ISDA Safe, Efficient Markets

October 2024

Derivatives, Margining and Risk in Emerging Market and Developing Economies

Derivatives have an important role to play in the development of economies and financial markets in emerging jurisdictions. Financial regulation, in turn, is a critical element in shaping the safe, efficient use and growth of risk management activity in these countries. One of the most important elements of the financial regulatory framework for derivatives is margining: the exchange of collateral, or margin, for derivatives transactions. This paper explains what margining is, how it works and the key issues for policymakers in emerging market and developing economies (EMDEs) to consider when transposing margin-related regulation to their jurisdictions, with a particular focus on non-cleared derivatives.

INTRODUCTION

In two previously published papers[1,2], ISDA has articulated the importance of derivatives to EMDE financial markets, and the key issues policymakers might consider to facilitate their safe, efficient development[3].

This paper continues ISDA's support for capacity building of financial markets in EMDEs by discussing one of the most important elements of derivatives regulatory reform: the exchange of collateral, or margin, for derivatives transactions. Mandates to post and collect margin, along with requirements for specific counterparties to centrally clear certain derivatives, were intended to mitigate counterparty credit risk and prevent contagion in the financial system. The paper explores key issues for EMDE policymakers to consider when transposing margin-related regulation to their jurisdictions, with a particular focus on non-cleared derivatives. These include:

- What are the different types of margining for non-cleared and cleared derivatives?
- How does margining work to mitigate risk?
- What are the basic elements of regulatory requirements for derivatives?
- How are these requirements being transposed in developed jurisdictions and EMDEs?

[1] *Policy Framework for Safe and Efficient Derivatives Activity in Emerging and Developing Markets*, May 2022, www.isda.org/2022/05/11/policy-framework-for-safe-and-efficient-derivatives-activity-in-emerging-and-developing-markets/. This report outlines the key elements – legal, regulatory and risk management – that policymakers should consider in their regulatory approaches. In doing so, it draws on previous work by global standard setters, regulators and supervisors in advanced economies, as well as market participants and others, to identify issues and practices in these areas

[2] *Interest Rate Derivatives, Benchmark Rates and Development of Financial Markets in EMDEs*, April 2024, www.isda.org/2024/04/17/interest-rate-derivatives-benchmark-rates-and-development-of-financial-markets-in-emdes/. This report examines the significance of reliable, robust interest rate benchmarks, a cornerstone for developing efficient interest rate derivatives markets. The paper draws valuable lessons from the transition from LIBOR to overnight risk-free rates in advanced economies, applying these insights to the context of emerging markets and developing economies (EMDEs). Through case studies, it shows how various EMDE jurisdictions have successfully adopted and implemented more robust and transparent interest rate benchmarks

[3] For additional information on collateral and margin-related issues, visit www.isda.org/category/margin/infohub/. The ISDA Margin InfoHub is a comprehensive list of margin and collateral management reference tools, suggested operational practices (SOPs) and non-cleared margin guides

OVERVIEW OF MARGINING FOR DERIVATIVES EXPOSURE

Collateral, or margin, helps to protect one derivatives counterparty from the risk of loss should the other counterparty default. There are two forms of derivatives margin posted by counterparties:

- Variation margin (VM), which covers actual changes in the market value of the derivatives position over a period of time (typically daily); and
- Initial margin (IM), which covers potential changes in market value from the time a position is terminated or closed out (following a counterparty default) until it is settled.

Variation Margin

The value of financial instruments frequently changes due to a variety of factors (such as changing expectations about the economy, interest rates, corporate earnings, etc). In a fixed-to-floating interest rate swap, for example, a fixed-rate payer would incur a mark-to-market loss should interest rates decline. Conversely, a fixed-rate receiver (that is paying a floating rate) would realize a mark-to-market gain and would receive a VM payment to reflect that gain.

VM is typically exchanged on a daily basis. The payment must be made in cash for cleared derivatives but can include certain other financial instruments for non-cleared derivatives. Larger jurisdictions generally have a list of what qualifies as eligible collateral for VM under their regulations for non-cleared derivatives, and counterparties agree on their choice for collateral from that list and codify that decision in their credit support annexes. According to ISDA research[4], about 76% of the $944.5 billion of VM collected by firms for their non-cleared derivatives was in cash as of year-end 2023.

Initial Margin

IM covers potential changes in market value from the time a position is terminated or closed out (following a counterparty default) until it is settled. The exchange of IM in most major jurisdictions reflects a two-way payment – each counterparty pays IM to the other at the start of the transaction. This contrasts with VM, in which only the out-of-the-money counterparty pays the collateral.

Payments of IM can be in cash or certain other financial instruments. As with VM, larger jurisdictions generally have a list of what qualifies as eligible collateral under their regulations for non-cleared derivatives. According to ISDA research, about 85% of the $462 billion of IM received by firms for their non-cleared derivatives was in non-cash securities as of year-end 2023.

Table 1: Overview of VM and IM

Margin Type	Explanation
Variation Margin (VM)	• A payment made from one counterparty to the other to reflect changes in the market value of the contract(s). • VM is typically exchanged between counterparties on a daily basis. • VM is generally required for derivatives transactions by certain counterparties and above certain levels of activity/exposure under regulatory requirements for non-cleared derivatives. • Entities may require VM from their counterparty in addition to what is mandated by regulation for extra counterparty risk reduction and/or in cases where VM is not required by regulation. This could be for a trade that was executed prior to the regulatory compliance date or for a trade that is not in scope of the regulations.
Initial Margin	• Collateral posted at the beginning of a trade to cover potential losses that could arise between a defaulting entity's last VM payment and when its counterparty can close out its position. • IM is a two-way payment, where both parties send IM to the other. • IM is generally required for derivatives transactions by certain counterparties and above certain levels of activity/exposure under regulatory requirements for non-cleared derivatives. • Entities may require IM from their counterparty in addition to what is mandated by regulation for extra counterparty risk reduction and/or in cases where IM is not required by regulation. • IM that is collected in addition to, or for counterparties/trades that are outside the scope of, mandatory IM requirements is generally called independent amount.

[4] *ISDA Margin Survey Year-end 2023*, April 2024, www.isda.org/2024/04/16/isda-margin-survey-year-end-2023/

REGULATORY CONSIDERATIONS

The regulatory framework for the margining of non-cleared derivatives generally consists of a few core concepts[5]:

- The scope of firms to which margin rules apply (commonly called covered entities);
- The parameters within which covered entities are required to post IM/VM; and
- The method in which IM is calculated.

Scope of Applicability

In most major jurisdictions, the covered entities to which the margining regulations apply are largely financial firms and systemically important non-financial entities[6]. Non-financial entities are generally excluded because their transactions are viewed as posing little or no systemic risk. In some jurisdictions (such as the US), financial firms below a certain size ($10 billion in assets) are also excluded. Sovereigns, central banks and multilateral development banks are not in scope of the requirements.

Parameters for Mandatory Exchange of Margin

The regulations in most major jurisdictions set a floor below which the exchange of IM is not required. For example, the floor in the EU is €8 billion. If an entity's average aggregate notional amount of non-cleared derivatives is below this level, it does not need to exchange IM.

Regulations also generally only require margin to be transferred when it exceeds a certain level. Transfers of IM and VM that are below a minimum transfer amount (MTA) are not required, and MTA limits have been set by major jurisdictions. Under the EU regime, there is a maximum permitted MTA of €500,000 covering both VM and IM. Parties may agree how to allocate the MTA in practice – for example, it may all be allocated to VM if IM is not applicable. They may also agree to use an MTA that is less than the maximum permitted. In other words, entities may set a lower MTA when the rules of multiple jurisdictions apply in order to comply with various MTA limits expressed in different currencies.

IM Calculation

Regulations in most major jurisdictions generally require firms to exchange IM based on a schedule-based or approved model-based calculation, with rigorous and robust dispute resolution procedures in place. To help make the process as efficient and robust as possible, ISDA developed the Standard Initial Margin Model (ISDA SIMM), which is widely used by market participants to calculate IM[7].

[5] The Basel Committee on Banking Supervision (BCBS) and the International Organization of Securities Commissions (IOSCO) published a framework for margin requirements for non-centrally cleared derivatives in 2013 (www.bis.org/bcbs/publ/d475.htm). As stated at the time: "Under these globally agreed standards, all financial firms and systemically important non-financial entities that engage in non-centrally cleared derivatives will have to exchange initial and variation margin commensurate with the counterparty risks arising from such transactions. The framework has been designed to reduce systemic risks related to over-the-counter derivatives markets, as well as to provide firms with appropriate incentives for central clearing while managing the overall liquidity impact of the requirements"

[6] Derivatives dealers often required margin from their counterparties prior to the imposition of the regulation and may look to mitigate credit risk from counterparties excluded from the requirements

[7] For information on the ISDA Standard Initial Margin Model, visit www.isda.org/2020/02/07/calculating-initial-margin/

TRANSPOSING MARGIN REGULATIONS IN EMDEs: KEY ISSUES

Regulators considering margin requirements for non-cleared derivatives involving market participants in their jurisdictions need to keep a number of key considerations in mind.

This includes determining the scope of firms to which the rules should apply. As previously noted, most developed markets generally exclude non-financial firms (among other types of entities) from their margin rules, and some exclude smaller financial firms below a certain threshold in size (in assets).

As margin rules are meant to mitigate systemic risk, exposures that are relatively small (in terms of notional outstanding) may be below the appropriate threshold for requiring margin payments. Even when notional exposures are above these thresholds, the amount of margin to be paid may still be at a level below which margin payments are appropriately mandated.

For cross-border transactions, an entity subject to margin requirements in its home jurisdiction will need to comply with those rules when entering into derivatives with a counterparty in a different jurisdiction. This typically also includes transactions conducted by a foreign branch of a domestic entity. Many jurisdictions go further and apply the rules to a foreign entity that is guaranteed, or in some cases owned, by a domestic institution. Given the number of margin regimes in place and the cross-border nature of derivatives markets, it is likely that many transactions with entities in EMDEs are already subject to regulatory margin requirements.

Policymakers in major derivatives markets have introduced either partial or full exemptions from margin requirements for transactions with counterparties in non-netting jurisdictions (those where netting is not legally enforceable). In some cases, this has resulted in exemptions from mandatory margin rules, which may only apply in limited circumstances. In other jurisdictions, it has led to more onerous requirements – for example, an obligation to collect gross margin from a counterparty organized in a non-netting jurisdiction but only pay net margin to it. This treatment is likely to result in a dramatic reduction in trading activity with counterparties in non-netting jurisdictions until they adopt legislation ensuring the enforceability of close-out netting.

Before the exchange of bilateral IM is considered, certain conditions need to be satisfied, including:

- Implementing a clean close-out netting regime;
- Ensuring the legal framework supports bilateral IM agreements – for instance, by providing a robust collateral enforcement regime for bilateral IM arrangements;
- Developing derivatives markets with a sufficient amount of standardized products;
- Having a liquid and efficient collateral market without undue restrictions; and
- Developing the collateral management capabilities of local financial institutions.

Once policymakers have ensured the enforceability of close-out netting in their jurisdiction, they may wish to consider imposing margin requirements along the lines of those in major derivatives jurisdictions, but that are scoped and scaled in line with their domestic markets.

In the meantime, derivatives market participants that enter into transactions with counterparties in non-netting EMDEs typically include an agreement on margin practices in their counterparty relationships. Even prior to the imposition of the global margin framework, dealers routinely exchanged VM with client firms, even on cross-border transactions.

CONCLUSION

Margining for non-cleared derivatives is an important element of a jurisdiction's financial regulatory framework. For EMDEs, so too is the need to ensure that the scope and parameters of margin regulations are proportionate to the size of domestic market and derivatives activity. The necessity for netting certainty and the development of market infrastructures to facilitate the transfer of margin are also important considerations for EMDEs.

Additional resources on margin issues are available on ISDA's website, including:

- ISDA Margin InfoHub: www.isda.org/2020/02/07/isda-margin-infohub/
- ISDA SIMM: www.isda.org/category/margin/isda-simm/
- *Policy Framework for Safe and Efficient Derivatives Activity in Emerging and Developing Markets*: www.isda.org/a/YHVgE/Policy-Framework-for-Safe-and-Efficient-Derivatives-Activity-in-Emerging-and-Developing-Markets.pdf
- *Interest Rate Derivatives, Benchmark Rates and Development of Financial Markets in EMDEs*: www.isda.org/a/AswgE/Interest-Rate-Derivatives-Benchmark-Rates-and-Development-of-Financial-Markets-in-EMDEs.pdf
- *ISDA Margin Survey Year-end 2023*: www.isda.org/2024/04/16/isda-margin-survey-year-end-2023/