices, mechanisms or changes that would streamline VM processes in centrally cleared markets which have not been covered in this report? If so, please describe such practices.

No, we do not see any other effective practices, mechanisms or changes that would streamline VM processes in centrally cleared markets which have not been covered in this report.

3. Questions on the proposed Effective Practices

3.1 Frequency, scheduling and timing

3.1.1 Scheduled vs unscheduled

The question of 'scheduled vs unscheduled' margin calls can also be understood as 'predictable vs unpredictable', with flexibility of using both depending on the CCP being preferable. Whilst the paper notes that unscheduled calls may be unclear – if the trigger for an unscheduled call is clear (e.g. margin requirements exceeding threshold intraday or significant % price change), then this should serve as a clear and predictable indicator to ensure liquidity preparedness. CCPs have regular intraday monitoring of each member's margin liabilities and employ a mix of between one to multiple scheduled ITD calls, depending on the business the CCPs conduct, jurisdictions covered, and the sophistication of the CCPs operational infrastructure. Even for those CCPs with multiple scheduled ITD calls, not every CM will be called every time as it depends on the CMs change in margin liability vs the margin already held to cover that liability. In summary, there are clear benefits to both scheduled and unscheduled calls, depending on the CCP, but both methods may have elements of unpredictability in them. Rather than focusing on scheduled vs unscheduled, EACH notes that it may be more helpful for clearing members to make use of available means providing near to/ real-time visibility into what margin calls the CCP is generating, so they can see if the call amount is building up or dropping away.

3.1.2 Covering large stresses

For large uncovered stresses, CCPs stress the importance of not waiting for the scheduled time to call for VM stress and rather react as soon as possible via unscheduled call if internal tolerance levels are breached. For those handling VM in dollars, it may also be important to call these large stresses as soon as possible as it may be harder to obtain dollars and send them out in reverse repo later in the day.

3.1.3 Offsetting VM

Regarding offsetting VM margins, we generally note that whilst it is feasible for cash equities to offset VM and IM, it is not possible if VM is passed-through ITD. Additionally, if a CCP allows VM requirements to be met in eligible cash and non-cash (as opposed to underlying currency of the trade) then it is possible for VM liabilities to offset IM ITD for one netted call. This offsetting process could then happen as part of the EOD margin call process, where VM has to be made in currency of the underlying trade, and any excess collateral called to meet the liability ITD gets returned as part of the EOD process.

3.1.4 Giving sufficient time to manage liquidity needs

EACH is supportive that market participants are given sufficient time to meet margin calls. As an example, a set cut-off time to meet an ITD margin call (e.g. 1hr hour from the time the call is sent) could give predictability to both the CCP and their participants, but also act as a clear threshold for a CCP to monitor against in assessing whether any credit issues with a CM.

3.2 Pass-through of VM

Whilst the concept of an ITD VM pass-through would appear to support market liquidity, there are several practical implications that need to be considered both during BAU as well as during stress periods. These implications are detailed in the three sections below and affect all European CCPs, even more so for those CCPs which are multi-currency, multi jurisdiction and near 24 hours in operations where it quickly becomes unworkable.

In response to question a), EACH questions whether the practice of passing through VM intraday is an effective practice. These implications fall under all of the following categories:

- Liquidity
- Operational
- Legal, regulatory and compliance

We develop our concerns on those issues below.

3.2.1 Liquidity risk

Introducing an ITD VM pass-through risks introducing a number of liquidity risks, as for example, it would leave some risks uncovered that are covered in today's procedure, reducing risk management standards. These risks are as follows:

- **Leaving uncovered risks** – From a Risk perspective, this would leave the CCP with uncovered risks in case positive VM are paid to Members and afterwards the Market goes against those Member's positions.

- **More cash left uncovered intra-day** – CCPs would be required to retain sufficient cash on hand to meet payment obligations should member(s) called fail to meet these. This could lead to greater amounts of cash being left unsecured intra-day by CCPs and/or attempts to access transformation markets to fund payments during illiquid periods of the day (if not already past cut-off times). In BAU (i.e., without non-receipt from loss makers), these funds then need to be invested later in the day, potentially when liquidity in secured markets is thinner or unavailable.

- **It could expose a CCP to additional significant risks and further aggravate the liquidity position of the participants, creating unjustified liquidity pressure** – A rapid change of trend could dissolve the gains on a position, with ensuing need to reprocess margin calls. This would create further liquidity drag, in a moment of already volatile market circumstances. Moreover, while VM may only be posted in cash, the present set up enables Clearing Member to cover VM calls vis-à-vis the CCP with non-cash collateral as there is no intraday variation margin pay out, hence limiting the potential liquidity stress on participants. This possibility cannot be maintained in the case of a pass through, and therefore Participants would be called for a cash integration also in the case of collateral excess (thus causing unjustified liquidity pressure).

- **Not accounting for P&L realisation would cause issues** – Taking the market volatilities into account, passing through the intraday margin without the realisation of profit and losses would create unnecessary cash flow and other possible obstacles in the market.

- **Possible VM loss charges** – Variation margin settlement is done in product currency. Paying out VM profits intraday in product currency would also require enforcing variation margin loss charges in possibly illiquid product currencies during the trading day.

- **Increased liquidity requirements as a burden** – Requiring CCPs and its CMs (and clients) to have ITD liquidity in all currencies that it clears intraday, would be a liquidity burden where multiple currencies are cleared. The currency required as VM for the settlement process may also not be available at the time required due to differing time zones, for example it may not prove possible to get Japanese yen at 1am Japan time (6pm CET).

- **Increased collateral transformation** – Increased usage of markets by members to transform collateral to meet calls, in some cases at times when liquidity is thinner.

- **Damaging to clearing members investment possibilities late-day** – Those members being paid profits may find difficulties investing appropriately the later in the day intra-day payments are made; this would likely be more relevant for smaller members.

- **Market structure** – Not all markets are Realised Variation Margin (RVM) based and therefore make it less likely that a full net flat liquidity outcome could be supported. This could distort liquidity benefit, with gains paid being subject to some pro-rating, or leave CCP with liquidity shortfall upon payment out.

- **No possibility to fund VM losses** – As mentioned in the response to the previous section, passing through Variation margin intraday in cash would abolish any possibility to fund Variation margin losses with non-cash collaterals or in case of cash, preferred currencies, in the currency in which VM would need to settle or to net them with other advantageous margin changes.

- **Default Management implications** – There are implications on a CCP in the event of a CM default. Where VM is called and paid out as under a VM pass-through framework, the CCP will be required to use the defaulter's collateral to raise cash in the relevant currencies to meet their intraday margin calls. This would be a significant extension of the CCP's current intraday cash management activities as would require significant amounts of cash/liquidity to be available across all VM currencies.

3.2.2 Operational risk

As well as liquidity risk, introducing an ITD VM pass-through also risks creating a number of operational risks for the CCP, which are as follows:

- **Increase in intraday margin calculations / less robust intraday price controls** – This approach could potentially require multiple RVM runs intra-day with associated controls needed around market pricing. A balance may be required in terms of robustness of controls vs time and data available intra-day to conduct these controls appropriately, given it may not always be possible to design the pricing controls as robustly as at end of day due to (a) less price data available intra-day and (b) the reduced amount of time to conduct such controls ahead of an intra-day run. If this process creates actual P&L, this could create unexpected market behaviours.

- **Operational pressures for members with in & outflows** – Could potentially lead to operational implications for members with flows both in and out on the same day, particularly if underlying clients demand the benefit of profits paid.

- **Compatibility issue with USD swap market** – When considering the USD swap market, CCPs would need to move to a twice daily Settle-to-market (STM) to 'settle' and pass through the USD settlement proceeds. If one follows that thinking through, would STM now mean e.g. half a day PnL? Does this means that CCPs should keep e.g., EUR swaps on daily STM (full day PnL)? This becomes overly complex.

- **Multiple currency contracts** – The operational challenges are exacerbated for CCPs (and likely CMs and Clients with contracts in multiple currencies across differing time zones.

- **Cut-off times for multilateral settlements** – This change would imply a challenging process for both the CCP and Clearing Members, given that one or more cut-off times for different multilateral settlements should be incorporated, with the corresponding transfer files to be managed also intra-day. Further uncertainties may also arise around which theoretical price should be used for intra-day VM settlement.

- **No margin offset possibility** – Paying out margin intra-day, clearing members would lose the benefits of the margin offsets that they currently enjoy. This would likely lead to a dramatic increase in the number of intra-day margin calls.

- **Limitations for loss makers margin possibilities** – It would not be possible for loss makers to post excess non-cash collateral to mitigate against intra-day calls in an intra-day RVM process.

- **Effect on accounting** – Consideration would need to be given to accounting implications and whether the revised approach would impact mark-to-market/settle-to- market frameworks in any way.

- **Fixed payout points already exist** – Consideration should also be given to current practices and the effect that an ITD VM pass-through could have on them. Some CCPs do provide at least one fixed point of the day (in addition to EOD) to pay members excess collateral, based on an approximate Mark to Market (MtoM) process rather than a full RVM process at a time when investment facilities are still available and controlled through withdrawal limits. It is also important to take into consideration that the current mechanism already allows members to withdraw excess cash resulting from variation margin gains on demand. Such payouts are only possible in case the overall collateralisation is sufficient and requested cash amount is pledged with the CCP.

- **Questionable effectiveness in equity space** – Does intraday VM makes sense in a cash equity world where positions will likely be settling on T+1 in a shorter timeframe. In this context, it does seem to create more operational risks than are solved where credit risk is concerned.

- **Costs for the market** - Lastly, an intraday VM-pass through could, counter-intuitively, increase costs for the market rather than reduce it, by:
    - Creating additional transaction costs due to increased flows through settlement banks.
    - Possibly creating an increase in daylight liquidity lines required, potentially used later in the day, increasing costs for the market.

3.2.3 Legal, regulatory and compliance issues

Challenging legal hurdles would also arise as a result of an ITD VM pass-through, in the following ways:

- **It goes against the principles of the EU framework legislation regulating settlement activities (CSDR[2])** – Further consideration should be given to the possibility that VM will be paid out to the party that is not meeting the original settlement date of a transaction. In other words: the proposed measure could mean that clearing members get rewarded for failing to deliver on the settlement date. Something that runs contrary to the ideas in CSDR.

- **Questionable compatibility with US jurisdiction** – This challenge becomes explicit in some jurisdictions like the US, where Designated Clearing Organisation (DCO) cannot pass through customer property (client margin) unless it is settlement proceeds (i.e. it is the result of settle-to- market or STM – which occurs once per day). All cleared customer OTC trades in the US have been STM since 2017.

3.3 Excess collateral and collateral eligibility

EACH is supportive of allowing excess collateral to meet ITD VM obligations. If a CM has sufficient excess then this could eliminate the need for an ITD call (or reduce its size). This also gives CMs additional flexibility in terms of their liquidity management - i.e. they can choose to keep an excess on their account specifically to help reduce the need / sizes of ITD calls. A further benefit of using excess collateral is that this is already available at the CCP and can therefore be immediately blocked to cover an additional VM Call.

[2] Central Securities Depository Regulation, see: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32014R0909

However, it should be noted that the use of excess collateral is only practicable if there is no VM pass-through expectations where ITD VM would need to be met in the VM currency (i.e. underlying currency of the trade).

3.4 CCP-to-CM transparency and engagement with participants

3.4.1 Disclosure of VM-related details

EACH members note that many of the elements above, such as circumstances related to when ITD-VM calls are made and the timing and notice periods, are already disclosed via the CCP rulebooks. However, regarding ITD margin call performance, CCPs currently only share these details with regulators on a monthly basis, and do not disclose this information to clearing members. Similar to the comments made on the proposal on IM, EACH considers that widely sharing such information with clearing members has the potential to distort markets, particularly in a stress scenario.[3] If disclosed, the preference would be to keeping it private between the CCP and individual Clearing Member concerned. Regarding balancing the need for appropriate disclosures, EACH emphasises the need for a CCP to retain the right to call for margin at its discretion.

Second, EACH notes CCPs have numerous mechanisms of obtaining feedback from clearing members on aspects of their risk framework, which would include VM practices, so CMs are able to provide feedback via these means.

3.5 CM-to-client transparency

EACH agrees that CMs should ideally provide transparency on their processes and timings of their ITD VM processes as it may help client preparedness.

3.6 Other issues

No further comments from EACH members.

-END-

[3] See the EACH response here: https://eachccp.eu/wp-content/uploads/2024/04/EACH-Response-%E2%80%93-BCBS-CPMI-IOSCO-consultative-report-on-transparency-and-responsiveness-of-initial-margin-in-centrally-cleared-markets-April-2024.pdf