

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

Submitted via www.eba.europa.eu

London, July 14, 2014

Consultation Paper Draft regulatory technical standards on risk-mitigation techniques for OTC-derivative contracts not cleared by a CCP under Article 11(15) of Regulation (EU) No 638/2012

Dear Sirs,

We welcome the publication of the *Consultation Paper Draft regulatory technical standards on risk-mitigation techniques for OTC-derivative contracts not cleared by a CCP under Article 11(15) of Regulation (EU) No 638/2012* (the “**Consultation Paper**” or “**CP**”) by the EBA, EIOPA, and ESMA (together “**the ESAs**”) and we appreciate the opportunity to provide you with our comments.

Markit is a provider of financial information services to the global financial markets, offering independent data, valuations, risk analytics for internal capital models, and related services across regions, asset classes and financial instruments. Our products and services are used by numerous market participants to reduce risk, increase transparency, and improve the operational efficiency in their financial markets activities.¹

Markit has been actively and constructively engaged in the debate about regulatory reform of the global OTC derivatives markets and the implementation of the Pittsburgh G20 commitments. Over the past years, we have submitted more than 100 comment letters to regulatory authorities around the world and have participated in numerous roundtables. We also regularly provide the relevant authorities with our insights on current market practice, for example, in relation to valuation methodologies, the provision of scenario analysis, or the use of reliable and secure means to provide daily mid-market marks. We have also advised regulatory authorities on appropriate approaches to enabling a timely and cost-effective implementation of newly established requirements through the use of multi-layered phase-in or by providing participants with a choice of means for satisfying regulatory requirements. In relation to the topic of margin requirements for uncleared derivatives, we have previously submitted comment letters to BCBS IOSCO, the CFTC, the SEC, and the US Prudential Regulators.

¹ Please see www.markit.com for further information.

Introduction

As part of Markit's Solutions business, Markit Analytics provides participants in global financial markets with state-of-the-art analytical services across asset classes, often in conjunction with our pricing and valuation services. Markit Analytics supports, for example, banks (including those that have received or are expecting to receive IMM approval) with the calculation of their regulatory capital requirements, including measures such as PFE, IMM EAD, IRC, CRM, and the CVA Capital VaR charge. Also relevant in the context of margin calculation are our independent valuation services, Markit's Totem service that provides benchmark valuations for OTC derivatives as well as our pricing services across asset classes, products and regions, the Markit enterprise data management software, as well as our derivatives processing platforms that operate across asset classes, products and regions.

Based on our expertise in all of these areas, numerous buy-side and sell-side firms have approached us to discuss how we could help them address upcoming challenges related to the calculation of initial margin ("*IM*") and variation margin ("*VM*") for their portfolios of cleared and uncleared derivatives transactions.

Comments

We welcome the publication of the Consultation Paper by the ESAs and we appreciate the opportunity to provide you with our comments.

In general, we encourage the ESAs to strike an appropriate balance for the margin requirements applicable to cleared and to uncleared derivatives, regardless of whether they remain uncleared because of their customized nature or due to any end-user exception. Cleared and uncleared derivatives both serve their purposes, and margin rules should leave sufficient room for appropriate contractual arrangements to take place between the parties. More specifically, we believe that the mandatory calculation and collection of VM and IM for transactions in OTC derivatives that remain uncleared could significantly impact the functioning and, potentially, the stability of financial markets due to the resulting operational challenges and the demands on liquidity and collateral. Our below recommendations therefore aim at ensuring that such margin calculations appropriately reflect the degree of risk posed by various derivative transactions whilst facilitating an operationally efficient and timely implementation of the margin requirements.

We believe that the ESAs could achieve these goals by: (1) ensuring that a large number of counterparties, including both buy-side and sell-side firms, are permitted to use model-based IM calculations, including those provided by third parties; (2) allowing counterparties to agree for their respective IM amounts to be calculated by a third party provider or to base their IM calculations on inputs and calculation methodologies as provided by such third party; (3) allowing firms to choose between using a model-based or a grid-based IM calculation on a sufficiently granular level; and (4) permitting counterparties to reference dispute resolution methods, valuations, or inputs in relation to VM calculations.

The issue of margin disputes

We agree with the ESAs that the implementation of bilateral margin requirements for uncleared OTC derivatives will represent a significant challenge for the marketplace from an operational perspective and we appreciate the focus that the ESAs have put on considering potential solutions to such operational challenges. We also believe that the ESAs have correctly identified the potential for disputes between

counterparties about the “correct” margin amount as a significant issue that will need to be addressed before the margin requirements become effective.

We believe that counterparties will generally prefer using model-based calculations to determine the amount of IM they will need to collect from their counterparties. This is because model-based calculations will generally more appropriately reflect the actual risks of the portfolio of OTC derivative transactions with a certain counterparty. They will hence lead to more accurate and most likely also lower margin amounts compared to those resulting from use of the standardized approach. The use of model-based calculations is more risk sensitive and will reduce the drain that the introduction of margin requirements would impose on activity in the uncleared OTC derivatives markets and the demand on collateral.

However, at the same time, the use of model-based IM calculations by counterparties could also significantly increase the potential for disputes about IM amounts between counterparties. Such disputes are not only costly to resolve, but they also result in increased systemic risk in the meantime by increasing liquidity funding risks.² Importantly, from the perspective of the firms that will need to post IM to their counterparties, the challenge in relation to model-based IM calculation does not just arise post-trade in form of the potential for disputes but already at a pre-trade stage. This is because, in a situation where universal two-way margin requirements apply, a firm that is looking to enter into a transaction will need to know what IM call to expect from the range of its potential counterparties to be able to decide which of these counterparties it should trade with whilst also providing the appropriate amount of pre-funding. Uncertainty about the expected IM demands of the various potential counterparties would prevent a firm from making a rational decision about which party to trade with.

The general approach to addressing the risk of margin disputes

We welcome the ESAs’ willingness to potentially endorse industry-wide solutions in relation to margin calculation. We also welcome ISDA’s SIMM (Standard Initial Margin Model) initiative as we agree that a broader agreement on the use of standardized models for IM calculation would be an important measure to reduce the potential for disputes about IM amounts. However, in relation to the relevance of the use of standard IM models the ESAs should be aware of the following issues:

- The model that is used for an IM calculation is only one of a number of factors that counterparties would need to agree upon in order to calculate the same margin amount,
- Any standardized IM modelling approach might not cover all products from the start, at least initially it would probably focus on the more standardized products, and
- It cannot be ruled out that some firms, particularly larger firms that have already established sophisticated modelling capabilities, would rather use their own, approved models than a standardized model.³

² As some investment banks experienced in their VM disputes on ABS on CDS with, for example, AIG.

³ This is because such approach is likely to provide them with a competitive advantage by being a “cheaper” counterparty to trade with relative to their peers.

Factors underlying the margin calculation

To agree on the actual margin amounts, be it VM or IM, for a derivatives transaction that remains uncleared counterparties would need to agree upon a number of factors (please see Graph 1 for a visualisation).

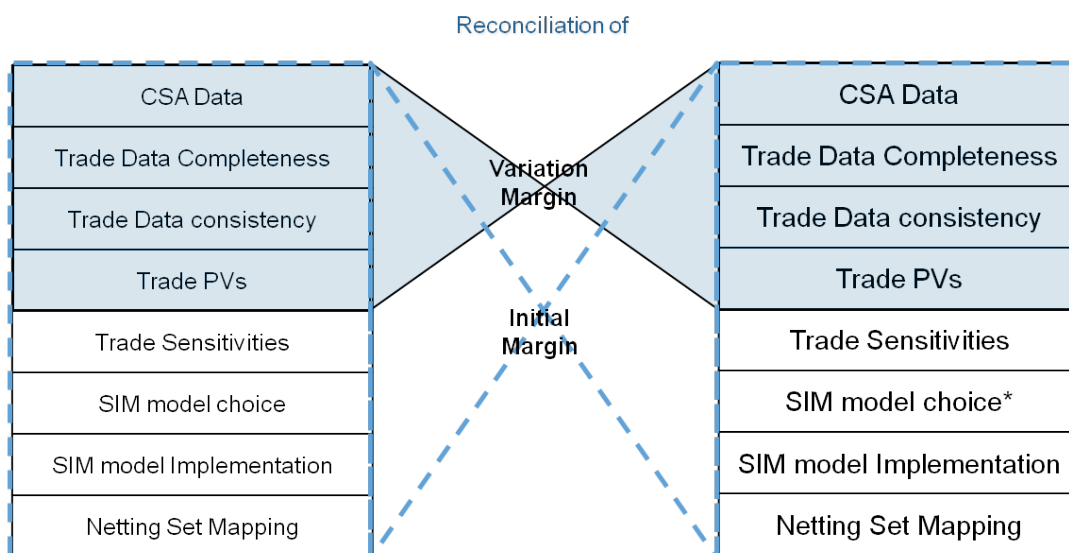
Specifically, for VM, the counterparties would need to agree on the following input factors:

- CSA data,
- Trade data completeness,
- Trade data consistency, and
- Trade valuations (PVs).

In addition to these four input factors, to agree on IM, counterparties will need to agree upon:

- Trade sensitivities,
- SIM Model choice,
- SIM Model implementation, and
- Netting set mapping.

Graph 1: **Factors underlying the margin calculation**



That said, an agreement on a SIM Model would address just one of the above listed factors, whilst the other elements would still be open to disagreements between the counterparties and hence potential disputes about the resulting margin amounts.

Our discussions with major market participants have shown that third party service providers could be instrumental in providing solutions to reduce the potential for post-trade margin disputes and also create transparency about the expected margin calls pre-trade. Third party involvement that could be considered in this context includes:

- A fully outsourced IM calculation for one or both counterparties by a third party,

- Third parties providing all input data and scenarios that both counterparties would use as input into their IM calculation,
- Third parties providing a “methodology harness” that could contain an agreed upon pool of market data and would allow for consistent backtesting by the counterparties
- Firms using IM amounts that have been calculated by a third party as benchmark to validate their own calculations, be it internally for product control purposes, or externally vis-a-vis their counterparties and clients.
- In addition to helping with the actual calculation or inputs for it, third parties could also offer services to help with the timely matching of transaction data and the collateral management.⁴

Conclusion

To allow for the efficient implementation of bilateral margin requirements whilst maintaining liquidity in the trading of uncleared derivatives an appropriate framework will need to be in place to address the issue of potential margin disputes between counterparties. Whilst an agreement on a SIM Model will be an important step in this respect it will only be of the necessary conditions to avoid such disputes. We believe that the involvement of third parties will be essential to help the marketplace to reach agreement on the standardization of some of the other relevant input factors.

We appreciate that, from the perspective of the ESAs, the provision of margin-related services by third parties cannot be a black box and we agree that regulators will need to establish whether a firm is using the model appropriately and understands it sufficiently. At the same time we note the concern that regulatory authorities might not have the necessary resources available to approve individual model-based approaches in time for all of the firms that would want to use them. This could lead to an unlevel playing field between competing firms, could harm activity in the markets for uncleared derivatives, and trigger collateral demands that are unnecessarily high. As potential solution we encourage the ESAs to identify those aspects that are feeding into the IM calculation that can be deemed to be firm independent (such as back testing, model implementation, calibration and documentation) and aim to approve those aspects for third party providers on a standalone basis, i.e. independent of which firm would use it. That said, the ultimate regulatory approval of the use of an IM model for a firm would still be subject to the firm demonstrating that it is using the model appropriately and understands the details.

We therefore encourage the ESAs to consider the various roles that third party service providers could play in the context of margin calculations. We also urge the ESAs to establish a streamlined IM model approval process where models, inputs and scenarios would be approved by a National Competent Authority for broader use by all entities in its jurisdiction. Furthermore, given the large percentage of derivative transactions that are cross-border, it will be essential that such approvals that have been provided for third party services by a regulatory authority in one jurisdiction would also be recognized by regulatory authorities in other jurisdictions for use by their firms.

We hope that our above comments are helpful to the ESAs. We would be more than happy to elaborate or further discuss any of the points addressed above in more detail. In the event you may have any questions, please do not hesitate to contact us.

⁴ However, these functions are largely outside the scope of our response.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'M. Schüler', with a stylized flourish at the end.

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