Initial Margin Interest Income

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1. Introduction

The NSE Derivatives market is a **fully cash collateralized** market. This means that, for a participant to take a position (buy/sell a contract) in this market, they will have to post cash **before** trading. The minimum amount required to buy or sell a contract is called the **Initial Margin**.

Initial Margin is defined as the collateral required in order to trade a derivatives contract. At the launch of the NSE Derivatives market, only cash collateral will be accepted for the purpose of funding trades.

2. Margin Investment

The NSE will invest the Initial Margins in accordance to the Initial Margin Investment Policy governed through NSE's governance structures. The policy is driven by:

- *Liquidity*: Any investment should not hinder the availability of funds when required to settle margin obligations to clients
- *Safety*: Given that the Initial Margin is a refundable deposit, any investment should not pose any risk of funds loss. Institutions and securities where the funds are invested should be of the lowest risk class.
- *Returns*: To be considered once the above two criteria have been taken into account.

3. Treatment of Margins in Other Jurisdictions

The following regions were investigated with regard to how they distribute the proceeds of initial margin investment:

- South Africa
- Dubai
- India
- Turkey
- Brazil

The exchanges in these regions include the benchmarks against which the NSE measures its progress and framework. Some of the guiding principles that were apparent in determining how invested margin proceeds were distributed are:

- *Interest Rate Environment* – in a low interest rate environment, there isn't much investment income to pass round to other market participants;

- *Non Cash Collateral Payments* – in markets where collateral is primarily paid in forms other than cash, the investment of the collected cash will not yield much, and will make the requisite re-distribution to other participants difficult;
- *Prevailing Law* – in the case where the law is explicit on how the income is distributed, that becomes the primary driver. In this case, the exchanges may opt for charging a small management fee; and
- *Margin Duration* – if the average length of time that clients hold positions in the market is short, the margin duration at the exchange is short. As such, the yield on such investments is also very low, discouraging passing the income down to other participants.

Below is a summary of the approach of different jurisdictions:

a. South Africa (Johannesburg Stock Exchange – JSE)

The legal structure is such that margin funds, while deposited with the exchange, are never legally theirs. Therefore, all returns, profits in the form of interest and losses if any in the case of an investment counterpart default, are borne by those to whom the funds belong.

The Exchange therefore levies a charge that caters for the risk and governance services they provide on the margins.

In summary, within their framework, there is no scope for the distribution of interest income amongst market participants as it belongs to the end client.

b. Dubai (Dubai Gold and Commodity Exchange – DGCX)

In this market, they don't pass back any of the investment income. Some of the key reasons for this are:

- Low rate environment – as with many low interest rate jurisdictions, DGCX does not pass through the investment income. Given the restrictions on margin investments, the returns are low enough that they would equal any management fees associated with handling the investments; and
- High turnover to open interest ratio – the daily turnover in the market is higher than the outstanding open interest. When this ratio is high, it implies that the amounts that the exchange needs to hold in liquid cash are high. This stipulation negatively affects the amount that can be made through investing the margins.

c. India (Bombay Stock Exchange – BSE)

In BSE, they do not pass back any of the investment income. The prevailing regulations require that the exchanges, if they decide to invest the margin, to invest it in very secure securities (like government debt) that tend to be the lowest yielding investments. In addition, the cash collected is lowered due to the acceptance of non-cash collateral.

The BSE is considering sharing the margin proceeds with the other market intermediaries, but it is something they have yet to put into practice.

d. Turkey (Takasbank)

Takasbank is the central counterparty that clears trades done on the Borsa Istanbul. At Takasbank, they take 4% of the interest income from the investment of margins and pass the rest on to the client. Trading and Clearing members aren't allowed to collect a percentage, though some do manage to do so (through a prior commercial agreement).

e. Brazil (BVMF)

At the BVMF, a very small portion (~1%) of their collected margins is in the form of cash. This forms the basis of their reasoning that this income is not passed on to other participants. It is also worth noting that they explicitly state that the risk resulting from investment of the margins is solely theirs, and as such, would make up any losses resulting from the investment of margins.

4. NSE Position on Margin Income

The NSE proposes the following:

- To charge a management fee for the margin monitoring, investment and risk handling on the accrual of interest on the margins for the members trading in the derivatives market. This **management fee** will be **capped at 2% (annualised) of the posted margin**, and will be sourced from the investment income from the margins. The 2% will be charged as a management fee rather than a haircut. This figure is of the same order of magnitude that money managers in the country charge for their money market accounts, and is currently provided for in the NSE Derivatives Rules
- The balance of the investment income will be passed back to the client that posted the margin. If there are commercial agreements between the client and the other market participants (CMs and TMs) in the value chain, that affect the distribution of this investment income, the NSE will not stand between.

The rationale behind the NSE position is:

- NSE expects a situation mirroring the Dubai market where, at the start of the market, daily turnover will be greater than the open interest. The average duration on the invested margin portfolio will not exceed 1 day. As such, the returns from this will be low; and
- With the expectation of adding non-cash collateral, there needs to be clarity in the law as to who the beneficial owner of proceeds from collateral, particularly with regards to margin in derivatives.