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Clarifying UMR Phase 5 & 6 requirements for firms under EMIR: Present & Future

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Acadia has partnered and advised many firms over the past years regarding Uncleared Margin Rules (UMR). The European Banking Authority finally issued the latest RTS (Regulatory Technical Standards) for comment in November 2021- providing specific clarity on EMIR regulation for Initial Margin Model Validation.

Many firms may assume that since the RTS will not be "in force" for another two to three years (Phase 5 & 6 respectively) that they are exempt up to that time from any requirements with regard to model validation. Unfortunately, according to current regulation this is not the case. Under today's regulation, all firms under EMIR that are exchanging IM using an IM Model like ISDA SIMM™ are required to perform a Backtest.

The RTS provides greater specificity on the requirements and is in part a relief from the current regulation that is in force today. Quoting directly from the regulatory text, you can see very clearly that the RTS works in conjunction with existing regulation:

According to the "**Commission Delegated Regulation (EU) 2016/2251**" which is a supplement of Regulation 648/2012 (EMIR) counterparties are currently required to the following:

- Counterparties shall calculate the amount of initial margin to be collected using either the standardized approach set out in Annex IV or the initial margin models referred to in Section 4 or both[1]. » **You need to either use Grid or a Model**

- Initial margin models shall be developed in a way that captures all the significant risks arising from entering into the non-centrally cleared OTC derivative contracts included in the netting set, including the nature, scale, and complexity of those risks and shall meet the following requirements[2]: » **If you use a model (e.g. ISDA SIMM™) you need to do the following:**

  - The model incorporates methodologies used for back-testing which include statistical tests of the model's performance; » **This means Backtesting is currently a regulatory requirement; more explicitly:**

  - The risk management procedures referred to in Article 2(1) shall ensure that the performance of the model is monitored on a continuous basis including by back-testing the model at least every 3 months[3].

So, as you can see, if you are in Phase 5 and are using a model like ISDA SIMM™, you need to be performing a quarterly Backtest. Phase 6 firms that plan to exchange initial margin will also need to put in place a Backtest, which will move to a "dynamic" or daily Backtest once the RTS comes into force.

It is also important to stress that a model validation process is a requirement under existing EMIR regulation. Quoting once again from the text:

- Counterparties shall establish an internal governance process to assess the appropriateness of the initial margin model on a continuous basis, including all of the following[4]:
  - 1 (a). an initial validation of the model by suitably qualified persons who are independent from the persons developing the model » **an Initial validation of the model needs to take place**
  - 1 (b). a follow up validation whenever a significant change is made to the initial margin model and at least annually » **an annual validation process needs to be run**
  - 1 (c). Regular model audit
  - 2. Documentation of risk management procedures

The RTS has made clear that (dynamic) Backtesting will be a requirement for Phase 5 and & 6 that use an IM Model. Therefore, if you plan to move margin within the next 12 months start implementing a SIMM™ model now along with a Backtest to ensure that you are compliant with the regulation. Whatever you put in place today, will be fit for purpose once the RTS comes into force.

Reach out to Acadia if you need any further guidance on Backtesting or Model Validation. We have helped many firms overcome their compliance hurdles.

BOOK A MEETING

Footnotes:

[1]Section 3, Article 11 (1)

[2]Section 4, Article 14 (2)

[3]Section 4, Article 14 (3)

[4]Section 4, Article 18 (1 & 2)

About Robert Kirchner

Robert Kirchner is a senior risk management professional with extensive experience in risk management consulting. He has worked for leading top management consultancies as well as specialised advisory firms. A partner at Quaternion, Acadia's Quant Services division, Robert is responsible for the European branch of the Quant Services division. Throughout his career he has acted as an independent advisor to Investment Banks, Commercial Banks and specialised financial institutions leading multiple large scale transformations and reorganisations. His methodological focus is on Credit Risk, Counterparty Credit Risk, ICAAP as well as Economic Capital. He concentrated in particular on rebuilding and stabilising the Risk Management, Treasury and Trading functions of banks. Robert holds a Ph.D. in Theoretical Particle Physics from the University of Hamburg and a Diploma in Physics from the University of Bonn.

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