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Common Problems, Mutualized Solutions in the Derivatives Market

To walk onto a modern trading floor is to witness the extraordinary power of technology in changing how business is conducted. While trades were once struck with esoteric shouts and signals, machines now dominate, with microseconds saved and dollars gained by the smartest systems. Just as smartphones have revolutionized how we communicate and consume information, technology has created unprecedented efficiencies in trading financial instruments.

But scratch below the surface, and you'll find the financial world is not always as automated and efficient as it might appear. The over-the-counter (OTC) derivatives market enables governments and companies worldwide to manage their business risks and create greater certainty and stability. Yet, despite its importance, the industry still relies on paper documents, manual processes and non-standard practices. Unlike on the trading floor, where individual entities can yield a competitive advantage by adopting faster and more powerful systems, operational challenges are addressed most effectively when market participants work together to design common solutions.

At ISDA (International Swaps and Derivatives Association), we've worked with our members in the global derivatives market to develop a set of mutualized solutions to address industry challenges. For example, a common methodology for calculating the amount of collateral to be exchanged on certain derivatives trades has helped to reduce costs and avoid disputes. The process of negotiating derivatives documents, which has long been dominated by manual intervention and long paper trails, is becoming more efficient as digital solutions are adopted. And we're exploring new areas that might benefit from digital approaches, including the process by which critical notices are delivered to trading counterparties.

Margin

Following the 2008 global financial crisis, a series of reforms were implemented to reduce systemic risk in the OTC derivatives market. These included central clearing of standardized contracts and initial margin (IM) requirements for non-cleared contracts. IM regulations were introduced on a phased basis, with the largest derivatives dealers required to exchange IM from September 2016. In September 2022, the sixth implementation phase brought hundreds more market participants into scope, including many smaller entities.

As intended, the amount of collateral in the system has risen because of these reforms, with $325.7 billion of IM collected by 32 of the largest firms by year-end 2022, up 7 percent on the previous year, according to an ISDA survey. For entities required to exchange IM, from the largest dealers to the smallest buy-side entities, there is no competitive advantage to building the required infrastructure in isolation. In fact, there are significant benefits to be gained from using a shared methodology to calculate the IM amounts that need to be exchanged. It is more efficient and cost-effective while reducing potential disputes between parties.

This recognition drove the development of the ISDA Standard Initial Margin Model (ISDA SIMM). Launched in 2016, it has been rigorously maintained and regularly recalibrated to keep pace with market developments. More than 350 firms now use the model to calculate their IM requirements. From 2025, we'll calibrate the ISDA SIMM semiannually, having originally carried out annual calibrations and, more recently, moved to a framework that allows for off-cycle calibrations when needed. The decision to move to semiannual calibration was made in close collaboration with global policymakers, with the shared goal of ensuring the model responds to market volatility while maintaining IM requirements at a risk-appropriate level.

In the seven years since the ISDA SIMM's inception, derivatives-market participants have sought to address other shared challenges with similarly collaborative approaches. From retiring LIBOR (London Inter-Bank Offered Rate) to implementing updates to derivatives regulatory reporting, developing mutualized solutions has repeatedly yielded better results than going it alone.

Documentation

Of the many areas in which digitization can create efficiencies and savings, legal documentation is among the most tangible. Despite huge technological advances, the processes of accessing, negotiating and executing the documents that underpin every derivatives trade are often still dominated by paper and PDFs (Portable Document Format), manual markups and email exchanges. This is not only cumbersome and time-consuming, but it can also be a source of operational risks.

ISDA is well advanced in the process of digitizing industry documents. Starting with the flagship interest-rate derivatives definitions, which were completely updated and republished in digital form in 2021, around 90 derivatives documents have transitioned to a digital format hosted on the MyLibrary platform.

The benefits are extraordinary. Rather than sifting through hundreds of pages of legal documents to locate important contractual terms, users can now access all the benefits of digital functionality, including intuitive navigation and search. The digital format also means documents can be seamlessly and quickly updated to reflect changes in regulations and market practices, rather than parties having to access and append multiple supplements, which can quickly become burdensome.

For market participants, manually negotiating documents often consumes significant resources. That drove ISDA and Linklaters to jointly develop ISDA Create, a digital document-negotiation platform. At its launch in 2019, ISDA Create focused exclusively on IM documentation, as implementing non-cleared margin regulations was the immediate priority. It has since expanded to cover a wide range of critical documents, including the ISDA Master Agreement and credit-support documentation, with 375 firms using the platform and 400 more in testing.

ISDA Create is now available through S&P Global Market Intelligence's Counterparty Manager service, a widely used industry platform that allows users to make certain adjustments to their ISDA documents. As integrating these two platforms continues, market participants will eventually be able to access complete digital records of their relationships and contractual data. This resource will be valuable in normal market conditions, increasing efficiency and reducing potential errors. It will be even more critical during periods of market stress, when firms need to ascertain the impacts of sudden shocks on their trades quickly.

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Doing this digitally rather than wading through reams of paper documents will reduce the risk of market disruptions.

Delivery of notices

As existing solutions are adopted in the derivatives market, attention is turning to other challenges shared across multiple entities that may also warrant a digital approach. One example is the practical challenge of physically delivering critical notices to counterparties.

As it stands now, if a firm fails to pay the amount due on a derivatives trade, the ISDA Master Agreement allows the other party to deliver a notice of non-payment, which triggers the start of a grace period. If the payment is not made during the grace period, a second notice can be delivered to specify a date for the early termination of the trade. Both notices must be delivered to the company address listed in the agreement.

The problem is that the company may move offices, and the ISDA Master Agreement is not always updated with the correct details. Physical delivery of notices also became problematic during the pandemic, when lockdown restrictions were imposed and offices vacated. More recently, Russia's 2022 invasion of Ukraine highlighted the challenges of delivering notices in a hostile environment.

Certain workaround solutions have been considered, but both parties need certainty on when a notice has been delivered, as this determines the start and end of the grace period and the earliest point at which trades can be valued and terminated. A lack of certainty over the timing of delivery can have economic consequences.

Here again, technology may provide the answer, and we've been working with market participants to explore the concept of an industry notices hub. This would act as a central platform for firms to load notices, with automatic alerts sent to receiving entities. Parties would need to agree in advance that uploading a notice would constitute effective delivery, and designated staff at each firm could access the hub from anywhere in the world.

Certain legal and technological issues would need to be addressed to bring this project to fruition, but it has the potential to be an elegant solution to a shared problem. It has already garnered strong support in the market and indications of interest from some resolution authorities. ISDA will continue to move this initiative forward, ensuring that any solution addresses the requirements of market practitioners.

While the derivatives market still has some way to go before realizing the full benefits of technology and automation, the entire industry has a strong appetite for efficiency and cost reduction. At ISDA, we will maximize the market's potential by advancing and innovating existing solutions while identifying new areas in which digital solutions could create further efficiencies. As more and more firms implement those mutualized solutions that are proven to address common challenges effectively, the market will transition to a fully digital future. «