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## Best Practices for the OTC Derivative Collateral Electronic Margin Messaging Process

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## Introduction

Collateral professionals through the International Swaps and Derivatives Association, Inc. (“ISDA”) and its Collateral Steering Committee maintain a long history of efforts to enhance their practices for effective collateral management. These efforts date back to 1998 with the publication of the first Guidelines for Collateral Practitioners. More recently, the 2011 ISDA Best Practices for the OTC Derivatives Collateral Processes were published, which build on earlier best practices documentation from June 2010. Collectively, these efforts demonstrate ISDA’s pro-active commitment to engage industry participants to drive improvements and establish a set of best of breed practices.

Since the 2008 financial crisis, industry participants have experienced continued growth in margin call volume along with increased scrutiny of the collateral processes. With the onset of regulatory reform across the globe the collective market expectation is that margin call volumes will further increase. Drivers for these increases include:

- the ‘un-netting’ of margin into discrete processes for variation margin and initial margin
- the bi-lateral posting of initial margin
- the reduction in thresholds and minimum transfer amounts
- the move away from uncollateralized derivative transactions, and
- the move to currency based margin silo’s via the Standard Credit Support Annex

This increase in margin call volumes requires practitioners to further develop their processes to allow for scale while ensuring control. One area of focus is the communication of margin calls and related margin activities (e.g. substitutions, interest processing) between parties. Historically, email has been the most widely used form of communication in the collateral space. However, with the recent introduction of electronic messaging for margin activity there is an opportunity for firms to streamline this aspect of their process.

ISDA and its members have been strong supporters of electronic messaging, as evidenced by the development of agreed message standards and message attributes (2009 ISDA Standards for the Electronic Exchange of OTC Derivative Margin Calls) and commitments to test such functionality across a number of vendor platforms. In 2013, ISDA brings together these past efforts into a new document, Best Practices for the OTC Derivative

Collateral Electronic Margin Messaging Process (the “Best Practices”).

The purpose of this document is to provide members with guidelines designed to ease their work to implement electronic margin message communication. A group of buy and sell side participants have created these Best Practices based on their experiences in implementing such changes within their own infrastructure. The goal clearly is to aid fellow industry participants as they do the same. To that end, these Best Practices focus on integration and counterparty on-boarding, as well as, the specific margin call scenarios. The document is purposely vendor agnostic and the practices are applicable regardless of the vendor selected.

As with previous Best Practice documents this initiative is not intended to create legal obligations nor alter any existing obligations of the parties as represented in their bi-lateral documentation. As industry participants continue to move toward electronic messaging communication, we expect this document will be revised to incorporate those additional learnings.

The document focuses on OTC derivative trades collateralized under an ISDA Credit Support Annex (CSA). It does not specifically cover centrally cleared trades. However, it is the intention of the document to provide a foundational layer for electronic margin messages that can be leveraged for cleared derivatives in the future.

Further, the best practices described in this document may change as a result of pending rulemaking in various jurisdictions (e.g. CFTC and EMIR proposals). Similarly, new industry initiatives may also lead to alterations of this document.

## Section 1 - CSA Setup and Onboarding

### Introduction

This section is intended for operational managers who will be agreeing on the population of CSAs that will eventually be margined on the electronic messaging system.

#### Best Practice 1.1: Pre-onboarding Process

##### Principle

*Firms should clearly define and communicate key CSA terms prior to onboarding into an electronic margin messaging platform to ensure a smooth transition post-go live.*

##### Description

A defined population of in-scope agreements must be communicated and agreed upon by both counterparties. A subsequent reconciliation of key CSA terms should then take place to eliminate discrepancies before onboarding into the electronic messaging platform, to include (but not limited to):

- Party Name,
- Party Unique ID,
- Party Legal Entity Name,
- Counterparty Name,
- Counterparty Unique ID,
- Counterparty Legal Entity Name,
- Master Agreement Name,
- Agreement Type,
- Messaging Start Date,
- Agreement Time Zone,
- Agreement Currency,
- Netting Type,
- Threshold,
- MTA.

Once verified, the two parties should set a date of implementation of margin call processing via the electronic messaging provider, while also agreeing upon a naming convention to remove the potential for ambiguous/unknown arrangement names.

At this stage, there should also be an exchange of key contacts to facilitate active communication between parties throughout the onboarding process and beyond.

#### Best Practice 1.2: Electronic Proposal and acceptance of new agreements

##### Principle

*Any new margin agreement should be proposed through the electronic messaging provider and accepted by the counterparty to formalize the electronic CSA linking process.*

##### Description

Within any electronic messaging platform, functionality should be implemented to allow users to easily and formally propose new margining agreements in the system, which will subsequently be accepted by the counterparty. This process must be completed before the margining process goes live to ensure there is no disconnect between parties causing unnecessary ambiguity. It will also become increasingly necessary as firms move towards integrated solutions with their in-house margining systems and look to establish automated linking for client onboarding.

#### Best Practice 1.3: Discuss and Agree Call Response and Issue Resolution Timeframes

##### Principle

*Firms should discuss and agree margin call response and issue resolution timeframes*

##### Description

All margin calls processed through the electronic messaging platform must be processed through to either a Disputed or Pledge Accepted state by the end of each day. Users margining agreements on the electronic messaging platform should discuss and agree expectations around times by which this process should be completed, and also establish the procedure for cases where calls are left open or have not been accepted by end of day unless specified otherwise in the CSA.

Periodic updates between firms will be essential to review the terms of any such SLA and monitor adherence to the established terms.

#### Best Practice 1.4: Allowance for review period in initial go-live phase

##### Principle

*Firms should identify and resolve any major operational or technical issues within the initial phase after onboarding*

##### Description

Firms should define a review period once agreements are initially on-boarded into the electronic messaging platform to provide an opportunity to identify any potential operational or technical issues. This will be particularly important for firms that are new to the market or do not have an established integrated solution. This period should be used to identify any gaps in the process, or in individual firms understanding of the process. Firms should only move beyond this initial phase once they are comfortable with the initial results and process.

## Section 2 - Integration Considerations

### Introduction

This section is intended for business and systems analysts, development managers, developers and testers who will be evaluating and implementing connectivity options between internal systems and electronic messaging platforms.

#### Best Practice 2.1: IRM, Compliance, and Data Privacy considerations

##### Principle

*Firms should consider their Information Risk Management (IRM) Policies and consult their Compliance department when integrating internal systems with external parties.*

##### Description

It is essential that firms recognize that their IRM and Compliance policies might have a great impact on the way they integrate internal systems with other firms/outside data sources.

The method of data exchange in part will depend on the firm's network, security, and risk policies. For example, if the firm's risk policy does not allow it to accept any message requests initiated by the outside source, the firm might not be able to implement a "true" two way message exchange mechanism with another party/messaging hub platform. In this case, the firm might implement a process where it **sends** data to the other party/messaging hub and also **pulls** data from the other party/messaging hub such initiating messaging going in both ways to remain compliant with its risk policy.

Also, each firm's Data Privacy and Compliance policies will determine what data the firm is allowed to share with the other parties/clients. In some cases, data allowed to be exchanged might be limited by those policies.

#### Best Practice 2.2: Criticality of Appropriate Level / Sufficient Documentation

##### Principle

*Documentation provided by the electronic messaging vendor to the parties for integration purposes must be complete, accurate, and up-to-date.*

##### Description

As with any integration effort, a properly detailed level of documentation is the key to success. Documentation of the messaging protocols provided by the electronic messaging vendor to the firms for integration purposes must be complete,

accurate, and up-to-date in order to avoid a lengthy and costly 'trial and error' analysis, implementation, and testing effort.

As multiple parties/firms are involved in the integration efforts, a clear understanding of each field and its usage is required for proper integration. Some fields are not always used in the same manner by different parties. For example, price can be always quoted per unit by some parties, while other parties may quote per unit for Cash, but per 100 units for securities. Conversion of data would be required in this case to a commonly agreed notation. Documentation provided by the electronic messaging vendor must provide details to such level as to eliminate any ambiguity in the expected fields, data, and its usage.

When messaging protocols change, documentation must be properly updated and the version incremented accordingly. It is critical to ensure that the new version of messages are backward compatible with those already in use.

#### Best Practice 2.3: Verification of Live Connections

##### Principle

*It is important to recognize the difference in messaging connectivity between test and production system environments.*

##### Description

It is often the case that the level of security, set up, and other parameters of the system environments utilized by individual firms, as well as the electronic messaging vendor, may vary in test and production. Hence, live connectivity to production environments must be separately verified prior to Go-Live from all other functional and/or connectivity testing done in test or q.a. environments.

#### Best Practice 2.4: Recognizing Operational Differences/Individuality of each Messaging Party

##### Principle

*Operational differences between each messaging parties BAU margin process may impact their ability to go-live with each other.*

##### Description

It is important to recognize that each individual counterparty will have their own BAU margin process that may make it easier or harder for them to implement an electronic messaging solution that effectively seeks to standardize operating procedures between the parties. If either party is unable to meet the required new, standard processes, it may impact their ability to go live with electronic messaging.

Furthermore, if different technical solutions are used by different parties to integrate with the same electronic messaging vendor, it introduces more potential gaps for incompatibilities between parties.

#### Best Practice 2.5: Message Systems Delivery Confirmation Notifications

##### **Principle**

*Firms should have in place messaging technology which ensures that a margin call message has been received by the counterparty to the trade.*

##### **Description**

As the automation of the margin call process continues to evolve into solutions that feature less verbal communications between firms who are counterparties to a trade and more straight-through-processing (STP) between systems, it is not sufficient that Party A receives confirmation from the electronic messaging vendor that a margin message has been received. Electronic messaging vendors acting as an intermediary between two counterparties to a trade must design their message confirmation systems to ensure that it is obvious to Party A that Party B has received Party A's intended message.

#### Best Practice 2.6: Availability of Vendor Staff and Systems for Integration Testing

##### **Principle**

*The electronic messaging vendor must provide adequate access to its systems and staff for purposes of integration setup and testing.*

##### **Description**

System integrations can be complex and time consuming. Proper support from vendor integration staff and availability of test environments are requirements for a successful integration.

## Section 3 - Communication Considerations

### Introduction

This section is intended for collateral operations teams who will be relying upon the electronic messaging system to function properly.

#### Best Practice 3.1: Importance of Clear Communications Protocols and Procedures

##### Principle

*Firms should have in place formal escalation procedures for addressing and actioning margin call issues promptly*

##### Description

It is essential that firms have in place robust communication protocols that keep all margin call management system users well informed regarding issues that could affect the margin call process. Firms should identify individuals and teams who should receive key notifications for Routine or Emergency System Maintenance and System Upgrades.

System Support email address and phone contacts should also be identified and distributed to all users.

It is also important that firms identify the individuals or teams that are responsible for sending these messages. These escalation procedures should focus on timeframes and process for communicating with impacted internal groups and/or the counterparty.

#### Best Practice 3.2: Tech Release Changes Communicated in Advance

##### Principle

*Any technology changes to the vendor supplied margin messaging platform, communications software or messaging partner CMS should be communicated to all system users and interested parties well in advance of the change*

##### Description

Synchronized messaging systems require longer lead times to assess the front to back impact of any technology changes. System upgrades which introduce new features or functionality must be tested well in advance of being incorporated into the production environment. Communicating these changes well in advance of the actual change gives change management, quality control and production teams on both the vendor and the messaging partner sides adequate time to test for the proper system handling of each new change.

## Section 4 - Business Specific Scenarios – Margin Calls

### Introduction

This section is intended for the consideration of business and systems analysts as they define the business requirements for electronic messaging system integration.

The following best practices relate to the sequential workflow interaction with each end user's Collateral Management System (CMS). The focus is on the technical relationship and its actions in particular margin call scenarios. These best practices are designed to be system agnostic and foster interoperability between participants and vendors

The automation of the collateral margin call process through Electronic Messaging is an industry initiative that is viewed as strategically important to the industry. Where possible, organisations should be actively working alongside their chosen electronic messaging vendor to reach this end state.

The sequence, content, timing and frequency of messages to be electronically exchanged in the margin call process has been separately defined in the ISDA document, "Standards for the Electronic Exchange of OTC Derivative Margin Calls" published in November 2009.

### Best Practice 4.1: Workflow Overview

#### Principle

*The electronic messaging vendor needs to provide a messaging service that 'overlies' subscribers' collateral management systems (CMS) - it acts as an intermediary for the communication of margin call messages as they move through the respective systemic workflows of both parties to each bilateral collateral agreement.*

#### Description

The electronic messaging solution needs to 'interact' at all notable communication points through the bilateral collateral margin call agreement process. This includes call issuance, agreement of margin amount, selection and agreement to exchange collateral alongside a receipt confirmation of each message. The electronic messaging service is required to interact with the CMS of both bilateral parties. This communication needs to be reflected all in a language/format that is recognizable to both parties and their respective CMS's. At optimal usage, messages are exchanged at a systemic level i.e.

where there is no requirement for the respective margin teams to view data.

For example, where both independent amount (IA) and variation margin (VM) are in opposite directions, this should be treated as 2 separate margin events under one agreement by the CMS and through the electronic messaging portal.

### Best Practice 4.2: Netted Calls

#### Principle

*The electronic messaging vendor must be able to recognise and communicate the concept of 'Netted Calls' i.e. where there is one combined margin call calculation comprising of the underlying trade portfolio MTM, Collateral Balance and any Independent Amount.*

#### Description

The electronic messaging provider must be able to accommodate 'Netted' calls i.e. have the ability to communicate a final margin call amount and explain the breakdown of the amount in its components (i) portfolio MTM, (ii) collateral balance value, (iii) Independent Amount value at the net trade and/or agreement level. Communication of margin requirements and any subsequent agreements should be made through single messages, as generated in parties' CMS and through the electronic message portal.

### Best Practice 4.3: Non-Netted, Combine Collateral Balance

#### Principle

*The electronic messaging vendor must be able to recognise and communicate the concept of 'Non-Netted Calls' where VM and IA requirements are separate but the collateral balance for both VM and IA is combined in the message communication i.e. one margin notice where possible (i.e. instances where there is both a VM and IA requirement).*

#### Description

The electronic messaging vendor must be able to accommodate 'Non-Netted' where the Independent Amount is not netted with the variation margin amount but can be considered in one combined agreed margin call amount. In instances where both VM and IA are due, this should be communicated by the requesting party as one margin call, which can be agreed with one agreement message (if so chosen by the pledging party).

#### Best Practice 4.4: Non-Netted, Segregated IA Principle

*The electronic messaging vendor must be able to recognise and communicate the concept of 'Non-Netted Calls' where VM and IA requirements are separate and IA is segregated at a custodian.*

##### Description

The electronic messaging provider must be able to accommodate 'Non-Netted' where the Independent Amount is not netted with the MTM (Also referred to as Initial/Lock up margin) while also segregated at a custodian. This should create two separate messages under one agreement in the CMS and be sent through the electronic messaging portal. It should also accommodate instances where the IA requirement has a different MTA and rounding rules to the VM calculation rule in the agreement.

#### Best Practice 4.5: Return & Deliver Amounts

##### Principle

*The electronic messaging vendor must be able to recognize and transition instances where an agreed margin amount, incorporates a 'return' of previously pledged collateral, as well as a 'delivery' of a further new collateral amount in order to meet a full margin agreement.*

##### Description

The electronic messaging provider must have the ability to recognise and apply exchanges that transfer (i) the existing collateral balance from a 'held' to a 'pledged' position, (ii) selective collateral positions where collateral is 'open' on both sides of the agreement.

When Party A is making a margin call that requires a full return of previously posted collateral and a new delivery from Party B, this breakdown must be specified in the margin call response by Party B i.e. the overall margin call amount must detail both the return and delivery amounts. The message attributes need to be in a format that is recognised by the electronic messaging provider and that can be translated to the reciprocal parties CMS.

#### Best Practice 4.6: Intraday Calls

##### Principle

*Electronic messaging vendors need to have the ability to manage the workflow for agreements where margin can be called for intraday i.e. the calculation frequency is more than daily.*

##### Description

Where the collateral agreement permits issuance of margin calls intraday, the electronic messaging provider must have the ability to reflect and communicate the onward message(s) in a way that is understood by both parties in their respective workflows. It needs to have the ability to manage multiple calls within one collateral relationship within a business day.

#### Best Practice 4.7: Handling of Outstanding Calls

##### Principle

*The electronic messaging vendor must have the ability to manage the margin call events status after issuance – this means keeping a record of each issued margin call until that call issue has been responded to accordingly, per the legal terms.*

##### Description

In instances where a margin call has been issued but no response has been triggered on the recipient side – the electronic messaging provider must be able to provide the initiator of the margin call with the option to keep the unanswered call open until (i) the issuing party submits a new margin call [and/or rescinds or "expires" the previously sent margin call], (ii) the call is fully disputed or (iii) the call is fully or partially agreed to. The electronic messaging provider must be able to manage the transitions of the original message through each subsequent message state

#### Best Practice 4.8: Sign Values of Amount Fields

##### Principle

*The electronic messaging provider must have the ability to receive the series of messages from both parties required to agree a margin call and to translate the calculation variables and agreed collateral settlements into a format and language that both parties understand in their respective CMS's i.e. translate Party A's message into Party B's language and vice versa.*

##### Description

Typically CMS's are designed such that the reported figures are viewed from the principal parties perspective i.e. where a positive number means 'in the money' to the person viewing it. EM vendors must be able to interpret this when translating the message between the two parties.