EBA RTS IMMV

Public hearing

15 December 2021

Introduction

- The **proposal** included in the CP builds on:
  - The 2016 ESA joint RTS on risk mitigation techniques for OTC derivatives not cleared by a central counterparty (CCP) - adopted as DR (EU) 2016/2251 - which entered into force at the beginning of 2017
  - EMIR amendment (EMIR refit), which includes a specific mandate for EBA on the validation process and powers for CAs to validate IM models.
- Approval of IM models was not included in the ESA RTS on un-cleared derivatives due to a lack of a legal basis, which has since been included – in line with the recommendations of the ESAs.
- The RTS is however also mindful of the requirements set out in the original Basel/IOSCO framework, which requires model approval.

Legal mandate

- The EBA, in cooperation with ESMA and EIOPA, has been mandated to develop draft regulatory technical standards (RTS) to **specify the supervisory procedures** that would **ensure initial and ongoing validation** of the risk-management procedures referred to in Article 11(15) of Regulation (EU) No 648/2012 (EMIR) on uncleared over-the-counter (OTC) derivatives.
- The RTS is restricted to approval of IM models, given that VM is based on MtM. This implies that the RTS solely deals with procedures for validating the IM model.
- This validation framework has been designed to operate with the requirements set out in the Delegated Regulation (EU) 2016/2251 on uncleared OTC derivatives.
- It also takes into consideration well-known internal market risk models approval practices, such as the ones laid down in the Delegated Regulation (EU) 2015/942 on model changes, and the final draft RTS on the assessment methodology for market risk internal models.
- Collaboration with ESMA and EIOPA in order to ensure consistency with other frameworks.

Current situation on IM application

- Focus on:
  - **Number of subjects** (hundreds already in scope of IM, plus many others will follow)
  - **Variety of subjects** (international banks/OTC dealers vs final user – smaller banks, inv funds, insurances, pension funds, etc.)
  - Model already in place (phases already implemented)
- Industry suggestions on how to structure this project:
  - General grandfathering of the model in place
  - No approval for smaller subjects
  - Single validation authority
- These seem contrary to the legal mandate: validation must happen; no exemption for smaller institutions; no single authority to validate model
- The proposal included in the CP is pragmatic: **proportionate approach** (separating big and small institutions); **transitional phase** with no-objection approval; **facilitation for externalised models**.

Proportionate approach

- The **great variety of subjects** in scope suggests that provisions should be differentiated based on type of subject and size of activity
- **Banks and banking groups above 750 bn** € of AANA OTC derivatives will follow the standardised process for validation; the rest will follow the simplified process
- Derogation: subjects above 50 bn € of AANA may be validated via the standardised process if the CAs deemed it necessary
- Derogation to the pre-validation principle: for smaller subjects only, CAs may allow the application of the model up to 1 year after submission of the notification of the validation request

Standardised Process – Section 2 (Articles 4-23)

- General provisions, governance – robust model governance – complemented with clear quantitative requirements
- Requirements to submit documentation for **initial and on-going validation** – the latter in particular in case of material changes and extension
- Specification of material changes and extensions: +/- 5% & additional condition OR +/- 10% (without additional condition)
- Notification of non-material changes and extensions -> ex-ante notification OR ex-post notification once a year after implementation

Standardised Process – Governance 1/3

- CA shall verify that the *"counterparty has a clear organisational structure for the **governance and management** of the model with well defined, transparent and appropriate lines of responsibility"*

- **Senior management** should be actively involved and ensure adequate resources; approves policy; takes corrective actions; follows recommendations; approves methodologies; is aware of overshootings; receives notifications of material changes or extensions

- Independence of **model implementation unit**; represented in decision-making process; adequate and proportionate; report to SR management; responsible for the outcome; produces a report on IM model

- **Audit** independence; adequate resources; adequate process in place to follow audit recommendations; audit review the model and prepare a report (annual basis) to SR management; CA shall assess that remediations of issues are relevant, material and credible; and where appropriate remediations actions are adopted and followed

Standardised Process – Governance 2/3

- CA shall verify:
    (a) **internal validation** not involved in development;
    (b) adequate resources, experience and qualification;
    (c) continuous monitoring (especially (i) overshooting and (ii) change or extension);
    (d) findings of validation are reported in a validation report;
    (e) the validation report is comprehensive and sound.
- CA shall verify internal validation of: (a) general structure; & (b) implementation of the model (appropriateness of model, assumption and calibration process, performance of the model – BT; accuracy of the implementation);
- possibility to outsource, subject to specific conditions (plans, reports and results are available to counterparty and adequate resources of the third-party).

Standardised Process – Governance 3/3

- Internal validation of model calibration – Static backtesting (for every netting set above 50 mil €): at least at the end of every quarter, using the netting set and the IM computed at the end of that quarter: (i) identify MPoR; (ii) identify calibration period; (iii) – (v) compute a loss applying the returns identified in the calibration period; (vi) build a time series of the losses and count the overshootings.
- Used in the end-of-day valuation process; reflects only changes in **valuation adjustments** that are included in the counterpart's initial margin model and that are calculated **on a daily basis**; only for instruments covered by the model.
- Overshootings should be analysed, documented and communicated to CAs (**when > 10**).
- Each netting set is classified according to traffic light definition (green, amber, red) -> thresholds defined accordingly to Art 14.7 methodology.
- Differences with industry practice: BT time series is linked to calibration period, just IM is rolling; green and red thresholds are based on distribution X, based on proper empirical evidence – not necessarily Normal distribution

Standardised Process – Quantitative assessment 1/2

- Dynamic backtesting (for every netting set above 50 mil): at least at the end of every quarter, computed at the end of that quarter: (i) identify last 250 days; (ii) compute the change in value of netting set (1 business day / for each 250 observations); (iii) compute the IM (1-day MPoR / for each 250 observations); (iv) compute a loss applying by comparing change in value & IM; (v) build a time series of the losses and counting the overshootings.

- Used in the end-of-day valuation process; reflects only changes in **valuation adjustments** that are included in the counterpart's initial margin model and that are calculated **on a daily basis**; only for instruments covered by the model.

- Overshootings should be analysed, documented and communicated to CAs (**when > 2**).

- Each netting set is classified according to **traffic light definition** (green, amber, red) - > thresholds defined accordingly to Art 17.7 methodology.

- Note: BT time series is fixed to 250 days, netting set composition and IM are rolling; green and red thresholds are based on distribution X, based on proper empirical evidence – not necessarily Normal distribution – requirements 17.2-3-4-8-9-10-11 are identical to 14.2-3-4-8-9-10-11

Standardised Process – Quantitative assessment 2/2

- **Appropriateness of modelling assumptions**: well justified distributional and any other relevant statistical assumptions.
- Where the **risk factor** is incorporated into a counterparty's pricing model, but **not into** its initial margin **model** referred to in that Article, the counterparty provides an appropriate justification for such an omission.
- Capture of **non-linearities**: use of at least 1st and 2nd order Taylor series; assessment of time effect.
- **Use of proxies**: when market data are not sufficient or not reflecting true volatility of the position, conservativeness, periodic review of the proxies.
- Requirement to set up processes to identify **illiquid positions** and positions with limited price transparency and to capture their risks in the initial margin model conservatively.
- Assess the use of **empirical correlations**.

Simplified Process – Section 3 (Articles 24-29)

- Same structure as for the standardised process (general provisions, governance, quantitative assessment), but…
- **Thresholds are x2** (i.e., 10% and 20%) for defining material changes and extensions; but for non-material changes, ex-post notification applies, once a year.
- Reduced set of documentation requirements + <u>self-assessment of the compliance with requirements.</u>
- Governance: **less granular** documentation requirements:
  - (a) organisation structure of SR management; (b) documented evidence of SR management understanding of the model
  - (a) organisation structure of implementing unit/audit/internal validation; (b) evidence of independence; (c) reports produced.
- Backtesting requirements: **simple dynamic BT** (as STD process), but no other requirements.

Transitional phase (Article 30)

- 2 years starting from the application of the rules (which is phased-in).
- Only for CNTPs applying the model before the application of the rules, that submit the request of validation to their CAs.
- CAs can validate the model <u>by non-objecting to its use</u> (two years to raise issues with CNTPs). This "non-objection" approval is valid only during the transition phase.
- The standard rule is ex-ante validation (once transition ends).

Phase-in implementation (Article 31)

- Section 2 -> **1-year** delay
- Section 3 -> **2 or 3-year** delay, depending on the size of the AANA (50 bn threshold)

Provision for outsourced IM model

- Outsourcing: "*Where a counterparty has delegated some or all tasks, activities or functions related to the design, calibration, implementation, internal validation and audit of its initial margin model to a third party, or has purchased an initial margin model or services related to an initial margin model from a third party, competent authorities shall verify that the delegation or purchase does not hinder the application of the assessment methodology referred to in this Regulation and, more in particular*": (a) awareness of the senior management; (b) knowledge of the staff; (c) continuity; (d) non-limitation in the function outsourced; (e) full access to information for CA.

- Use of Validation results: "*For the purposes of verifying compliance of the general structure of the model with the governance requirements referred to in Article 13*", use of own results and findings (or the ones of a CAs in the scope of this Regulation), where: (a) design and calibration outsourced to the same subject & (b) same structure and calibration + (c) avails evidence of validation by CAs & (d) avails evidence of internal validation.

Next steps

- Consultation period ends on 4 Feb 2022
    - Comments to be received before

- Based on the comments received, EBA will review the responses and plans to finalise, most likely, by Q3 2022

- Focus will be, as highlighted today, at ensuring a gradual transition to approving models
    - Awareness of both limits to supervisory and counterparty resources

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