ISDA response to the targeted consultation document *"Assessing the Adequacy of Macroprudential Policies for Non-Bank Financial Intermediation"* (NBFI)

MANAGEMENT SUMMARY

ISDA welcomes the opportunity to respond to the European Commission's (EC) consultation on "Assessing the Adequacy of Macroprudential Policies for Non-Bank Financial Intermediation (NBFI)". ISDA represents market participants acting in the global derivatives markets, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodity firms, exchanges, clearing houses and banks, hence our membership comprises NBFIs, traditional banks, data and infrastructure providers. The focus of our response is therefore on risk and liquidity management practices and exposures via derivatives.

Non-banks will play a key role in supporting the development of the capital markets union, through their role in the provision of wholesale market-based funding. As such, NBFIs' role in the financial system should not be primarily seen as a source of risk, but rather as a source of diversification. With appropriate, risk-based and proportionate supervision and risk-management, they should contribute to making the financial system more resilient.

There is no doubt that reforms introduced after the 2008 financial crisis have reduced counterparty credit risk and made the financial system more robust. However, the same reforms have made markets more susceptible to liquidity risk, exacerbating shocks and disrupting the functioning of key markets.

The EC's evaluation of the effectiveness of its existing macroprudential tools and supervisory arrangements in addressing new emerging systemic risks arising from credit institutions' exposures to NBFI is a timely and important undertaking.

Against this backdrop, we would offer the following general comments before providing specific answers to the questions posed in the Consultation Paper:

First, ISDA supports the **programme of international work** coordinated by the Financial Stability Board (FSB), the Committee on Payments and Market Infrastructures (CPMI), International Organization of Securities Commissions (IOSCO), and the Basel Committee on Banking Supervision (BCBS) to understand and address potential vulnerabilities exposed by recent market shocks. Earlier this year, ISDA and the Institute of International Finance (IIF) responded to the BCBS-CPMI-IOSCO consultation on cleared margin transparency[1] and to the CPMI-IOSCO discussion paper on streamlining variation margin practices.[2] On June 18, ISDA submitted a response to the Financial Stability Board's (FSB) consultation on liquidity preparedness for margin and collateral calls.[3] More recently, on 28 August, ISDA and IIF submitted a response[4] to the BCBS's consultation on guidelines for counterparty credit risk management. In the response, we stress that the guidelines should be risk-based and proportional, considering a diverse universe of counterparties and financial markets across the world.

Second, ISDA believes that any future legislative changes should consider the **diversity of the NBFI sector.** As acknowledged by both the EC and the FSB, the NBFI sector is characterised by its high diversity (in terms of business models, risk profiles, ability to hold cash or liquid asset buffers etc.). The impact that their individual failure would have on the financial system or on end-investors/other non-financial counterparties would differ across the sector, too. In the EU, several NBFI actors are subject

[1] ISDA-Response-to-Margin-Transparency.pdf
[2] ISDA-and-IIF-Response-to-CPMI-IOSCO-on-VM-Practices.pdf
[3] ISDA response to the FSB consultation on liquidity preparedness for margin and collateral calls: ISDA-response-to-FSB-NBFI-consultation.pdf
[4] https://www.isda.org/2024/08/30/isda-and-iif-respond-to-bcbs-consultation-on-ccr-management/

to financial and market legislations (e.g. Money Market Fund Regulation (MMFR), European Market Infrastructure Regulation (EMIR), Solvency II, Alternative Investment Fund Managers Directive (AIFMD), Undertakings for Collective Investment in Transferable Securities (UCITS) Directive etc.), some of which include macroprudential tools and have been subject to recent reviews. In principle, overly prescriptive requirements or an additional NBFI layer of regulation, in particular on already regulated NBFIs, could be harmful for the functioning of markets and 'one-size-fits-all' solutions would be inappropriate.

Third, the EC should **explore ways to ease the pressure arising from collateral demands for NBFIs**, whose ability to hold large positions in cash may be significantly constrained by operational limitations or regulatory requirements, depending on their business model and investment strategies. One way to achieve this is through ensuring enough flexibility, where appropriate, on collateral eligibility. We acknowledge the EC's intention "not to revisit recent legislative agreements", such as EMIR 3, which has also introduced measures to improve margin preparedness for counterparties, including NBFIs, for example by enabling non-financial counterparties to use a wider set of collateral, including uncollateralised bank guarantees and public guarantees.[5] This is welcome progress towards the broadening of collateral eligibility. Relatedly, the ability to build flexibility in collateral arrangements through wider collateral eligibility would also reduce reliance on other sources of liquidity. In addition, ways to simplify and harmonize collateral requirements across jurisdictions should also be explored. We would also draw attention to ongoing industry efforts to further automate and standardize collateral management, as automation and data standards support stable markets. ISDA and its members are continuously improving the automation and standardization of collateral management, with initiatives such as ISDA's Collateral Management Suggested Operational Practices[6] and the Common Domain Model[7]. It might also be worth considering how innovation in collateral and tokenization may offer improvements in collateral mobility and reduce the need for collateral holders to liquidate collateral to realize cash and mitigate operational risks, especially during times of market volatility.

Fourth, to further help with margin preparedness, a **discussion on eligible collateral and, relatedly, on the future of a European Repo market** as an important vehicle for collateral transformation, is warranted. The European regulatory framework with respect to margins and collateral can be characterised as "cash-intense", such that counterparties are required to hold significant amounts of cash to pay collateral. As the recent episodes of market stress have illustrated, increased volatility leads to spikes in margin calls and increased demand for liquidity, which can act as a stress amplifier if market participants are not able to rapidly transform collateral into cash via the sudden sale of securities (including government bonds) and an efficient and liquid repo market. Given that greater collateralisation in the financial system, as an intended outcome of post-2008 reforms, has rendered market participants' ability to transform collateral absolutely critical, further consideration should be given to repo market resilience, considering how operations to restore functioning of core funding markets on financial stability grounds, in extreme stress events, could be part of the EU macroprudential toolkit. Finally, ISDA also noted Mario Draghi's report on the future of European competitiveness in relation to the creation of a "common safe asset", possibly a large scale and permanently EU-issued debt instrument with different maturities.[8] The report considers such a

[5] These measures are set out under Article 46 of the provisional agreement of the EMIR 3 text: https://data.consilium.europa.eu/doc/document/ST-6344-2024-INIT/en/pdf

[6] Collateral Management Suggested Operational Practices – International Swaps and Derivatives Association

[7] CDM – International Swaps and Derivatives Association

[8] https://commission.europa.eu/topics/strengthening-european-competitiveness/eu-competitiveness-looking-ahead_en

common safe asset as *"a type of safe collateral that can be used in every Member State and in all market segments, in the activities of central counterparties and in interbank liquidity exchanges, including on a cross-border basis".* Whilst we acknowledge the political challenges and long-term horizon of the "*common safe asset"* approach, the creation of a deep and liquid market of an asset, which is suitable for collateralisation of cleared and non-cleared transactions would be a major step forward in Europe's search for non-cash collateral.

Fifth, it should be noted that the growing role of the NBFI sector is also linked to **the capacity of the banking sector to intermediate,** especially in times of stress. The various constraints that banks' balance-sheets operate within – in terms of capital, leverage, liquidity and G-SIB requirements – may affect their ability to extend funding or conduct market making during periods of stress. As acknowledged in the July 2024 EBA Risk Assessment Report, *"regulatory reform and the urge to bolster EU/EEA capital market activity have contributed to growth in financial intermediation outside the banking system, where parts of the activity may remain less regulated".* Similarly, the BCBS, in its report on "Early lessons from the COVID-19 pandemic on the Basel reforms", noted that *"while the leverage ratio helps enhance overall bank resilience, an in-depth analysis of data from two jurisdictions [the US and UK] indicates that leverage ratio constraints may have affected banks' responses to the extraordinary demand for liquidity that arose early in the pandemic"*, such that temporary leverage ratio exemptions had to be implemented to ease constraints on banks' intermediation capacity.[9] We would therefore encourage EU policymakers to weigh how any restrictions on banks' intermediation capacity will affect NBFIs' and other market participants' liquidity preparedness. For example, regulatory haircuts on collateral for banks and NBFIs that are subject to such requirements should be appropriately sized and reflective of the risk of collateral transferred, and not punitive. More broadly, policy actions resulting from the NBFI workstream should not lead to more prescriptive requirements for banks or other NBFIs as this could – in addition to limiting the funding opportunities of regulated entities – serve as an incentive to move further activities out of the banking system.

Sixth, ISDA believes most of the **data about derivatives activities and exposures** is currently available to European Regulators via trade repositories and should – if used and shared among authorities appropriately – enable regulators to monitor the risk exposures faced by counterparties from their derivatives transactions. However, those data are not easily understood, not readily functional, not easily shared among regulators and therefore not as useful as it might otherwise be. Ultimately, we argue that, for regulators to capitalize on these opportunities and enhance cooperation among relevant authorities across jurisdictions, investments into data analysis capacities and enhanced use of Memoranda of Understanding (MOUs) among regulators, within jurisdictions and cross-border, will be an essential aspect of monitoring the build-up of risks in a timely manner.[10] Regulators should work to address challenges with respect to cross-border data sharing rather than imposing additional data collection requirements on dealer banks. We also noted the Dutch Authority for the Financial Markets (AFM) paper on centralisation of capital markets data in the EU.[11] We agree with the suggestion that inter-EU cross-border data sharing allows for a more comprehensive understanding of risk, quicker responses to emerging issues, including the ability to real-time monitoring, and that *"centralised data also enhances international cooperation among European regulators and their global counterparts".* However, the focus of new data flows resulting from new regulation would be insufficient as EMIR transaction reporting data would be the key element from a derivatives perspective.

[9] https://www.bis.org/bcbs/publ/d521.pdf

[10] ISDA paper 'Hidden in Plain Sight? Derivatives Exposures, Regulatory Transparency and Trade Repositories': https://www.isda.org/2023/10/10/hidden-in-plain-sight-derivatives-exposures-regulatory-transparency-and-trade-repositories/

[11] https://www.afm.nl/en/sector/actueel/2024/maart/centraliseren-financiele-toezichtgegevens

Seventh, ISDA notes the questions raised in the Consultation paper in relation to the **broader CMU-related topic of supervision in the European Union**. Whilst ISDA remains agnostic to the supervisory set-up, i.e. college approaches or direct EU supervision, we think the framework should be efficient, effective and allow regulators to timely monitor and analyse the build-up of risks, lead to streamlined and consistent implementation and supervision of regulatory requirements. Importantly, any supervisory solution needs to address risks associated with cross-border exposures will require close collaboration between regulators from different jurisdictions (for data sharing and intervention purposes) and the industry (for streamlining and digitalising regulatory reporting). However, we would caution against giving authorities a greater ability to take supervisory intervention measures in an ad-hoc manner in times of stress, as suggested in the consultation. ESAs already have significant intervention powers under current rules. We caution that a discretionary exercise of supervisory powers to address macroprudential risks might disrupt anticipations and generate herd behaviours, with significant unintended consequences.

Eighth, market participants **have legitimate reasons to trade derivatives on exchanges or OTC and make use of cleared transactions at CCPs and non-cleared transactions**. In the context of the energy crisis of 2022 and the introduction of the Market Correction Mechanism, it appeared that some authorities may have considered that a move to bilaterally margined transactions implies an increase in financial stability risks. In fact, non-cleared margin requirements have been well-developed after the Great Financial Crisis and give market participants an opportunity to transact in more liquid and customizable markets when liquidity on venues and CCPs drops. Bilateral contracts often allow for a broader range of collateral for non-centrally cleared VM compared to cleared VM, where only cash is allowed is a valuable feature. That reduces pressure on firms' need to obtain cash and increases the stability of commodity markets. In addition, bilateral OTC transactions have a higher degree of visibility and predictability of margin requirements, as compared to those under the centrally-cleared markets given the current[12] lack of transparency of CCP margin models. This flexibility, transparency and predictability are important considerations, particularly for end-users and other non-financial market participants who may not have as readily access to cash to fund margin calls as banks and in this way may mitigate risks of widespread selling of non-cash assets for such calls. Also, beyond commodities, some products are not suitable for central clearing (e.g. products that are not sufficiently standardised and/or liquid), and any expectation that such products should be cleared at all times would be counterproductive. The flexibility to enter into bilateral transactions plays a vital role for market participants' investment activities and risk management.

[12] Note that global standard setters (BCBS, CPMI and IOSCO) have made proposals that would significantly improve transparency of CCP margin requirements (https://www.bis.org/bcbs/publ/d568.pdf).

RESPONSE TO THE QUESTIONS SET OUT IN THE CONSULTATION PAPER

Question 26: What are your views on the preparedness of NBFIs operating in the EU in meeting margin calls, and on the ways to improve preparedness, taking into account existing or recently agreed EU measures aimed at addressing this issue? Please specify the NBFI sector(s) you refer to in your answer

It is our view that the following would improve preparedness of NBFIs with respect to meeting margin calls:

- **Expand eligible collateral:** EU authorities, in coordination with Standard Setting Bodies, should explore and consider ways to support extending the range of collateral that can be used to meet margin requirements, where appropriate. The European Commission and ESMA should consider to prudently expand eligible collateral, taking into account suitability criteria for IM and VM for cleared and non-cleared transactions. For example, ISDA supports the expansion of eligible collateral under EMIR for cleared transactions such as uncollateralised bank guarantees and public guarantees for NFCs. It would also be helpful to consider ways to extend the range of collateral that can be used for margin purposes in non-centrally cleared markets. The BCBS-IOSCO framework for eligible collateral in bilateral transactions is already broad, allowing high quality liquid assets for both IM and VM for NBFIs such as government securities, corporate bonds, equities, and MMFs (with government bonds underlyings) and gold. However, there are operational and economic constraints that prevent some NBFIs from posting such non-cash assets, but there is the option to negotiate between counterparties to include such assets in credit support documents and, if the firm has the operational capabilities to manage on a business-as-usual status and/or may use these assets only in times of volatility to prevent liquidating assets to raise cash. In any event, while the expansion of eligible collateral would go some way in easing the pressure arising from collateral requirements, operations to ensure that core markets do not become dysfunctional in times of extreme stress should be part of the EU macroprudential toolkit, as market participants' ability to rely on deep and liquid repo markets at all times is a prerequisite in the world of greater collateralisation post-Global Financial Crisis.
- **Support initiatives to further automate, standardize and optimise collateral management:** Automation and data standards support stable markets. While more manual operational workflow and variance in data standards do not cause market volatility themselves, straight-through processes driven by interoperability through the collateral management ecosystem can, for those markets and products where this is pragmatic and appropriate, help stabilize a fallout and mitigate the negative impact of increased collateral demands under stress. It might also be worth considering how innovation in collateral and tokenization may offer improvements in collateral mobility and reduce the need for collateral holders to liquidate collateral to realize cash and reduce operational risks, especially during times of market volatility Also, more use of pre-trade and post-trade risk reduction tools (PTRR, especially multilateral rebalancing tools), where appropriate, could reduce counterparty risk and liquidity requirements linked to counterparty risk, e.g. from margin requirements. The use of such tools could be incentivized by exempting the output transactions from PTRR exercises from the clearing obligation, as foreseen in the changes to the European Market Infrastructure Regulation (EMIR).
- **Strengthen the resilience of core funding markets:** In general, the EU should consider ways to enhance the resilience of its repo markets, such that they can be relied upon as a source of liquidity and collateral under stress. The ability to rely on well-functioning, deep and liquid repo markets is a key factor in NBFIs' capacity to manage liquidity and meet increased liquidity demands arising from margin calls and collateral demands in times of stress. Policymakers should therefore focus on solutions to strengthen the resilience of repo markets under stress. One way to achieve this would be by not applying inappropriate impediments to banks' ability to provide intermediation

services, as discussed further below. In addition, initiatives that may facilitate NBFI access to central clearing of repos may also be helpful by providing them with broader options to access repo market liquidity, for example through sponsored access. Despite the need for some further consideration around the impact of those models on mutualisation of risk, as noted in the ISDA response to the CPMI-IOSCO report on client clearing[13], recent developments appear to address the issue, such as with "guaranteed" sponsored models whereby the agent bank assumes full liability for the liquidation loss of a sponsored member. However, as noted in the CPMI-IOSCO report on client clearing[14], such models might not address the needs of smaller or leveraged clients. There is also an overall scarcity in the number of sponsors as under the current regulatory framework, there are no provisions for the sponsored activity within the capital treatment of the counterparty credit risk, such that there remains an uncertainty around the capitalisation of the agent bank's resources. Separately, in the long run, the emergence of a European common safe asset, inspired by US Treasuries and the US repo market, may allow for the development of a deep and liquid repo market across EU jurisdictions, serving as a significant expansion of eligible collateral for cleared and non-cleared derivatives transactions and additionally provide a deep and liquid source of liquidity. Finally, strengthening the resilience of core funding markets should be considered in conjunction with the question of ensuring operations in core funding markets on financial stability grounds in extreme scenarios are part of the macroprudential toolkit, as suggested above.

- **Increase transparency in CCP margining practices:** Increased transparency in CCP margining practices, which is being addressed as part of the BCBS-CPMI-IOSCO consultation *"Transparency and responsiveness of initial margin in centrally cleared markets: review and policy proposals"*[15] is a critically important aspect to liquidity preparedness and will help NBFIs and other market participants better prepare for potential margin calls in centrally cleared markets. Increasing transparency in CCP margining practices will only serve to increase the accuracy and robustness of liquidity risk management at NBFIs, where overly prescriptive requirements that do not account for the diverse nature of the NBFI segment will likely serve to constrain NBFIs from implementing optimal liquidity risk procedures. ISDA expressed support for the proposals on CCP transparency and as also noted that further work on the calibration of anti-procyclicality tools would be welcome.[16]
- **Simplify and harmonize collateral requirements across jurisdictions:** Collateral requirements are not consistent between jurisdictions. Simplifying and harmonizing collateral requirements across jurisdictions should therefore be explored, bearing in mind that making eligible collateral and margin requirements for both cleared[17] and uncleared transactions too strict risks disincentivizing hedging for some market participants.
- **Addressing constraints to banks' ability to perform their intermediation function, especially in times of stress:** As noted above, the various constraints that banks' balance-sheets operate within – in terms of capital, leverage, liquidity and GSIB requirements – may affect their ability to extend funding or make markets during periods of stress. Addressing constraints to banks' ability to perform their intermediation function will also contribute to the resilience of repo markets. The ability to rely on well-functioning, deep and liquid repo markets is a key factor in NBFIs' capacity to manage liquidity and meet increased liquidity demands arising from collateral and margin calls in times of stress. EU authorities, in coordination with international Standard Setting Bodies,

[13] ISDA-CPMI-IOSCO-Client-Clearing.pdf
[14] Client clearing: access and portability (bis.org)
[15] Transparency and responsiveness of initial margin in centrally cleared markets: review and policy proposals (bis.org)
[16] ISDA-Response-to-Margin-Transparency.pdf
[17] For example, some CCPs accept a wider range of collateral for initial margin requirements.

should therefore focus on ways to strengthen the resilience of repo markets under stress, for instance, by not applying inappropriate impediments to banks' ability to provide intermediation services.

Question 27: What are relevant risk metrics or tools that can be used to effectively monitor liquidity and margin preparedness across all NBFI entity types? Please provide examples specifying the sector you refer to.

We emphasize that ISDA's NBFI members – and many of the policymakers who currently supervise and regulate them – already consider liquidity and margin preparedness very thoroughly. Many entities, including leveraged funds, are currently subject to stress-testing requirements. As a result, market discipline and existing regulatory requirements mean that NBFIs largely follow robust liquidity risk management practices, including liquidity stress testing. In that regard, it appears that many NBFIs apply risk management practices akin to these outlined in the FSB Consultation Report on liquidity preparedness for margin and collateral.[18] Given the broad range of NBFIs, it might be challenging to identify the risk metrics relevant for all market participants deemed as NBFIs.

Relatedly, to enable NBFI entities to appropriately prepare for margin calls in all scenarios, the key priority should consist in ensuring that CCPs provide sufficient information and transparency on their margin models to their users, including simulators and details on models. Market participants should be able to understand and replicate margin models, to adequately predict and prepare for margin calls in times of stress.

We would also invite the EU authorities and Standard Setting Bodies to consider ways to make full use of key data about derivatives activity and exposures, which is already made available to regulators in all major jurisdictions due to derivatives trade reporting requirements. Such data includes counterparty identification, notional amounts, valuations and risk metrics, and can already enable regulators to track exposures of all counterparties to a trade, and to build management dashboards that can flag large increases/decreases in positions and exposures. We would urge that regulators use the data they collected before they consider imposing additional requirements on firms.

Question 40: In light of the potential risk of contagion from spot markets or off-exchange energy trading to futures markets, do you think that spot market participants should also meet a more comprehensive set of trading rules for market participation and risk management? Please elaborate on your response

ISDA supports professional risk management practices in the cleared and non-cleared derivatives market and does not usually comment on trading in spot energy markets. ISDA notes that spot energy market participants are subject to certain aspects of financial services regulation that mitigate any such perceived risk of contagion, such as the Market Abuse Regulation (MAR) which addresses market abuse offences. There are also specific regimes that apply to spot gas and power products as well as certain gas and power derivatives such as REMIT II, which contains provisions on market abuse and regulatory reporting. However, given the interlinkage between spot energy markets and commodity derivatives markets and the wider economy (although this should not be over-estimated, as explained below), EU spot market participants should always apply professional risk management and trading practices, to ensure these markets remain predictable and that any episode of volatility can be explained widely by fundamentals in the energy market. However, not all trading rules applicable to exchange-traded derivatives are appropriate for energy market participants in the spot market. Spot products relating to physical energy markets which are linked to physical energy assets, the actual production/ generation or supply and consumption of physical energy – such as power or gas. This is

[18] Liquidity Preparedness for Margin and Collateral Calls: Consultation report - Financial Stability Board (fsb.org)

distinct from financial futures, where there is only cash settlement and no physical deliverable tangibly being delivered or consumed.

The question could be interpreted as relating to the MiFID Ancillary Activity Exemption for commodity trading firms, i.e. the possibility to exempt firms from becoming a MIFID investment firm. Regulating energy firms as investment firms would likely further exacerbate stress resulting from events like the invasion of Russia into Ukraine as it would negatively impact their liquidity positions and limit their access to markets for hedging purposes.

The root cause of the EU energy crisis has been a physical scarcity of gas. The derivatives market played a vital role in providing important price signals to the physical market. Reports from supervisory authorities have not identified impacts on prices and volatility resulting from illegitimate behaviour of derivatives market participants. We therefore think that regulators and policymakers should focus on measures to alleviate supply constraints on the physical side of the market, i.e. increasing and diversifying energy supply, investment in energy infrastructure and reforms to the gas storage obligations, among other factors. This could be hampered by imposing trading rules appropriate for financial market participants (such as regulatory capital or liquidity requirements) to market participants in physical markets.

Also, it is important not to over-emphasise the potential for commodity markets to affect the stability of the wider financial system. The FSB's 2023 report on the Financial Stability Aspects of Commodities Markets notes that *"the commodities ecosystem as a whole was largely able to absorb the shock. There were no major disruptions to market functioning – with the exception of the LME nickel market – and there was a limited impact on the rest of the financial system".* The FSB also recognises that it was *"the COVID-19 event, subsequent supply chain bottlenecks, and the Russian invasion of Ukraine in February 2022 [which] led to a surge in the price of key commodities and extreme volatility in some commodities and related derivatives markets"*. As such, the price determination role of markets functioned, with the volatility in prices actually reflecting real economy disruptions. It was this volatility that led to a spike in margin calls and increased demand for liquidity, which the FSB identifies as a channel of contagion. The report also emphasizes that a key risk that commodities market players face in a scenario of margin spikes arises from (i) the constraints that banks face when it comes to providing them with more credit, for credit counterparty risk management reasons, and from (ii) lower market liquidity in some commodity markets as market participants retrench from these markets, which exacerbates volatility and leads to a negative feedback loop. These observations suggest that the key vulnerability exposed by the 2022 market stress in commodities markets does not so much pertain to individual players' liquidity preparedness, but rather to increased risk aversion and capacity constraints arising from capital, leverage, G-SIB and prudential liquidity frameworks, which can lead intermediaries to cut back activities on these markets in times of stress. We also note that this situation was exacerbated for non-bank market participants by a lack of transparency of CCP margining practices.

Question 41: How can it be ensured that the functioning of underlying spot energy markets and off-exchange energy trading activity does not lead to the transmission of risks to financial markets?

Spot energy markets are characterised by specific features. Physical world constraints, for example those arising from storage, as well as geopolitical events, will influence energy markets dynamics. In efficient markets, prices observed on energy markets will reflect all the information available from the underlying spot energy markets, including those physical constraints specific to energy markets. As such, the question should not be to limit the transmission of risks from the underlying spot energy markets to financial markets, but rather to ensure that energy traders in the physical world are effectively able to use efficient financial markets to appropriately manage their risks, including by hedging. In that regard, emergency regulations such as the "Market Correction Mechanism", targeting

the Dutch TTF price should lapse, because it could cause significant unintended consequences, harms market efficiency and might lead to transmission of risks to financial markets, for instance by affecting risk management of futures CCPs in the energy markets. Variation Margin (VM) is meant to collateralise the build-up of exposures. The VM amount is based on settlement prices at venues and CCPs. If such a price is capped, VM is capped and CCPs might end up with under-collateralised clearing participants compared to the real risk or ask for higher margin payments. This would negatively impact financial stability and may lead CCPs to increase margin requirements, further exacerbating liquidity stress.

It is worth noting that commodity firms, including those which are not authorised as investment firms, are already subject to requirements under multiple financial services regulation such as EMIR and MiFID II, as stated above. For example, the transaction reporting regime applicable under EMIR imposes reporting requirements in respect of all derivative financial instruments (including OTC commodity derivatives), to which regulators have access. It also imposes various risk mitigation requirements. Beyond the transaction reporting and risk mitigation requirements under EMIR, these firms are also subject to various rules designed to preserve market integrity and stability. For instance, position limits and position management regimes under MiFID II and other regulations such as the Market Abuse Regulation (MAR) and the regulation on wholesale energy market integrity and transparency (REMIT), which apply to spot energy markets as well as derivatives, play crucial roles in ensuring that commodity markets operate fairly and transparently. These regulations collectively aim to mitigate risks and maintain orderly markets, underscoring the extensive regulatory oversight already in place for commodity firms. Many of these regimes, including EMIR and REMIT, have been recently reviewed, and their impacts on commodity markets have not yet been fully observed. More time is needed to assess these impacts before imposing new measures. We would also strongly urge regulators to consider how they may more effectively use the significant amount of data to which they already have access under various existing reporting regimes before assessing whether additional measures are necessary.

Question 50: How can it be ensured that competent authorities can effectively reconcile positions in leveraged products (such as derivatives) taken via various legal entities (e.g. other funds or funds of funds) to the ultimate beneficiary?

Regulators already have tools to reconcile positions in leveraged products via derivatives. In the EU, counterparties have to report their exposures within the EMIR reporting framework, allowing regulators to monitor leverage and concentration risks in derivatives markets. Such data includes counterparty identification, notional amounts, valuations and risk metrics, and can already enable regulators to track exposures of all counterparties to a trade, and to build management dashboards that can flag large increases/decreases in positions and exposures. We would urge that regulators to enhance their use of available data rather than imposing additional reporting requirements for firms, in line with the EC's objective to reduce the reporting burden for EU firms.

For example, the ESMA Trends, Risk and Vulnerabilities Report (May 2022) discusses the case of Archegos.[19] The report states that EMIR data made it possible to understand the sudden increase of concentrated exposures at the family office within one month. We understand that there are limitations around data sharing across jurisdictions. For example, EMIR data are only collected from 30 EEA counterparties. However, all major jurisdictions have implemented similar derivatives trade reporting requirements. Authorities should explore to ways to overcome impediments to sharing data across jurisdictions, to be able to effectively monitor the build-up of concentrated positions.

[19] https://www.esma.europa.eu/sites/default/files/library/esma50-165-2096_leverage_and_derivatives_the_case_of_archegos.pdf

Furthermore, in order to react to sudden changes in exposures or unexpected events, regulators would need to enhance their data analysis capacities.

We invite the EU authorities, together with Standard Setting Bodies and international counterparts, to consider ways to make full use of key data about derivatives activity and exposures, which is already made available to regulators in all major jurisdictions due to mandated derivatives trade reporting requirements.

Question 51: What role do concentrated intraday positions have in triggering high volatility and heightening risks of liquidity dry-ups? Please justify your response and suggest how the regulatory framework and the functioning of these markets could be further improved?

On all cleared positions – whether concentrated intraday positions or other – CCPs have the ability to call for margin on an intraday basis during stressed periods, to ensure they do not have non-collateralised risk. Recent market trends, such as the growth of zero day to expiry options in recent years, makes the ability of market participants to meet intraday liquidity requirements even more critical.

Those intra-day, sometimes ad-hoc unscheduled VM calls create specific pressure on cash liquidity planning and sourcing for market participants. As regards ways to reduce the potential for those intraday margin calls to result in intraday "dry ups", ISDA suggested, in its response[20] to the CPMI-IOSCO discussion on streamlining variation margin practices, that as the first best, CCPs should always endeavour to pass-through intraday VM. Where intraday VM is not passed through, CCPs should access non-cash collateral to meet intraday calls. In terms of practices, ISDA members have a preference for scheduled, as opposed to unscheduled, intraday calls. Providing market participants with an appropriate payment deadline and transparency also helps with liquidity management. Maximising the use of netting against other cash flows and more effective collateral excess management should be applied by CCPs to reduce pressures on liquidity.

All these aspects should be part of a CCP's policy on intra-day margining, developed in consultation with clearing participants. This would allow market participants to best prepare for potential intraday margin calls that may arise in times of stress, and reduce the likelihood that these intraday margin calls heighten the risk of liquidity dry-ups.

Question 53: What are the benefits and costs of a regular EU system-wide stress test across NBFI and banking sectors? Are current reporting and data sharing arrangements sufficient to perform this task? Would it be possible to combine available NBFI data with banking data? If so, how?

We note that the most recent CCP stress testing exercise conducted by ESMA included an "ecosystem analysis", where ESMA looked at large clients of multiple clearing members and assessed client concentrations in the central clearing ecosystem. ESMA also used available data to look at the impact of stressed VM calls on market participants, under the base stress scenarios that it had defined for this stress-testing exercise. Such analyses show that authorities can develop thorough assessments of concentrations, potential sources of vulnerabilities and amplification channels in the financial system by using existing data, in combination with ad-hoc stress-testing exercises. However, this will require regulators to enhance their data analysis capacities and data quality based on globally agreed entity identifiers, and MoU agreements to enhance data sharing between different authorities within jurisdictions and across borders.

In this context, ISDA would also encourage EU policymakers to consider the findings of the Bank of England's system-wide exploratory scenario (SWES). In developing EU system-wide stress testing, EU

[20] ISDA-and-IIF-Response-to-CPMI-IOSCO-on-VM-Practices.pdf

authorities could follow a SWES-like approach, built on a two rounds of analysis, with the first round looking at market participants' reaction to a stress scenario, and the second round looking at how market participants would further react to the stress in light of actions of other market participants and other round 1 observations. While the final report on the SWES has not been published at the time of writing this response, the BoE already shared learnings from round 1 of the exercise[21], which led *"most participating NBFIs to report significant liquidity needs"*. The BoE also reported that *"about 80% of reported liquidity needs arising from the hypothetical scenario came from variation margin calls, just over 10% from initial margin calls, and just under 10% from redemptions"*. This observation further underlines the importance of looking at ways to ensure that market participants are able to meet increased collateral demands under stress, following the suggestions that we outline in response to Question 26. The BoE also observed *"some differences between CCPs' and other participants' expectations when estimating initial margin calls"*, which further emphasises the importance of improving CCPs' transparency around IM practices. In addition, the BoE also noted that round 1 showed that *"banks reported that they expected to continue making markets, and to roll clients' existing repo, albeit on tougher terms, implying a tightening in repo market conditions"*. This finding also underlines the importance of looking at the resilience of core funding markets under stress, including by considering the extent to which dealers' intermediation capacity might be constrained, as well as the conditions under which operations to restore market functioning might be needed when a tightening in repo markets would become too severe.

The early learnings from the SWES suggest that a two-round approach, focusing on financial markets core to the EU financial stability, might provide useful insights to EU policymakers' thinking on macroprudential policies. Given the EC consultation also seeks to address EU authorities' intervention powers in systemic events, a system-wide stress testing exercise could also include – perhaps under the second round – an exploration of how market participants would anticipate a market intervention, and how they would react to it. This would allow to evaluate the extent to which ad-hoc intervention measures in stress events may lead to unintended reactions further amplifying the stress.

Finally, we would emphasize the exploratory nature of such exercises, such that the findings need to be considered in light of how the stress scenario and modelling assumptions were defined. As such, these exercises should not inform the setting of specific supervisory measures, but rather contribute to a broader understanding of stress transmission channels.

Question 54: Is there a need for arrangements between NBFI supervisors and bank supervisors to ensure timely and comprehensive sharing of data for the conduct of an EU-wide financial system stress tests? Please elaborate.

We understand that regulators in the EU, whether between types of regulators (prudential, insurance, market regulators and central banks) or jurisdictions, face issues in sharing and analysing data, hampering the regulatory community to identify the build-up of risks in a timely manner. In order to conduct system wide stress tests, a more streamlined and comprehensive data sharing strategy between EU supervisors and the various NCAs in EU Member States would be required. Therefore, more centralised data, as suggested in the AFM position paper on centralisation of capital markets data would be critical, as long as EMIR transaction reporting data are included, to monitor derivatives exposures. Given the availability of EMIR transaction reporting data, any initiatives should refrain from imposing duplicative reporting requirements to NBFIs or banks. This is also in line with the EC's ambition to reduce reporting obligations for firms by 25% within the next EC legislative cycle.

[21] Financial Stability Report - June 2024 | Bank of England

Question 55: What governance principles already laid out in existing system-wide exercises in the EU, such as the one-off Fit-for-55 climate risk scenario analysis or the CCP stress tests conducted by ESMA, could be adopted in such system-wide stress test scenario?

We believe that some aspects of ESMA's approach to CCP stress-testing could be adopted in a system-wide stress test scenario. For example, in the 2024 CCP stress-testing exercise[22], ESMA assessed the adequacy of CCPs' resources in covering the cost of liquidating concentrated positions. ESMA also developed an ecosystem analysis, looking at CCPs' and clearing members' resources, exploring specific areas with potential spill-over effects to the broader financial system. Using derivative exposures reported from EU counterparties to Trade Repositories under the EMIR, ESMA presented a descriptive analysis of the client clearing ecosystem for selected asset classes (equity derivatives, energy commodity derivatives, and EU emission allowances derivatives). ESMA also looked at the impact of liquidity demands arising from margin calls on financial intermediaries. Those various components of the 2024 CCP stress-testing exercise could form part of a system-wide stress testing exercise. In addition, and with much relevance to NBFI resilience, we would suggest that a system-wide stress test scenario also looks at a situation where porting of clients' positions is necessary – looking into the obstacles and feasibility of porting, and also into the impact on the NBFI ecosystem if positions were not ported.

Question 66: What are the benefits and costs of gradually giving ESAs greater intervention powers to be triggered by systemic events, such as the possibility to introduce EU-wide trade halts or direct power to collect data from regulated entities? Please justify your answer and provide examples of powers that could be given to the ESAs during a systemic crisis.

We note that current EU rules already provide significant intervention powers to theas ESAs. For example, MIFID II/MIFIR include provisions in relation to triggering circuit breakers, position management in commodities markets; the short-selling regulation includes a power for ESMA to prohibit/restrict short selling transaction, as listed in the Annex to the consultation.

We do not support giving ESAs greater intervention powers, which add an element of uncertainty in stress circumstances. Under a discretionary policy framework, regulators should be extremely careful exercising such powers as this could lead to unintended consequences, such as:

- market participants will attempt to anticipate what authorities may or may not do in relation to these powers, while authorities will be attempting to anticipate how the market would react to discretionary measures;
- this may result in herd behaviours or negative feedback loops – either in reaction to an intervention, or in anticipation of a potential measure – which could amplify the stress;
- a broad sweeping discretionary measure, affecting a whole market, would also inevitably come with unintended consequences on some market participants, which cannot reasonably assume the cumulative effect of various discretionary powers triggered by different authorities, in a potentially uncoordinated fashion.

ISDA does not support EU-wide or country specific trading halts. Trading halts are an ineffective systemic risk management tool and even market participants possibly anticipating trading halts could negatively impact financial stability. Open markets are critical for risk management of all NBFIs (and banks) and halts should as a rule be avoided. Instead, systemic events in extreme stress scenarios, leading to severe dysfunction of core funding markets, should be addressed as part of the EU macroprudential policy toolkit. Some markets have rules that trigger brief (minutes not days) halts to enable market participants to process significant news events. For example, US equity markets have

[22] ESMA91-1505572268-3627_5th_ESMA_CCP_Stress_Test_Report.pdf (europa.eu)

rules that pause trading of specific securities or indices when prices rise or fall by a significant percentage in a short period of time. Trading resumes quickly to enable market participants to manage their investments and hedge risks.

For example, in the face of the Russian invasion of Ukraine, trading halts would not have changed the underlying reality of lower future supplies of Russian oil and gas that were driving price changes. They would have merely limited market participants ability to adjust their portfolios or hedge risks in response to real life events and exacerbated poor liquidity and high volatility.

Relatedly, before considering providing ESAs with greater intervention powers, European authorities should look to make full use of the transaction data that they receive in business-as-usual circumstances. ESMA has the ability to harness existing transaction reporting obligations as market participants have to report their transactions to trade repositories. In the EU, ESMA has the information to understand exposures between counterparties. However, analysing exposures from non-EU counterparties to EU counterparties may require further data sharing agreements via MoUs or other agreements. We consider that regulators would need to enhance their data analysis capacities, especially prior to making any interventions that might destabilise markets (rather than conducting post-event analyses). Increased data analysis capacity should enable EU authorities to proactively monitor the potential build-up of systemic risk at the macro level, rather than react amidst stressed market conditions with intervention measures that come with unpredictable second round effects.

Question 67: What are the benefits and costs of a more integrated system of supervision for commodities markets where the financial markets supervisor bears responsibility for both the financial and physical infrastructure of the commodity futures exchange, including the system of rules and contractual terms of the exchange that regulate both futures and (cash/physical) forward contracts?

ISDA members caution against a "super supervisor" for both the financial and physical infrastructure. Commodity markets, more than most asset markets, are driven in large part by global and regional supply and demand changes, and have unique characteristics and profiles related to physical assets and products. This is already recognised by the fact that separate regulatory frameworks exist for physical commodities and derivatives, which are specific to the nature of products and risks presented. An EU-wide "super supervisor" would still have limited ability to impact sudden price changes or increased volatility, also taking into account that supervision of physical commodities legitimately differs from financial markets such as aspects related to physical infrastructure and storage of commodities. We would instead encourage ACER and ESMA to continue to apply the specific regulatory frameworks developed for physical commodities and related financial products and further deepen their supervisory relationship and engage in more comprehensive data sharing, as a first step.

Question 68: Are there elements of the FSB programme on NBFI that should be prioritised in the EU? Please provide examples.

Greater transparency in CCP margining practices, a key part of the FSB NBFI work programme, should continue to be a priority, as it will help market participants to better predict and prepare for margin calls. Similarly, further work on the calibration of anti-procyclicality tools in particular would be welcome.

ISDA also supports the FSB's work on NBFI liquidity preparedness for margin and collateral.[23] ISDA considers that the FSB's recommendations are sensible, and seek to incorporate a proportionate and

[23] WGMP202326REV3

risk-based approach.[24] They recognize that non-bank market participants' exposure to liquidity risk is dependent on factors such as *"complexity of business models, risk profiles (including concentration and leverage), structure and size of market participants, and interconnectedness"* and that NBFIs (and other non-bank market participants) are often subject to distinct regulatory frameworks within and across jurisdictions.

We also note that the FSB NBFI work programme, as described in the FSB 2024 work programme[25], refers to *"conducting new work on the functioning and resilience of repo markets"*. The FSB published a comprehensive analysis of core funding markets in 2022[26], notably including an analysis of the costs and benefits of central clearing. In addition, and as noted in response to Question 26, the US authorities have mandated increased reporting and clearing of both cash Treasury and repo markets. Monitoring the implementation of these new rules may provide useful information to the EU when determining the usefulness of repo clearing in this market, and to identify potential issues before embarking on this path. For instance, it is not clear yet whether access models can be developed that enable repo clearing at affordable cost for all clients.

About ISDA

Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 1,000 member institutions from 76 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's website: www.isda.org. Follow us on LinkedIn and YouTube.

[24] ISDA-response-to-FSB-NBFI-consultation.pdf
[25] P240124.pdf (fsb.org)
[26] Liquidity in Core Government Bond Markets: Liquidity in Core Government Bond Markets