NFA Approval Process for Risk-Based Initial Margin Models for Uncleared Swaps and Lessons Learned
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Kristen Scaletta: Hello, everyone. Welcome to NFA's webinar on initial margin model submissions and lessons learned. My name is Kristen Scaletta and I'm a Senior Communications Manager at NFA. With me today are Jamila Piracci, Vice President of OTC Derivatives, and Alessandra Riccardi, Director of Capital and Risk.

With the September 1, 2017 initial margin model compliance date on the horizon, we are hosting this webinar to launch the margin model approval process for those firms subject to the September 1, 2017, compliance date, and to share our experience from the first phase of initial margin model reviews.

In addition to the content provided in this webinar, NFA's website contains a page dedicated to margin models, which includes resources such as relevant Notices to Members and a link to NFA's May 2016 webinar, which outlines in detail the margin model review and approval process. Visit www.nfa.futures.org and navigate to Swaps Information to read more.

Please note that although you are able to hear us today, you will not be able to ask questions over the phone. To ask a question, locate the box labeled Ask a Question on the left side of your webinar screen. Please type the question you would like to ask into the box and press the "Send" button. We are able to see questions as they are submitted. You may submit your questions now or at any time during this webinar. We will begin answering questions at the end of our remarks.

Finally, a recording of this webinar, along with a written transcript, will be on NFA's website in the coming week, so no need to take detailed notes throughout this presentation.

And now I will turn it over to Jamila, who will provide background on the initial margin model review and approval process.

Jamila Piracci: Thanks, Kristen. As you know, the CFTC's final rules on the margin requirements for uncleared swaps were published on January 6 of this year. Those requirements allow swap dealers to choose between calculating initial margin using a standardized, grid-based approach, or using an internal risk-based initial margin model approved by the CFTC or NFA. These rules apply to swap dealers and major swap participants that are not subject to oversight by a prudential regulator for purposes of margin. Throughout our presentation, we will refer to swap dealers that are subject to CFTC margin requirements as CFTC covered swap dealers.

The first compliance date for the CFTC's margin rules, which we will refer to as Phase 1, was September 1, 2016. The second compliance date, which we will call Phase 2, is September 1, 2017. This latter date applies to CFTC covered swap dealers with outstanding notional amounts of at least $2.25 trillion in transactions facing counterparties that also have outstanding notional amounts of at least $2.25 trillion.

NFA's goal is to make this process as efficient as possible for Phase 2 CFTC covered swap dealers that plan to submit internal models for approval. During this webinar, we will share our expectations and experience to help facilitate the initial model review and approval process and, hopefully, minimize the number of submission iterations.

For those firms in scope for Phase 2, NFA will begin accepting initial margin model submissions as early as January 1, 2017.

Now Alessandra will walk through the process for swap dealers in scope for seeking NFA approval of an initial margin model by September 1, 2017. Alessandra?

Alessandra Riccardi: Thank you, Jamila. At a high level, NFA's review and approval process of CFTC covered swap dealers' margin models involves a number of steps, including initial exploratory discussions, margin model submission, review and assessment, and approval. I will now quickly walk you through each step.

As also outlined during NFA's May 2016 webinar on initial margin model review and approval, the first step in this process is an exploratory discussion. Because every CFTC covered swap dealer has a unique business model, NFA will arrange exploratory discussions with each firm seeking to submit a margin model for approval after the firm lets us know that they will submit an initial margin model for review. The exploratory discussion is meant to help us understand the firm's business strategy, portfolio composition, and overall implementation and documentation readiness.

After the exploratory discussion, NFA will issue an email to the CFTC covered swap dealer that contains a First Day letter with the preliminary details of the items required for model review, a unique link to NFA's Margin Model Submission System, and additional instructions to access the margin System and upload documentation. Each CFTC covered swap dealer wishing to receive an approval from NFA will need to submit a margin model proposal to NFA that demonstrates that the margin model meets the applicable CFTC requirements.

Typically, firms should expect a 90-day timeframe for our review, so please plan accordingly in terms of the timing of your submission. We suggest that CFTC covered swap dealers be proactive in initiating conversations around margin model submissions. We ask that firms provide to NFA an expected timeline for deliverables that are not fully finalized at the time of the exploratory conversations or when initiating the submission process. During Phase 1, a number of firms had to work closely with NFA over a longer period of time to get approved, in some cases, rewriting documentation. Given this, to ensure adequate review time, we encourage you to submit your model for a September 1, 2017, approval as soon as possible, but no later than March 31 of 2017.

In order for NFA to determine the reasonableness of the CFTC covered swap dealer's margin model plans, the firm will be expected to provide detailed documentation showing its initial margin model plans, its model implementation, and the appropriateness of the margin model used in the firm's business, such as assumptions and limitations analysis, back-testing and benchmarking results, and the analysis of the risks not captured by the initial margin model.

In terms of the model, ISDA created a working group that developed a standardized initial margin model, or SIMM, based on an initial capital model that has been enhanced and calibrated and therefore became more sophisticated. This approach was reviewed by a consulting firm selected by the ISDA working group. The overall model development was also tested and documented by the ISDA participants on the original working group, and an ISDA Steering Committee was created as part of the ongoing overall model governance with representation from adhering firms.

It is our understanding that most, if not all, Phase 2 firms will seek to implement the SIMM. However, the process we're describing would be the same for firms that might decide to adopt a different proprietary internal model.

Each Phase 2 CFTC covered swap dealer's model must be fully implemented, tested, and validated by the firm before NFA can start reviewing a firm's submission.

As NFA is not giving approval of the SIMM "in vacuum," the review process is aiming at making determinations of the implementation of the initial margin model at each firm, whether it is the SIMM or another proprietary model, and therefore firms cannot be over-reliant on the ISDA or other industry standard documentation.

Some of the key documents CFTC covered swap dealers must include as part of this submission are model development and model validation documents; a qualitative and quantitative description of the portfolio in scope, including asset classes, product types, sensitivities, and material risks not captured in SIMM; backtesting results for all portfolios in scope, or a representative sample; benchmarking results against a corporate risk measure, fully validated, tested, and calibrated in line with SIMM's calibration; and finally, detailed ongoing monitoring plans.

Once a CFTC covered swap dealer submits a margin model, the next step in this process is to review the submission and assess the model performance. NFA will review each CFTC covered swap dealer's margin model submission and conduct onsite reviews as necessary to evaluate a number of items.

There are two parts of NFA's margin model review process. The first focuses on the conceptual soundness of the model as well as its model validation, model testing, and governance. The second part consists of onsite visits and focuses on understanding and assessing the model implementation and use and the overall governance and control framework set up by each CFTC covered swap dealer.

To help firms prepare their submissions, I will share with you suggestions to streamline the review process based on some of the lessons learned during Phase 1.

My first suggestion relates to documentation. If using the SIMM model, do not over-rely on ISDA documentation.

ISDA documentation and testing results can form part of the SIMM conceptual soundness submission. However, the CFTC covered swap dealer's documentation must demonstrate the firm's implementation and use of the model. It also must include the firm's specific qualitative and quantitative analysis of assumptions and limitations as well as model performance testing results based on the firm's theoretical portfolio across, at least, all in-scope counterparties.

Additionally, in order to validate the firm's use of the model, theoretical portfolios used for testing purposes must be representative of the firm's business strategy in scope after the compliance date.

If a firm is part of a corporate family with oversight from multiple regulators, the documentation submitted must be related exclusively to each separate CFTC covered swap dealer in scope.

Finally, it is essential that CFTC covered swap dealers submit detailed ongoing monitoring plans.

Now I will speak about model developers and model validation documentation based on what we noted during Phase 1. The model developer's documentation must contain enough information to enable the independent implementation of the model by the model validation team. In addition, the model validation documents must be in-line with best-practice guidelines as per SR 11-7, "Guidance on Model Risk Management," issued by the Federal Reserve Board in 2011, or the OCC 2011-12, "Supervisory Guidance on Model Risk Management," issued by the OCC in 2011.Best practices in model validation indicate that firms should explicitly validate the conceptual soundness of the model, and the implementation and use of the model within the firm's specific business scope.

The Fed and OCC best practices documents mentioned earlier provide firms with detailed sets of assessments to be disclosed in their documentation as part of the conceptual soundness and implementation and use validation, in order to enable the independent reviewer to reach the conclusion of the model's appropriateness to each firm's business strategy.

And now some suggestions related to testing. First, make sure to have performed exhaustive back-testing on the portfolio in scope. Also, you must analyze and explain any exceedances and quasi-exceedances. And lastly, in order to ensure that benchmarking results are comparable to the initial margin calculations and meaningful, the benchmarking must be based on a corporate risk measure that is fully validated, back-tested, and calibrated in line with the SIMM calibration. This back-testing and benchmarking should be completed in advance of the submission and should cover a representative sample of the population that is expected to be in scope after the Phase 2 compliance date.

We hope that these suggestions, which address common issues that arose in Phase 1, will help firms provide more complete submissions early in the process and improve the efficiency of the model approval process.

And now I will turn it back over to Jamila.

Jamila Piracci: Thanks, Alessandra. Once NFA has completed its review of the submitted documentation and approved the initial margin model, the CFTC covered swap dealer may employ that model for purposes of complying with the CFTC's margin rules. Such CFTC covered swap dealers will receive written notice of approval from NFA by a generic system-generated correspondence email prompting the firm to access the Margin Model Submission System.

Phase 2 CFTC covered swap dealers that elect not to submit a model for approval at this time, or that don't receive an approval at the end of the review process, have to calculate initial margin on uncleared swaps based on the grid-based approach until approval is granted.

Before we begin taking questions, I want to take a moment to recap some of the lessons learned from Phase 1 of the initial margin model review and approval process. First, please allow adequate time for model review. We suggest submitting by March 31, 2017, for a September 1, 2017, compliance date. Second, perform extensive back-testing and benchmarking. Third, submit firm-specific detailed model developer's and model validation documents. Finally, submit detailed ongoing monitoring plans.

In closing, this is a significant undertaking, so we encourage firms to develop and stick to internal implementation dates, allowing time for appropriate testing, reconciliation exercises, and early engagement in bilateral and tri-party documentation.

By taking these suggestions, CFTC covered swap dealers will minimize the number of resubmissions to NFA, maximizing efficiency on both ends. That being said, NFA is here to answer any questions while you are preparing your submission and are happy to review incremental submissions as documentation becomes available. Our contact information can be found on your screen.

Kristen Scaletta: Thanks, Jamila. This concludes the prepared portion of our webinar. Throughout the discussion, we've received some great questions. Should we not answer your question during the webinar, an NFA staff member will respond to you via email.

Our first question is, "We have heard that there will be a new SIMM release. Do we need to submit testing and documentation?"

Alessandra Ricardi: Thank you. The recent new SIMM release version 318 that is planned to take place in early 2017, we're not expecting to review this particular release pre-implementation. However, the expectation is that firms will go through all the best-practice guidelines before releasing changes in production, which would also involve documentation, testing, and signoff from the model validation team.

Kristen Scaletta: Our next question is, "Is the ISDA back-testing exercise enough to satisfy back-testing?"

Alessandra Ricardi: Thank you. While the ISDA back-testing exercise gives a preliminary good indicator on the margin model performance, this back-testing, because of how it is designed, is considered more of a benchmarking exercise, as it compares a firm's portfolio to multiple historical market conditions. According to the Basel Committee on Banking Supervision, back-testing is defined as the quantitative comparison of the model forecast against realized values. Therefore, true backtesting would compare a model prediction to the realized P&L, and this comparison will characterize model performance.

I would also like to add that other risk-based models follow the same back-testing principles. Firm-specific back-testing results need to be included in the documentation submitted for model approval. And also, details of each firm's back-testing plans need to be included in the ongoing monitoring plan, which has to be opined upon by model validation and is also part of the documentation requested for model review.

Kristen Scaletta: Thanks, Alessandra. Our next question is, "How do you expect to see risk not reflected in SIMM?"

Alessandra Ricardi: Thank you. So risk not in SIMM can be assessed via benchmarking against other corporate risk measures. For example, typically VaR captures a more granular set of risks and will allow also to monitor the materiality of those risks that are missed from the SIMM.

But also, we should not forget to quantify the risk that is not captured by the traditional risk measure, which is usually measured by already-developed corporate methodologies.

Kristen Scaletta: Thank you. It looks like there are no more questions, so we would like to thank all of you for your participation today. We hope that you found this information provided to be helpful.

To close, I would like to remind you that you will be able to access a recording and transcript of today's webinar on NFA's website within the next week. Also, if we did not get to your question today, an NFA staff member will respond to you with an answer via email. So if you had a question that you didn't want to ask via the webinar, please reach out. Thank you for participating in today's webinar.