ISDA Variation Margin Protocol—what is it about?

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Banking & Finance analysis: Edmund Parker, partner and global head of derivatives & structured products and head of the banking & finance Group at Mayer Brown International LLP London, comments on the International Swaps and Derivatives Association's (ISDA) 2016 Variation Margin Protocol.

What is the ISDA 2016 Variation Margin Protocol designed to do?

The implementation of the new margin regulations will require market participants to re-write thousands of their collateral agreements. In order to assist the market with this exercise, ISDA has published the protocol as a scalable solution which allows the parties to amend derivatives documentation with multiple counterparties.

The protocol caters for five margin regimes which have already published the margin rules in their final form:

- the CFTC and PR rules (for the US)
- the OSFI rules (for Canada), and
- the Japan rules

As and when the corresponding regulations in the EU and Switzerland are finalised, ISDA will publish supplementary documentation to ensure that those regimes are also within the scope of the protocol.

What is variation margin?

The margin rules distinguish between two types of margin: initial margin and variation margin. The purpose of variation margin is to protect the counterparties against their exposure relating to the changing market value of their over-the-counter (OTC) derivatives transactions. By contrast, initial margin is intended to constitute additional buffer protecting the parties during the time period between the last exchange of variation margin, and a default by a counterparty.

Variation margin is transferred from one party to another, whereas initial margin requires the use of a custodian. As the documentation for variation documentation is more standardised, the Protocol only facilitates the parties' compliance with their obligations relating to variation margin (and not initial margin).

Why is there an option to amend existing collateral arrangements or create new collateral arrangements?

The protocol allows for four principal methods for compliance with variation margin obligations.

Amend-and-add method

The parties may decide to amend their existing master agreement to add a new credit support annex that complies with the new rules.

Amend method

The parties may decide to amend their existing collateral agreement to ensure that it fully complies with the new rules. This is the simplest method, but its drawback is that the changes will also apply to derivatives transactions which are outside the scope of the margin rules (such as any legacy trades).

Replicate-and-amend method

Here, the parties may replicate their existing agreement, and only then make the necessary amendments. This would ensure that transactions which are outside the scope of the margin rules are not captured.

New Credit Support Annex (CSA)

There is also an option to create a new collateral agreement. This is for parties concerned that replicating their existing documentation, and subsequently applying standardised amendments, may not work or may have undesirable consequences.

How do parties adhere to the protocol?

As for any other protocol published by ISDA, the parties will first need to submit an adherence letter, which will then be published on the ISDA website. They will also need to pay an adherence fee of $1,000. The protocol opened for adherence on 16 August 2016 and will be available on ISDA Amend from October 2016.

Once both parties to a collateral agreement have adhered to the protocol, they will then need to exchange questionnaires between each other. Each of them will need to provide answers to up to 30 questions, specifying, for example, whether they elect the ‘amend-and-add’, ‘amend’, ‘replicate-and-amend’ or ‘new CSA’ method. If the parties have provided the same responses to the threshold questions, the questionnaire will be termed a ‘Matching Questionnaire’, the protocol will kick in and its amendments will apply automatically to the parties’ collateral documentation. If the questionnaire is not a Matching Questionnaire, the protocol will not have any effect between the parties—the parties can amend and resend their questionnaire to each other until the conditions are satisfied and the questionnaire is a Matching Questionnaire.

Interviewed by Anne Bruce.

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