

Anti-Procyclicality Framework

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Summary

- This policy framework is established to set out LMEC's management of procyclicality in all its risk management activities and how procyclicality can be measured, managed and balanced with the protections from member default risk.
- This Framework should also be taken into account:
 1. As part of the model assessment/validation process for newly proposed models. Any findings as a result should be reviewed and approved by the relevant level of governance as specified in the applicable methodology/policy.
 2. As part of the annual validation exercise in accordance with the LMEC's Model Risk Governance Framework. Any findings or changes proposed as a result should be reviewed and approved by the relevant level of governance as specified in the applicable methodology/policy.
 3. As part of the annual assessment of the risk types covered in LMEC's Risk Appetite to identify areas that are subject to potential procyclicality concerns. The result of this analysis should be made available to LMEC's Board Risk Committee. And the relevant policies/methodologies governing the risk types identified in the analysis should refer to this Framework to address the concerns.
 4. As part of the regular risk reviews (daily, monthly or quarterly depending on current process), such as for margin parameters, collateral haircuts, model calibration, credit reviews, etc.; or where an ad-hoc review is required, such as triggered by a new stress period. Results of such reviews should be made available to the relevant governance in accordance with this Framework and the related methodology/policy and where material procyclical issues are identified changes to the underlying model should be considered against any weakening in its risk coverage.

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Risk Appetite

- To understand where procyclicality concerns can come from, LMEC first identified two types of procyclicality that can impact its various risk areas;
 - The idiosyncratic type, i.e. the risk changes that are mainly concerning individual counterparty, or a defined subset of counterparties, such as changes driven by credit assessments.
 - The systematic type, i.e. the risk changes that are more broad-based, such as changes driven by market risk assessments or methodology changes.
- Within the annual assessment of the risk types covered in LMEC's Risk Appetite Statement, where a risk type is identified as subject to procyclicality concern, it needs to be clearly stated which one or a combination of the above mentioned procyclicality types the particular risk type is subject to.
- Whilst procyclical control is of high importance and LMEC shall aim to minimise it where possible, LMEC considers that it should balance its risk coverage (in accordance with the prevailing market conditions) against procyclical risks.

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Quantitative Measurement of Procyclicality

- The key focus areas of a quantitative measurement of procyclicality are:
 1. Financial instability should be driven by speed and degree of margin increases, but not necessarily the speed and degree of margin reductions.
 - For financial system instability concerns, margin increases are what draws liquidity from the market rather than reductions.
 - For financial system instability concerns, margin increases over a short period of time should be the more important consideration rather than margin increases over a very long market cycle.
 2. Co-movements to market stresses is key to address the ‘mutually reinforcing interactions’ point.
 - Without the co-movement, procyclicality becomes cyclicity.
- LMEC utilises an N-day stressed procyclicality approach, measuring the largest increase in risk assessment (such as initial margin, margin add-ons and collateral haircuts) over an n-day period for a constant portfolio over a fixed observation period, restricted to those sub-periods where volatility is elevated. And the following considerations should be taken into account when applying this approach:
 1. For the N-day definition, LMEC uses a rolling 5 business days as a balance between being longer than LMEC’s assumed liquidation period while still focusing on the short term impacts.
 2. Because the proposed measure doesn’t specify an absolute threshold, it is the most suitable to be used as a relative measure against a benchmark model. The benchmark model can either be the existing model (i.e., to compare the status quo with an alternative modelling approach) or a base model prior to adding in procyclicality controls methods

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Quantitative Measurement of Procyclicality continued

Apart from the relative comparison against a benchmark model, LMEC also monitors a short-term measure for key margin parameters of metals that are material to LMEC, each time the parameters change within a relevant stress period. If the measure shows an increase of over 50% in the defined 5 day window, analysis of the breach and its outcomes will be presented to the Clearing Risk Committee for consideration. If the Clearing Risk Committee decides a model change or a threshold change is required as a result of the analysis, then the proposed changes will also be presented to the Board Risk Committee for approval.

As an extension to the above mentioned short-term measure, LMEC also applies a long-term measure of margin stability using a 1-month (i.e. 22 business days) rolling percentage increases. Similar to the short-term measure, LMEC also monitors this long-term measure for key margin parameters of metals that are material to LMEC each time the parameters change. If the measure shows an increase of over 100%, analysis of the breach and its outcomes need to be presented to the Clearing Risk Committee for consideration. If the Clearing Risk Committee decides a model change or a threshold change is required as a result of the analysis, then the proposed changes are also be presented to the Board Risk Committee for approval.