ISDA Response to the BCBS-IOSCO WGMR consultative report on: "Streamlining VM Processes and IM Responsiveness of Margin Models in Non-Centrally Cleared Markets"

General comments

We appreciate the Working Group on Margining Requirements' (WGMR's) consideration of the insight, resources, and actions by the International Swaps and Derivatives Association, Inc. (ISDA), the Institute of International Finance (IIF), and their respective members in response to the BCBS-IOSCO-CPMI Review of Margining Practices (September 2022) which are reflected in the BCBS-IOSCO WGMR consultative report on Streamlining VM Processes and IM Responsiveness of Margin Models in Non-Centrally Cleared Markets (the "Report").

ISDA's Collateral Initiatives work responds to our members' goals to reduce collateral management costs and risks by automating and streamlining collateral management, including documentation and onboarding, margin call and settlement, and collateral optimization.

ISDA is committed to ensuring the longevity of the ISDA SIMM®, a robust, regulatory compliant and effective global initial margin model. Dialogue with global regulators has resulted in the adoption of a number of enhancements to the SIMM Governance Framework.

Responses to questions

First, we look at questions 1 to 3, which relate to the recommendations on streamlining of VM processes, and then we look at questions 4 to 7, which relate to the recommendations on Initial margin responsiveness of margin models.

<u>Questions regarding streamlining of VM processes</u>

1. Do the resulting recommendations sufficiently address the issues identified in the outreach sessions? If not, what additional recommendations might further address these issues?

ISDA, IIF, and their respective member firms participated in the outreach sessions held in July of 2023. During those sessions, similar recommendations to the published report were discussed:

1) Coordinating streamlined legal negotiation and operational workflows;

2) Expanding eligible collateral options within VM CSAs, within WGMR parameters;

3) Using industry suggested operational practices, such as those published and maintained by ISDA, along with automating non-centrally cleared margin processes; and

4) Using, when appropriate, third-party services and/or infrastructure providers with more robust technological offerings and operations.

Coordinating streamlined legal negotiation and operational workflows

First, it is imperative, per regulatory requirements, that all counterparties have their relationships documented with an ISDA Master Agreement, a Credit Support Annex (or other similar document), and the Eligible Collateral Schedule (ECS).

The negotiation and maintenance of such documents should be well coordinated by those managing collateral operations, legal representatives, and front-office/trading team members. This coordinated approach can be especially useful when there are times of market volatility and liquidity constraints.

Using online negotiation tools and digital output solutions can reduce the costs of legal documentation negotiations, streamline the onboarding process and improve time to onboarding, along with automating input to relevant systems via digital documentation output.

Expanding eligible collateral options within VM CSAs, within WGMR parameters

WGMR parameters allow for a broad list of eligible collateral. When negotiating ECSs, counterparties may limit eligible collateral options to just cash or cash and one type of government security to ensure an operationally efficient business process. This limited list of eligible collateral in an ECS can also streamline pricing with counterparties as rehypothecation is considered at time of trade.

However, in times of market volatility, having such limited options of eligible collateral documented can increase operational risk and liquidity constraints. For example, if a firm can only post cash and their portfolio of non-cash assets must be liquidated, there are transaction costs and steps necessary during a very tight timeframe of margin calls and collateral settlement workflows. We encourage counterparties to entertain a broad list of eligible collateral and ensure streamlined operational capabilities, expanding beyond cash and/or cash and government securities, with each counterparty considering the most appropriate eligibility to both the counterparty relationship and risk appetite.

It is important to note that, as stated in an ISDA/AFME position paper on the leverage ratio in CRD5[1], where the current leverage ratio framework strongly disincentives banks to accept collateral other than cash as variation margin from their counterparties. Those counterparties that naturally hold a large inventory of assets with a very limited cash position (e.g. insurers, pension funds etc) therefore still may need to raise additional cash solely to meet the variation

[1] CRD 5: Leverage Ratio – ISDA/AFME Position Paper – International Swaps and Derivatives Association

margin requirements arising from their derivative hedges. This disincentive for banks could be largely avoided by reviewing the leverage ratio framework to allow high quality assets as eligible variation margin.

Updating eligible collateral schedules may have a pricing implication to trades and will require resources from legal, collateral management operations, and the front office. As mentioned above, coordinating this effort with a streamlined approach will help mitigate the impact to those resources.

It is important to understand and plan for the operational implications to expanding VM CSAs with broadened eligible collateral schedules, such as accelerated settlement for sourcing collateral and managing substitutions. ISDA published a white paper in 2023 that may serve useful to firms planning to expand their eligible collateral schedules: Mitigating Eligible Collateral Risks: From Documentation to Operations.

It is important to note that there are jurisdictional differences with VM requirements which can cause challenges for firms managing cross-border relationships. These issues could be mitigated with substituted compliance and/or updates to rules that are out of sync with the majority of jurisdictions that have similar requirements.

Using industry suggested operational practices, such as those published and maintained by ISDA, along with automating non-centrally cleared margin processes.

The process to calculate a margin call, send communication of a margin call, select the appropriate collateral, affirm the choice of collateral, and settle the collateral with the counterparty should not be unique to each counterparty and counterparty relationship. Each opportunity for uniqueness creates an equal opportunity of friction for both counterparties involved.

ISDA and its members have developed and published, and continue to maintain a series of Collateral Management Suggested Operational Practices (SOPs) and supporting materials that are available to all market participants, not limited to ISDA members:

- OTC Collateral Processes
- Portfolio Reconciliation, Dispute Management and Reporting
- Settlement, Release, and Reporting of Triparty and Third Party Segregated Collateral
- Notice of Exclusive Control and Pledgor Access Notice
- Posting Cash as IM to be Reinvested into a Money Market Fund (MMF)
- ISDA Collateral Asset Definitions

Firms should access these SOPs, compare to their own operating procedures, identify opportunities for improvement, and then develop implementation plans, where deemed appropriate.

<u>Using, when appropriate, thirdparty services and/or infrastructure providers with more robust technological offerings and operations</u>

Some firms may have limited resources and capacity to build out robust internal systems and processes, such as collateral management calculations, margin call messaging, collateral optimization, and portfolio reconciliation.

If that is the case for one or any of those steps of the collateral management process - those firms should research and analyze third party services and/or infrastructure providers that provide mutualized solutions and can serve a purpose at a lower expense compared to internally-built options. These services may include, but are not limited to portfolio reconciliation, margin calculation, settlement processing, collateral selection and optimization, and end-to-end outsourcing.

2. What operational or legal challenges may arise in effective implementation of these recommendations?

Implementing new workflows and operating models may require short-term strains on resources and/or an investment of additional resources. However, firms must develop business cases that justify this investment, including future cost reduction and risk-reducing benefits.

3. Are there additional topics or issues that the BCBS and IOSCO should also consider in the final proposals or recommendations?

BCBS and IOSCO should also consider encouraging the industry to contribute to and implement data standards, specifically the Common Domain Model for collateral management. ISDA's members have collectively developed open-source code that supports:

1) ISDA documentation in digital form;

2) margin call processing;

3) cash collateral interest calculation and processing; and

4) with a wider collaboration of industry members that developed collateral representation for OTC derivatives, repo, securities lending, and ETDs.

Using mutually-developed standard data can reduce operational friction and expedite processing with counterparties, vendors and infrastructure providers, and even within firms that use multiple systems for collateral management, risk oversight, trading, and liquidity resourcing.

For example, in times of market volatility, if collateral sourcing systems used the same data model for collateral representation as the collateral valuation system, there would be less friction and time between data transfers which could improve operational capabilities, resulting in collateral optimization and fewer fails and resulting fees and funding charges.

Implementing contract lifecycle management, including (i) streamlined KYC and counterparty due diligence and (ii) online negotiation and execution of documents with digital output into collateral management and downstream systems, may reduce legal and onboarding resources and reduce costs for all counterparties involved. Digital output of documents can also reduce time to onboard to, and downstream operational risks with, third parties such as collateral management administrators and triparty providers.

Questions regarding IM responsiveness of margin models

4. Do you see any issues related to semi-annual calibration to ISDA SIMM?

Yes, we see some critical issues related to transitioning to the semi-annual calibration to ISDA SIMM® (SIMM).

In response to the BCBS-IOSCO-CPMI Review of Margining Practices (September 2022) and dialogue with global regulators, ISDA has committed to transition in 2025 to a semi-annual calibration cycle, which inserts a recalibration of all delta risk weights in between the annual recalibration of all model parameters, guaranteeing two versions of SIMM each year.

The issues of the scope and timing of regulatory review of SIMM changes are a potential impediment to moving towards semi-annual calibration. In particular, the amended EU EMIR 3.0 regulations approved by the co-legislators add an extra 1 to 4 months to the original proposed timeline.

The SIMM Governance Forum and ISDA will instead propose a new paradigm for SIMM calibration and testing to allow the semi-annual calibration process to be feasible. This revised approach will also require regulatory understanding and forbearance on some points.

Absent that, it would not be possible to move to semi-annual calibration in accordance with the previously agreed timeline.

Summary of the impediment to semi-annual calibration

(1) The recent update to EMIR 3.0 means that the current plan for the semi-annual cycle will now take longer to complete (see the "**Background**" section for more details).

(2) There are ambiguities in the EMIR 3.0 text, but even with the best possible interpretation of the text, there would be an additional one month's delay to each half-year's calibration.

This would increase the times for each half-year's calibration from 7.5 months to 8.5 months (best case) or from 7.5 months to 11.5 months (worst case).

(3) The lengthened plan for the semi-annual cycle due to the EMIR 3.0 impact goes against the recommendations in the Report to have a more responsive initial margin model.

ISDA will continue to engage proactively with the community of global regulators and SIMM users to develop an alternative approach which could feasibly achieve a semi-annual calibration cycle.

Background

Here are the excerpts from the EU regulation found in the *Compromise text on the EU regulation* for EMIR 3.0:

Amendments to Article 11, paragraph 3 (***emphasis added***):

> *Financial counterparties and non-financial counterparties referred to in Article 10 shall apply for authorisation from their competent authorities before using, or adopting a change to, a model for initial margin calculation with regard to risk management procedures laid down in the first subparagraph. In applying for authorisation, counterparties shall provide their competent authorities, via the central database referred to in Article 17c, with all relevant information regarding the risk management procedures referred to in the first subparagraph.* ***Those competent authorities shall grant or refuse such authorisation*** *within 6 months from the receipt of the application for a new model and* ***within 3 months from the receipt of the application for a change to an already authorised model****.*

Amendments to Article 11, paragraph 12a (***emphasis added***):

> "*12a EBA shall set up a central validation function for the elements and general aspects of pro-forma models, and changes thereto, used or to be used by financial counterparties and non-financial counterparties referred to in Article 10 for the purpose of complying with the requirements set out in paragraph 3. In its role as a central validator, EBA shall validate the general elements and aspects of those models, including their calibration, design and coverage of instruments, assets classes and risk factors.* ***EBA shall grant or refuse such validation*** *within 6 months from the receipt of the application for validation referred to in the fourth subparagraph of paragraph 3 of this Article for a new model and* ***within 3 months from the receipt of the application for a change to an already authorised model****. To facilitate EBA's validation work, developers of those models shall, upon its request, submit to EBA all the necessary information and documentation.*"

It is not clear from this text whether the EBA's and national regulators' reviews will be in parallel (three months elapsed time) or series (six months elapsed time). ISDA has sought clarification on this. In either case, the period is longer than the 2 months included in the current plan for the semi-annual calibration cycle.

5. Are there any concerns with introducing additional procyclicality by more frequent recalibration for SIMM?

We do not expect that additional procyclicality will be introduced due to more frequent SIMM recalibrations because we expect our current annual calibration plus off-cycle calibration to perform in a similar way for the following reasons:

- The current SIMM calibration process has been implemented to satisfy the requirements of the BCBS and IOSCO *Margin requirements for non-centrally cleared derivatives*[2] (the "framework"). Under the framework, the specific requirement that the calibration includes stress data is meant to limit procyclical changes in the amount of initial margin required.

- In addition, as part of the calibration process, ISDA adopts the stress-balance method to ensure that the stress period is around (and at least) 25% of the historical period used to calibrate SIMM.

- We would expect that more frequent calibration would speed-up the impact of recent market stress on SIMM parameters. But it would mostly bring forward the changes that would happen in any case, similar to the existing off-cycle calibrations. We do not expect a material increase in pro-cyclicality due to this change, though it is something we can bear in mind to review in the light of experience.

6. Are there additional public disclosures you would wish to see to make the non-centrally cleared initial margin model (SIMM) more transparent?

As recognized in the Report, SIMM is appropriately transparent. Model and governance documents are public, and other documents relevant to SIMM implementation and use are made available to SIMM users.

Documentation for the SIMM model, including periodic assessments, are made available to designated individuals at global authorities with oversight of SIMM use. ISDA continues to refine our reporting in response to regulatory feedback.

7. Do you have any suggestions not mentioned in the report to increase the IM responsiveness of SIMM to market shocks?

Given that the recommendation for more frequent calibration goes beyond the regulatory requirements, ISDA would welcome continued engagement with the global regulators and SIMM users that would remove any roadblocks to transition to the semi-annual calibration cycle.

[2] https://www.iosco.org/library/pubdocs/pdf/IOSCOPD651.pdf

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 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 X, LinkedIn, Facebook and YouTube.

About IIF

The Institute of International Finance (IIF) is the global association of the financial industry, with about 400 members from more than 60 countries. The IIF provides its members with innovative research, unparalleled global advocacy, and access to leading industry events that leverage its influential network. Its mission is to support the financial industry in the prudent management of risks; to develop sound industry practices; and to advocate for regulatory, financial and economic policies that are in the broad interests of its members and foster global financial stability and sustainable economic growth. IIF members include commercial and investment banks, asset managers, insurance companies, professional services firms, exchanges, sovereign wealth funds, hedge funds, central banks and development banks.