

Legal Update

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RBI MASTER DIRECTION ON VARIATION MARGIN IN NCCDS – ANALYSIS

INTRODUCTION

Derivatives are contracts between two or more parties whose value is reliant on an underlying financial asset or set of assets. These underlying assets can be an index, bonds, equities, or commodities. The underlying financial asset is a primary security, whereas the derivative contract is secondary.

The RBI supervises derivatives and provides a secure trading environment. In September, the RBI announced the Variation Margin (Reserve Bank) Directions, 2020 for public feedback.¹ In furtherance to this, RBI released the Reserve Bank of India (Variation Margin) Directions, 2022 on June 1, 2022.² Variation Margin Directions will come into force on December 1, 2022.

UNDERSTANDING NCCDS, INITIAL MARGIN AND VARIATION MARGIN

To understand the Variation Margin Directions, we must first understand certain concepts about the derivatives ecosystem. Derivatives can be centrally cleared or non-centrally cleared. A central party clears and settles derivative contracts between two parties. Non-centrally cleared derivatives are not cleared by a central counterparty. The central party guarantees the derivative contract if one party defaults. Non-Centrally Cleared Derivatives (NCCD) are cleared and settled by the parties themselves.

Another key concept in the derivative ecosystem is margins. Margin categories include Initial Margin and Variation Margin. Initial Margin is the collateral posted to safeguard the parties to an NCCD from potential fluctuations in the market value of the underlying asset throughout the time period of closing out and replacing the contract in case of a default by either party. Variation Margin safeguards the parties to an NCCD from current market value exposure. Therefore, Initial Margin protects against possible exposure at the time of entering the contract, while Variation Margin focuses on current exposure on a day to day basis.³

APPLICABILITY

The Variation Margin Directions apply to a set of contracts which have been listed down by the RBI. This set includes:

1. NCCDs undertaken in terms of the Foreign Exchange Management (Foreign Exchange Derivative Contracts) Regulations, 2000⁴;
2. NCCDs undertaken in terms of the Rupee Interest Rate Derivatives (Reserve Bank) Directions, 2019⁵;
3. NCCDs undertaken in terms of Master Direction – Reserve Bank of India (Credit Derivates) Directions 2022⁶, and
4. Any other NCCD as may be specified by the RBI.⁷

The Variation Margin Directions should not apply to physically settled forward and swap contracts or contracts between same-consolidated-group entities. They also don't apply to derivative contracts in which one of the parties is the government of India or a state, a foreign sovereign, a central bank, or an RBI-recognized MDB.⁸

Variation Margin Directions enumerates a difference between Domestic and Foreign covered entities. Domestic covered entities are those entities that are regulated by a financial sector regulator and have an Average Aggregate Notional Amount ("AANA") of outstanding NCCDs of ₹25,000 crore and above, on a consolidated group wide basis and all other resident entities that have an AANA of outstanding NCCDs of ₹60,000 crore and above, on a consolidated group wide basis. Non-resident financial entities that have an AANA of outstanding NCCDs of USD 3 billion and above, on a consolidated group wide basis along with non-resident entities having an AANA of outstanding NCCDs of USD 8 billion and above, on a consolidated group wide basis are considered as foreign covered entities. The Variation Margin Directions provides the process for calculation of AANA.⁹

EXCHANGE OF VARIATION MARGIN

The Variation Margin Directions provide that a domestic covered entity shall exchange Variation Margin with the other party of an NCCD if the other party is a Domestic covered entity or a Foreign covered entity. Additionally, the Domestic covered entity shall put in place a process for the identification of the other party as a Domestic or Foreign covered entity and can rely on declarations for this purpose.¹⁰

As per the Variation Margin Directions, the Variation Margin should be calculated on a daily basis and the same should be called and exchanged amongst the parties themselves at the earliest time possible after the transaction

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date ("T") or margin recalculation date ("R"), but no later than three local business days from the transaction date ("T+3") or margin recalculation date ("R+3"). The Variation Margin should be calculated and exchanged on an aggregate net basis across all NCCD contracts that are executed under a single, legally enforceable netting agreement. This would mean that the Variation Margin for all the NCCDs entered by the party under the same netting agreement would have to be exchanged within the aforementioned time period.

Additionally, a minimum transfer amount, which shall not exceed ₹3.5 crore shall be set and in case the Variation Margin exceeds the minimum transfer amount, then the entire margin amount should be exchanged. The Variation Margin that has to be exchanged should fully collateralize the market and the exposure of an NCCD contract.

COLLATERALS FOR EXCHANGE

The Variation Margin Directions provide that in cases of Variation Margin between two Domestic covered entities, the exchange can be undertaken through following types of collaterals:

- a. Indian Currency;
- b. Debt securities issued by Government of India and State Governments; and
- c. Rupee bonds issued by persons resident in India which are:
 - Listed on a recognized stock exchange in India; and
 - Assigned a credit rating of AAA by a rating agency registered with the Securities and Exchange Board of India. If different ratings are accorded by two or more credit rating agencies, then the lowest rating shall be reckoned.

Additionally, Variation Margin between Domestic covered entity and a Foreign covered entity shall be exchanged, subject to RBI Circular on Margin for Derivative Contracts dated February 15, 2021, through following types of collaterals:

- a. Indian currency;
- b. Freely convertible foreign currency;
- c. Debt securities issued by Government of India and State Governments;
- d. Debt securities issued by foreign sovereigns with a credit rating of AA- and above issued by S&P Global Ratings / Fitch Ratings or Aa3 and above issued by Moody's Investors Service. If different ratings are accorded by two or more credit rating agencies, then the lowest rating shall be reckoned; and
- e. Rupee bonds issued by persons resident in India which are:
 - Listed on a recognized stock exchange in India; and
 - Assigned a credit rating of AAA by a rating agency registered with the Securities and Exchange Board of India. If different ratings are accorded by two or more credit rating agencies, then the lowest rating shall be reckoned.

Additionally, risk-sensitive haircuts should be applied to the value of collateral that is received. The Variation Margin Directions provide for a schedule of minimum haircuts that have to be applied on different types of collaterals. Securities that are issued by the parties to an NCCD contract, or their related parties, would not be accepted as collaterals.¹¹

Finally, the Variation Margin Directions also provide for margin requirements in cases for cross-border transactions, wherein in an NCCD contract between a Domestic covered entity and a Foreign covered entity, may decide to comply with the Variation Margin Directions issued by RBI, or the margin requirements implemented by the foreign jurisdiction provided the margining framework in the foreign jurisdiction is assessed by the Domestic Covered Entity to be comparable to the requirements by RBI.¹²

ANALYSIS

Generally, the margin standards in relation to NCCDs are implemented to ensure a reduction of counterparty credit risk and limit the contingencies arising out of the same. The margin standards ensure that the exchanged collateral can be used to offset losses that arise out of the default by the counterparty. This process internalizes the cost of risk-taking and therefore creates an incentive for the parties to an NCCD to not take excessive risk when entering into such contracts. Therefore, margin requirements limit the externalities that would arise in case a major market participant would default on its obligations. This in turn reduces the systemic risks associated with margin standards.

Lack of margin standards could potentially lead to markets crashing. A very prominent example of the same is the global financial crisis of 2008 where the results of interconnectedness of financial institutions engaged in derivatives led to a domino effect owing to the contingencies and increased systemic risks.¹³ Post the financial crisis, the regulators started strict enforcement of margin standards to ensure that the derivative ecosystem is subjected to lesser risks. The directions issued by RBI are in consonance to the standardized margin requirements applicable across the globe.¹⁴

— Anurag Shah & Ratnadeep Roychowdhury

You can direct your queries or comments to the authors

¹ RBI releases Draft Variation Margin (Reserve Bank) Directions, 2020 under Section 45 W of the RBI Act, 1934, September, September 07, 2020.

https://rbi.org.in/Scripts/BS_PressReleaseDisplay.aspx?prid=50322

² Master Direction – Reserve Bank of India (Variation Margin) Directions, 2022, June 01, 2022.

<https://rbi.org.in/Scripts/NotificationUser.aspx?Id=12328&Mode=0>

³ Discovering Derivates, Nishith Desai Associates, Nishith M. Desai and Lubna Kably,

⁴ Foreign Exchange Management (Foreign exchange derivative contracts) Regulations, 2000

<https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=179&Mode=0>

⁵ Rupee Interest Rate Derivatives (Reserve Bank) Directions, 2019,

<https://rbi.org.in/Scripts/NotificationUser.aspx?Id=11602&Mode=0#FA>

⁶ Master Direction – Reserve Bank of India (Credit Derivatives) Directions, 2022,

https://rbi.org.in/Scripts/BS_ViewMasDirections.aspx?id=12226

⁷ Direction 2(2) of Master Direction – Reserve Bank of India (Variation Margin) Directions, 2022 - RBI gives an exemption to Variation Margin Directions. The exemption applies to legitimate amendments made to a derivative contract entered before Variation Margin Directions enter into force ("Grandfathered Contracts"). Non-material amendments that do not significantly impact the derivative contract terms, amendments made solely to address benchmark reforms, and contracts arising from novation, portfolio compression, and application of standard trade maintenance process on Grandfathered Contracts are genuine amendments. Derivative contracts that emerge from compressing Grandfathered Contracts with contracts that have to comply with Variation Margin Directions are not covered by this exemption

⁸ Direction 4.3 of Master Direction – Reserve Bank of India (Variation Margin) Directions, 2022

⁹ Direction 4.1 of Master Direction – Reserve Bank of India (Variation Margin) Directions, 2022

¹⁰ Direction 5 of Master Direction – Reserve Bank of India (Variation Margin) Directions, 2022

¹¹ Direction 6, of Master Direction – Reserve Bank of India (Variation Margin) Directions, 2022

¹² Direction 7, of Master Direction – Reserve Bank of India (Variation Margin) Directions, 2022

¹³ Role of Derivatives in Creating Mortgage Crisis, [https://www.thebalance.com/role-of-derivatives-in-creating-](https://www.thebalance.com/role-of-derivatives-in-creating-mortgage-crisis-3970477)

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¹⁴ Margin requirements for non-centrally cleared derivatives, Basel Committee on Banking Supervision,

<https://www.bis.org/publ/bcbbs261.pdf>

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