Commission de Surveillance du Secteur Financier

Circular CSSF 20/761 on liquidity risks arising from margin calls

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Luxembourg, 11 December 2020

To all clearing members and to all financial and non-financial counterparties

Ladies and Gentlemen,

On May 25th 2020, the ESRB published a recommendation (with reference ESRB/2020/6) on liquidity risks arising from margin calls. This recommendation has several implications for the CSSF as a competent authority in charge of the supervision of clearing members and of financial and non-financial counterparties in Luxembourg. The definition of clearing members and of financial and non-financial counterparties follows regulation EU 648/2012. The law of 15th of March 2016 clarifies the respective powers granted to the Luxembourg supervisory authority of the financial sector (*Commission de Surveillance du Secteur Financier* - CSSF) in the context of Regulation 648/2012/EU (the European Market Infrastructure Regulation - EMIR).

The ESRB recommendation ESRB/2020/6 attempts to address liquidity risks stemming from margin calls, in the context of volatile markets and uncertain collateral valuation. A large part of the recommendation concerns central counterparties ('CCPs') and their supervisors, while some sub-recommendations are also addressed to clearing members, financial and non-financial counterparties and their supervisors. All types of entities, CCPs, clearing members, financial and non-financial counterparties are defined in accordance with regulation EU 648/2012. The main objective of the recommendation is to limit cliff effects in relation to the demand for collateral and to limit liquidity constraints related to margin collection.

As highlighted in the recommendation, central clearing of derivatives and collateralisation of non-centrally cleared derivatives positions is essential to financial stability.

The outbreak of the Covid-19 pandemic resulted in significant margin calls across centrally cleared and non-centrally cleared markets. CCPs have issued calls for and collected large amounts of intraday variation margin with the corresponding payout often occurring only the next morning and causing liquidity to be temporarily held on the accounts of the CCPs. On the other hand, many clearing members faced liquidity constraints as initial margin calls increased.

Looking ahead, the ability of market participants to cover margin calls will depend on volatility levels and on the resilience of their liquidity management. With this recommendation, the ESRB seeks to ensure that decisions in terms of risk management do not lead to excessive procyclical features, thus unintentionally creating liquidity strains that could develop into solvency issues.

This would imply that sudden and significant changes and cliff effects relating to initial margins and collateral would be 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. It further implies that CCPs, while maintaining their financial resilience avoid excessive liquidity constraints for clearing members and that clearing members do so for clients.

The CSSF intends to comply with the ESRB recommendation and recommends that Luxembourg clearing members and Luxembourg based financial and non-financial counterparties apply the principles described in the paragraphs below.

a) Recommendations to clearing members

1. It is recommended that, clearing members, when providing clearing services to their clients, apply risk management procedures that do not result in sudden and significant changes and cliff effects in margin calls and in the collection of margins, unless these sudden and significant changes are an inevitable result of market events. Furthermore, in the event of downgrades, it is recommended that clearing members' collateral practices do not materially curtail the soundness of the risk management practices adopted by the clearing members or affect their resilience.
2. It is recommended 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 prioritize the use of excess initial margin collateral over collecting additional collateral unless the client voluntarily posts the additional 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.

b) Recommendation to financial and non-financial counterparties

It is recommended that, 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: (i) by using a progressive and granular sequence when implementing downgrades of credit ratings, in their overall risk management practices; (ii) by maintaining 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.

Yours faithfully,

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