ISDA Safe, Efficient Markets | sifma | sifma asset management group | alfi association of the luxembourg fund industry

May 17, 2019

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Re: Margin Requirements for Non-Centrally Cleared Derivatives – Initial Margin Models

Dear Sirs,

The International Swaps and Derivatives Association, Inc. (ISDA), the Securities Industry and Financial Markets Association (SIFMA), the Securities Industry and Financial Markets Association's Asset Management Group (SIFMA AMG) and the Association of the Luxembourg Fund Industry (ALFI) (hereinafter the Associations) support the efforts of regulators to help the industry in the implementation of the initial margin (IM) rules applicable to non-centrally cleared derivatives.

In September 2018, ISDA, SIFMA and other industry associations submitted a letter to the Basel Committee on Banking Supervision (BCBS) and the International Organization of Securities Commissions (IOSCO) to raise issues associated with the final stages of the uncleared margin rules[1],

[1] September 2018 letter sent by ISDA, SIFMA, American Bankers Association, the Global Foreign Exchange Division of the Global Financial Markets Association and the Institute of International Bankers: 20180912-Initial-Margin-Phase-In-Implementation-Joint-Trade-Association-Comments.pdf.

particularly with the introduction of IM requirements for a large universe of counterparties as of September 1, 2020.

On 5 March 2019, BCBS and IOSCO published a joint statement on the final implementation phases of the margin requirements for non-centrally cleared derivatives where they note that: '*In the remaining phases of the framework's implementation in 2019 and 2020, initial margin requirements will apply to a large number of entities for the first time, potentially involving documentation, custodial and operational arrangements. The Basel Committee and IOSCO note that the framework does not specify documentation, custodial or operational requirements if the bilateral initial margin amount does not exceed the framework's €50 million initial margin threshold. It is expected, however, that covered entities will act diligently when their exposures approach the threshold to ensure that the relevant arrangements needed are in place if the threshold is exceeded.*'

The Associations welcome this statement but advise that regardless of whether counterparties coming into scope of the initial margin requirements in 2019 (phase 4) and 2020 (phase 5) are able to delay some of their documentation, custodial and operational requirements because they will not immediately have to exchange IM, these counterparties will still face substantial burden to implement and maintain an IM calculation method in order to monitor their IM amounts and/or calculate IM for exchange. This burden is due primarily to regulatory requirements for the approval to use a quantitative IM model and the governance requirements associated with its initial and ongoing use.

In this context, we urge the European policy makers and national regulators to appropriately calibrate the EMIR implementing rules on:

- The back-testing and internal governance requirements associated with the use of globally approved IM models, including the ISDA SIMM™ (SIMM);
- The initial and on-going approval on initial margin models under article 11 paragraph 15 of EMIR (as modified by EMIR Refit), for which the ESAs shall draft Regulatory technical standards (RTS);

1. Remove back-testing and internal governance process requirements for use of globally approved IM models for smaller end users

The Associations strongly believe that regulators should reduce the compliance and operational burdens for smaller counterparties to use quantitative models to calculate regulatory IM, including internal back-testing and model governance processes. These requirements, which we refer to as "prudential-style governance", are based on mechanics already utilized by banks to comply with capital requirements and include: internal initial validation for conceptual soundness; model documentation (including limitations and assumptions); ongoing monitoring and back testing; and independent auditing of all of the above[2].

Under US rules, these prudential-style model-related requirements generally apply only to registered swap dealers[3]. Under the EU rules, however, the requirements directly apply to all in-scope counterparties. For the non-dealers brought into scope in phases 4 and 5, compliance with these

[2] This bank-centric approach requires users to establish the conceptual soundness of the models used, as well as demonstrate suitable implementation within certain processes and proper data inputs (i.e., risk factor inputs). Users must also demonstrate proper internal governance for model usage, covering areas such as dispute management, model performance tracking and remediation where IM levels fall short of regulatory standards (i.e., one-tailed 99% risk coverage using a 10-day risk horizon). Firms achieve compliance through extensive internal policies and procedures that give rise to very significant amount of work for compliance, model validation, risk management and internal audit staff.
[3] Such requirements will also generally apply to major swap participants and are anticipated to apply to security-based swap dealers and major security-based swap participants.

requirements may prove impossible, as they will need to develop and manage expensive monitoring and governance capabilities from scratch. These obstacles and obligations present a significant impediment to the expanded use of internal models – including the ISDA SIMM.

As a result, phase 4 and 5 counterparties may opt to use grid-based methodologies, despite the fact that such calculations are less risk sensitive and will be more expensive for diversified portfolios – proving more costly. ISDA analysis shows that, on average, grid-based IM amounts for phase 5 portfolios two years into the non-cleared margin requirements will be more than *twice* as expensive as those using internal models such as the SIMM (a 2.1 ratio). When the grid-based and SIMM figures are compared after the application of an IM threshold of USD 50 million, the ratio rises even higher, to 2.8.

The use of the ISDA SIMM has been widely approved and accepted by global regulators and has to date been the primary margin methodology used for uncleared margin rules implementation. SIMM implementation standards are well-known by regulators and markets participants alike, and SIMM model performance monitoring on actual portfolios takes place on a global basis. Management and development of the SIMM is governed through a well-established framework, which involves consultation and reporting to regulators[4].

For these reasons, where non-dealers are relying on a broadly used model that has already been reviewed or approved by regulatory or supervisory authorities to calculate their regulatory IM (either directly, or by a third party on their behalf), individual model governance requirements should not be necessary and regulators should exempt all phase 4and 5 non-dealers from both the internal back-testing requirements of Article 14 (provisions 3-6) and the Article 18 requirement for an internal governance process.

2. Restrict initial margin model approval under EMIR

EMIR Refit legislation includes a modification to Article 11, Paragraph 15 of EMIR (risk-mitigation techniques for OTC derivative contracts not cleared by a CCP) by which initial margin models have to be approved (initial and ongoing approval).

The text gives a mandate to the ESAs (EBA, EIOPA, ESMA) to develop draft regulatory technical standards (RTS) in order to specify the procedure for the *a priori* supervisory approval of the IM model.

During the EMIR Refit legislative process, we had raised with EU policy makers that considering the internationally agreed phase-in approach for the implementation of non-cleared margin requirements, the timeline of application of the EMIR Refit legislation would in itself be problematic. EMIR Refit will go live after phases 1 to 4 are completed. Accordingly, it appears that the model approval requirement would apply initially to phase 5 firms, for which the aforementioned burdens associated with IM model implementation are already the most challenging.

Broadly adopted IM models, like SIMM not only enable a degree of collateral-efficiency but also prevent considerable operational obstacles to firms as they seek to comply with EU margin rules. National competent authorities (NCAs) have already reviewed this model and checked its compliance with EMIR margin rules through compliance testing. The current compliance testing processed by NCAs should suffice to assure full compliance of the models with the EMIR margin rules. If the existing compliant models are ignored in favor of the new model approval requirement, market participants would face a new uncertainty that would hamper efforts to comply with the existing phase-in schedule in relation to IM under EU and other jurisdictions' rules.

In addition, the EMIR Refit provision would force both the dealers and their clients to obtain IM model approval, which would create a disproportionate burden for clients compared with other jurisdictions,

[4] See ISDA SIMM Governance Framework: ISDA-simm-governance-framework-19-september-2017-public.pdf.

especially the US[5], where currently only swap dealers[6] must obtain such approval. It would then be appropriate, in the future RTS drafted by the ESAs, to limit the approval requirement to dealers, which in the EU would be institutions under the Capital Requirements Regulations[7] (CRR Institutions) subject to phases 1 to 3, or over €1.5 trillion in AANA in future years.

Lastly, we fully appreciate that the new regime aims to harmonise across the EU the supervisory practices and to have only one process to 'review' the models. It would then seem logical that the ESAs are directly in charge of the validation rather than the NCAs. At least, if such EU level approval is not possible, it is critical to assure that the validation given by any NCA within the EU is considered a validation for the use of the model across the EU.

Based on the above, the Associations' members strongly believe that the future RTS that the ESAs shall draft to specify the approval procedure for IM models should give the following clarifications:

- Scope of application:
  - Pre-approval should not apply to existing models that have already been reviewed by NCAs in the EU or approved by authorities in other BCBS-IOSCO non-cleared margin commitments-compliant jurisdictions;
  - The new approval procedure should apply only to 'dealers' and not to end users. By dealers the Associations mean firms that: a) are subject to phase 1, phase 2, phase 3 of application of initial margin rules for non-cleared derivatives under EMIR <u>and</u> b) are CRR Institutions.

- To whom is the application made and how approval is granted:
  - Application should be made to ESMA or EBA <u>or</u> (if such process is not possible under EU legal constraints) to the NCA of the dealer who has to get approval;
  - The approval is granted: <u>either</u> by a response given by the concerned ESA or NCA within a short timeframe <u>or</u> by consideration of the absence of opposition within this short timeframe.

- The approval granted by an NCA (if the ESAs are not in charge of the validation) to a dealer shall cover the use of the model in all EU jurisdictions where the dealer operates.

In addition to the above recommendations, the Associations request certainty as to whether the territorial scope of the IM model approval requirement would apply only to EU-based entities. The application of the requirement to non-EU counterparties would pose specific issues that need to be assessed. Particularly, how could an EU-based NCA that has no supervisory powers over a non-EU firm run an IM model examination and possibly contradict the review done by the firm's home country regulator on compliance with uncleared margin rules?

Non-dealer counterparties may face difficulties in obtaining required regulatory approvals and/or developing required governance processes to effectively implement SIMM. Exempting phase 4 and 5 non-dealers from the pre-approval and prudential-style governance requirements would create a path to allow dealers to calculate IM on their behalf.

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[5] In the US, 236 firms are estimated to come into scope of the initial margin requirements during phase 5 whereas 546 firms are concerned in the EU (including the United Kingdom), and only a small fraction of US phase 5 firms are swap dealers (42). As a result the EU has a very different magnitude in terms of implementation burden.

[6] Model approval requirements are also applicable to major swap participants and may apply to security-based swap dealers and security-based major swap participants; though currently there are no parties with such classification.

[7] 'Institution' in the sense of point (3) of Article 4(1) of Regulation (EU) No 575/2013. i.e. credit institutions and investment firms, being noted that the EMIR definition of financial counterparties under Article 2(8) cross-refers to the CRR for credit institutions and investment firms. The Associations note that the definition of institutions has already been used to clarify which firms have to exchange Variation Margin for FX contracts under EMIR (see Draft-modified-margin-RTS).

Thank you for your consideration and please contact us if you have any questions.

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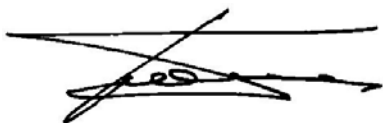

About the Associations

The International Swaps and Derivatives Association

Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has more than 900 member institutions from 70 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 depositories, as well as law firms, accounting firms and other service providers. Additional information on ISDA is available at http://www.isda.org.

The Securities Industry and Financial Markets Association

SIFMA is the leading trade association for broker-dealers, investment banks and asset managers operating in the U.S. and global capital markets. On behalf of our industry's nearly 1 million employees, we advocate on legislation, regulation and business policy, affecting retail and institutional investors, equity and fixed income markets and related products and services. We serve as an industry coordinating body to promote fair and orderly markets, informed regulatory compliance, and efficient market operations and resiliency. We also provide a forum for industry policy and professional development. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit http://www.sifma.org.

The Securities Industry and Financial Markets Association's Asset Management Group

SIFMA AMG brings the asset management community together to provide views on U.S. and global policy and to create industry best practices. SIFMA AMG's members represent U.S. and global asset management firms whose combined assets under management exceed $45 trillion. The clients of SIFMA AMG member firms include, among others, tens of millions of individual investors, registered investment companies, endowments, public and private pension funds, UCITS and private funds such as hedge funds and private equity funds.

The Association of the Luxembourg Fund Industry (ALFI) represents the face and voice of the Luxembourg asset management and investment fund community. The Association is committed to the development of the Luxembourg fund industry by striving to create new business opportunities, and

Created in 1988, the Association today represents over 1,500 Luxembourg domiciled investment funds, asset management companies and a wide range of business that serve the sector. These include depositary banks, fund administrators, transfer agents, distributors, legal firms, consultants, tax advisory firms, auditors and accountants, specialised IT and communication companies. Luxembourg is the largest fund domicile in Europe and a worldwide leader in cross-border distribution of funds. Luxembourg domiciled investment funds are distributed in more than 70 countries around the world.