association of the luxembourg fund industry

Luxembourg, 27 January 2022

Response to the EBA consultation paper on draft technical standards on Initial Margin Model Validation under EMIR

(EBACP/2021/33)

Introduction

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 through the exchange of information and knowledge.

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.

We thank the EBA for the opportunity to participate in this consultation on the Initial Margin Model Validation (IMMV) framework under Article 11(15)aa EMIR. We will respond to this consultation from the perspective of investment funds.

General comment

As a general comment, ALFI has been expecting regulatory updates for some time on this IMMV topic belonging to the Uncleared Margin Rules (UMR) sphere, already touched upon in industry best practices published by ALFI in 2020.

Indeed, Regulation 2019/834 (EMIR Refit) has amended Article 11(15) of EMIR, with the insertion of point (aa) on supervisory procedures to ensure initial and ongoing validation of those risk-management procedures; for which EBA, in cooperation with ESMA and EIOPA, shall submit the draft regulatory technical standards to the Commission by 18 June 2020.

Beforehand, in a joint letter co-signed on 17 May 2019 with ISDA (see Annex 1 in appendix), ALFI shared its views on the necessity not to impose burdensome obligations to the participants of UMR Phases 5 and 6 that would use a standard model already approved. The purpose of this initiative was to outline the specificities of the non-banking entities having a business model different from the one of the credit institutions that EBA is used to regulate.

Q1: What are the stakeholders' views regarding the split between standard and simplified validation processes?

A split is justified to consider separately the most significant counterparties in terms of exposure from the small and medium sized ones, the latter -including investment funds- not representing systemic risk.

The introduction of proportionality in the model validation process is justified with regard to the characteristics of the above two types of counterparties.

Nevertheless, we would like to recall the elements stated in our letter of May 2019 justifying the need for a carve out for the counterparties using the ISDA-SIMM model that is already approved and used. Moreover this model is reviewed on a yearly basis by ISDA based on a backtesting campaign.

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

We 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. They are similar to the provisions of the CRR (EU 575/2013) limiting the use of prudential internal models.

Under the EU rules, however, the requirements directly apply to all in-scope counterparties. For the non-brokers investment funds brought into scope in UMR phases 5 and 6, compliance with these banking-like 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.

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. For these reasons, where non-brokers investment funds 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 5 and 6 non-brokers from both the internal back-testing requirements of Article 14 (provisions 3-6) and the Article 18 requirement for an internal governance process, in the CDR 2016/2251.

b. Restrict initial margin model approval under EMIR

Article 11(15)aa of EMIR now includes provision regarding the initial and ongoing validation of risk-management procedures, that includes IM Models.

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 favour 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 new EMIR Refit provision would force both the brokers and their clients to obtain IM model approval, which would create a disproportionate burden for clients compared with other jurisdictions.

Q2: What are the stakeholders' views regarding the Euro 750 bn threshold selected?

We understand that counterparties below the 750 Bn threshold, i.e. those eligible to UMR phases 5 and 6 would benefit from a slightly lighter validation process.

A phase-in approach is proposed for the implementation: 2 years for phase 5, 3 years for phase 6.

Q3: What are the stakeholders' views regarding Article 2, Par 2, and the 50 Euro bn. threshold selected to allow the switch from simplified to standardised validation processes?

Q4: What are the stakeholders' views regarding Article 2, Par 3, that would allow a temporary implementation of the model to subject in the simplified validation process?

Q5: What are the stakeholders' views regarding section 1? Please specify the issue by article where possible.

Q6: What are stakeholders' views regarding the methodology applied to identify material changes and extensions in the IM model?

Q7: What are the stakeholders' views regarding the threshold selected (5% and 10%) in order to trigger the process?

Q8: What are the stakeholders' views regarding the selected extensions and changes in the Annex I Part I and II?

Q9: What are the stakeholders' views regarding the documentation to be provided for the application under the Standardised supervisory process.

Q10: What are the stakeholders' views regarding the section 2 subsection 1 in general? Please specify the issue by article where possible.

Q11: What are the stakeholders' views regarding the outsourcing provisions proposed by Article 7 in the RTS?

Q12: What are the stakeholders' views regarding the use of validation results proposed by Article 8 in the RTS?

Q13: What are the stakeholders' views regarding the possibility to rely on the assessment of a third country competent authority and the treatment proposed by Article 8 in the RTS?

Q14: What are the stakeholders' general views regarding the senior management requirements as stated in article 10? Also, please highlight specific issues.

Q15: What are the stakeholders' general views regarding the model implementation unit requirements as stated in article 11? Also, please highlight specific issues.

Q16: What are the stakeholders' general views regarding the audit requirements as stated in article 12? Also, please highlight specific issues.

Q17: What are the stakeholders' general views regarding the internal validation requirements as stated in article 13? Also, please highlight specific issues.

Q18: What are the stakeholders' views regarding the split between the general structure of the model and the actual implementation of the model for the validation as stated in article 13(2)?

Q19: What are the stakeholders' views regarding the thresholds suggested to trigger for the CAs notification, as described in paragraph 5 of article 14?

Q20: What would be the stakeholders' choice on the value of Ks, as described in paragraph 7 of article 14?

Q21: What would be the stakeholders' choice on the distribution of Xi applied? Could you please specify the first four moments (mean, standard deviation, standardized skewness and standardized excess kurtosis)? Additionally, could you please describe the distribution Xi, e.g., by means of an analytical approximation or a plot of the empirical distribution density, with the normal distribution included as comparison?

Q22: What would be the stakeholders' choice on the values of Ng,s and Nr,s. Would you please provide a concise description of the methodology to obtain Ng,s and Nr,s?

Q23: What are the stakeholders' methods applied to transactions maturing in less days than the MPoR?

Q24: What are the stakeholders' views on the static backtesting proposal as stated in article 14?

Q25: What are the stakeholders' views regarding the thresholds suggested to trigger for the CAs notification, as described in paragraph 5 of article 17?

Q26: What would be the stakeholders' choice on the value of Kd, as described in paragraph 7 of article 17?

Q27: What are the stakeholders' views regarding the dynamic backtesting as set in article 17?

Q28: What are the stakeholders' views regarding the treatment of the Valuations Adjustments within the requirement of the backtesting programme as set in article 14 and the monitoring programme of article 17?

Q29: What are the stakeholders' views regarding the requirement in the backtesting programmes as set in Articles 14 and 17? Should the requirements be specified in terms of IM collected only?

Q30: What are the stakeholders' views regarding Articles 18 through 23? Please specify the issue by article where possible.

Q31: What are the stakeholders' views regarding the section 2 subsection 2 in general? Please specify the specific issue by article where possible.

Q32: What are the stakeholders' views regarding section 3 in general? Please specify the issue by article where possible.

Q33: What are the stakeholders' views regarding the thresholds selected (10% and 20%) to trigger the process for model changes and extensions in Article 25 for the simplified assessment?

Q34: What are the stakeholders' views regarding the scope of the documentation requirements in Articles 27 and 28 for the simplified assessment?

Q35: What are the stakeholders' views regarding the transitional provision in Article 30? Are the two years of transition suggested sufficient to have a first validation of the models in place?

Q36: What are the stakeholders' views regarding the final provision in Article 31? Is the phase-in of 1, 2 and 3 years appropriate, considering the population of counterparties in the scope of the validation requirement?

Q37: What are the stakeholders' views regarding the transitional and final provisions in general? Are there aspects that should further be considered?

We are of the view that three major dimensions are not sufficiently developed:

a. the types of counterparties and the reason why their business models are using OTC derivatives.
b. the specificities of the asset classes underlying the OTC derivatives
c. Need of flexibility in the collateral re-use limitations

a. Business models of counterparties

ESMA recently issued a discussion paper on the review EMIR clearing thresholds. It provides statistics[1] on the types of counterparties subject to the clearing obligation: 52% UCITS, 24% AIFs. Investment funds eligible to the UMR are all in phases 5 or 6, save for a couple of exceptions.

Investment funds are net buyers of financial instruments with respect to their respective investment policies. OTC derivatives are mostly used for hedging purposes.

b. Assets classes

UCITS funds proceed to hedging operations, in particular through the use of Foreign Exchange (FX) physically settled derivatives (FX Forwards, FX Swaps) in order to hedge

[1] §80 of ESMA consultation on "Discussion paper on the review of the clearing thresholds under EMIR" (ESMA70-156-5010) 17 Nov. 2021.

their investment classes denominated in different currencies, in line with the ESMA opinion of 30 January 2017.

Art. 50 of the UCITS Directive provides strict investment restrictions in liquid financial instruments. Art. 1(2)a of the Directive emphasises the role of these investment restrictions as the shares of a UCITS fund can be subscribed by the public (i.e. including natural persons).

Thus, these hedging transactions play an important role to protect individuals against currency risk.

In light of the above provisions outlining the safety of the UCITS framework, we keep on recommending to the policy makers exclusion of these FX hedging transactions from the calculation of the exposure against the clearing threshold, similarly to the regime benefiting to the NFCs.

Such considerations about are very much in line with Rec. 19 of EMIR (EU) 648/2012 that underlines the specific characteristics of FX derivatives as follows: *In determining which classes of OTC derivative contracts are to be subject to the clearing obligation, due account should be taken of the specific nature of the relevant classes of OTC derivative contracts. The predominant risk for transactions in some classes of OTC derivative contracts may relate to settlement risk, which is addressed through separate infrastructure arrangements, and may distinguish certain classes of OTC derivative contracts (such as foreign exchange) from other classes. CCP clearing specifically addresses counterparty credit risk, and may not be the optimal solution for dealing with settlement risk.*

Moreover, these considerations would represent a simple carve out with regards to the principle of interconnectedness between the different asset classes stated in Rec. 7 of EMIR 2019/834.

Against his background, we also recommend the exclusion on these FX hedging transactions from the calculation of the AANA in the meaning of the UMR framework, knowing these short term transactions are not subject to mandatory VM exchange. For this request, we refer to the 5 June 2019 letter sent by EFAMA to the ESAs and Commission (see Annex 2 in appendix).

c. Need of flexibility in the collateral re-use limitations applicable to UCITS and ETFs

The IM exchange requirement under the UMR represents a new need of funding for the concerned investment funds.

In light of the liquidity constraints faced by the investment fund industry, illustrated by the March-2020 measures to manage redemptions linked to the pandemic, we would like to reiterate our advocacy for a recalibration of the ESMA guidelines 2014/937 on collateral re-use limitations applicable to ETFs and UCITS funds. In the attached letter sent to ESMA in December 2019 (see Annex 3 in appendix), we explained the necessity to update Art. 43 §i and j of these guidelines to authorise collateral reuse to satisfy the new collateral needs implied by the EMIR and UMR frameworks, which entered into force after the drafting of these guidelines.