Delivered via email

July 3, 2024

Jennifer Robertson
European Commission (EC)

Lars Overby
European Banking Authority (EBA)

Carsten Ostermann
European Securities and Markets Authority (ESMA)

**Re: EMIR 3 Initial Margin Model Validation**

Dear Ms. Robertson,
Dear Mr. Overby,
Dear Mr. Ostermann,

We are writing to you regarding the Initial Margin Model approval requirements set out in EMIR 3.0.

**Model Change Approval Timeline**

The three-month timeframe granted to EBA and National Competent Authorities (NCA) to validate changes to an Initial Margin (IM) model is inconsistent with the agreement reached last year with global regulators to recalibrate ISDA SIMM twice a year starting in 2025, i.e. to conduct an annual full recalibration in the first half of each year and a recalibration of main delta risk weights in the second half. The timeline accepted by global regulators includes 60 days for regulator notification/approval and so would not be viable once the 3 month EMIR 3.0 approval timelines are in effect.

To address this challenge, ISDA worked with SIMM users to develop an alternative proposal which decouples the semi-annual recalibration cycles from model change assessment and approval. This approach would provide more timely recalibrated parameters (each 6 months) and annual updates to the model[1]. It would allow a semi-annual recalibration of SIMM as requested by the global

[1] Recalibration would not be subject to a full backtest prior to the release of the new parameters, in line with the approach adopted for capital models. Prior to the release of the new parameters, ISDA will continue to have the calibration results independently validated, provide an explanation of the major changes to the SIMM parameters, calculate the impact of the new parameters on the industry SIMM margin, and provide firms with a unit test to check their SIMM methodology implementation. In addition, ISDA will continue to conduct the quarterly monitoring for the live version of the model and parameters, based on backtesting results submitted by firms covering their counterparties in all the phases.

regulatory community and, at the same time, would allow for a three-month approval of IM model changes, including changes to the calibration procedure, as required by EMIR 3.0.

We welcome the confirmation by global regulators, including the EBA and ESMA, in a letter dated 11 June that they have no objection to decoupling of model changes from calibration changes. We take this to mean that EU authorities will consider recalibration as a Business As Usual process that is not subject to a 3 month approval timeline and that ISDA can implement the new approach.

On a related note we also request confirmation that the three-month approval periods by EBA and NCA run concurrently, notwithstanding the limitation on the NCA to pre-empt the EBA's approval. If such clarification is not provided through the EMIR 3.0. Jurist Linguist revisions, we ask that the EC and/or ESAs address this issue through a separate communication as soon as possible. A six-month approval cycle would impose a significant impediment to the timely application of model changes to IM calculations globally.

**Model authorisation requirement for Phase 5 and 6 firms**

We would like to highlight specific concerns for smaller counterparties (i.e. firms that came into scope in Phase 5 or Phase 6 and firms that come into scope post the phase-in period, collectively referred to in this letter as "Phase 5 and 6 firms") that have come to light since our February letter.

While we welcome the application of the detailed validation procedures (to be specified in the EBA RTS) only to counterparties with an Average Aggregate Notional Amounts (AANA) above EUR 750 billion, the requirement for counterparties with less than EUR 750 billion AANA to obtain approval from NCAs to use pro forma-validated IM model is disproportionate.

We ask the ESAs to provide guidelines for NCAs that set out proportionate and practical approaches to authorising the use of, or changes to, IM models by Phase 5 and 6 firms. These guidelines should ensure that the authorisation requirements imposed on Phase 5 and 6 firms are targeted and do not, in effect, result in these firms using the regulatory (grid) schedule, which is much less risk sensitive and which would likely cause performance drag and have other detrimental consequences on end-investors due to the significantly larger amounts of IM the schedule generates.

In particular, our strong recommendation is that where Phase 5 and 6 firms are using a pro forma IM model, which will in most cases by EBA validated, then NCA authorisation should simply consist of firms notifying their NCA that they will be using a pro forma IM model (whether that be its own, its counterparties', its investment manager's, or that of a service provider). Where Phase 5 and 6 firms are facing a non-EU counterparty, the pro forma IM model used will be the same as the one validated by the EBA as there is only one pro formal model used globally: ISDA SIMM. In other words, NCA authorisation to use (or make changes to) such IM model is by way of negative consent. NCAs may request further information or clarification (as required)[2] or indeed block a firm's use of any particular model, but absent any express disapproval by the relevant NCA Phase 5 and 6 firms should be able to use the pro-forma IM model once they have notified their NCAs. We would highlight that such an

[2] It should be noted that where Phase 5 and 6 firms are using a dealer/investment manager/service provider's IM model, there may be limits on what sensitive proprietary information can be provided, but that would also be the case under any express confirmation process too.

approach would broadly be in line with certain other EMIR requirements such as how the FC+/- process works, i.e. firms run the calculation annually, if they are below the relevant clearing thresholds they do nothing and keep a record; if they are above, they notify the regulator that they are above but without any requirement to provide any detail other than the fact that they are above one or more thresholds, and NCAs can come back and ask for more information if required.

In addition, we further recommend that Phase 5 and 6 firms are not in any event required to apply for IM model approval if Phase 5 and Phase 6 firms are using the IM model only for IM monitoring purposes, and not to calculate IM to be exchanged. Many Phase 5 and 6 firms have agreed with their counterparties to threshold monitor their portfolios and manage exposures below the applicable regulatory threshold for the long-term. They incur no regulatory obligation to exchange IM, and are instead following the BCBS IOSCO guidance to "act diligently" if exposures approach a posting threshold[3].

Underlying the proposals above are two cornerstone elements of the IM regime, in terms of the legal and operational practicalities of using an IM model.

Firstly, IM models are by their nature bilateral. No single entity can select a unique model and implement it without the agreement of a counterparty. It is all but impossible, practically, for Phase 5 and 6 firms to use a proprietary model which will be acceptable to their major dealer counterparties. An industry standard model, such as ISDA SIMM, which will be centrally validated by the EBA under the EMIR 3 proposals, is the only available alternative to using the regulatory schedule.

Secondly, IM obligations between in-scope entities are symmetrical. Of far greater significance to system resilience is that smaller in-scope firms (i.e. Phase 5 and 6 firms) are correctly identified during the official observation windows, and dealer counterparties are aware of their status. Through this mutual understanding of which entities are in scope, appropriate bilateral controls can be implemented to ensure threshold monitoring is correctly set-up, or the exchange of IM can take place. Critical to the functioning of this symmetrical relationship is the use of consistent IM models.

We would finally but importantly note that a large proportion of Phase 5 and 6 entities are managed by asset managers as "separately managed accounts" (or "SMAs"). Pension funds, endowments and insurance companies are among the types of entities that use SMA structures, and it is common for these entities to use multiple different asset managers for their derivative trading activity.

Typically, each manager will trade under bespoke trading documents, thus resulting in each SMA entity needing to treat its IM obligations facing the same dealer entity through different managers independently, such that no one asset manager will know what another manager is trading. Through the Phase 5 and Phase 6 implementation, in-scope entities have as a result allocated a portion of their €50mn threshold to each asset manager needing to trade uncleared derivatives. Many Phase 5 and Phase 6 entities as a result have multiple IM portfolios with the same dealer.

For those SMAs (including those using an IM model through their designated asset managers), a system whereby express model authorisation must be sought creates numerous logistical and administrative challenges and complexities. At a basic level, pension funds, endowments and

[3] Press release: BCBS/IOSCO statement on the final implementation phases of the Margin requirements for non-centrally cleared derivatives (bis.org)

insurance companies are not typically set up to obtain regulatory approvals for derivatives and IM and/or speak to the complexities of IM models. Further, any asset managers they may use to trade derivatives are also not in a position to coordinate across the SMA (and its other asset managers) to facilitate model approval (and in any case assets managers do not generally engage directly with a client's regulator on its behalf), nor is the SMA likely able to seek concurrent approval of IM models used by different asset managers. SMAs are not set up for these types of activities and will typically lack the resources to collate information and submit an application for model authorisation per asset manager even if it were feasible for the SMA to collate, process and analyse the variety of sensitive proprietary information necessary to support a model approval.

Similar challenges, to a lesser extent, would also impact Phase 5 and 6 firms that are UCITS or AIFs. Such entities do not have the same resources as large multinational firms (i.e. Phases 1-4 firms).

We believe moreover that the logistical complexities that such a model authorisation regime would create are artificial and avoidable; artificial because there is only one industry standard model currently in use (ISDA SIMM), and avoidable because ISDA SIMM, if used by Phase 5 and 6 firms, will already have been broadly approved for use by Phase 1-4 firms. An IM model used by Phase 5 and 6 firms is constrained by limitations inherent in the IM operational or legal control framework, and this results in an outcome that any in-scope entity using an IM model will be using one that is supported by rigorous and continuous oversight, and robust processes for model enhancements.

We are willing to engage in further conversations on the structural characteristics of Phase 5 and 6 firms (including SMAs) that pose particular logistical challenges when it comes to model approval, and we are further willing to discuss refinements on the conditions we have proposed to allow for an alternative pathway for smaller in-scope firms to use pro forma IM models.

Finally, on a separate technical note, we urge EU authorities to clarify - through the EMIR 3.0 Jurist Linguist revisions or a separate communication - that Phase 5 and 6 firms are not required to notify NCAs/apply for IM model authorisation upon entry into force of EMIR 3.0. In the absence of a transition period in EMIR 3.0, Phase 5 and 6 firms will be required to notify/apply for IM model authorisation well before Phase 1 to 4 firms, as these will only become subject to IM model validation after the EBA RTS are in force. This would be a preposterous outcome, which we don't believe was the intention of the co-legislators.

To avoid any market disruption, we also expect that the EBA RTS on IM model validation will clarify that Phase 1 to 4 firms can continue to use an IM model (and any updated version of the model) while the regulatory approval process by EBA and NCA is ongoing.

Sincerely,

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Besides fostering a Capital Markets Union, consumer empowerment and sustainable finance in Europe, we also support open and well-functioning global capital markets and engage with international standard setters and relevant third-country authorities. EFAMA is a primary source of industry statistical data and issues regular publications, including Market Insights and the authoritative EFAMA Fact Book. More information is available at www.efama.org

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Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 1,000 member institutions from 77 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 Twitter, LinkedIn, Facebook and YouTube.

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