FSB FINANCIAL STABILITY BOARD

Liquidity Preparedness for Margin and Collateral Calls: Consultation report

Response to Consultation

The Investment Association

1. **Does the outlined approach identify all key causes of some non-bank market participant's inadequate liquidity preparedness with respect to spikes in margin and collateral calls during times of stress? Are there any sector specific causes that should be considered?**

The analysis in section 1, while fairly comprehensive, underplays the significant turmoil and uncertainty that NBFIs encountered in some of the events. We recognise that this consultation is limited to the liquidity preparedness of NBFIs for margin calls, but restricting the scope this way prevents a more holistic review of the circumstances of the events and all actors involved. For example, the crisis in March 2020 took place in circumstances where companies were going into lockdown, having to make remote working arrangements for staff, particularly those on trading desks, who had previously only been office based. Inevitably this led to challenges with communication, making finding markets and checking on risk limits etc more difficult. A complete shutdown of the economy had not previously happened on this scale, particularly in Western economies. The increasing volatility was therefore harder to measure and react to than in previous crises.

We note that, while Money Market Funds are singled out, these were not the only funds impacted during the Covid crisis. Units were also sold in other investment funds, particularly fixed income, in order to raise cash for collateral, reflecting not only immediate margin calls but uncertainty on whether volatility would increase and how long it would last. These outflows were largely reversed over the coming months as the government actions became better understood, economies adapted to lockdowns and confidence increased.

Similarly, in 2022, the actions affecting commodities markets were not impacted via normal market factors. Political actors were intentionally trying to disrupt the supply of commodities and destabilise markets. It is far harder for economic modelling to predict shocks driven by political events, such as the lockdowns, commodity disruptions in 2022 and the UK's mini budget in September 2022, which led to the crisis in the gilt markets that resulted in difficulties for LDI strategies.

While Archegos highlights the dangers of taking on too much leverage, and the need for all counterparties to have robust due diligence and risk management practices, it is

important to note that Archegos was not a regulated entity, and therefore not under the same scrutiny as many NBFI sectors, such as insurers, asset managers and investment funds. It should also be noted that the founder of Archegos Capital Management, Bill Hwang, is currently standing trial for fraud in the USA, though at the time of writing the case is ongoing and the outcome unknown. Nonetheless, the harm arising from the actions of bad actors should not be conflated with NBFIs more broadly, particularly the legitimate activities of regulated entities.

We support sensible measures to encourage market participants to be prepared for stressed market conditions, including stress testing, and having the right governance frameworks to be able to react to sudden increases in margin calls. But the next crisis is never the same as the last, and authorities must accept that an element of adaptability, including the fast adoption of measures that were previously unanticipated, may be required in the future regardless of the how prepared all market participants are.

2. **Is the scope of the proposed policy recommendations appropriate?**

As noted in our response to question 1, we would have preferred the recommendations to have included consideration of the role of all market participants, including credit institutions and central counterparties, though we recognise that the specific recommendations that apply to these latter participants might differ. An important part of preparing for margin calls is understanding how stressed market conditions would impact on margin calls – at the moment there is insufficient transparency on initial and variation margin calculations by CCPs and clearing members to understand this. In addition, current margining practices are overly reliant on cash. The IA recognises that post-2008 reforms have significantly reduced counterparty risk in the system, and welcomes this enhancement to the overall resilience of the system. But these reforms have increased liquidity pressures on the markets and amplified liquidity stresses in stressed market conditions. Rules and practices around margining need to be recalibrated so that these liquidity pressures can be mitigated while preserving the counterparty risk mitigation benefits. Such solutions require a holistic view of the whole market, and all participants, not a segmented approach that only considers some participants.

The IA notes several initiatives for non-cleared and cleared derivatives that allow a broader range of assets to be used as collateral. These initiatives should be encouraged, and rules calibrated to allow more non-cash assets to be used as collateral without punitive economic haircuts, as long as those non-cash assets are of a high quality nature, such as government bonds, ideally for both initial and variation margin, although we recognise the use case for initial margin will be more feasible.

3. **Is the focus of the FSB’s policy recommendations on liquidity risk management and governance, stress testing and scenario design and collateral management practices appropriate? Are there any other areas the FSB should consider?**

Our remarks about the limitations of the scope notwithstanding, the IA considers the FSB’s recommendations on liquidity preparedness to be broadly appropriate. From an asset management perspective, most of the recommendations already reflect existing best practice. Robust governance and risk management is critical to managing liquidity. Stress tests provide valuable information to risk managers on how portfolios might be impacted

by market stresses. While the main focus on liquidity management in asset management has been managing redemption requests, there is increased awareness of liquidity requirements that can arise from margin calls.

It is important that asset managers and managers of investment funds have a strong understanding of where liquidity demands may arise in order to manage liquidity optimally. Investment funds are designed to give investment exposure – carrying excess liquidity reduces the investment exposure and drags on returns. To understand liquidity demands, asset managers must understand how margin will be calculated in times of stress, so margin calls can be better anticipated. It is also important that asset managers have a good knowledge of their investor base – even funds that don't engage heavily in derivatives may be subject to redemptions by investors needing to raise cash to meet margin calls. Investment funds are increasingly intermediated, and managers have consistently encountered difficulty in obtaining information on underlying investors from intermediaries that is necessary to understand potential liquidity pressures. Regulators need to ensure that regulated NBFIs, especially asset managers, have the right to access information from other intermediaries that is necessary for them to understand and prepare for liquidity demands.

But anticipating margin calls also requires a higher transparency from CCPs regarding their risk models, as well as notice periods from clearing members when clearing members decide to apply adds-on in their margin calls vis-à-vis their clients. Thus, by improving transparency, users will be more able to prepare in advance for providing cash or high-quality assets as collateral to answer margin calls, including in stressed situations.

4. **Is the approach to proportionality and materiality clear for all non-bank market participants?**

We welcome the recognition that proportionality and materiality should be a consideration when applying the recommendations to different non-bank market participants. However, it is not clear to us exactly how this principle will be applied. Eg will the directionality of derivatives compared to the broader portfolio be a consideration? Will entities such as investment funds that are subject to strict risk and global exposure limits, eg UCITS, be exempt from some of the recommendations? In particular, we note that interconnectedness within the NBFI sector and between the NBFI and banking sector is not well understood. There is a risk of a disproportionate approach being applied to some sectors due to perceptions of interconnectedness that are not accurate. We recognise that the recommendations are intended to be high level and will require more detailed consideration by regional and national authorities when applying to particular sectors, but it is important that the principle of proportionality and materiality is properly observed at this level.

We do not consider that the size alone of the market participant should be a factor in determining the regulatory standards that they are held to, for example based on their assets under management (AUM). The overall size of the market participant is not relevant to risks in market functioning and is not an appropriate measure of that entity's risk. Larger participants have not been demonstrated to be more vulnerable to liquidity shocks from margin or collateral calls than smaller participants. Applying different rules to larger and

smaller participants based purely on their overall size, rather than the risks and nature of the activities they are undertaking, risks regulatory arbitrage.

In addition, a clear differentiation should be made between Regulated NBFIs and Non-Regulated NBFIs. Regulated NBFIs, such as asset managers and insurers, are already directly identified by securities regulators, who monitor them and can ask them about information at any time. Non-Regulated NBFIs are not well known or monitored by regulators, such as family offices like Archegos, and it is this cohort where regulatory action should be prioritised, in order to avoid the building of risks in the unknown part of the market.

If regulation of the activities of those NBFIs is not considered appropriate or possible, an alternative way of reducing risks would be to ensure that the requirements on banks to assess their counterparty risks for non-regulated NBFIs are enhanced, along with enhanced monitoring by banking supervisors of banks engaging in such counterparty relationships (eg in the case of Crédit Suisse case vis-à-vis Archegos as a counterparty).

5. **Section 3.1 sets out key elements of a liquidity risk management framework to identify, monitor and manage liquidity risk exposures arising from margin and collateral calls. Are these sufficiently clear for all non-bank market participants?**

   We regard these recommendations as being clear and reasonable for non-bank market participants. For regulated entities such as asset managers, these are already considered best practice.

6. **Are the recommendations on liquidity stress testing and scenario design with respect to margin and collateral calls clear and sufficiently specified?**

   Given the requirements are high level, we consider these to be clear and sufficiently specified. We note though that stress testing is a significant undertaking, and this is an area where proportionality and materiality needs to be considered. For entities whose use of derivatives is limited, or for products subject to strict risk limits, we would expect stress testing requirements to be less stringent than for entities who have larger risk exposures via derivatives.

7. **Are there any jurisdictional or sector-specific differences that are not accounted for in the recommendations?**

   Overall, we consider the recommendations appropriate, noting that some proportionality is necessary when applying the stress testing requirements to some NBFI entities with low derivatives exposures.

8. **Collateral readiness at the right time, quality and location is a critical aspect of effective liquidity preparedness for spikes in margin and collateral calls to mitigate the risk of having to liquidate collateral under stressed market conditions. Do the FSB's recommendations in Section 3.3 address all key elements required to be effective in mitigating liquidity risk arising from margin and collateral calls?**

   We strongly support recommendation 6 – operational readiness and resilience is essential for ensuring unexpected market stresses can be properly managed. Operational resilience

and financial stability are often discussed as separate topics, but in our view there is a strong connection between the two – firms that have effective operational resilience structures and procedures can react far more quickly and effectively to unexpected market stresses. Testing operational readiness for stressed scenarios, eg implementing liquidity management tools, is an exercise that IA members have found valuable, ensuring key contacts and individuals can be quickly identified.

The IA has concerns with the wording of recommendation 7, which suggests significant cash buffers should be held in case of unexpected spikes in margin calls. Cash buffers are not an appropriate tool for the majority of investment products. These reduce investor exposure and lead to "cash drag" on investment performance. Investors expect to gain investment exposure through investment products, such as funds. Expecting these products to hold cash to cover rare scenarios creates an unnecessary drag on performance. Cash buffers can also create cliff edge risks – if investors and counterparties believe that NBFIs will be relying purely on cash buffers to meet liquidity obligations, whether redemptions or margin calls, and see cash levels start to fall, or liquidity demands increase, that may lead to a loss of confidence in the product or service and an increase in withdrawals, leading to runs.

We acknowledge that liquidity buffers may be necessary in very specific and limited sectors, where there are high concentrations of similar participants in particular markets – the sterling LDI strategies and pooled funds were an example of this, where ownership models and investment strategies were the same, asset sales could not be relied on due to the assets being concentrated in the same markets that the leveraged positions were taken against, and where LDI strategies made up a majority of market participants in the asset class concerned (long dated gilts). It should also be noted that the highly concentrated nature of the gilt market also played a role in the LDI crisis highlighting the importance of taking a holistic view of market disfunction where lessons and potential remedies may extend well beyond the NBFI sector. But for the majority of NBFIs, which are far more diversified in both their asset classes, client bases, investment and trading strategies, these concentration risks are not present, and do not justify excessive cash buffers.

It is important that a market wide approach is taken to considering margin readiness. In particular, alternative margin models that allow high quality assets other than cash to be posted, such as government bonds, are required.

9. **Are there any material challenges to collateral management practices that some non-bank market participants may face that should be considered?**

The reliance on cash for margining is a significant challenge for non-bank market participants. These entities typically hold assets rather than cash. This requires converting assets to cash to meet margin calls (eg through asset sales or repurchase agreements), which exacerbates market volatility in stressed market conditions. Industry risk management practices and models are adapting to account for cash demands. However, for the benefits of margining to be optimised and to avoid pro-cyclical margin calls amplifying financial stability risks, non-cash based margining models need to be adopted. We note that several CCPs are creating models allowing a proportion of non-cash assets to be posted, which we welcome – and it should be recognised for all CCPs, particularly

for initial margin calls. We would also welcome initiatives to allow clearing models at CCPs to be revised to allow the use of non-cash assets to be extended to variation margin calls. New technologies, such as distributed ledger technology and asset tokenisation, also offer the potential to extend even further the ability and operationalisation of non-cash margining practices. These should be explored with the cooperation of both regulators and market participants, including counterparties and infrastructure providers such as CCPs, ensuring that the regulatory environment is is favourable to these developments.

If you have any additional comments, please provide them below.

About the Investment Association:

The Investment Association (IA) champions UK investment management, a world-leading industry which helps millions of households save for the future while supporting businesses and economic growth in the UK and abroad. Our 270 members range from smaller, specialist UK firms to European and global investment managers with a UK base. Collectively, they manage £8.8 trillion for savers and institutions, such as pension schemes and insurance companies, in the UK and beyond. 46% of this is for overseas clients. The UK asset management industry is the largest in Europe and the second largest globally.

Executive Summary of The Investment Association's Response:

The IA welcomes the opportunity to input into the FSB's Consultation on Liquidity Preparedness for Margin and Collateral Calls. We broadly support the FSB's recommendations, which reflect existing good practice in governance and risk management in the investment management industry. The exception is principle 7, where we are concerned that this places an excessive reliance on cash buffers, which are not an appropriate tool for most investment products.

Overall though, we do not believe that the scope of this consultation should have been limited to considering only the role of Non-Bank Financial Intermediaries (NBFIs). While the specific recommendations and measures applicable might vary between participants, it is important that a holistic consideration of how the whole market interacts is taken when considering macroprudential measures. In particular, determining the appropriate liquidity needed, and performing robust stress testing of liquidity preparedness for margin calls, requires an understanding of how initial and variation margin calculations performed by counterparties and Central Clearing Counterparties (CCPs) will be calculated so that models can be appropriately calibrated. Margin transparency is a key missing element of this discussion.

A clear differentiation should be made between Regulated NBFIs, which are already directly identified and actively monitored by securities regulators, and Non-regulated NBFIs where there is less visibility of their activities. Enhanced counterparty risk monitoring and reporting may be required for banks transacting as counterparties to Non-regulated NBFIs. We also call on policy makers to consider measures that might reduce the reliance on cash in margining practices. The post-2008 reforms have undoubtedly reduced counterparty risk in derivatives transactions, but have also amplified liquidity risks in stressed market conditions. The ability to use high-quality assets as collateral such as

government bonds for variation margin calls, and transfer these seamlessly without having to sell assets, will reduce pro-cyclicality and the amplification of liquidity risks in the market without losing the benefits of counterparty risk mitigation.

Finally, it is important that there is a proportionate application of these measures across different NBFI sectors. While we welcome the commitment to proportionality, it is not always clear what this will mean regarding particular recommendations. We do not consider that the size alone of the market participant should be a factor in determining the regulatory standards that they are held to, for example based on their assets under management. The nature and risks of the activity, and the regulations that apply to sectors, should be taken into consideration when applying this principle to specific sectors.