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Opinion on regulatory scope and validation of initial margin models

Introduction and legal basis

The EBA, ESMA and EIOPA have been mandated, pursuant to Article 11(15) of Regulation (EU) No 648/2012 [1] ('EMIR'), to develop draft regulatory technical standards (RTS) on risk mitigation techniques for non-centrally cleared over-the-counter (OTC) derivatives. After the submission from EBA, ESMA and EIOPA, those draft RTS were adopted by the European Commission (EC) as Delegated Regulation (EU) 2016/2251 of 4 October 2016[2], and published in the Official Journal on 15 December 2016. These RTS are the framework that prescribes the exchange of variation and initial margins (IM) in the EU and implements the global standards agreed by BCBS and IOSCO.

With the publication of the EMIR Refit in 2019[3], the EBA was mandated, by the new Article 11(15), point (aa), of EMIR, to submit, in cooperation with ESMA and EIOPA, draft RTS to provide '*the supervisory procedures to ensure initial and ongoing validation of those risk-management procedures*' set out by Delegated Regulation 2016/2251. In fact, since that Delegated Regulation allows derivatives counterparties to calculate the initial margin by using their internal models, a new mandate was necessary to empower the EBA with the development of RTS focusing on the methodology for the validation of the initial margin models used by derivatives counterparties.

The framework, known as the RTS on Initial Margin Model Validation (IMMV), was since developed, consulted by EBA in November 2021[4], and finalised jointly with the publication of this opinion.

[1] Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories (OJ L 201 27.7.2012, p. 1).

[2] Commission Delegated Regulation (EU) 2016/2251 of 4 October 2016 supplementing Regulation (EU) No 648/2012 of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories with regard to regulatory technical standards for risk-mitigation techniques for OTC derivative contracts not cleared by a central counterparty (OJ L 340 15.12.2016, p. 9).

http://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1491566608628&uri=CELEX:32016R2251

[3] Regulation (EU) 2019/834 of the European Parliament and of the Council of 20 May 2019 amending Regulation (EU) No 648/2012 as regards the clearing obligation, the suspension of the clearing obligation, the reporting requirements, the risk-mitigation techniques for OTC derivative contracts not cleared by a central counterparty, the registration and supervision of trade repositories and the requirements for trade repositories (OJ L 141, 28.5.2019, p. 42).

https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32019R0834&from=EN

[4] https://www.eba.europa.eu/regulation-and-policy/market-infrastructures/regulatory-technical-standards-immv-under-emir

The IMMV framework has been designed to operate in accordance with the requirements set out in Delegated Regulation (EU) 2016/2251 on uncleared OTC derivatives. It is based on existing practices regarding internal models' approval, such as those laid down in Commission Delegated Regulation (EU) 2014/529 on model changes[5], and in the Draft RTS on the assessment methodology for market risk's internal models[6]. The IMMV framework has been however adapted to accommodate existing practices related to bilateral initial margin exchange and international IM models.

Recently, the EMIR review proposal, published by the EC on 7 December 2022[7], introduces a series of amendments to EMIR aimed at reducing the regulatory burden for clearing services. Among those changes, the EC proposes to amend Article 11(15) of EMIR, to withdraw the EBA mandate in point (aa), and thus remove the legal basis for the draft RTS on IMMV.

The competence of the European Banking Authority (EBA) to deliver this opinion is based on Article 16a(1) of Regulation (EU) No 1093/2010 of the European Parliament and of the Council[8], as the supervisory procedures to ensure initial and ongoing validation of risk-management procedures within the framework of risk mitigation techniques for non-centrally cleared OTC derivative contracts relate to the area of competence of the EBA.

In accordance with Article 14(7) of the Rules of Procedure of the EBA Board of Supervisors[9], the EBA has adopted this opinion.

This opinion is addressed to the Commission, the Council and the European Parliament.

Initial margin model validation

The BCBS-IOSCO margin framework gives explicit guidance on which models can be used, alternatively to the standardised schedule, for the quantification of the IM: '*Models that have not been granted explicit approval may not be used for initial margin purposes. Models may be either internally developed or sourced from the counterparties or third-party vendors, but in all such cases, these models must be approved by the appropriate supervisory authority*'[10].

Contrary to the BCBS-IOSCO standards, the original joint ESAs RTS mandate on uncleared OTC derivatives provided by Article 11(15) of the EMIR did not envisage a supervisory approval process

[5] Commission Delegated Regulation (EU) No 529/2014 of 12 March 2014 supplementing Regulation (EU) No 575/2013 of the European Parliament and of the Council with regard to regulatory technical standards for assessing the materiality of extensions and changes of the Internal Ratings Based Approach and the Advanced Measurement Approach Text with EEA relevance (OJ L 148, 20.5.2014, p. 36).

[6] EBA RTS on the specification of the assessment methodology to use internal models for market risk.

[7] https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52022PC0697

[8] Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority) amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC (OJ L 331, 15.12.2010, p. 12).

[9] Decision of the EBA of 22 January 2020 concerning the Rules of Procedure of the Board of Supervisors (Decision EBA/DC/2020/307).

[10] See BCBS-IOSCO margin framework, § 3.3 on p. 13.

for IM models. Accordingly, the RTS on uncleared OTC derivatives introduced several requirements to the IM models, in line with the requirements set out in the Basel-IOSCO margin framework[11].

A supervisory approval framework for EU counterparties' internal margin models was introduced with the adoption of the 2019 EMIR refit and the insertion of point(aa) into Article 11(15) of EMIR[12].

During the development of the RTS on IMMV, one of the key policy issues was the need to accommodate the expectations of a significant number of counterparties, which would be in the scope of the model approval. This is due to the broad diffusion of IM models, as the industry has since developed a standard model, known as the ISDA Standardised Initial Margin Model (SIMM) model, which is widely used. Hence a vast variety of model users, in the form of credit institutions, insurance companies, investment funds, asset management companies and so forth, are applying this model as part of their margin set-up. In contrast, in comparable jurisdictions in terms of the size of the OTC derivatives market, such as the US, the approval process is reserved solely to *swap dealers* (i.e., the major international and national banks that operate as market makers in the non-centrally cleared OTC derivatives); therefore in such jurisdictions, the IM model approval process is applied to a few dozens of significant banks, leaving their "clients" (i.e., smaller banks, and all the other counterparties of the dealers), outside the scope of the IM model approval. Therefore, in order to keep the validation process manageable for competent authorities and supervised counterparties, the EBA designed a proportioned dual process for validation: a standard process for the larger/most active credit institutions and a simplified process for all the others.

The EBA's RTS on IMMV also pays great attention to the international practice adopted in the uncleared OTC derivatives market with regard to the standard exchange of IM, which today is predominantly done using the model developed by the industry-driven initiative (the ISDA SIMM). Furthermore, great attention is paid to the possibility of outsourcing a variety of aspects linked to the IM model implementation by the counterparties in the scope of the application of the IM exchange.

The almost unanimous response to the Consultation Paper on RTS on IMMV was that the simplified framework still needed to be more manageable for the majority of counterparties, especially the smaller ones, even if simplified with respect to the standard process. A great number of respondents advocated for the total exemption from validation requirements. This exemption was clearly not possible to be granted within the EBA's draft RTS, since it appeared to be beyond the mandate and would need to be explicit in the EMIR. Nonetheless, in its final RTS on IMMV, the EBA

[11] Margin requirements for non-centrally cleared derivatives: https://www.bis.org/bcbs/publ/d317.htm; https://www.bis.org/bcbs/publ/d475.pdf

[12] On this provision, guidance is provided in recital 20 of the EMIR Refit, which provides:

"(20) To avoid inconsistencies across the Union in the application of the risk-mitigation techniques, due to the complexity of the risk-management procedures requiring the timely, accurate and appropriately segregated exchange of collateral of counterparties which involve the use of internal models, competent authorities should validate those risk-management procedures or any significant change to those procedures, before they are applied."

provided further simplifications for the counterparties in the scope of the simplified process, which can easily rely on the outsourcing services provided by counterparties in the scope of the standard validation process.

Nevertheless, EBA is of the view that the regulatory scope of RTS on IMMV, as it is imposed by the EMIR, is overly broad, therefore suggests that this is considered by the Commission and co-legislators as detailed in the subsequent section.

In addition to the issue related to the regulatory scope, another significant issue was observed during the discussions on the RTS on IMMV. The issue is linked to the intrinsic difficulty faced by competent authorities in validating the implementation, at the counterparties level, of an industry-wide model such as the ISDA SIMM. The design of the model is centrally decided at one point (ISDA) and can hardly be significantly affected by the preference of every single user or by the different assessments of every single competent authority. In practice, since the same model is applied by a large number of counterparties all around the EU and is supposed to be validated by a plurality of competent authorities, a clear coordination problem emerges.

This issue becomes particularly relevant when shortcomings are identified as part of the validation process related to the IM model design rather than to the specific counterparty's implementation. Furthermore, this issue is even more exacerbated by the fact that the model is used globally, and any measures taken may impact EU counterparties in their relationships with counterparties outside of the EU, implying, therefore, that not just coordination at the EU level, but also global coordination would be beneficial. EBA, therefore, suggests that an overall coordination mechanism is implemented as detailed in the subsequent section.

The EBA's opinion

The EBA is of the opinion that, with the finalisation of the RTS on IMMV, the EU uncleared OTC derivatives framework is now complete with respect to BCBS-IOSCO standards.

On the matter of the regulatory scope, the EBA is inviting the European Parliament, the Council and the European Commission to consider, instead of removing the EBA RTS on IMMV mandate, retaining the RTS mandate and reconsidering the scope of the validation requirements [13], preserving, therefore, both the validation power for supervisors of the most significant counterparties and the establishment of a harmonised validation practice. Removal of the mandate would entail a significant misalignment of the European framework with the international standards, namely the BCBS-IOSCO framework on margin requirements for non-centrally cleared derivatives[14], which was the original reason for the introduction of the mandate in the EMIR.

[13] It needs to be stressed that the EBA opinion concerns only the Credit Institutions and Investment Firms, since the other subjects in the scope of EMIR are typically not under the supervision of EBA's members.

[14] The Basel Committee on Banking Supervision and the International Organization of Securities Commissions (IOSCO) have revised the framework for margin requirements for non-centrally cleared derivatives.
https://www.bis.org/bcbs/publ/d317.htm

Moreover, the removal would impede efforts for the EU to continue being active with this market segment and ensure that industry practices continue to be prudent.

On the exact regulatory scope for IM approval, the EBA believes this choice should be naturally made by the co-legislators, given that this is also a matter of international alignment. It is, however, clear that at least the largest credit institutions in the EU above a certain threshold in terms of their derivatives activity should be included.

Nonetheless, considering the coordination issue linked to the validation of an industry-wide IM model by a plurality of competent authorities, it is the opinion of the EBA that the EU uncleared OTC derivatives framework would greatly benefit from the introduction of a centralised validator at the EU level. In this respect, the EBA could operate as a central validator of the general elements of SIMM; as such, EBA would have the task of expressing a common view on the general aspects of the model (such as calibration, model design, instruments and assets class coverage), through its validation of the common aspects of the model, but also collecting feedback from the local supervisors, coordinating their views and providing a single point of discussion with the industry, conveying, therefore, a more effective EU influence on the model. Such a role would be envisaged for EBA, as it would cover all EU jurisdictions and it would also leverage its experience with risk mitigation techniques for non-centrally cleared OTC derivatives, the IMMV framework, with the ISDA SIMM and its broad experience in internal market risk models.

The EBA would facilitate the interactive dialogue with supervisors in other jurisdictions (such as the US and the UK) concerning the IM model, easing communication with the industry also at the global level, and enhancing, therefore, the convergence in the implementation of the IM model validation within and outside the EU.

It should be stressed that the solution proposed is intended as a coordination/validation mechanism of the central elements of the IM models, which needs to draw on the experiences of the approvals done by European competent authorities, as those authorities would continue to be responsible of validating the IM model implementation at the counterparty level. It is however clear that the EBA coordination function should be designed in such a way, that it assists competent authorities in their approval processes regarding the general aspects of the implementation of the model. In this manner, competent authorities would be free to focus their resources on the counterparties' specific issues and their IM models implementation.

The EBA recommends that the co-legislators consider an additional mandate in the forthcoming EMIR amendment, where such role of central validator of industry-wide IM models would be introduced in the EMIR and assigned to the EBA, with a specific description of its powers and appropriate resources, and as a complement of the mandates in Article 11(15) as per the present EMIR text.

This opinion will be published on the websites of the EBA.

Done at Paris, 3 July 2023

[signed]

Jose Manuel Campa

Chair, EBA