

Geneva, July 10, 2015

The European Supervisory Authorities (ESAs)
EBA, EIOPA, and ESMA

Submitted via www.eba.europa.eu

Dear Sir or Madam,

We welcome the publication of the second version of the draft RTS on risk-mitigation techniques for OTC-derivative contracts not cleared by a CCP and we appreciate the opportunity to provide you with our comments.

For more than 40 years, MSCI's research-based indexes and analytics have helped the world's leading investors build and manage better portfolios. Clients rely on our offerings for deeper insights into the drivers of performance and risk in their portfolios, broad asset class coverage and innovative research. Our line of products and services includes indexes, analytical models, data, real estate benchmarks and ESG research. Our risk management clients include many of the world's largest banks, hedge funds, institutional asset managers and asset owners.

Our comments are related to Question 3 of the consultative document: *„Respondents are invited to provide comments on whether the draft RTS might produce unintended consequence concerning the design or the implementation of initial margin models”*. We grouped our comments under two topics below:

The Choice of Stressed Period for Calibration

According to the draft RTS, initial margin models shall be calibrated on historical data that contains at least 25% of data representative of significant financial stress („stressed data”). The initial margin amount is then based on the one-tailed 99 percent confidence interval of the variation of the value of the netting set over a margin period of risk of at least 10 days. We believe that this results in a nearly constant initial margin in calm periods, since the tail of the value distribution will depend only on the stressed part of the historical data, which could remain the same for a long time. What is worse, this almost constant initial margin will depend on the rather arbitrary choice of the stressed period. The RTS, in fact, does not define how this stressed period should be selected.

We understand that the idea of using stressed calibration appeared in regulatory documents as early as Basel 2.5, where the choice of stressed historical data has to be approved by the local regulator. This solution might be

sufficient for calculating regulatory capital, but can lead to unresolvable disputes in OTC margin calculations, where the two counterparties of the trade might operate under different jurisdictions. For example, the first half of 2011 might be accepted as a „stressed period” in one jurisdiction, while not in another, leading to materially different initial margin amounts even if the counterparties use the same historical data and the same IMM model.

We therefore envisage here a possible twofold problem: the initial margin risks becoming a static number, ultimately arbitrary. While the former can produce the intended effect of acting as an initial margin floor in calm periods, the latter can introduce elements of subjectivity and lead to unsolvable disputes between counterparties.

We believe that for such a rule to be effective, the notion of “stressed period” should be made more objective, by either providing a list of past stressed periods or a measurable way to determine them. The problem, in our opinion, is already there in Basel regulation, but it becomes more pronounced here, given the bilateral nature of counterparty risk.

Basis Risk and Non-linearity

The introduction of the draft RTS clearly states that „additional quantitative requirements are set out to ensure that all relevant risk factors are included in the model and that all basis risks are appropriately captured”. We believe that the current requirements set out in paragraph 3 of Article 5 MRM are not enough to ensure that all basis risk is properly captured. For example, the yield curve has to be divided into a minimum of six maturity buckets, ignoring all basis risk between tenors that end up in the same bucket. Paragraph 7 of the same Article states that “The initial margin model shall be calibrated in a sufficiently conservative manner such that aspects like parameter uncertainty, correlation, basis risk and data quality are properly captured.” However, any simplified bucketing approach to risk, by definition, is blind to some basis risks. We do not believe that ignoring some basis risk can be mitigated by conservative calibration, since non-standard OTC derivatives can be arbitrarily sensitive to any type of basis.

We welcome that the RTS states that the model should capture the main non-linear dependencies, but we believe that the importance of higher-order effects is not emphasized enough in the requirements. The only output of IMM models used in margin calculation will be a deep tail measure (the 99th percentile), where the accuracy of simple sensitivity based approaches is questionable at best, especially for non-standard OTC derivatives whose value might depend on



the underlying risk factors based on a function not even close to linear (for example, binary options).

The problem we want to highlight is that models based on risk classifications and sensitivity measures cannot capture all possible basis risks on one-hand and instrument nonlinearity on the other. Given the non-standard nature of derivatives contracts that are the objective of the current RTS, and given the unrestricted potential complexity of their payoffs, it's easy to predict that ineffective models would incentivize new generations of ad-hoc payoffs designed to game the rule.

We believe that the only way to properly capture all the possible risk sources and to account for possible highly nonlinear payoffs is to revalue the full portfolio via granular Monte Carlo simulations, accounting for all possible risks and bases. Schematic, sensitivity-based approaches could represent an acceptable solution only in the presence of a maximum limit to instrument complexity. To prevent regulatory arbitrages, simulation approaches should be required for portfolios containing instruments of arbitrary complexity.

We applaud the efforts of the ESAs in establishing the requirements in this Consultative Document, and for allowing the industry the opportunity to comment. We are available for further comment or clarification, if necessary.

Sincerely,

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