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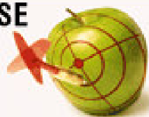

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Discretion in margins

GUEST COLUMN/MARGIN SYSTEM

Jayanth R Varma / Ahmedabad March, 01 2004

In the early 1990s, the Indian stock market lurched from one payment crisis to another as it operated without an effective margin collection system.

Today, margins have become the central element of the risk containment system and the solvency of the trading system is now taken for granted even under acute market stress.

However, there is one issue about margins that has still not been fully debated and resolved - the issue of rules versus discretion in the levy of margins.

There appears to be a belief among market participants and regulators alike that exchanges and regulators should exercise their discretion to change margins or impose special margins in response to changing market conditions.

I wish to argue that discretion is both unnecessary and undesirable. Unnecessary, because simple rules based on recent volatility do a very good job of modifying the margins as market conditions change.

Undesirable, because discretionary regulations are often highly destabilising and could pose a threat to market integrity.

Rule-based margins perform very well because they do a good job of forecasting volatility. It is a surprising fact about financial markets that while it is very difficult to forecast the future direction of markets, it is much easier to forecast their future volatility.

Statistical techniques for doing so have improved significantly in the last two decades, and Robert Engle, the man who contributed most to this improvement, was rewarded with the Nobel prize in economics last year.

More interestingly, even relatively crude and simple formulas based on recent volatility do a very good job of setting margins. Consider for example the largest single-day percentage drop in the Sensex in the last 20 years.

On April 28, 1992, the Sensex dropped nearly 13 per cent as the news about the Harshad Mehta scam emerged. One might think that any margining system would have been devastated by such a sharp drop.

But that is not so at all. The market had been so volatile during the months of March and April that a rule-based margining system would have absorbed this quite comfortably.

Actually, the 13 per cent rise in the Sensex a month earlier (on March 24, 1992) would have been a bigger strain on a rule-based margining system, but still not big enough to break it.

Turning from back-testing to actual experience, we have been using rule-based margins for nearly four years in our index futures market, and the system has been quite successful in adapting margins to changing market conditions.

Rule-based margins do have difficulty dealing with developments that come as a bolt from the blue.

For example, on Monday, March 31, 1997, the index dropped over 8 per cent after the government was unexpectedly reduced to a minority on a Sunday afternoon, casting doubts on what was seen as a market-friendly budget.

Since this happened during a period of low volatility, it would have stretched a rule-based margining system to the limit.

However, discretionary margins would not have helped unless decision makers could have acted on Sunday afternoon or early Monday morning.

As soon as the markets opened on Monday, the rule-based margins would have moved up automatically in response to the observed volatility.

I now turn to why discretionary margins are not just unnecessary but actually undesirable. The first reason is that there are long time-lags in decision-making (particularly where committees take decisions).

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By the time discretionary margins are imposed, the market situation could have changed completely. The risk of discretionary margins being applied at the wrong time increases regulatory risk for market participants and leads to less efficient markets.

By contrast, rule-based margins can be delegated to computers that can attack problems in real time as they arise.

The more important case against discretionary margins is that while they may start out as attempts to reduce risk, they invariably end up being attempts by margin setters to push the market in a particular direction.

In the short run, they do often succeed, and the result is a successful market manipulation. The margin setters might think that they have only been regulating the market, and they might not even realise that they have been indulging in market manipulation.

There may indeed be no corruption or fraud, but the fact is that this manipulation also creates a false market, distorts price discovery and leads to wrong resource allocation signals to the rest of the economy.

Discretionary margins are, therefore, a threat to market integrity and should be avoided as far as possible.

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